BUS 26: SMALL BUSINESS MANAGEMENT



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Noureddine Lalami

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This text was compiled on 05/07/2026

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1.1.1: Prelude to the Entrepreneurial Perspective

Phil Libin and Chloe Huang

Phil Libin, co-founder and former CEO of Evernote, once said there are “lots of bad reasons to start a company. But there’s only one good, legitimate reason . . . it’s to change the world.” Evernote is an example of an entrepreneurial startup. Its goal is to make our lives more organized and increase our personal memory abilities by storing necessary and desired information on the Evernote app. Evernote is designed to capture information through note-taking (including pictures, web pages, drawings, and even audio), track and organize this material, and then save and archive the information. Evernote Corporation describes itself as “not only an organization, rather it is a family of professionals who are creative, innovative and experienced in their respective fields.”



Figure 1.1.1.1: Phil Libin, former CEO of Evernote, discusses his product. Evernote is an app that allows users to create notes in a variety of formats and save and share them across platforms. *(Credit (a): modification of “Phil Libin and Loic Le Meur - LeWeb Day 1 - Dan Taylor/Heisenberg Media” by Heisenberg Media/Flickr, CC BY 2.0; credit (b): modification of “screenshot of the old Evernote iPhone app” by Jason Jones/Flickr, CC BY 2.0)*

Around the globe, individuals, communities, and organizations advocate for and support the entrepreneurship movement. Many colleges and universities offer courses, degrees, and competitions for entrepreneurship teams. Communities provide support through services such as incubators that foster planning and startup activities. Organizations like UNESCO’s Global Action Programme on Education for Sustainable Development holds a Youth Entrepreneurship Competition annually. That is where student Chloe Huang, in 2017, submitted her idea for an algae energy pavilion to the Education for Sustainable Development competition. Huang recognized the problem of lakes suffering from oversaturation of algae and saw a solution in converting the algae into a biofuel, creating green energy while alleviating an environmental problem.

In the examples of both Libin and Huang, the entrepreneurial products focus on the use of technology and improving life, but they also represent two vastly different approaches to entrepreneurship. Libin’s focus was on improving quality of life by allowing users to track and organize information in their business and personal lives, whereas Huang focused on a global environmental issue to sustainably improve water quality. Each idea solves a problem that many people might not even have noticed. Becoming aware of problems that need to be solved, then solving the problem to make our lives easier or better, is part of the entrepreneurial perspective.

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1.1.2: Entrepreneurship Today

Learning Objectives

By the end of this section, you will be able to:

- Define entrepreneur and entrepreneurship
- Describe types of entrepreneurial careers and lifestyles
- Understand entrepreneurs as problem solvers
- Explain current factors driving the growth of entrepreneurship
- Compare differences in entrepreneurial opportunities around the globe

As we delve into the study of entrepreneurship, let's define what we mean by the word *entrepreneur*. An **entrepreneur** is someone who identifies and acts on an idea or problem that no one else has identified or acted on. This combination of recognizing an opportunity to bring something new to the world and acting on that opportunity is what distinguishes an entrepreneur from a small business owner. A small business owner is someone who owns or starts a business that already has an existing model, such as a restaurant, whereas an entrepreneur is someone who creates something new. This new creation can be a new process or product, a business that identifies a new or unique target market, or a combination of ideas that creates a new approach or method, for example.

In a broader sense, what people consider an *entrepreneur* can vary. Some scholars strictly differentiate between entrepreneurs and small business owners. Others acknowledge that a small business owner may also be an entrepreneur—they are not mutually exclusive. Someone may start a venture that is not a completely new idea, but that introduces a product or service to a new region or market. Where does a franchise fall in this discussion? Again, there is not complete agreement, with some claiming that a franchisee and entrepreneur cannot be the same, and others arguing that a franchise is, indeed, an entrepreneurial venture. According to an article in *Forbes*, "In the for-profit world, an entrepreneur is someone who creates and runs a new business where one did not exist before. And, no, the McDonald's franchisee didn't create McDonald's. But he certainly created a McDonald's where there never was one before. Franchisees are entrepreneurs." The point is that small business owners and franchisees can be considered entrepreneurs. For the purposes of this course, you will learn the key principles of entrepreneurship alongside the concepts, strategies, and tools needed to succeed as a small business owner or franchisee.

Entrepreneurs have many different talents and focus on a variety of different areas, taking advantage of many opportunities for entrepreneurial ventures. An **entrepreneurial venture** is the creation of any business, organization, project, or operation of interest that includes a level of risk in acting on an opportunity that has not previously been established. For some entrepreneurs, this could be a for-profit venture; for other entrepreneurs, this could be a venture focused on social needs and take the form of a nonprofit endeavor. Entrepreneurs might take a variety of approaches to their entrepreneurial venture, such as those shown in Table 1.1.2.1.

Table 1.1.2.1: Types of Entrepreneurs

Type of Entrepreneur	Approach to Venture
Innovators	Find new approaches, methods, or products that add value through solving a problem in a unique manner
Creators	Make something new or see a problem that other people have not noticed
Market makers	Innovate or reinvent their market from a future perspective by asking what the market could evolve into
Expanders and scalers	Seek out opportunities to expand upon previously created methods, processes, or products

In this text, you will explore these myriad avenues toward entrepreneurship.

ARE YOU READY?

How Do You Define Success?

- What is your personal definition of success? How would you define success for your venture idea? Take time to consider these questions carefully.
- Write your answers to both questions as formal descriptions of your definition of success.
- After completing your definitions, meet with your family members or your personal support group (the important people whose support you need to achieve the defined success statement) to discuss your personal definition of success.
- After hearing their input, you might want to revise your personal success statements.
- Follow through with this activity by talking to your startup team or other supporting people about your venture's success definition. This activity may help guide you in decision-making throughout your life journey and the journey of starting your venture. It will also be helpful when you and your startup team create a vision statement for your venture.

The Entrepreneurial Lifestyle and Career

People often have thought of entrepreneurs as corporate rebels, nonconformists, or activists. Being an entrepreneur has become synonymous with being an innovator, a change agent, or a risk-taker. Regardless of job titles or descriptive characteristics, entrepreneurship has a universal appeal for how people think and engage with the world.

Choosing the path of entrepreneurship requires a willingness to take on calculated risks. The difference between risk and *calculated* risk is **due diligence**, or conducting the necessary research and investigation to make informed decisions that minimize risk. Not everyone is comfortable letting go of a steady paycheck, especially when we know that there is no long-term guarantee that the paycheck will continue into the future. In one approach to minimizing personal financial risk, some startup entrepreneurs continue with their current employment while working on the side to develop their idea into a venture that eventually will generate an income. Until the venture requires near full-time work and generates income, maintaining an outside income works well for many entrepreneurial teams.

Consider the eyeglass startup Warby Parker. Dave Gilboa and Neil Blumenthal, lead entrepreneurs for Warby Parker, were still working their normal jobs when they approached an angel investor with their idea. The angel investor asked a few questions and wasn't impressed. This investor believed that Gilboa and Blumenthal should demonstrate their solid commitment to the venture by quitting their day jobs to dedicate more time and energy to Warby Parker. Instead of following that advice, Gilboa and Blumenthal kept their day jobs while they continued to work toward building their venture, and Warby Parker eventually became highly successful. There are many paths to becoming an entrepreneur, and many paths to creating a successful venture. It is important to identify the path that works best in your life—and for the venture—and that supports your goals and your unique situation and visions.



(a)



(b)

Figure 1.1.2.1 (a): Co-founder and co-CEO Dave Gilboa helped push. Modificaiton of "775208326EC00084_TechCrunch" by TechCrunch/Flickr.

Figure 1.1.2.1 (b): Warby Parker to become a successful entrepreneurial venture. Modification of "Warby Parker Aventura Mall" by Phillip Pessar/Flickr

Figure 1.1.2.1 Within the entrepreneurial world, the idea of a **lifestyle venture** has evolved to mean a business in which the founders' primary focus is the lifestyle they will attain through becoming entrepreneurs, rather than a primary interest in financial rewards through the selling of the business. Within the entrepreneurial world, harvesting is the typical exit strategy. The **harvest** is the point at which the investors and entrepreneurial team receive their return on creating and building the venture.

For a lifestyle venture, the entrepreneur is more likely to be a solo entrepreneur, someone who moves forward in starting a new venture without the support of a team or group of like-minded individuals who recognize the value or potential of an entrepreneurial idea that could potentially result in significant returns. A lifestyle venture is also more likely to be funded through family and friends, and more traditional methods such as a bank loan or a small business loan. This lifestyle includes greater freedom to decide areas of responsibilities, hours of contribution to the venture, and other decisions that support the desired lifestyle. An example of a startup lifestyle venture is The Wander Girls, a company that identified the unique concerns of women traveling alone. The Wander Girls organizes trips and events for groups of women traveling in India. A team member organizes the trip, travels with the female tourists, and handles daily interactions and transactions.

Another example of a lifestyle venture is based on how an entrepreneur aligns values, interests, and passions to create a balance between enjoying life and earning enough money to support those passions. Roxanne Quimby had a passion for living off the grid, creating her own life in the woods of Maine, and not being restricted by the rules and regulations required when working as an employee. After becoming a parent, Quimby faced the challenges presented by her lifestyle choices and started making candles to earn enough money to support her family. Eventually, Quimby's lifestyle candle-making business expanded into the highly successful Burt's Bees Corporation, moving her lifestyle business into a career as the CEO of Burt's Bees. After selling Burt's Bees to Clorox Co., Quimby continued her passion for the north woods of Maine by donating land and money to create a wildlife sanctuary and preserve that land from development.



Figure 1.1.2.2: The Burt's Bees product line grew from an idea for a lifestyle entrepreneurial venture into a major company. by "Burt's Bees" by Carol Bleistine/Flickr

Quimby's latest endeavors include creating a pasta company, My Pasta Art, focused on increasing employment opportunities for people in northern Maine, and building the tourist industry to encourage people to enjoy the region's beautiful habitat and scenery. Although she is highly successful from a financial perspective, money was never the motivation for her ventures. As you can see, there are many paths to finding your career in entrepreneurship, and multiple trigger points at which you might make the decision to become an entrepreneur.

WHAT CAN YOU DO?

How Can You Put Your Strengths to Work?

Create a list of ten strengths that you currently possess. If you need help creating your list, ask your friends or family what they believe you are good at doing. Think about what achievements you have accomplished, what compliments you have received, and what people say about you. The answers to these questions will help you identify your strengths.

- Create a list of ideas that build off your strengths or are related to your strengths.
- Then analyze this list to create another list of possible businesses that you could start that relate to your strengths.

The Entrepreneur as a Problem Solver

What are some challenges you face in your life? Have you ever actively thought about how you could solve those problems? Or have you actively identified exactly what the problem is from an analytical perspective? We often have a tendency to jump quickly from noticing a problem to selecting a solution, with little understanding of whether we have even correctly identified the problem. Identifying the problem—and testing the potential, novelty, and feasibility of your solution—is an important part of resolving the problem. Often, when we start to explore the problem, we find that it has multiple causes. Among them are:

- The need for something to be better, faster, or easier
- The effects of changes in world on your industry, product, or service
- Market trends based on geography, demographics, or the psychology of the customers

One characteristic of a savvy entrepreneur is recognizing the ability to identify a problem from an opportunity-identification perspective. We might identify feeling hungry as a problem, but an entrepreneur would identify the problem using an **opportunity-identifying perspective** by determining how the problem could be translated into an opportunity to create a new venture—perhaps combining the problem of feeling hungry between meals into a street kiosk or a vending machine with food choices or creating a new snack that is nutritious, satisfying, and portable. People need to eat, and they get hungry, but during a busy day with no open time or convenient food, people end up hungry. Rephrasing the problem, or need, from an opportunity viewpoint opens the search for a sustainable solution beyond the simple awareness of feeling hungry. We might solve this problem by opening a snack bar with offerings that contain essential vitamins and proteins, and is easy to transport with a long shelf life. Understanding the problem from the perspective of how to solve it for one person into how to solve it for multiple people rephrases the problem into an opportunity-identification perspective.

You might also have an interest in solving food-related problems on a larger scale. People trapped in a war-torn region may not be able to leave the safety of their shelters to find food, grow food, or barter for food, or they may not have the money to buy food. How could you reach your target market within a war-torn area? Red Cross emergency response vehicles traveled 2.5 million miles to deliver food, relief supplies, and support to communities affected by disasters during 2017. That's the equivalent of driving around the globe 103 times. Could your idea of creating a snack bar fit into a partnership with the Red Cross?

Although this might seem like a simple problem with a simple solution, persevering from the recognition of a problem to finding a realistic solution, then moving that solution forward into a successful venture, requires an entrepreneurial mindset. Every day, people become entrepreneurs as they identify and solve problems, or face new challenges or frustrations, and resolve them in creating products or services to address these issues.

WHAT CAN YOU DO?

Recognizing Problems

In your daily life, what problems do you encounter? What would make your life easier? How would you finish this sentence: "If only _____ existed, my life would be better or easier"? To spur your creativity, you might research global problems to find an area that interests you, that sparks your passion for living a fulfilling life. When identifying a problem, consider process-related problems as well as service-related problems.

For more ideas like Chloe Huang's, visit the UNESCO Global Action Program on Education for Sustainable Development (https://en.unesco.org/gap) and review other submissions that may activate your own creativity in thinking about how you want to contribute your skills and knowledge to improve our world.

- What problem have you identified?
- What can you do to resolve that problem?

Factors Driving the Growth of Entrepreneurship

Do you know anyone who has lost their job? Or who has been rejected or mistreated at work? Or had their income reduced, or benefits removed? Research shows that 47 percent of all US employment is at risk through artificial intelligence and other technologies, although there will also be new opportunities for jobs that currently don't exist. These types of experiences and outlooks have provided the impetus for many people to start their own businesses. When we work for someone else, we are at the

mercy of their decisions and actions, but we get paid and don't carry the full risk of their decisions. When we work for ourselves, we get to make the decisions (not that making decisions is easy). But when we have our own business, we have greater control—in exchange, we also carry the risk for all decisions we make. This control over decision-making is one reason that some people find the world of entrepreneurship attractive.

Another contributing factor to the desire to become an entrepreneur is the excitement and fun of creating something new. Many entrepreneurs are excited at the idea of moving the concept through to the materialization of the idea.

A third factor that supports the growth in entrepreneurship is the combination of retirement and longer life expectancies. Many people enjoy working. For them, retirement consists of too much open time and not enough activities or the type of engagement with the outside world that fulfilled their needs during their working lives. Retirement also presents unique financial considerations, depending on an individual's lifetime savings and planning. The combination of having available time and a desire for continued earnings encourages some older adults to explore their own entrepreneurial opportunities.

A fourth factor driving the growth of entrepreneurship is the expanding awareness and support of entrepreneurship as a viable career choice. In much of the twentieth century, families encouraged their children to find a stable career with a large corporation. During this era, there was a certain expectation of reciprocal loyalty between the employer and the employee based on some traditional employee-employer roles in that century. The general, informal agreement was that if employees came to work every day and fulfilled their responsibilities, they would have long-term employment with that corporation. But as competition increased and new business practices evolved, this unspoken guarantee no longer held true. The model of certainty of employment gradually disappeared. As people acquired a new perspective on their careers and income, they increasingly realized that we are all responsible for our own paths. Most studies suggest that people change their careers between three and seven times. Note that this is not how often people change jobs, but how often they change their careers, moving from one industry to another, or moving from one type of work to a different type of work. The older model of stability through working hard for someone else has vanished. This awareness and acceptance have encouraged recent generations to consider creating their own futures through entrepreneurial ventures.

Just as individuals have become aware of the benefits of entrepreneurship, communities and organizations have also become aware of how entrepreneurial ventures add economic development and enhancements worth supporting, bolstering opportunities for those who decide on this path.

Entrepreneurship around the Globe

In the United States, entrepreneurial opportunities abound, relatively speaking. Between 1990 and 2014, the number of campus-based entrepreneurship education programs increased from 180 to over 2,000. Comparing globally, the United States has the greatest number of entrepreneurial ventures, with Switzerland, Canada, Sweden, Denmark, and Australia following in order, according to Global Entrepreneurship Index, a global consulting firm Figure 1.1.2.3.

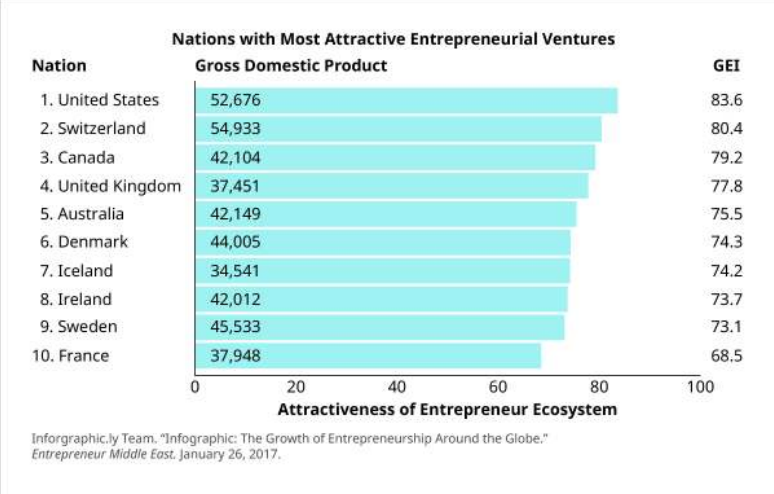


Figure 1.1.2.3: The number of entrepreneurial businesses, in millions, is shown for several countries. Copyright by Rice University, OpenStax.

Why is the United States leading with the greatest number of entrepreneurial ventures? What does it take to become an entrepreneur? In addition to having an entrepreneurial mindset, entrepreneurs also need education and funding to support their new ventures.

You will learn more about funding later, but as an introduction, you should know there are three primary sources of outside funding: family and friends, angel investors, and venture capitalists. Some family members and friends are willing and able to invest money in helping the entrepreneurial team. An angel investor is someone who has available funds and an interest in supporting a new venture. They are often entrepreneurs who have successfully launched and harvested their own ventures, and who have an interest in helping other entrepreneurs in their startups, staying active in the entrepreneurial world, and a desire to receive a return on their investment in the venture. Angel investors often provide funding early in the life of a venture. As the venture grows, it typically requires more funding, at which time venture capitalists may invest in the venture. A venture capitalist (VC) is a group of people (or organizations) who pool resources to invest in entrepreneurial ventures, contributing larger sums of funds than are available through angel investors. In each funding round, investors receive an equity stake in the venture with expectations that at some point in the future, the venture will be sold, or harvested, at which time the investors will receive a return on their investment. Because they tend to be in larger groups, VCs typically have access to larger amounts of money and resources than individual angel investors.

In the United States, VCs contributed $72.3 billion in 2015 for 3,916 deals, or funding rounds. In China that same year, $49.2 billion were invested in 1,611 ventures. European VC investment totaled $14.4 billion and 1,598 deals. Tracking these numbers over time shows steady increases in VC funding as entrepreneurial ventures have become more common Figure 1.1.2.4.

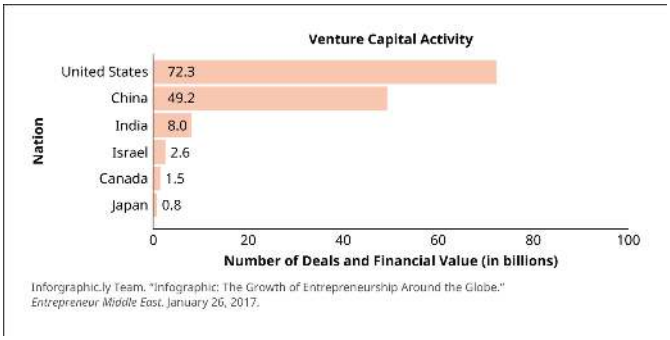


Figure 1.1.2.4: The total venture capitalist investment and number of deals for several countries are shown. Attribution: Copyright Rice University, OpenStax.

Other factors that can affect entrepreneurial opportunity include employment rates, government policies, and trade issues. For example, in the Middle Eastern kingdom of Saudi Arabia, a newer driver of entrepreneurship includes a high unemployment rate with a large percentage of the population in its prime earning years. In the past, employment was less of a concern because of dependency on state support from oil revenue. The population received monthly allotments to cover expenses from state-owned oil production. More recently, the population has become restless, with a desire to become productive and have greater control over their own resources. And the rulers recognize that oil production income is volatile and unsustainable. Today, with more future-oriented leaders, countries in the Middle East desire to encourage their citizens to consider starting their own businesses. The example of entrepreneurship in the United States has spread around the globe, with other countries taking an interest in developing support systems to encourage their populations to become entrepreneurs.

As noted, the United States is a world leader in entrepreneurial innovation. Perhaps because the United States is, in large part, a nation of immigrants, with people arriving from all over the world, Americans have few prescribed traditions that encourage conformity. America's longstanding traditions and reputation for individualism, ingenuity, and self-reliance have reinforced this mindset. However, the governments of other nations have discouraged their citizens from independent or innovative thinking. Some cultures emphasize political, cultural, and economic unity, and place a strong value on not being noticed, blending in, and following prescribed habits and traditions. Countries like Japan, France, Russia, China, and others continue to reflect these norms. Other countries have complex bureaucracies that prevent quick responses and place barriers to entrepreneurial activities. Parts of worldwide economic structures (banking, investments, and technology) are not accessible or even explicitly exclude some nations and the poor. Systems like this discourage people from coming forward with entrepreneurial ideas because the culture and bureaucracy prevent people from finding access to information necessary for the successful advancement of an idea. In contrast,

other countries are noticing the benefits of encouraging their populations to become more open-minded and creative through new ventures.

LINK TO LEARNING

Transparency International is an organization that tracks corruption, which can be an inhibitor to entrepreneurship. The Transparency International website provides information to rank 180 countries in identifying the abuse of entrusted power for private gain.

Key characteristics that encourage entrepreneurship include support for freedom to create and innovate. What conditions encourage creativity and innovation? Acceptance of failure is a key characteristic for success as an entrepreneur. Many of the great inventions in the United States resulted after dozens of failures, as when Thomas Edison eventually developed a working light bulb. Edison identified a problem: Once the sun set, working hours were restricted, as were daily activities such as reading a book or washing dishes. Edison, along with many other inventors, recognized the need for an artificial light source. Consider how complex this idea was and how many failures must have occurred before creating a product that emitted light.

Another condition that encourages entrepreneurial behavior is the ability and opportunity to connect with other people to discuss ideas, problems, challenges, and solutions. This connection with other people, in an open environment that supports the exchange of ideas, is essential for encouraging creativity and innovation.

With the advent of the Internet, people around the planet are becoming increasingly aware of geopolitical and environmental situations across the globe. As more people observe these changes and situations, more people exchange ideas. These discussions can generate new opportunities for people to discover methods for solving problems. Any one of us could be living in one country but identifying a problem in another country. Given our interests and backgrounds, we could actively choose to develop a solution for that problem. What we need, as a general approach, is an efficient and transparent way to form companies and enable constructive competition, along with continued free and fair trade.

These are just some of the areas that many nations and organizations consider as they seek to encourage a transition away from group-prescribed thinking toward uniquely individual entrepreneurial ideas. Each of us encounters life from a different perspective. Although we all might recognize the restrictions presented by the sun setting every night, only a few people might question why we couldn't change that situation by creating our own light. Similarly, someone in another country may observe our country (or vice versa) and ask why that country has a particular problem. Meanwhile, people living with that problem may have become so accustomed to it that they might not recognize the opportunity to seek solutions.

Increasing opportunities in entrepreneurial education are also driving growth. More colleges and universities are teaching entrepreneurial studies and opening entrepreneurial centers that encourage students from every discipline to become entrepreneurs. As the employment and entrepreneurial landscape continue to evolve, some institutions have started offering courses to prepare students for work in the gig economy. In fact, some of the best new entrepreneurial ideas come from groups of students in different majors who collaborate to create new, innovative business ideas that meet specific needs and challenges in today's world. In some cases, students from different universities around the globe are connecting to come up with business ideas to solve global problems, such as the lack of clean drinking water and the need for medical vaccination programs. Technology and global travel have made such partnerships more common and very productive.

The world of entrepreneurship opens doors for each of us to look beyond our own self-created barriers and explore opportunities around the world. Consider the creation of Starbucks, borne from the realization of how pleasant it can be to sit at a European café and drink excellent coffee. Awareness of an idea that is commonplace in one country, but new to a different country, presents the possibility of introducing that idea to another nation. In the Starbucks example, was there a problem that needed to be solved? Not necessarily, but the founder, Howard Schultz, had a desire to bring a specific quality-of-life element from one country to another, a business idea with an entrepreneurial aspect. One of the entrepreneurial aspects of creating Starbucks was the idea of mass expansion of coffee shops. Prior to Starbucks, the idea of creating a high-quality coffee drink hadn't been developed. Even more significant was the idea of expanding the business across the United States and then around the world.

Given the growth of coffee shops throughout the United States, we might not think that this idea is innovative, but before Starbucks, coffee typically was served at a diner, and it was served out of habit, rather than as the main attraction. With Starbucks, people changed their ideas about coffee and their coffee-drinking habits. Although businesses like Dunkin' Donuts served coffee,

their focus was on selling donuts, not coffee. As Starbucks grew through repositioning coffee as their main product, other companies like Dunkin' Donuts and McDonalds realized the missed opportunity in not reinventing the coffee market with multiple choices of high-quality coffee. In fact, Dunkin' Donuts has changed its name to just "Dunkin," removing the emphasis on doughnuts.

Social and Environmental Issues and Opportunities

A **social entrepreneur** has an interest in solving a social, environmental, or economic problem. A social entrepreneur identifies a problem with a social or community focus, a concern for quality of life, or concern for our entire planet's health. One such person is Angad Daryani, a young serial inventor. Daryani left school in the ninth grade to join the Media Lab at the Massachusetts Institute of Technology (MIT), where he worked on an industrial-scale air filter to clean pollutants and carcinogens out of our planet's air. Daryani's home country of India is the world's third-largest emitter of carbon dioxide, according to Global Carbon Atlas, behind China and the United States (Figure 1.1.2.5).



Figure 1.1.2.5: The Mumbai skyline is clouded by hazy pollution. *(Credit: modification of "Smog over Mumbai" by Christian Haugen/Flickr)*

WHAT CAN YOU DO?

Social Entrepreneurship

Consider a social issue that you might feel compelled to take on as a passion project. Some social issues include childhood hunger, access to clean water, access to education, or opioid abuse. Watch Johann Hari's Ted Talk on addiction to learn more.

- Do you have any ideas for creating an entrepreneurial venture around the idea of building quality relationships and communities?
- How would you balance a passion project with an entrepreneurial purpose?

Not only is Daryani interested in solutions for air pollution, but his product will also provide financial gains and add to his personal credibility as a **serial entrepreneur**, or someone who starts and harvests multiple entrepreneurial ventures. Darvani describes himself as an inventor and social entrepreneur, combining his interest in improving lives through a variety of entrepreneurial ventures including products like Sharkits (a do-it-yourself-kit company that teaches children how to build technology), the SharkBot 3D Printer (an attractive, low-cost, and reliable 3D printer), and several other projects that combine technology and human needs. As each of these products advances to commercialization, the products and technology are becoming more applicable for other uses as well. For more examples of projects that Darvani is working on, take a look at his website (http://www.angadmakes.com), which includes videos and articles, and highlights the international recognition he has received for his innovative work.

ENTREPRENEUR IN ACTION

Angad Daryani

Research Angad Daryani and his technology to remove air pollution (https://www.cnn.com/2018/03/28/healt...ero/index.html).

- What other products could this technology or methodology be used for, besides the originally intended application of improving air quality?
- What critical decisions would you anticipate that Angad will face in creating and commercializing his product?
- How would you define success for Angad or this air-cleaning company?

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1.1.3: Entrepreneurial Vision and Goals

Learning Objectives

By the end of this section, you will be able to:

- Define an entrepreneurial vision
- Develop a vision statement

When you think of yourself as a successful entrepreneur, what types of images or feelings do you experience? Do you find yourself daydreaming about creating the next great solution to society's problems, or do you see yourself providing a solution for the next health or environmental crisis? Maybe you can imagine yourself creating something that equally balances art, function, and ingenuity.

This section is designed to help you develop your entrepreneurial vision. Vision is an important part of everyone's future, and this is especially true for entrepreneurs. Establishing your vision is the first of several steps toward making your venture a reality.

Many would-be entrepreneurs aspire to launch the next great business or organization that will change the world. Some know exactly what they want to create, whereas others figure it out as they go along. Although there is no secret to success, you do need to have some idea about what you envision for your entrepreneurial future. What do you see in your future? How do you want to contribute to the world?

Entrepreneurial Vision

Every successful entrepreneur that you encounter or read about likely started with an image or idea related to something he or she felt passionate about creating. This occurs even when the person has no idea how (or if) what they desire to accomplish or create will become a reality. An entrepreneur's vision is the start of a roadmap that will determine where he or she wants to go with their entrepreneurial efforts. Vision speaks to what the entrepreneur wants the business to look like in the future—perhaps five or ten years out. Unfortunately, many potential entrepreneurs have dreams and ideas but never develop a concrete vision. A vision statement is the picture you have for what the venture will become in the future: what it will grow into. Be aware, though, that oftentimes, the identified vision at the start of the venture changes into something different. In later chapters, we discuss how this change requires open-mindedness and a willingness to adapt. The mission statement is a formal declaration about what the venture will do, what value it will provide to the end customer, and how it will accomplish this action. In describing your mission, carefully think about the value proposition that you provide. The value proposition is a summary statement that conveys the benefits your product, service, or unique business process/model provides to customers. This relates back to the perspective of problem-solving. Not only do you need to solve the problem, but you also must provide value. We might solve a problem, but if the value proposition isn't relevant or seen as "real" by the customer, the venture will probably not be successful. Both concepts of a future vision and the mission of the venture should be formalized into statements.

In spite of your best efforts, you may have trouble putting your entrepreneurial vision on paper. This is normal, especially in the early stages of the process. You may want to start with an outline and fill in the details later. Or set aside a short time each day that you can spend on this task so you train your mind to think about the vision you are setting for yourself. If you experience a mental block, try changing your environment—go outside, try a different time of day, or go to a setting that has similarities to the business you are interested in creating. You might also consider talking with someone who has experience in the industry to give you suggestions. Or better yet, find a mentor in your chosen area of interest and keep this person apprised of your progress. Having someone to bounce ideas off is a great asset to have when imagining the possibilities of the future.

WORK IT OUT

Finding a Mentor

Mentorships can provide you with numerous benefits Figure 1.1.3.1.



Figure 1.1.3.1: Finding a mentor can provide you with invaluable benefits. *Attribution: Copyright Rice University, OpenStax.*

Read this article on the benefits of having a mentor, and click on the resources the author provides in the article.

Then read this article, which discusses types of mentors. Notice that in this second article, the author focuses on sales, operations, business development, and entrepreneurial experience as the most significant areas that need expertise for startups.

Next, describe the areas that you would want help from a mentor for learning and developing your business idea. Then, list a few possible avenues where you could find a mentor who fits your needs. Considering the information in these articles, how would this information help you develop your statements and describe your value proposition?

An entrepreneurial vision considers what you want your venture to become, what this venture will look like, what the driving forces are, and what values and culture should surround it. Each individual entrepreneur has a unique picture of what the venture will become. For example, Kevin F. Adler wanted to help homeless people. He created Miracle Messages, a volunteer-based nonprofit organization with a goal of helping homeless people reconnect with loved ones. The vision for this organization includes building a vast network of volunteers and partnerships to stop homelessness and bring people together. This vision is about creating community, helping each other, and strengthening communities. The business model encourages homeless people to create short Miracle Messages through video, audio, or text, with messages then uploaded to social media and other methods to find that person's loved one.

WHAT CAN YOU DO?

Globalizing Miracle Messages

Go to the website www.miraclemessages.org to learn about the vision and mission of Miracle Messages. Their slogan, "Everyone is someone's somebody," conveys their culture of care and concern for all human life. As you read about this organization, consider what this organization could become in the future, with an extensive network that supports connecting volunteers to homeless people, then to loved ones, and to other organizations that support the physical relocations and resources to address the original reasons why the person became homeless. How can this organization become a global business? Consider families dislocated through wars, famine, and other disasters who want to find their loved ones. The infrastructure developed with Miracle Messages could be replicated for other populations besides homeless people in the United States. Depending on the founder's vision, Miracle Messages could continue to focus on homelessness in the United States, or the vision could expand into other geographic areas and needs.

In an entrepreneurial venture, when the vision has a shorter timeline, such as five years, it could focus on a local problem or situation, and over time evolve into a vision that is broader and includes more diverse markets or populations. Your vision should inspire the people involved in your startup to support your venture. Use your imagination to create this picture of your venture with a focus on the future of the venture. Even though entrepreneurs use their imaginations and creativity in developing this picture, they also need to understand the venture's industry, the competition, and trends that are evolving or might evolve in the future. This information helps guide the vision for the venture and define how it is uniquely different from any other business. Ideally, the vision should be insightful, bold, inspirational, and believable, and it should be developed into a formal vision statement.

The vision statement should also be clearly stated and discussed with the startup team. Although you might not have a startup team, a mentor, or a support group developed yet, to create an entrepreneurial venture, you will need support. Your support network understands that working without pay is often the normal situation at the beginning, with the potential for financial rewards coming when the venture is harvested or sold. For some entrepreneurs, knowing the vision includes the sale of the venture to another group or corporation is difficult to accept. However, that is the point at which the venture can grow to become ever more viable. Alternatively, if your vision is to be a small business owner, such as owning a franchise, then you are buying into a business plan package that has already fine-tuned the processes and decisions to support your success as the owner/manager of that business. A small business owner starts or buys into a business idea that already exists, whereas an entrepreneur is someone who seeks to create something new through either new products, services, methodologies, or combinations of ideas that create a new venture or organization.

The lead entrepreneur should share the vision statement with employees and investors, as these groups are formalized, communicating what this vision means personally and to the success of the venture. You might also need to revisit this vision as your venture grows, making changes based on your decisions and knowledge about your industry, products, and customers' needs. Even if your vision statement changes based on new information and decisions, creating an initial vision statement is a valuable step and will help guide your decisions.

ARE YOU READY?

A Personal Vision Statement

What do you want your life to look like ten to twenty years from now? Consider these questions:

- Where are you living?
- What are you doing for a living?
- What does your home look like?
- Who lives in your home?
- What are you doing with your life?

You could describe a typical workday and weekend day in your life as part of answering these questions. Create a vision statement that describes the answers to these questions.

Creative Approaches to Developing Your Vision

There are many definitions of and ways to express creativity. Artists typically show their creative side in their art, musicians show their creativity through music, and writers express their creativity in writing. Others express technical creativity through cell phone innovations or new car technology. It is up to you to determine how you will express your creativity in your venture and in your professional life. In most cases, when people follow their passions, their creativity flows from that passion.

One approach to discovering your vision for your future is to begin with the end in mind. What picture of your desired future do you have in mind? How could this vision fit with the ideas you have of creating a successful venture? Notice that these questions are about both your personal future and the vision for your venture's future. These two pictures should coexist. The vision for your personal future should allow for the necessary resources to support the venture's future, just as the venture's future will provide for your personal future. We will discuss work-life balance later in the chapter to help you identify what creates success as you describe your vision.

Another approach to developing your vision is to use a creative thinking process. This type of thinking allows people to come up with ideas that they might not have had without adopting a creative mindset. The creative thinking process has four steps: preparation, incubation, illumination, and verification (Figure 1.1.3.2).

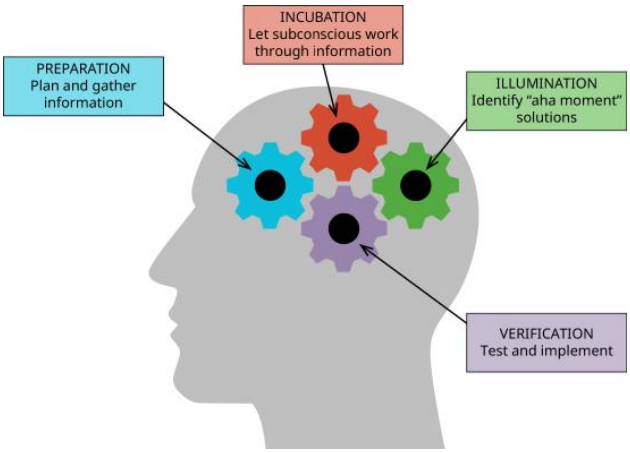


Figure 1.1.3.2: These are the four steps of the creative thinking process. *(CC BY 4.0; Rice University & OpenStax)*

In the preparation stage, gather information and collect ideas. As part of the process of tapping into creative ideas, you can apply divergent thinking by generating as many ideas as possible, even when those ideas do not seem logical. Create a list of conflicting ideas, or ideas that are diverse and disparate. *Preparation* is the first step of the creative thinking process. The next action is to walk away from thinking about the activity: *incubation*. We are programming our minds to realize that the work done in preparation is an important topic for consideration. When we walk away from consciously thinking about the activity or problem, we allow our unconscious minds to continue to think about the activity, even though our conscious minds are busy doing other things. This incubation period is essential for advancing creativity. In the incubation stage, you might go for a walk, take a nap, or just continue with your daily activities. At some point, you may have a sudden inspiration or *illumination*—an *aha!* moment—that clearly addresses the activity or problem you want to solve. In this step, the answer often pops into our conscious minds, and we recognize how to proceed. The last step is *verification*, crafting our vision statement or message, or responding to the exercise in creative thinking. You can apply this creative thinking process to many different business situations. Once we further develop and crystallize our ideas, we provide an opening for a creative and viable solution as we continue to think about the issue.

Design thinking, brainstorming, and mind mapping are tools that you will learn about later in the course. Although these tools may be familiar, there are specific methodologies that can optimize their success in entrepreneurial situations. Brainstorming requires that participants generate ideas around the desired topic without judgment. You can do this alone or with others, but including other people provides a greater variety of ideas, as one person's ideas might trigger another idea from someone else. Be sure to write down your thoughts so that you can return to them later. Brainstorming is different from divergent thinking, which does not require ideas to be associated with the identified topic. For example, in brainstorming on the topic of helping the homeless population, we might come up with ideas such as finding community food and housing, or providing free medical care. Using divergent thinking, we would arrive at more diverse ideas, such as filming homeless people then uploading the videos to a social media website to connect family members with the homeless person. These tools could incorporate divergent thinking in the idea-generation step, but typically, unless people are taught how to use divergent thinking, the ideas generated are more structured and constrained, and more logical. As much as we want to encourage divergent ideas, we also want to discourage any judgment around our ideas. Once we start judging our ideas, we restrict our creativity and end up with less than ideal solutions. Approach this process with some playfulness and relaxation.

Mind mapping is another popular technique for creative thinking. Here, you create an illustration on paper or a chalkboard. Write down the words that come to mind then link those words together with lines in a diagram that shows how each word relates to the others. The idea is that one word can lead to another. You can discover associations that might not have been evident before you created the mind map.

You can conduct research on entrepreneurial ideas by creating surveys and asking people questions about their experiences related to your idea. For example, let's say you are considering creating a new non-messy health food that can be eaten while commuting to work. You could ask people about their experiences eating while commuting to work or ask questions about nutritional concerns or diets. Or you could find secondary data on when people eat, eating while commuting, popular diets, or other related topics. Or you could find case studies that focus on a few in-depth similar areas of interest or perform your own case studies by selecting a

few peers to track their eating habits. Or you could create a prototype of your product and ask people to tell you about their experience using your product.

ARE YOU READY?

Creativity through a Change in Routine

Practice your creativity skills by changing your routine. Because our brains block out many routine activities, such as our commute to work, or other repetitious habits, we often fail to notice our surroundings. Pick one day this week to experience the world through a new perspective. Change your routine in as many ways as possible. As you change your routine, pay attention to how you are experiencing the day.

- What was the experience like?
- Did you notice being more alert to your surroundings?

Consider how you can use this experience to learn how to identify new opportunities and to interact with people, situations, and objects to identify problems in a way that could be translated into an entrepreneurial venture.

Achieving Balance

Entrepreneurship comes with many challenges because the entrepreneur must wear many hats. This is especially true if the entrepreneur is the only employee in the business. But regardless of the business model, all entrepreneurs must be able to achieve balance in their lives between their dedication to growing their entrepreneurial venture and their personal life. Developing a vision that includes different areas of your professional and personal life can help make this type of balance achievable.

How do you define balance in your life? What areas do you consider when you think about a balanced life? Having enough money to support your lifestyle might be one goal. Other areas might include physical activities or hobbies, social interactions and entertainment, satisfaction with how you earn money, your family and personal relationships, and other interests and values. Some entrepreneurs start lifestyle ventures to achieve this balance. But how do we achieve balance when our goal is to be a career entrepreneur?

A career entrepreneur is someone who takes on the daily management as the owner of the venture, accepting, and perhaps enjoying, the daily risks and rewards of managing and building the venture such as Roxanne Quimby. For Roxanne Quimby, growing Burt's Bees involved making difficult decisions, such as relocating from Maine to California to meet the growth needs of the company. Even though Roxanne wanted to provide employment opportunities to people in northern Maine, she knew that her business needed the right infrastructure for success, and that infrastructure wasn't available in Maine. If you choose to become a career entrepreneur, your focus may be primarily on advancing your entrepreneurial idea into a successful venture, like Roxanne did with Burt's Bees; this can come at the expense of personal life goals.

Many career entrepreneurs need support from family and friends who accept that the lead entrepreneur's attention and energy are required for the success of the venture, and many lifestyle entrepreneurs will find challenges in meeting the needs of the venture while maintaining work-life balance. Discussions with family, close connections, and the entrepreneurial team should occur in the early idea-formulation stage to gauge the support of the people whose interests might be compromised by the entrepreneur's dedication to advancing the venture.

Clearly defining your idea of success for your life, and for your venture, is an important step in achieving balance. What are your priorities? What can you do to balance the success of your new venture, the success of your own life, and the success of your family? Considering that balancing all the roles that we have in life is a frustration point for many people, can you find an opportunity to create an entrepreneurial venture?

WORK IT OUT

Exploring What Success Means to You

What is your own definition of success? It's helpful for your entrepreneurial ventures for you to explore and define what success means for you personally and professionally.

- This short Ted Talk explores what makes a person successful. Knowing how you personally define success is a worthwhile activity to help achieve balance.
- Consider these eight secrets to success as you think about work-life balance.
- Here is another Ted Talk that offers perspective on our lives and what we consider as success.

After reviewing these resources, think about how you would define success, and how you can use that knowledge to plan for a satisfying work-life balance.

As you explore what success means for your venture and how your definition aligns with balance between your personal life and dedication to your venture, you should consider some of the unique challenges entrepreneurs can face. For example, there might be a learning curve in unfamiliar areas of business, such as accounting or finance. Or you might face a dilemma about whether to expand a product line, or whether or where to open a new location. Entrepreneurs often mention the physical requirements of starting up a business. Physical demands can include the sheer stamina needed to clean a new space, move in, and set up shop. Depending on your business, you also might need to adjust to being on call twenty-four/seven. Here again, developing a vision of where you want to be in the future can help you plan for the challenges you will face in the early stages of your business.

Entrepreneurship can be especially draining if you are not prepared for the tasks at hand—as can be the case with any professional or personal role. Therefore, self-care and emotional awareness can play a key role in maintaining your emotional health as an entrepreneur. Taking time for yourself is very important. This could involve creating a time management calendar. Tracking how you spend your time can keep you on schedule with tasks and prevent you from expending too much on any one area of the business or your personal life in detriment to the other. Taking time away from the business is emotionally healthy and can provide important perspective that can help you make better decisions. “Leaving work at the office” is a successful strategy that many business people use to separate their personal and professional lives. If this is not possible—for example, if you work from home—setting aside family or personal time can allow for work-life balance.

Having trusted advisors and mentors for your business and personal life can also promote emotional health. When you face a decision or challenge that you have difficulty with, it is important to have someone to talk to who knows you and knows your situation. Some entrepreneurs may find themselves in their first experience of leading others, with total responsibility for the outcomes as owner of the business. Every business person should have a personal leadership improvement plan. This plan can take the form of academic classes or professional coaching, but sometimes, it will be a personal commitment to improvement. You should identify your preferred leadership styles, as well as leadership strengths and weaknesses. It might be useful to look back on your own work experiences to identify which leadership traits you admired and which ones you didn’t. As with any other business skill set, you can learn and improve these strengths in yourself. You also can hire people with complementary skills to handle the areas that you feel unsure about.

Being aware of your own strengths and weaknesses, as well as of your preferences and dislikes, will help you achieve and maintain balance in your life. Having counselors, mentors, advisors, checklists, and timelines can keep you on track and prevent any one area of your business or personal life from taking over or being neglected.

The Importance of Goals

Entrepreneurial vision imagines a future, whereas goals focus on a desired outcome. Although vision is key to creating the future that you want for yourself and your business, goals are important to help you realize the steps needed to make that vision a reality.

Read through your definitions of success and your vision statement. Now create a list of possible actions that will help you achieve success and accomplish your vision. Review your list and categorize the words and actions in terms of relevance and time frames.

SMART goals are well-structured and defined goals that are specific, measurable, achievable, realistic, and timely (Figure 1.1.3.3).

- Specific: Your goals should be precise rather than overly broad.
- Measurable: You should be able to test in some quantifiable manner whether a goal has been met, meaning that there needs to be some method to determine if the goal has been met or not.
- Achievable: The goal must be attainable; it cannot be so lofty that it cannot be accomplished. On the other hand, the goal should not be so easy that it can be accomplished quickly or with little effort.

- Relevant: The goal should be well suited for what you want to accomplish; this means that the goal should be relevant to the outcome needed.
- Timely: Each goal needs to have a defined deadline, the time when the goal must be accomplished. What time frame do you have for completing your goals? How does this timeline fit into your overall plan?

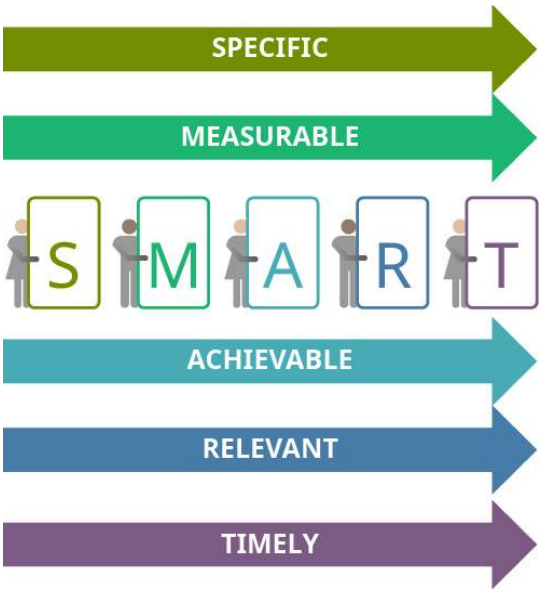


Figure 1.1.3.3: Creating SMART goals can help you realize your vision. *(CC BY 4.0; Rice University & OpenStax)*

For example, if your personal definition of success and your vision for your future include financial independence—with, say, a vacation home in the mountains—what goals can you define today that will lead to this outcome? You would include financial goals tracked either monthly or yearly to save a set amount of money based on your projection of how much money it will take to own these two vacation homes. You would also set goals about finding the right locations. This process is also necessary to support the success of your business venture. Setting goals is a powerful approach that leads us to the future we want for our lives.

ENTREPRENEUR IN ACTION

Roomify's Goals

Research Roomify at https://www.inc.com/profile/roomify and www.roomify.com. If you were one of the co-founders of this company, what goals would you create for this business? Should you harvest the company? Expand into other related products? Repackaging products for ease of purchasing is an excellent idea that can be translated into other areas. Can you think of a new idea based on repackaging products that is focused on the benefits of saving people time and the hassle of decision-making? Create a list of at least ten ideas based on the idea of saving people time and adding convenience to their lives. Which ideas most appeal to you?

Here is a fictional example of an entrepreneur's goals, which we can test against the SMART criteria to see if they are feasible. Soraya runs a small tutoring business in Dallas, Texas. Her target market is high school students. Soraya is currently the only employee in her sole proprietorship, but she hopes to hire more employees soon. She is excited about her business, and so far, she has done well in the four years that she has been operating it. On the advice of a friend in business school, Soraya has defined three business goals for the next year. They are:

1. Increase sales by 50 percent.
2. Open a new location.
3. Hire two employees.

In reviewing these goals using the SMART criteria, it is evident that goals one and three are *specific* because they are quantitative, but goal two is not. All three goals can be *measured*. With Soraya as the only employee, it is unlikely that she can achieve goals one and two, but goal three is *achievable*. And hiring more staff would increase the likelihood of achieving additional goals. All three goals are *relevant* to growing the business. And each goal could use more detail in terms of being *timely*. That is, in order to

increase sales by 50 percent in the upcoming year, Soraya should have additional monthly or quarterly sales goals to meet her annual goal. Likewise, the opening of a new location requires more time-bound details, such as leasing or purchasing the location, and determining the business model for this location. Finally, hiring additional employees should have a time component as well, such as a timeline for recruiting, interviewing, selection, hiring, and training. Therefore, Soraya's goals are appropriate for her small tutoring business, but they need refining so that they meet the SMART criteria. Soraya is more likely to achieve SMART goals, and they are more likely to lead to desired business outcomes.

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1.1.4: The Entrepreneurial Mindset

Learning Objectives

By the end of this section, you will be able to:

- Explain what it means to have an entrepreneurial mindset
- Describe what is meant by entrepreneurial spirit or passion

Entrepreneurship takes many forms (see Table 1.1.2.1), but entrepreneurs share a major trait in common: An entrepreneur is someone who identifies an opportunity and chooses to act on that opportunity. Most business ventures are innovative variations of an existing idea that has spread across communities, regions, and countries, such as starting a restaurant or opening a retail store. These business ventures are, in some ways, a lower-risk approach but nonetheless are entrepreneurial in some way. For example, Warby Parker, a profitable startup founded by four graduate students at Wharton, disrupted a major incumbent (Luxottica) by providing a more convenient (online initially), affordable, and stylish product line for a large segment of consumers. In this sense, their innovation is about creating something new, unique, or different from the mainstream. Yet they attracted an existing, and in some ways mature, sector of an established industry. In a different way, McDonalds, which is 90 percent owned by franchisees, introduced an "all-day breakfast" menu in 2017 that was hugely successful; it also targeted a larger segment (in part younger consumers) and brought back consumers who had chosen other options. In summary, many entrepreneurs start a new venture by solving a problem that is significant, offering some value that other people would appreciate if the product or service were available to them. Other entrepreneurs, in contrast, start a venture by offering a "better mousetrap" in terms of a product, service, or both. In any case, it is vital that the entrepreneur understand the market and target segment well, articulate a key unmet need ("pain point"), and develop and deliver a solution that is both viable and feasible. In that aspect, many entrepreneurs mitigate risks before they launch the venture.

Being aware of your surroundings and the encounters in your life can reveal multiple opportunities for entrepreneurship. In our daily lives, we constantly find areas where improvements could be made. For example, you might ask, "What if we didn't have to commute to work?" "What if we didn't have to own a vehicle but still had access to one?" "What if we could relax while driving to work instead of being stressed out by traffic?" These types of questions inspired entrepreneurial ventures such as ride-sharing services like Uber, the self-driving vehicle industry, and short-term bicycle access in the free bike-sharing program in Pella, Iowa (Figure 1.1.4.1).



Figure 1.1.4.1: A bike-sharing program in Pella, Iowa, allows users to access bikes at a variety of locations. (credit: "Corral of VeoRide Dockless Bike Share" by "paul.wasneski"/Flickr, Public Domain)

These ideas resulted from having an **entrepreneurial mindset**, an awareness and focus on identifying an opportunity through solving a problem, and a willingness to move forward to advance that idea. The entrepreneurial mindset is the lens through which

the entrepreneur views the world, where everything is considered in light of the entrepreneurial business. The business is always a consideration when the entrepreneur makes a decision. In most cases, the action that the entrepreneur takes is for the benefit of the business, but sometimes, it helps the entrepreneur get ready to adopt the appropriate mindset. The mindset becomes a way of life for the entrepreneur. Entrepreneurs often are predisposed to action to achieve their goals and objectives. They are forward-thinking, always planning ahead, and they are engaged in "what if" analyses. They frequently ask themselves, "What if we did this?" "What if a competitor did that?"—and consider what the business implications would be.

Most people follow habits and traditions without being aware of their surroundings or noticing the opportunities to become entrepreneurs. Because anyone can change their perspective from following established patterns to noticing the opportunities around them, anyone can become an entrepreneur. There is no restriction on age, gender, race, country of origin, or personal income. To become an entrepreneur, you need to recognize that an opportunity exists and be willing to act on it. Note, however, that the execution of the entrepreneurial mindset varies in different parts of the world. For example, in many Asian cultures, group decision-making is more common and valued as a character trait. In these regions, an entrepreneur would likely ask the advice of family members or other business associates before taking action. In contrast, individualism is highly valued in the United States and so many US entrepreneurs will decide to implement a plan for the business without consulting others.

Entrepreneurial Spirit and Passion

An entrepreneurial spirit allows entrepreneurs to carry a manner of thinking with them each day that allows them to overcome obstacles and to meet challenges with a can-do attitude. What does it mean to have an entrepreneurial spirit? For the purposes of this discussion, it could mean being passionate, purposeful, positive, bold, curious, or persistent.

The founders of Airbnb have a passion for supporting individual rights to rent out unused space. Why should the established model of hotels prevail? Why shouldn't an individual homeowner have the freedom to rent out unused space and leverage that space into an income? Airbnb has succeeded in creating more flexible and affordable options in the space of the rapidly growing "sharing" economy. At the same time, some states and municipalities have raised issues about the regulations monitoring ventures like this. While entrepreneurial spirit is partly about fighting for individual rights and freedoms, there should be a balance between economic freedom and consumer protection. The entrepreneurial spirit involves a passion for presenting an idea that is worthwhile and valuable, and a willingness to think beyond established patterns and processes, while still keeping in mind local laws and regulations, in the quest to change those established patterns, or at least to offer alternatives to those established patterns.

Passion is a critical component of the entrepreneurial process. Without it, an entrepreneur can lose the drive to run the business. Passion can keep an entrepreneur going when the outside world sends negative messages or less-than-positive feedback. For example, if you are truly passionate about starting an animal shelter because of your love of animals, you will find a way to make it happen. Your internal drive to help animals in need will spur you on to do whatever it takes to make the shelter become a reality. The same is true of other types of startups and owners with similar passions. However, passion needs to be informed by the entrepreneur's vision and mission—passion of the sake of passion is not enough. A clear mission statement—which details why the business exists and the entrepreneur's objectives for achieving that mission—will guide an entrepreneur's passion and keep the business on track. Passion, vision, and mission can reinforce each other and keep the entrepreneur on the right track with next steps for the business.

Some ideas might seem small or insignificant, but in the field of entrepreneurship, it's important to recognize that for every new startup, someone else may recognize a spin-off idea that expands upon the original idea. The opportunities for identifying new possibilities are endless. Review your work in creating spinoff ideas for Angad Darvani's projects, or Kevin F. Adler's Miracle Messages venture. Or consider possible spin-off ideas around the technology used in agriculture. Creating spin-off ideas fits well with our discussion of divergent thinking and brainstorming. Through these processes, we can discover new uses for existing technology, just as Ring did by using video technology to add security by allowing customers to see who is at the door without opening it.

An Entrepreneurial Mindset in Your Discipline or Field

Within your industry of interest or area of study, what are the challenges that create frustration? How can these be turned into opportunities? Earlier in this chapter, we discussed Evernote, a company that focuses on expanding our memories by storing and

organizing information. Let's look at some other examples of entrepreneurial endeavors in specific industries to help you plan your own venture in your own industry.

In the agriculture industry, insects, weeds, weather conditions, and the challenges of harvesting crops are all ripe for entrepreneurial activities. The move toward organic produce has also affected this industry. From an entrepreneurial perspective, what products could you invent to support both organic farming and the problems of insects that damage or destroy crops? The old method was to use chemical sprays to kill the insects, but today, the growing demand for organic foods and increased awareness of the impact of chemical sprays on our environment are changing this scenario. One new idea to solve this problem combines a vacuum cleaner with an agriculture product.

LINK TO LEARNING

Watch this video on the creation of a crop vacuum that sucks up insects and bugs to learn more.

A bug vacuum is an example of how using divergent thinking contributed to the solution of removing bugs from crops without using chemicals. In the group activity of creating divergent ideas, this idea may not have been received well. However, in the incubation stage, the idea must have come forward as a viable solution. Entrepreneurs frequently face the challenge of pressure to conform to established habits and patterns within industries.

Often, the entrepreneurial mindset includes futuristic ideas that shake up the normal, conventional processes that are grounded in experience over time. Tried-and-tested processes and products that have a proven history of success can be a formidable obstacle to new ideas. A new idea may even appear as impossible or outlandish, perhaps even an embarrassment to the steady and predictable practices established within an industry. This can create a dilemma: Do we try something new and unproven that lacks documented research? Sometimes, we must disregard our past successes and research to be open to new possibilities for success and failure. An entrepreneurial mindset includes creativity, problem-solving skills, and a propensity to innovation. Open-mindedness is one characteristic that supports creativity, problem-solving, and innovation. Taking the time to explore new ideas, dream, reflect, and view situations from a new perspective contribute to the entrepreneurial mindset. Some innovations can lead to disruptions within the industry, or even create a new industry.

The innovator's dilemma was presented by Clayton Christensen to explain **disruptive technology**, which are technologies that, once introduced, displace established patterns, processes, and systems previously accepted as normal or accepted. One example of a disruptive technology is Airbnb, a company that threatens the established hotel industry by connecting personal resources to people who desire those resources. If you have a spare bedroom that you aren't using, why not sell that space to someone who wants and needs the space?

Airbnb has become a significant threat to the established hotel industry's business model of building large hotels and renting rooms within those hotels to their customers. Airbnb has reconfigured that model, and since its 2008 launch, 150 million travelers have taken advantage of 3 million Airbnb listings in more than 191 countries. Airbnb has raised more than $3 billion (plus a $1 billion credit line) and is considering selling stocks to support significant expansion. The value of Airbnb is approximately $30 billion. Compare this market value to Hilton's market capitalization of $19 billion and Marriott's of $35 billion. If you were the CEO of Hilton or Marriott, would you be worried? The hotel industry recognized Airbnb as a threat, and in 2016, began a campaign to create legislation to rein in Airbnb's growth and popularity. From the hotel industry's perspective, Airbnb is not playing by the same rules. This is the definition of disruptive technology, the focus on creating a new idea or process that negates or challenges established process or products.

Sometimes disruptive technologies result from *not* listening to customers. Customers don't always know what they want. Customer groups might need to be redefined by the entrepreneurial team on the basis of better models, knowing when to invest in developing lower-performance products that promise lower margins while still satisfying the need, and knowing when to pursue small markets at the expense of larger or established markets. Basically, disruptive technologies occur through identifying new and valuable processes and products.

The founders of Airbnb recognized that some people have unused resources, bedrooms, that other people need. We can apply this idea to other unused resources such as vehicles and motor homes. We see this model reproduced in short-term car rental and bike-sharing programs.

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1.1.5: Key Terms

career entrepreneur
someone who takes on the daily management as the owner of the venture, accepting, and perhaps enjoying, the daily risks and rewards of managing and building the venture

disruptive technology
technology that once introduced, displaces established patterns, processes, and systems previously accepted as normal or accepted methods

divergent thinking
process of generating as many ideas as possible, even when those ideas do not seem logical; the list of ideas can be conflicting, diverse, and disparate

due diligence
conducting the necessary research and investigation to make informed decisions that minimize risk

entrepreneur
someone who identifies an idea that no one else has acted on or identified; small business ownership and franchising are also entrepreneurial options

entrepreneurial mindset
awareness and focus on identifying an opportunity through solving a problem, and a willingness to move forward to advance that idea

entrepreneurial venture
any business, organization, project, or operation of interest that includes a level of risk in acting on an opportunity that has not previously been established

entrepreneurial vision
idea of what an entrepreneur wants a venture to become, what it will look like, what the driving forces are, and what values and culture should surround it

harvest
point at which the venture is sold, at which time the investors receive a return on their investment

lifestyle venture
business whose founders' primary focus is the lifestyle they will attain through becoming entrepreneurs, rather than a primary interest in financial rewards

mission statement
statement of an organization's reason for being that defines its primary long-term goal, explains what the venture will do, what value it will provide to the end customer, and how it will accomplish that action

opportunity-identifying perspective
method for identifying a problem and determining how it could be translated into an opportunity to create a new venture

quantifiable manner
method to determine if a goal has been met or not

serial entrepreneur
entrepreneur who becomes involved in starting multiple entrepreneurial ventures

SMART goals
well-structured and defined goals that are specific, measurable, achievable, realistic and timely

social entrepreneur
entrepreneur who has an interest in solving a social, environmental, or economic problem

value proposition
summary describing the benefits (value) customers can expect from a particular product or service

vision statement
picture of what the venture will become in the future or what the venture will grow into

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1.1.6: Summary

Entrepreneurship Today

An entrepreneur is someone who takes on an entrepreneurial venture to create something new that solves a problem; small business ownership and franchising are also entrepreneurial options. The venture could be for profit or not for profit, depending on the problem it intends to solve. Entrepreneurs can remain in a full-time job while pursuing their ideas on the side, in order to mitigate risk. On the opposite end of the spectrum, entrepreneurs can take on lifestyle ventures and become serial entrepreneurs. There are many factors driving the growth of entrepreneurship, including employment instability, motivation to create something new, financial factors and free time associated with retirement, and the greater acceptance of entrepreneurship as a career choice. The cultures of nations around the world affect the ability for entrepreneurs to start a venture, making the United States a leader in entrepreneurial innovation. Entrepreneurs often find inspiration in social, environmental, and economic issues.

Entrepreneurial Vision and Goals

Establishing an entrepreneurial vision helps you describe what you want your venture to become in the future. For most entrepreneurial ventures, the vision also includes the harvesting or selling of the venture. There are creative ways, such as brainstorming and divergent thinking, as well as investigative ways to define an entrepreneurial vision. Once you have established your vision, it is important to write goals to help you realize the steps toward making your vision a reality.

The Entrepreneurial Mindset

Identifying new possibilities, solving problems, and improving the quality of life on our planet are all important aspects of entrepreneurship. The entrepreneurial mindset allows an entrepreneur to view the world as full of possibilities. Entrepreneurial passion and spirit help entrepreneurs overcome obstacles to achieve their goals. Disruptive technologies involve using existing technology in new ways and can provide new opportunities as well as new challenges. Entrepreneurship is transforming some industries and potentially creating others, though many entrepreneurs create value by starting small businesses, buying franchises, or introducing new services in mature industries. The key thing to remember is that anyone can be an entrepreneur and that new technologies are making the cost of starting a new business less costly, but still risky at some level.

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1.1.7: Review Questions

1. What factors contribute to a growing interest in entrepreneurship?
    a. Unemployment levels
    b. Low job turnover rates
    c. Increasing levels of creativity
    d. Decreasing rates of discrimination
2. Angel investors contribute to the entrepreneurial world by _____.
    a. Outpacing venture capitalists in access to startup funds
    b. Directly investing in entrepreneurial startups
    c. Holding seminars to teach people how to become an entrepreneur
    d. Forming groups of other investors to supply greater quantities of investment funds to entrepreneurs.
3. An entrepreneur is someone who _____.
    a. Creates a small business based on other existing businesses
    b. Creates a home-based business that sells products available through other retailers
    c. Creates a business around the idea of solving a problem
    d. Is highly creative
4. Roxanne Quimby of Burt's Bees is an example of an entrepreneur primarily for which of the following reasons?
    a. She saw available resources and recognized the resources could be used to create a business.
    b. She acted on her passions.
    c. She solved a significant societal problem.
    d. She had the time and energy to dedicate to starting a business.
5. In the early stages of developing an entrepreneurial venture, the entrepreneur might seek funding from which group?
    a. Venture capitalists
    b. The local bank
    c. Friends and family
    d. Shark tank
6. The acronym SMART for goal setting stands for _____.
    a. Short-term, measurable, accurate, relevant, and timely
    b. Specific, measurable, accurate, relevant, and timely
    c. Specific, measurable, achievable, realistic, and time-oriented
    d. Specific, measurable, achievable, results, and time-oriented
7. A vision statement does not include _____.
    a. A picture of the future described in words
    b. Concepts and ideas that inspire and focus people's actions toward a united outcome
    c. Both creative and exploratory processes in creating the vision
    d. The scope of the venture
8. Which one of the following is not a quantifiable result?
    a. 5 percent annual growth in sales
    b. Increase market share by 2 percent
    c. Decrease collection of accounts receivable by $5,000.00
    d. Increase creativity throughout the venture
9. Which of the following is not a creativity building technique or tool?
    1. Conducting a case study
    2. Brainstorming activities
    3. Mind map creation
    4. Brainwriting

10. Disruptive technologies include all but which of the following?
    a. New methods or approaches that make established methods obsolete
    b. Self-booking of air travel
    c. Restaurant food delivery services
    d. A change from ownership of resources to the ability to have access to resources
11. The entrepreneurial mindset includes _____.
    a. A willingness to develop ideas that are not always initially popular
    b. A willingness to wait for an idea to become popular before moving forward with that idea
    c. An ability to focus on past successes
    d. A belief in following tradition and established patterns

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1.1.8: Discussion Questions

1. Why is the United States a leader in entrepreneurship?
2. What commonalities do the top five countries have that put them in the lead for entrepreneurial ventures?
3. One of Roxanne Quimby's motivations in starting businesses included helping employ people in her community. How does or doesn't this motivation fit in the definition of an entrepreneur as someone who identifies a problem and solves that problem?
4. What are the similarities and differences between the business ventures of Wander Girls and Roxanne Quimby?
5. Why is knowing your vision for the future important?
6. Why should we create goals using the SMART method?
7. What is the value in using divergent thinking when trying to solve a problem?
8. How would you explain the concept of an entrepreneurial vision to your college roommate who is a history major?
9. What is the primary difference between divergent thinking and brainstorming?
10. Identify five disruptive technologies and the industries that these technologies impact.
11. In thinking about the future, and your own experiences, what opportunities are there for disruptive technologies in one or two familiar industries?
12. What is the difference between an entrepreneurial mindset and entrepreneurial spirit?
13. Describe your own level of entrepreneurial spirit.

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1.1.9: Case Questions

1. What suggestions could you make to Angad Daryani on other products that would fit his focus on improving the lives of people?
2. On Angad Daryani's website, he says he believes "that the path humanity follows, need to be pivoted for the better." What other needs or problems do humans have? Create a list of twenty needs that would fit Angad Daryani's belief statement.
3. Research Miracle Messages. Identify Miracle Messages vision statement, mission statement, and value statements. Do not copy their statements, but rather create your own statements based on what you would create if you were the lead entrepreneur for this organization.
4. Identify five other organizations that have services or products that you would want to partner with if you were the lead entrepreneur of Miracle Messages. What value does each of these five organizations provide to Miracle Messages' vision, mission, and value? What services or products are not supported either through Miracle Messages or the five organizations you addressed? What new for-profit or nonprofit could be created as a spinoff idea from your research on Miracle Messages?
5. Review the website http://www.coastaltractor.com/ to learn more of about Coastal Tractor. What spinoff ideas could you identify using this same technology or concept as the bug vacuum?
6. In reviewing Coastal Tractor's website, what evidence of an entrepreneurial mindset is present within this company's website?
7. Do you think Coastal Tractor is using a disruptive technology? Why or why not?

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1.1.10: Suggested Resources

Entrepreneurship Today

https://www.entrepreneurship-campus.org

https://www.youtube.com/watch?v=zV2vi8FilLM

Entrepreneurial Vision and Goals

The following links might provide you with more ideas about creating a vision statement.

https://website-designs.com/business...entrepreneurs/

https://www.businessnewsdaily.com/38...statement.html

Check out this website's ideas for developing your vision: https://www.executestrategy.net/blog...sion-statement

Eleven Free Goal Setting Software & Tools You Can Use: http://www.goal-setting-college.com/...-use-for-free/

YouTube: Achieve More by Setting Smart Goals: www.youtube.com/watch?v=yA53yhiOe04

Twenty-four Essential Mind Mapping and Brainstorming Tools: http://mashable.com/2013/09/25/mind-.../#jP47h7Q818qM

Read more about the challenges of work-life balance and what brings satisfaction to entrepreneurs in this article: https://www.wsj.com/articles/why-som...ont-1432610236

Learn about applying a SWOT analysis (strengths, weaknesses, obstacles, threats) to your personal life: https://www.forbes.com/sites/lisaqua...-o-t-analysis/

The Entrepreneurial Mindset

M. M. Baluku, J. F. Kikooma, and K. Otto, "Positive mindset and entrepreneurial outcomes: The magical contributions of psychological resources and autonomy." *Journal of Small Business & Entrepreneurship* 30, no. 6 (2018): 473–498.

E. Fleck, "Needed: Entrepreneurial mindset." *Central Penn Business Journal* 34, no. 12 (2018): 10.

M. Israr and M. Saleem, "Entrepreneurial intentions among university students in Italy." *Journal of Global Entrepreneurship Research* 8, no. 1 (2018): 1.

https://www.christenseninstitute.org...ive-innovation

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SECTION OVERVIEW

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1.2.4: Small Business - Driving America's Growth

1.2.5: Ready, Set, Start Your Own Business

1.2.6: Managing a Small Business

1.2.7: Small Business, Large Impact

1.2.8: The Small Business Administration

1.2.9: Trends in Entrepreneurship and Small-Business Ownership

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1.2.1: Introduction

Learning Objectives

After reading this section, you should be able to answer these questions:

- Why do people become entrepreneurs, and what are the different types of entrepreneurs?
- What characteristics do successful entrepreneurs share?
- How do small businesses contribute to the U.S. economy?
- What are the first steps to take if you are starting your own business?
- Why does managing a small business present special challenges for the owner?
- What are the advantages and disadvantages facing owners of small businesses?
- How does the Small Business Administration help small businesses?
- What trends are shaping entrepreneurship and small-business ownership?

EXPLORING BUSINESS CAREERS

Natalie Tessler, Spa Space

Natalie Tessler has always had an entrepreneurial spirit. After she graduated from New York University's law school, she began working as a tax attorney for a large firm in Chicago. But Tessler soon realized that this left her feeling unfulfilled. She didn't want to practice law, and she didn't want to work for someone else. "I wanted to wake up and be excited for my day," Tessler said. Not until one night, though, when she was having dinner with a friend who recently had begun a writing career, did she realize it was time. "I was listening to her talk about how much she loved her job. Her passion and excitement—I wanted that. I wanted something that grabbed me and propelled me through the day—and being a lawyer wasn't it."

She began searching for what "it" was. She had a tremendous passion and talent for hospitality, entertaining others, and presentation. Seeking an outlet for that flair, she found the spa industry, and the idea for Spa Space was born.

"People think that, owning a spa, I'm able to live this glamorous lifestyle," she laughs. "Owning a spa is nothing like going to one—my nails always are broken from fixing equipment; my back is usually in pain from sitting hunched over a computer trying to figure out the budget or our next marketing promotion." Tessler is a true entrepreneur, embodying the spirit and drive necessary to see her vision become a reality.

Tessler wanted to design a spa that focused on something new: creating a comfortable, personalized environment of indulgence while not neglecting the medical technology of proper skincare. "My father's a dermatologist, so we discussed the importance of making this more than a spa where you can get a frou-frou, smell-good treatment that might actually harm your skin. We both thought it was important to create an experience that is as beneficial for people's skin as it is for their emotional well-being." To address this need, Spa Space has a medical advisory board that helps with product selection, treatment design, and staff training.

Armed with a vision and a plan, Tessler turned her sights toward making it a reality. Spa Space opened in 2001 and has received a great deal of national recognition for its service excellence, unique treatments and products, and its fresh approach to appealing to both men and women. But it hasn't always been smooth sailing for Spa Space. Tessler had to steer the business through several obstacles, including the 9/11 tragedy just three months after the spa's grand opening, and then the Great Recession. Tessler learned to adapt her strategy by refining her target market and the services Spa Space offered. Her resiliency enabled the company to not only survive difficult economic periods, but to thrive and grow 17 years later into what the press recognizes as Chicago's best spa.

Tessler recently turned the reins over to Ilana Alberico, another entrepreneur and founder of Innovative Spa Management, a company that has been named twice to *Inc*. magazine's list of fastest-growing companies. When Alberico met Natalie Tessler and learned about her vision, she was inspired to invest in Spa Space. "Natalie's vision still resonates... I'm inspired to champion her vision into the future."

Typical of many who catch the entrepreneurial bug, Natalie Tessler had a vision and pursued it single-mindedly. She is just one of thousands of entrepreneurs from all age groups and backgrounds. Even kids are starting businesses and high-tech firms. College graduates are shunning the corporate world to head out on their own. Downsized employees, mid-career executives, and retirees who have worked for others all their lives are forming the companies they have always wanted to own.

Companies started by entrepreneurs and small-business owners make significant contributions to the U.S. and global economies. Hotbeds of innovation, these small businesses take leadership roles in technological change and the development of new goods and services. Just how important are small businesses to our economy? Table 1.2.2.1 provides insight into the role of small business in today's economy.

You may be one of the millions of Americans who's considering joining the ranks of business owners. As you read this chapter, you'll learn why entrepreneurship continues to be one of the hottest areas of business activity. Then you'll get the information and tools you need to help you decide whether owning your own company is the right career path for you. Next, you'll discover what characteristics you'll need to become a successful entrepreneur. Then we'll look at the importance of small businesses in the economy, guidelines for starting and managing a small business, the many reasons small businesses continue to thrive in the United States, and the role of the Small Business Administration. Finally, the chapter explores the trends that shape entrepreneurship and small-business ownership today.

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1.2.2: Entrepreneurship Today

Why Do People Become Entrepreneurs, and What Are the Different Types of Entrepreneurs?

Brothers Fernando and Santiago Aguerre exhibited entrepreneurial tendencies at an early age. At 8 and 9 years old respectively, they sold strawberries and radishes from a vacant lot near their parents' home in Plata del Mar on the Atlantic coast of Argentina. At 11 and 12, they provided a surfboard repair service from their garage. As teenagers, Fer and Santi, as they call each other, opened Argentina's first surf shop, which led to their most ambitious entrepreneurial venture of all.

The flat-footed brothers found that traipsing across hot sand in flip-flops was uncomfortable, so in 1984 they sank their $4,000 savings into manufacturing their own line of beach sandals. Now offering sandals and footwear for women, men, and children, as well as clothing for men, Reef sandals have become the world's hottest beach footwear, with a presence in nearly every surf shop in the United States.

Table 1.2.2.1: The Economic Impact of Small Business

Most U.S. Businesses Are Small:
• 80% (approximately 23.8 million) of the nearly 29.7 million businesses have no employees (businesses run by individuals or small groups of partners, such as married couples). • 89% (approximately 5.2 million) of the nearly 5.8 million businesses with employees have fewer than 20 employees. • 99.6% (approximately 5.7 million) of all businesses have 0–99 employees—98% have 0–20 workers. • Approximately 5.8 million businesses have fewer than 500 employees. • Only about 19,000 businesses in the United States have more than 500 employees. • Companies with fewer than 50 employees pay more than 20% of America's payroll. • Companies with fewer than 500 employees pay more than 41% of America's payroll. • 32.5 million people (1 employee in 4) work for businesses with fewer than 50 employees. • These businesses also pay tens of millions of owners, not included in employment statistics.

CATCHING THE ENTREPRENEURIAL SPIRIT

Young Entrepreneur Living the Dream

Jack Bonneau is the quintessential entrepreneur. In the three years he has been in business, he has expanded his product line, opened multiple locations, established strategic partnerships, and secured sponsorship from several national brands. His business has garnered publicity from *The New York Times*, *The Denver Post*, *The Today Show*, *Good Morning America*, and numerous other media. He has shared his business success on several stages, speaking at TechStars and the Aspen Ideas Festival, and recently delivered the closing keynote speech at a national STEM conference. He even landed a gig on *Shark Tank*.

Jack Bonneau is smart, charismatic, an excellent spokesperson, and persistent in his mission. And he is only 11 years old—which also makes him very adorable.

Jack's business was born from a need that most kids have: a desire for toys. He asked his dad, Steve Bonneau, for a LEGO Star Wars Death Star. The problem was that it cost $400. Jack's dad said he could have it but only if he paid for it himself. This led Jack to do what a lot of kids do to earn some extra cash. He opened a lemonade stand. But he quickly learned that this would never help him realize his dream, so, with the advice and help of his father, he decided to open a lemonade stand at a local farmers market. "There were lots of people who wanted to buy great lemonade from an eight-year-old," says Jack. In no time, Jack had earned enough to buy his LEGO Death Star. "I had sales of around $2,000, and my total profit was $900," Jack said.

Jack realized that he was on to something. Adults love to buy things from cute kids. What if he could make even more money by opening more locations? Jack developed an expansion plan to open three new "Jack Stands" the following spring. Realizing that he would need more working capital, he secured a $5,000 loan from Young Americas Bank, a bank in Denver that specializes in loans to children. Jack made $25,000 in 2015.

The following year, Jack wanted to expand operations, so he secured a second loan for $12,000. He opened stands in several more locations, including shopping malls during the holiday season, selling apple cider and hot chocolate instead of lemonade. He also added additional shop space and recruited other young entrepreneurial kids to sell their products in his space, changing the name to Jack's Stands and Marketplace. One of his first partnerships was Sweet Bee Sisters, a lip balm and lotion company founded by Lily, Chloe, and Sophie Warren. He also worked with 18 other young entrepreneurs who sell a range of products from organic dog treats to scarves and headbands.

Jack's strategy worked, and the business brought in more than $100,000 last year. This year, he became the spokesperson for Santa Cruz Organic Lemonade, and he's now looking at expanding into other cities such as Detroit and New Orleans.

Even though Jack is only 11 years old, he has already mastered financial literacy, customer service, marketing and sales, social skills, and other sound business practices—all the qualities of a successful entrepreneur.

Critical Thinking Questions

1. What do you think enabled Jack Bonneau to start and grow a successful business at such a young age?
2. What personal characteristics and values will Jack need to continue running his business while also attending school full-time?

Christy Glass Lowe, who monitors surf apparel for USBX Advisory Services LLC, notes, "They [Reef] built a brand from nothing and now they're the dominant market share leader."

The Aguerres, who currently live two blocks from each other in La Jolla, California, sold Reef to VF Corporation for more than $100 million in 2005. In selling Reef, "We've finally found our freedom," Fernando says. "We traded money for time," adds Santiago. Fernando remains active with surfing organizations, serving as president of the International Surfing Association, where he became known as "Ambassador of the Wave" for his efforts in getting all 90 worldwide members of the International Olympic Committee to unanimously vote in favor of including surfing in the 2020 Olympic Games. He has also been named "Waterman of the Year" by the Surf Industry Manufacturers Association two times in 24 years. Santi raises funds for his favorite not-for-profit, SurfAid. Both brothers are enjoying serving an industry that has served them so well.

The United States is blessed with a wealth of entrepreneurs such as the Aguerres who want to start a **small business**. According to research by the Small Business Administration, two-thirds of college students intend to be entrepreneurs at some point in their careers, aspiring to become the next Bill Gates or Jeff Bezos, founder of Amazon.com. But before you put out any money or expend energy and time, you'd be wise to check out Table 1.2.2.2 for some preliminary advice.

The desire to be one's own boss cuts across all age, gender, and ethnic lines. Results of a recent U.S. Census Bureau survey of business owners show that minority groups and women are becoming business owners at a much higher rate than the national average. Table 1.2.2.3 illustrates these minority-owned business demographics.

Why has entrepreneurship remained such a strong part of the foundation of the U.S. business system for so many years? Because today's global economy rewards innovative, flexible companies that can respond quickly to changes in the business environment. Such companies are started by **entrepreneurs**, people with vision, drive, and creativity, who are willing to take the risk of starting and managing a business to make a profit.

Table 1.2.2.2

Are You Ready to Be an Entrepreneur?
Here are some questions would-be entrepreneurs should ask themselves: • What is new and novel about your idea? Are you solving a problem or unmet need? • Are there similar products/services out there? If so, what makes yours better? • Who is your target market? How many people would use your product or service? • Have you talked with potential customers to get their feedback? Would they buy your product/service? • What about production costs? How much do you think the market will pay? • How defensible is the concept? Is there good intellectual property? • Is this innovation strategic to my business? • Is the innovation easy to communicate? • How might this product evolve over time? Would it be possible to expand it into a product line? Can it be updated/enhanced in future versions? • Where would someone buy this product/service? • How will the product/service be marketed? What are the costs to sell and market it? • What are the challenges involved in developing this product/service?

Table 1.2.2.3

Statistics for Minority-Owned Businesses
• The number of Hispanic-owned businesses almost tripled between 1997 (1.2 million) and 2012 (3.3 million). • The percentage of U.S. businesses with 1 to 50 employees owned by African Americans increased by 50% between 1996 and 2015. • Almost a million firms with employees are minority-owned: 53% are Asian American-owned, 11% are African American-owned, and almost a third are Hispanic-owned. • 19% of all companies with employees are owned by women.

Entrepreneur or Small-Business Owner?

The term *entrepreneur* is often used in a broad sense to include most small-business owners. The two groups share some of the same characteristics, and we'll see that some of the reasons for becoming an entrepreneur or a small-business owner are very similar. But there is a difference between entrepreneurship and small-business management. Entrepreneurship involves taking a risk, either to create a new business or to greatly change the scope and direction of an existing one. Entrepreneurs typically are innovators who start companies to pursue their ideas for a new product or service. They are visionaries who spot trends.

Although entrepreneurs may be small-business owners, not all small-business owners are entrepreneurs. Small-business owners are managers or people with technical expertise who started a business or bought an existing business and made a conscious decision to stay small. For example, the proprietor of your local independent bookstore is a small-business owner. Jeff Bezos, founder of Amazon.com, also sells books. But Bezos is an entrepreneur: He developed a new model—web-based book retailing—that revolutionized the bookselling world and then moved on to change retailing in general. Entrepreneurs are less likely to accept the status quo, and they generally take a longer-term view than the small-business owner.

Types of Entrepreneurs

Entrepreneurs fall into several categories: classic entrepreneurs, multipreneurs, and intrapreneurs.

Classic Entrepreneurs

Classic entrepreneurs are risk-takers who start their own companies based on innovative ideas. Some classic entrepreneurs are *micropreneurs* who start small and plan to stay small. They often start businesses just for personal satisfaction and the lifestyle. Miho Inagi is a good example of a micropreneur. On a visit to New York with college friends in 1998, Inagi fell in love with the city's bagels. "I just didn't think anything like a bagel could taste so good," she said. Her passion for bagels led the young office assistant to quit her job and pursue her dream of one day opening her own bagel shop in Tokyo. Although her parents tried to talk her out of it, and bagels were virtually unknown in Japan, nothing deterred her. Other trips to New York followed, including an

unpaid six-month apprenticeship at Ess-a-Bagel, where Inagi took orders, cleared trays, and swept floors. On weekends, owner Florence Wilpon let her make dough.

In August 2004, using $20,000 of her own savings and a $30,000 loan from her parents, Inagi finally opened tiny Maruichi Bagel. The timing was fortuitous, as Japan was about to experience a bagel boom. After a slow start, a favorable review on a local bagel website brought customers flocking for what are considered the best bagels in Tokyo. Inagi earns only about $2,300 a month after expenses, the same amount she was making as a company employee. “Before I opened this store I had no goals,” she says, “but now I feel so satisfied.”

In contrast, *growth-oriented entrepreneurs* want their business to grow into a major corporation. Most high-tech companies are formed by growth-oriented entrepreneurs. Jeff Bezos recognized that with Internet technology he could compete with large chains of traditional book retailers. Bezos’s goal was to build his company into a high-growth enterprise—and he chose a name that reflected his strategy: Amazon.com. Once his company succeeded in the book sector, Bezos applied his online retailing model to other product lines, from toys and house and garden items to tools, apparel, music, and services. In partnership with other retailers, Bezos is well on his way to making Amazon’s vision “to be Earth’s most customer-centric company; to build a place where people can come to find and discover anything they might want to buy online.”—a reality.

Multipreneurs

Then there are *multipreneurs*, entrepreneurs who start a series of companies. They thrive on the challenge of building a business and watching it grow. In fact, over half of the chief executives at *Inc.* 500 companies say they would start another company if they sold their current one. Brothers Jeff and Rich Sloan are a good example of multipreneurs, having turned numerous improbable ideas into successful companies. Over the past 20-plus years, they have renovated houses, owned a horse breeding and marketing business, invented a device to prevent car batteries from dying, and so on. Their latest venture, a multimedia company called StartupNation, helps individuals realize their entrepreneurial dreams. And the brothers know what company they want to start next: yours.



Figure 1.2.2.1: If there is one person responsible for the mainstream success of solar energy and electric vehicles in the past 10 years, it’s Elon Musk, founder and CEO of Tesla. Since the 2000s when he founded Tesla, launching innovation in solar technology, and commercial space exploration with SpaceX, Musk has pioneered countless innovations and has challenged traditional automobile, trucking, and energy companies to challenge and rethink their businesses. What entrepreneurial type best describes Elon Musk? *(Credit: Steve Jurvetson/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

Intrapreneurs

Some entrepreneurs don’t own their own companies but apply their creativity, vision, and risk-taking within a large corporation. Called **intrapreneurs**, these employees enjoy the freedom to nurture their ideas and develop new products, while their employers

provide regular salaries and financial backing. Intrapreneurs have a high degree of autonomy to run their own mini-companies within the larger enterprise. They share many of the same personality traits as classic entrepreneurs, but they take less personal risk. According to Gifford Pinchot, who coined the term *intrapreneur* in his book of the same name, large companies provide seed funds that finance in-house entrepreneurial efforts. These include Intel, IBM, Texas Instruments (a pioneering intrapreneurial company), Salesforce.com, and Xerox.

Why Become an Entrepreneur?

As the examples in this chapter show, entrepreneurs are found in all industries and have different motives for starting companies. The most common reason cited by CEOs of the *Inc.* 500, the magazine's annual list of fastest-growing private companies, is the challenge of building a business, followed by the desire to control their own destiny. Other reasons include financial independence and the frustration of working for someone else. Two important motives mentioned in other surveys are a feeling of personal satisfaction with their work, and creating the lifestyle that they want. Do entrepreneurs feel that going into business for themselves was worth it? The answer is a resounding yes. Most say they would do it again.

CONCEPT CHECK

1. Describe several types of entrepreneurs.
2. What differentiates an entrepreneur from a small-business owner?
3. What are some major factors that motivate entrepreneurs to start businesses?

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1.2.3: Characteristics of Successful Entrepreneurs

What Characteristics Do Successful Entrepreneurs Share?

Do you have what it takes to become an entrepreneur? Having a great concept is not enough. An entrepreneur must be able to develop and manage the company that implements his or her idea. Being an entrepreneur requires special drive, perseverance, passion, and a spirit of adventure, in addition to managerial and technical ability. Entrepreneurs *are* the company; they tend to work longer hours, take fewer vacations, and cannot leave problems at the office at the end of the day. They also share other common characteristics as described in the next section.

The Entrepreneurial Personality

Studies of the entrepreneurial personality find that entrepreneurs share certain key traits. Most entrepreneurs are

- *Ambitious:* They are competitive and have a high need for achievement.
- *Independent:* They are individualists and self-starters who prefer to lead rather than follow.
- *Self-confident:* They understand the challenges of starting and operating a business and are decisive and confident in their ability to solve problems.
- *Risk-takers:* Although they are not averse to risk, most successful entrepreneurs favor business opportunities that carry a moderate degree of risk where they can better control the outcome over highly risky ventures where luck plays a large role.
- *Visionary:* Their ability to spot trends and act on them sets entrepreneurs apart from small-business owners and managers.
- *Creative:* To compete with larger firms, entrepreneurs need to have creative product designs, bold marketing strategies, and innovative solutions to managerial problems.
- *Energetic:* Starting and operating a business takes long hours. Even so, some entrepreneurs start their companies while still employed full-time elsewhere.
- *Passionate.* Entrepreneurs love their work, as Miho Inagi demonstrated by opening a bagel shop in Tokyo despite the odds against it being a success.
- *Committed*. Because they are so committed to their companies, entrepreneurs are willing to make personal sacrifices to achieve their goals.

CUSTOMER SATISFACTION AND QUALITY

Ethical Choices Transform Family Business into International Brand

Ever since Apollonia Poilâne was a young girl growing up in Paris, she always knew what she wanted to do when she grew up: take over the family business. But she didn't anticipate how quickly this would happen. When her father—Lionel Poilâne—and her mother died in a helicopter crash in 2002, France lost its most celebrated baker, and Apollonia stepped into the role. She was just 18 years old at the time with plans to matriculate to Harvard in the fall, but the moment her parents had prepared her for had come. As her Harvard admissions essay said, "The work of several generations is at stake."

With organization and determination, Apollonia managed one of the best French bakeries in the world—based in Paris—from her apartment in Cambridge, Massachusetts. She would usually wake up an extra two hours before classes to make sure she would get all the phone calls done for work. "After classes, I check on any business regarding the company and then do my homework," she says. "Before I go to bed I call my production manager in Paris to check the quality of the bread." Because the name Poilâne has earned a place with a very small group of prestige bakers, the 18-year-old was determined to continue the tradition of customer satisfaction and quality her grandfather established in 1932. When her grandfather suffered a stroke in 1973, his 28-year-old son, Lionel, poured his heart into the business and made the family bread into the global brand it is today. Lionel opened two more bakeries in Paris and another in London. He developed and nurtured a worldwide network of retailers and celebrities where bread is shipped daily via FedEx to upscale restaurants and wealthy clients around the world.

Experimenting with sourdough is what distinguished Poilâne's products from bread produced by Paris's other bakers, and it has remained the company's signature product. It is baked with a "P" carved into the crust, a throwback to the days when the use of communal ovens forced bakers to identify their loaves, and it also ensures that the loaf doesn't burst while it's baking.

Today, Poilâne also sells croissants, pastries, and a few specialty breads, but the company's signature item is still the four-pound *miche*, a wheel of sourdough, a country bread, *pain Poilâne*.

"Apollonia is definitely passionate about her job," says Juliette Sarrazin, manager of the successful Poilâne Bakery in London. "She really believes in the work of her father and the company, and she is looking at the future, which is very good."

Apollonia's work ethic and passion fueled her drive even when she was a student. Each day presented a juggling act of new problems to solve in Paris while other Harvard students slept. As Apollonia told a student reporter from *The Harvard Crimson* writing a story about her, "The one or two hours you spend procrastinating I spend working. It's nothing demanding at all. It was always my dream to run the company."

Her dedication paid off, and Apollonia retained control of important decisions, strategy, and business goals, describing herself as the "commander of the ship," determining the company's overall direction. Today, Poilâne is an $18 million business that employs 160 people. Poilâne runs three restaurants called Cuisine de Bar in Paris and in London, serving casual meals such as soups, salads, and open-faced *tartines*. The company ships more than 200,000 loaves a year to clients in 20 countries, including the United States, Japan, and Saudi Arabia. "More people understand what makes the quality of the bread, what my father spent years studying, so I am thrilled about that," says Apollonia.

Critical Thinking Questions

1. What type of entrepreneur is Apollonia Poilâne?
2. What personal ethics drove Apollonia's decision to take over the family business?

Most entrepreneurs combine many of the above characteristics. Sarah Levy, 23, loved her job as a restaurant pastry chef but not the low pay, high stress, and long hours of a commercial kitchen. So she found a new one—in her parents' home—and launched Sarah's Pastries and Candies. Part-time staffers help her fill pastry and candy orders to the soothing sounds of music videos playing in the background. Cornell University graduate Conor McDonough started his own web design firm, OffThePathMedia.com, after becoming disillusioned with the rigid structure of his job. "There wasn't enough room for my own expression," he says. "Freelancing keeps me on my toes," says busy graphic artist Ana Sanchez. "It forces me to do my best work because I know my next job depends on my performance."



Figure 1.2.3.1: Celebrity Ashton Kutcher is more than just a pretty face. The actor-mogul is an active investor in technology-based start-ups such as Airbnb, Skype, and Foursquare with an empire estimated at $200 million dollars. What personality traits are common to successful young entrepreneurs such as Kutcher? *(Credit: TechCrunch/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

Managerial Ability and Technical Knowledge

A person with all the characteristics of an entrepreneur might still lack the necessary business skills to run a successful company. Entrepreneurs need the technical knowledge to carry out their ideas and the managerial ability to organize a company, develop

operating strategies, obtain financing, and supervise day-to-day activities. Jim Crane, who built Eagle Global Logistics from a start-up into a $250 million company, addressed a group at a meeting saying, “I have never run a $250 million company before so you guys are going to have to start running this business.”

Good interpersonal and communication skills are important in dealing with employees, customers, and other business associates such as bankers, accountants, and attorneys. As we will discuss later in the chapter, entrepreneurs believe they can learn these much-needed skills. When Jim Steiner started his toner cartridge remanufacturing business, Quality Imaging Products, his initial investment was $400. He spent $200 on a consultant to teach him the business and $200 on materials to rebuild his first printer cartridges. He made sales calls from 8.00 a.m. to noon and made deliveries to customers from noon until 5:00 p.m. After a quick dinner, he moved to the garage, where he filled copier cartridges until midnight, when he collapsed into bed, sometimes covered with carbon soot. And this was not something he did for a couple of months until he got the business off the ground—this was his life for 18 months. But entrepreneurs usually soon learn that they can’t do it all themselves. Often they choose to focus on what they do best and hire others to do the rest.

CONCEPT CHECK

1. Describe the personality traits and skills characteristic of successful entrepreneurs.
2. What does it mean when we say that an entrepreneur should work on the business, not in it?

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1.2.4: Small Business - Driving America's Growth

How Do Small Businesses Contribute to the U.S. Economy?

Although large corporations dominated the business scene for many decades, in recent years small businesses have once again come to the forefront. Downsizings that accompany economic downturns have caused many people to look toward smaller companies for employment, and they have plenty to choose from. Small businesses play an important role in the U.S. economy, representing about half of U.S. economic output, employing about half the private sector workforce, and giving individuals from all walks of life a chance to succeed.

What is a Small Business?

How many small businesses are there in the United States? Estimates range from 5 million to over 22 million, depending on the size limits government agencies and other groups use to define a small business or the number of businesses with or without employees. The Small Business Administration (SBA) established size standards to define whether a business entity is small and therefore eligible for government programs and preferences that are reserved for "small businesses." Size standards are based on the types of economic activity or industry, generally matched to the North American Industry Classification System (NAICS).

Small businesses are defined in many ways. Statistics for small businesses vary based on criteria such as new/start-up businesses, the number of employees, total revenue, length of time in business, non-employees, businesses with employees, geographic location, and so on. Due to the complexity and need for consistent statistics and reporting for small businesses, several organizations are now working together to combine comprehensive data sources to get a clear and accurate picture of small businesses in the United States. Table 1.2.4.1 provides a more detailed look at small-business owners.

Table 1.2.4.1

Snapshot of Small-Business Owners
• Start-up activity has risen sharply over the last three years, from an all-time low of minus 0.87% in 2013 to positive 0.48% in 2016. • Between 1996 and 2011, the rate of business ownership dropped for both men and women; however, business ownership has increased every year since 2014. • The Kauffman Index of Startup Activity, an early indicator of new entrepreneurship in the United States, rose again slightly in 2016 following sharp increases two years in a row. • New entrepreneurs who started businesses to pursue opportunity rather than from necessity reached 86.3%, more than 12 percentage points higher than in 2009 at the height of the Great Recession. • For the first time, Main Street entrepreneurship activity was higher in 2016 than before the onset of the Great Recession. This increase was driven by a jump in business survival rates, which reached a three-decade high of 48.7%. Nearly half of new businesses are making it to their fifth year of operation. • 47% of U.S. businesses have been in business for 11 or more years. • In 2016, about 25% of all employing firms had revenues over $1 million, but 2% had revenues under $10,000.

One of the best sources to track U.S. entrepreneurial growth activity is the Ewing Marion Kauffman Foundation. The Kauffman Foundation is among the largest private foundations in the country, with an asset base of approximately $2 billion, and focuses on projects that encourage entrepreneurship and support education through grants and research activities. They distributed over $17 million in grants in 2013.

The Kauffman Foundation supports new business creation in the United States through two research programs. The annual Kauffman Index of Entrepreneurship series measures and interprets indicators of U.S. entrepreneurial activity at the national, state, and metropolitan level. The foundation also contributes to the cost of the Annual Survey of Entrepreneurs (ASE), which is a public–private partnership between the foundation, the U.S. Census Bureau, and the Minority Business Development Agency. The ASE provides annual data on select economic and demographic characteristics of employer businesses and their owners by gender, ethnicity, race, and veteran status. The Kauffman Index of Entrepreneurship series is an umbrella of annual reports that measures how people and businesses contribute to America's overall economy. What is unique about the Kauffman reports is that the indexes don't focus on only inputs (as most small-business reporting has been done in the past); it reports primarily on entrepreneurial

outputs—the actual results of entrepreneurial activity, such as new companies, business density, and growth rates. The reports also include comprehensive, interactive data visualizations that enable users to slice and dice a myriad of data nationally, at the state level, and for the 40 largest metropolitan areas.

The Kauffman Index series consists of three in-depth studies—Start-up Activity, Main Street Entrepreneurship, and Growth Entrepreneurship.

- The Kauffman Index of Startup Activity is an early indicator of new entrepreneurship in the United States. It focuses on new business creation activity and people engaging in business start-up activity, using three components: the rate of new entrepreneurs, the opportunity share of new entrepreneurs, and start-up density.
- The Kauffman Index of Main Street Entrepreneurship measures established small-business activity—focusing on U.S. businesses more than five years old with less than 50 employees from 1997 to 2016. Established in 2015, it takes into account three components of local, small-business activity: the rate of businesses owners in the economy, the five-year survival rate of businesses, and the established small-business density.
- The Kauffman Growth Entrepreneurship Index is a composite measure of entrepreneurial business growth in the United States that captures growth entrepreneurship in all industries and measures business growth from both revenue and job perspectives. Established in 2016, it includes three component measures of business growth: rate of start-up growth, share of scale-ups, and high-growth company density.

Data sources for the Kauffman Index calculations are based on Current Population Survey (CPS), with sample sizes of more than 900,000 observations, and the Business Dynamics Statistics (BDS), which covers approximately 5 million businesses. The Growth Entrepreneurship Index also includes *Inc.* 500/5000 data).

Small businesses in the United States can be found in almost every industry, including services, retail, construction, wholesale, manufacturing, finance and insurance, agriculture and mining, transportation, and warehousing. Established small businesses are defined as companies that have been in business at least five years and employ at least one, but less than 50, employees. Table 1.2.4.2 provides the number of employees by the size of established business. More than half of small businesses have between one and four employees.

Table 1.2.4.2: Number of Employees, by Percentage of Established Small Businesses

Established small businesses are defined as businesses over the age of five employing at least one, but less than 50, employees.	
Number of Employees	Percentage of Businesses
1–4 employees	53.07%
5–9 employees	23.23%
10–19 employees	14.36%
20–49 employees	9.33%

CONCEPT CHECK

1. What are three ways small businesses can be defined?
2. What social and economic factors have prompted the rise in small business?

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1.2.5: Ready, Set, Start Your Own Business

What are the First Steps to Take if you are Starting Your Own Business?

You have decided that you'd like to go into business for yourself. What is the best way to go about it? Start from scratch? Buy an existing business? Or buy a franchise? About 75 percent of business start-ups involve brand-new organizations, with the remaining 25 percent representing purchased companies or franchises. Franchising may have been discussed elsewhere in your course, so we'll cover the other two options in this section.

Getting Started

The first step in starting your own business is a self-assessment to determine whether you have the personal traits you need to succeed and, if so, what type of business would be best for you. Table 1.2.5.1 provides a checklist to consider before starting your business.

Finding the Idea

Entrepreneurs get ideas for their businesses from many sources. It is not surprising that about 80 percent of *Inc.* 500 executives got the idea for their company while working in the same or a related industry. Starting a firm in a field where you have experience improves your chances of success. Other sources of inspiration are personal experiences as a consumer; hobbies and personal interests; suggestions from customers, family, and friends; industry conferences; and college courses or other education.

Table 1.2.5.1

Checklist for Starting a Business
Before you start your own small business, consider the following checklist: • Identify your reasons • Self-analysis • Personal skills and experience • Finding a niche • Conduct market research • Plan your start-up: write a business plan • Finances: how to fund your business

An excellent way to keep up with small-business trends is by reading entrepreneurship and small-business magazines and visiting their websites. With articles on everything from idea generation to selling a business, they provide an invaluable resource and profile some of the young entrepreneurs and their successful business ventures (Table 1.2.5.2).

Table 1.2.5.2: Successful Entrepreneurs

Name and Age	Company and Description
Philip Kimmey, 27	Kimmey's dog-sitting and dog-walking network, Rover.com, raised almost $100 million in venture capital and was valued at $300 million in 2017.
Max Mankin, 27	Mankin co-founded Modern Electron and raised $10 million in venture capital to create "advanced thermionic energy converters" that will generate "cheap, scalable, and reliable electricity." Modern Electron will turn every home into a power station.
Alexandra Cristin White, 28	In her early 20s, White founded Glam Seamless, which sells tape-in hair extensions. In 2016, her self-funded company grossed $2.5 million.
Steph Korey, 29; Jen Rubio, 29	Korey and Rubio founded Away, selling "first-class luggage at a coach price" in 2015. They raised $31 million in funding and grossed $12 million in sales in 2016.
Allen Gannet, 26	Gannet founded TrackMaven, a web-marketing analytics company, in 2012; by 2016, his company was grossing $6.7 million a year.
Jake Kassan, 25; Kramer LaPlante, 25	Kassan and Kramer launched their company, MVMT, through Indiegogo, raising $300,000, and in 2016 grossed $60 million, selling primarily watches and sunglasses.
Brian Streem, 29	Streem's company, Aerobo, provides drone services to the film industry, selling "professional aerial filming and drone cinematography." Aerobo grossed $1 million in 2016, its first full year of business.
Natalya Bailey, 30; Louis Perna, 29	Accion Systems began in 2014, raised $10 million in venture funding, and grossed $4.5 million in 2016, making tiny propulsion systems for satellites.
Jessy Dover, 29	Dover is the co-founder of Dagne Dover, a company making storage-efficient handbags for professional women. She and her co-founders grossed $4.5 million in 2016 and debuted on Nordstrom.com in 2017.

These dynamic individuals, who are already so successful in their 20s and 30s, came up with unique ideas and concepts and found the right niche for their businesses.

Interesting ideas are all around you. Many successful businesses get started because someone identifies a need and then finds a way to fill it. Do you have a problem that you need to solve? Or a product that doesn't work as well as you'd like? Raising questions about the way things are done and seeing opportunity in adversity are great ways to generate ideas.

Choosing a Form of Business Organization

A key decision for a person starting a new business is whether it will be a sole proprietorship, partnership, corporation, or limited liability company. As discussed earlier, each type of business organization has advantages and disadvantages. The choice depends on the type of business, number of employees, capital requirements, tax considerations, and level of risk involved.

Developing the Business Plan

Once you have the basic concept for a product or service, you must develop a plan to create the business. This planning process, culminating in a sound **business plan**, is one of the most important steps in starting a business. It can help to attract appropriate loan financing, minimize the risks involved, and be a critical determinant in whether a firm succeeds or fails. Many people do not venture out on their own because they are overwhelmed with doubts and concerns. A comprehensive business plan lets you run

various “what if” analyses and evaluate your business without any financial outlay or risk. You can also develop strategies to overcome problems well before starting the business.

Taking the time to develop a good business plan pays off. A venture that seems sound at the idea stage may not look so good on paper. A well-prepared, comprehensive, written business plan forces entrepreneurs to take an objective and critical look at their business venture and analyze their concept carefully; make decisions about marketing, sales, operations, production, staffing, budgeting and financing; and set goals that will help them manage and monitor its growth and performance.



Figure 1.2.5.1: Each year, a variety of organizations hold business plan competitions to engage the growing number of college students starting their own businesses. The University of Essex and the iLearn entrepreneurship curriculum developed by the University of Texas in Austin, which partnered with Trisakti University in Jakarta, Indonesia, and the U.S. embassy to help run an entrepreneurship course and competition are examples of such competitions. Seven students from “iLearn: Entrepreneurship” were selected as finalists to pitch their business plans to a panel of Indonesian business leaders and embassy representatives. The winning business plan, which was an ecotourism concept, earned $1,000 in seed money. What research goes into a winning business plan? *(Credit: University of Essex /flickr/ Attribution 2.0 Generic (CC BY 2.0))*

The business plan also serves as the initial operating plan for the business. Writing a good business plan takes time. But many businesspeople neglect this critical planning tool in their eagerness to begin doing business, getting caught up in the day-to-day operations instead.

The key features of a business plan are a general description of the company, the qualifications of the owner(s), a description of the products or services, an analysis of the market (demand, customers, competition), sales and distribution channels, and a financial plan. The sections should work together to demonstrate why the business will be successful, while focusing on the uniqueness of the business and why it will attract customers. Table 1.2.5.3 describes the essential elements of a business plan.

A common use of a business plan is to persuade lenders and investors to finance the venture. The detailed information in the plan helps them assess whether to invest. Even though a business plan may take months to write, it must capture potential investors’ interest within minutes. For that reason, the basic business plan should be written with a particular reader in mind. Then you can fine-tune and tailor it to fit the investment goals of the investor(s) you plan to approach.

Key Elements of a Business Plan
Executive summary provides an overview of the total business plan. Written after the other sections are completed, it highlights significant points and, ideally, creates enough excitement to motivate the reader to continue reading.
Vision and mission statement concisely describe the intended strategy and business philosophy for making the vision happen. Company values can also be included in this section.
Company overview explains the type of company, such as manufacturing, retail, or service; provides background information on the company if it already exists; and describes the proposed form of organization—sole proprietorship, partnership, or corporation. This section should include company name and location, company objectives, nature and primary product or service of the business, current status (start-up, buyout, or expansion) and history (if applicable), and legal form of organization.
Product and/or service plan describes the product and/or service and points out any unique features, as well as explains why people will buy the product or service. This section should offer the following descriptions: product and/or service; features and benefits of the product or service that provide a competitive advantage; available legal protection—patents, copyrights, and trademarks.
Marketing plan shows who the firm's customers will be and what type of competition it will face; outlines the marketing strategy and specifies the firm's competitive edge; and describes the strengths, weaknesses, opportunities, and threats of the business. This section should offer the following descriptions: analysis of target market and profile of target customer; methods of identifying, attracting, and retaining customers; a concise description of the value proposition; selling approach, type of sales force, and distribution channels; types of marketing and sales promotions, advertising, and projected marketing budget; product and/or service pricing strategy; and credit and pricing policies.
Management plan identifies the key players—active investors, management team, board members, and advisors— citing the experience and competence they possess. This section should offer the following descriptions: management team, outside investors and/or directors and their qualifications, outside resource people and their qualifications, and plans for recruiting and training employees.
Operating plan explains the type of manufacturing or operating system to be used and describes the facilities, labor, raw materials, and product-processing requirements. This section should offer the following descriptions: 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.
Financial plan specifies financial needs and contemplated sources of financing, as well as presents projections of revenues, costs, and profits. This section should offer the following descriptions: historical financial statements for the last 3–5 years or as available; pro forma financial statements for 3–5 years, including income statements, balance sheets, cash flow statements, and cash budgets (monthly for first year and quarterly for second year); financial assumptions; breakeven analysis of profits and cash flows; and planned sources of financing.
Appendix of supporting documents provides materials supplementary to the plan. This section should offer the following descriptions: management team biographies; the company's values; information about the company culture (if it's unique and contributes to employee retention); and any other important data that support the information in the business plan, such as detailed competitive analysis, customer testimonials, and research summaries.

But don't think you can set aside your business plan once you obtain financing and begin operating your company. Entrepreneurs who think their business plan is only for raising money make a big mistake. Business plans should be dynamic documents, reviewed and updated on a regular basis—monthly, quarterly, or annually, depending on how the business progresses and the particular industry changes.

Owners should adjust their sales and profit projections up or down as they analyze their markets and operating results. Reviewing your plan on a constant basis will help you identify strengths and weaknesses in your marketing and management strategies and help you evaluate possible opportunities for expansion in light of both your original mission and goals, current market trends, and business results. The Small Business Administration (SBA) offers sample business plans and online guidance for business plan preparation under the "Business Guide" tab at https://www.sba.gov.

Financing the Business

Once the business plan is complete, the next step is to obtain financing to set up your company. The funding required depends on the type of business and the entrepreneur's own investment. Businesses started by lifestyle entrepreneurs require less financing than growth-oriented businesses, and manufacturing and high-tech companies generally require a large initial investment.

Who provides start-up funding for small companies? Like Miho Inagi and her Tokyo bagel shop, 94 percent of business owners raise start-up funds from personal accounts, family, and friends. Personal assets and money from family and friends are important for new firms, whereas funding from financial institutions may become more important as companies grow. Three-quarters of *Inc*. 500 companies have been funded on $100,000 or less.

The two forms of business financing are **debt**, borrowed funds that must be repaid with interest over a stated time period, and **equity**, funds raised through the sale of stock (i.e., ownership) in the business. Those who provide equity funds get a share of the business's profits. Because lenders usually limit debt financing to no more than a quarter to a third of the firm's total needs, equity financing often amounts to about 65 to 75 percent of total start-up financing.



Figure 1.2.5.2: FUBU started when a young entrepreneur from Hollis, Queens, began making tie-top skullcaps at home with some friends. With funding from a $100,000 mortgage and a later investment from the Samsung Corporation, CEO Daymond John, turned his home into a successful sportswear company. The FUBU brand tops the list for today's fashionistas who don everything from FUBU's classic Fat Albert line to swanky FUBU suits and tuxedos. How do start-ups obtain funding? *(Credit: U.S. Embasy Nairobi/ flickr/ Attribution 2.0 Generic (CC BY 2.0))*

One way to finance a start-up company is bootstrapping, which is basically funding the operation with your own resources. If the resources needed are not available to an individual, there are other options. Two sources of equity financing for young companies are angel investors and venture-capital firms. **Angel investors** are individual investors or groups of experienced investors who provide financing for start-up businesses by investing their own money, often referred to as "seed capital." This gives the investors more flexibility on what they can and will invest in, but because it is their own money, angels are careful. Angel investors often invest early in a company's development, and they want to see an idea they understand and can have confidence in. Table 1.2.5.4 offers some guidelines on how to attract angel financing.

Making a Heavenly Deal

You need financing for your start-up business. How do you get angels interested in investing in your business venture?

- Show them something they understand, ideally a business from an industry they've been associated with.
- Know your business details: Information important to potential investors includes annual sales, gross profit, profit margin, and expenses.
- Be able to describe your business—what it does and who it sells to—in less than a minute. Limit PowerPoint presentations to 10 slides.
- Angels can always leave their money in the bank, so an investment must interest them. It should be something they're passionate about. And timing is important—knowing when to reach out to an angel can make a huge difference.
- They need to see management they trust, respect, and like. Present a competent management team with a strong, experienced leader who can explain the business and answer questions from potential investors with specifics.
- Angels prefer something they can bring added value to. Those who invest could be involved with your company for a long time or perhaps take a seat on your board of directors.
- They are more partial to deals that don't require huge sums of money or additional infusions of angel cash.
- Emphasize the likely exits for investors and know who the competition is, why your solution is better, and how you are going to gain market share with an infusion of cash.

Venture capital is financing obtained from *venture capitalists*, investment firms that specialize in financing small, high-growth companies. Venture capitalists receive an ownership interest and a voice in management in return for their money. They typically invest at a later stage than angel investors. We'll discuss venture capital in greater detail when discussing financing the enterprise.

Buying a Small Business

Another route to small-business ownership is buying an existing business. Although this approach is less risky, many of the same steps for starting a business from scratch apply to buying an existing company. It still requires careful and thorough analysis. The potential buyer must answer several important questions: Why is the owner selling? Does he or she want to retire or move on to a new challenge, or are there problems with the business? Is the business operating at a profit? If not, can this be corrected? On what basis has the owner valued the company, and is it a fair price? What are the owner's plans after selling the company? Will he or she be available to provide assistance through the change of ownership of the business? And depending on the type of business it is, will customers be more loyal to the owner than to the product or service being offered? Customers could leave the firm if the current owner decides to open a similar business. To protect against this, many purchasers include a *noncompete clause* in the contract of sale, which generally means that the owner of the company being sold may not be allowed to compete in the same industry of the acquired business for a specific amount of time.

You should prepare a business plan that thoroughly analyzes all aspects of the business. Get answers to all your questions, and determine, via the business plan, whether the business is a sound one. Then you must negotiate the price and other terms of purchase and obtain appropriate financing. This can be a complicated process and may require the use of a consultant or business broker.

Risky Business

Running your own business may not be as easy as it sounds. Despite the many advantages of being your own boss, the risks are great as well. Over a period of five years, nearly 50% percent of small businesses fail according to the Kauffman Foundation.

Businesses close down for many reasons—and not all are failures. Some businesses that close are financially successful and close for nonfinancial reasons. But the causes of business failure can be interrelated. For example, low sales and high expenses are often directly related to poor management. Some common causes of business closure are:

- Economic factors—business downturns and high interest rates
- Financial causes—inadequate capital, low cash balances, and high expenses
- Lack of experience—inadequate business knowledge, management experience, and technical expertise
- Personal reasons—the owners may decide to sell the business or move on to other opportunities

Inadequate early planning is often at the core of later business problems. As described earlier, a thorough feasibility analysis, from market assessment to financing, is critical to business success. Yet even with the best plans, business conditions change and unexpected challenges arise. An entrepreneur may start a company based on a terrific new product only to find that a larger firm with more marketing, financing, and distribution clout introduces a similar item.

The stress of managing a business can also take its toll. The business can consume your whole life. Owners may find themselves in over their heads and unable to cope with the pressures of business operations, from the long hours to being the main decision-maker. Even successful businesses have to deal with ongoing challenges. Growing too quickly can cause as many problems as sluggish sales. Growth can strain a company's finances when additional capital is required to fund expanding operations, from hiring additional staff to purchasing more raw material or equipment. Successful business owners must respond quickly and develop plans to manage its growth.

So, how do you know when it is time to quit? "Never give up" may be a good motivational catchphrase, but it is not always good advice for a small-business owner. Yet, some small-business owners keep going no matter what the cost. For example, Ian White's company was trying to market a new kind of city map. White maxed out 11 credit cards and ran up more than $100,000 in debt after starting his company. He ultimately declared personal bankruptcy and was forced to find a job so that he could pay his bills. Maria Martz didn't realize her small business would become a casualty until she saw her tax return showing her company's losses in black and white—for the second year in a row. It convinced her that enough was enough and she gave up her gift-basket business to become a full-time homemaker. But once the decision is made, it may be tough to stick to. "I got calls from people asking how come I wasn't in business anymore. It was tempting to say I'd make their basket but I had to tell myself it is finished now."

CONCEPT CHECK

1. How can potential business owners find new business ideas?
2. Why is it important to develop a business plan? What should such a plan include?
3. What financing options do small-business owners have? What risks do they face?

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1.2.6: Managing a Small Business

Why Does Managing a Small Business Present Special Challenges for the Owner?

Managing a small business is quite a challenge. Whether you start a business from scratch or buy an existing one, you must be able to keep it going. The small-business owner must be ready to solve problems as they arise and move quickly if market conditions change.

MANAGING CHANGE

Learning How to Pivot

Most small business owners either use, or at least know of, the iconic email service MailChimp, a company that is growing by more than $120 million every year and is on track to bring in $525 million over the coming year. But Ben Chestnut, the CEO and co-founder, says it took MailChimp several years to figure out what it did well.

When Chestnut was laid off from his job at the Cox Media Group in Atlanta, he founded Rocket Science Group, a web design firm. Co-founder Dan Kurzius (who taught himself to code) joined Chestnut, and they began to focus their sales efforts on tech companies. But when the tech bubble burst, they pivoted to focus on selling to airline and travel companies. Then 9/11 hit, and they needed to change focus again, this time on the real estate market. However, both Chestnut and Kurzius discovered they didn't enjoy sales (and they weren't very good at it), nor did they like the bureaucracy of working with large companies. "The only companies we could relate to were small businesses, and they always asked for email marketing."

This insight helped Chestnut to recall a product feature the Rocket Science Group had previously developed for an email greeting card project. So Chestnut and Kurzius evaluated the marketing software and began to test it with small businesses. "Our day jobs felt like going to these big organizations and pitching to them, and it was miserable," Chestnut says. "But we really loved our nighttime jobs, which were helping the small businesses use this email marketing app." Their passion, along with market feedback, led to their decision to completely focus on email marketing for small businesses. But it wasn't until almost 2009 that MailChimp found its sweet spot. The founders initially wanted to give away one product that collected subscribers and then charge for another, which was sending emails, but it would have been very difficult to divide the product into two pieces. That's when they landed on the Freemium idea. "Let's just make the whole thing free," said Chestnut.

The idea was that if they made it cheap and easy for small businesses to try MailChimp, their business would grow and they would be happy to pay for MailChimp services. MailChimp allows customers to send an email for free to 1,999 people at once but charges for emails sent to over 2,000 people and for premium features. MailChimp charges a monthly recurring fee starting at $10 for sending more than 12,000 emails a month.

The idea quickly proved to be a huge success. MailChimp went from a few hundred thousand users to 1 million users in a year. The next year they added another million users.

The MailChimp founders learned a lot of lessons during their 17 years in business. One of their most important lessons is knowing when to change. When you see an opportunity, don't be afraid to pivot and change course, especially if it means focusing on a market you're passionate about. Listening to market feedback and following their passion earned MailChimp's founders recognition as "2017 Business of the Year" by *Inc.* magazine.

Critical Thinking Questions

1. What led MailChimp's founders to change its focus on the customers they were selling to?
2. What was MailChimp's "big idea" that changed the business, and why was it so successful?

A sound business plan is key to keeping the small-business owner in touch with all areas of his or her business. Hiring, training, and managing employees is another important responsibility because the owner's role may change over time. As the company grows, others will make many of the day-to-day decisions while the owner focuses on managing employees and planning for the firm's long-term success. The owner must constantly evaluate company performance and policies in light of changing market and economic conditions and develop new policies as required. He or she must also nurture a continual flow of ideas to keep the

business growing. The types of employees needed may change too as the firm grows. For instance, a larger firm may need more managerial talent and technical expertise.

Using Outside Consultants

One way to ease the burden of managing a business is to hire outside consultants. Nearly all small businesses need a good certified public accountant (CPA) who can help with financial record keeping, decision-making, and tax planning. An accountant who works closely with the owner to help the business grow is a valuable asset. An attorney who knows about small-business law can provide legal advice and draw up essential contracts and documents. Consultants in areas such as marketing, employee benefits, and insurance can be used on an as-needed basis. Outside directors with business experience are another way for small companies to get advice. Resources such as these free the small-business owner to concentrate on medium- and long-range planning and day-to-day operations.

Some aspects of business can be outsourced or contracted out to specialists. Among the more common departments that use outsourcing are information technology, marketing, customer service, order fulfillment, payroll, and human resources. Hiring an outside company—in many cases another small business—can save money because the purchasing firm buys just the services it needs and makes no investment in expensive technology. Management should review outsourced functions as the business grows because at some point it may be more cost-effective to bring them in-house.

Hiring and Retaining Employees

It is important to identify all the costs involved in hiring an employee to make sure your business can afford it. Recruiting, help-wanted ads, extra space, and taxes will easily add about 10–15 percent to their salary, and employee benefits will add even more. Hiring an employee may also mean more work for you in terms of training and management. It's a catch-22: To grow you need to hire more people, but making the shift from solo worker to boss can be stressful.

Attracting good employees is more difficult for a small firm, which may not be able to match the higher salaries, better benefits, and advancement potential offered by larger firms. Small companies need to be creative to attract the right employees and convince applicants to join their firm. Once they hire an employee, small-business owners must make employee satisfaction a top priority in order to retain good people. A company culture that nurtures a comfortable environment for workers, flexible hours, employee benefit programs, opportunities to help make decisions, and a share in profits and ownership are some ways to do this.

Duane Ruh figured out how to build a $1.2 million business in a town with just 650 residents. It's all about treating employees right. The log birdhouse and bird feeder manufacturer, Little Log Co., located in Sargent, Nebraska, boasts employee-friendly policies you read about but rarely see put into practice. Ruh offers his employees a flexible schedule that gives them plenty of time for their personal lives. During a slow period last summer, Ruh cut back on hours rather than lay anyone off. There just aren't that many jobs in that part of Nebraska that his employees could go to, so when he received a buyout offer that would have closed his facility but kept him in place with an enviable salary, he turned it down. Ruh also encourages his employees to pursue side or summer jobs if they need to make extra money, assuring them that their Little Log jobs are safe.

Going Global with Exporting

More and more small businesses are discovering the benefits of looking beyond the United States for market opportunities. The global marketplace represents a huge opportunity for U.S. businesses, both large and small. Small businesses' decision to export is driven by many factors, one of which is the desire for increased sales and higher profits. U.S. goods are less expensive for overseas buyers when the value of the U.S. dollar declines against foreign currencies, and this creates opportunities for U.S. companies to sell globally. In addition, economic conditions such as a domestic recession, foreign competition within the United States, or new markets opening up in foreign countries may also encourage U.S. companies to export.

Like any major business decision, exporting requires careful planning. Small businesses may hire international-trade consultants or distributors to get started selling overseas. These specialists have the time, knowledge, and resources that most small businesses lack. Export trading companies (ETCs) buy goods at a discount from small businesses and resell them abroad. Export management companies (EMCs) act on a company's behalf. For fees of 5–15 percent of gross sales and multiyear contracts, they handle all aspects of exporting, including finding customers, billing, shipping, and helping the company comply with foreign regulations.

Many online resources are also available to identify potential markets for your goods and services, as well as to decipher the complexities involved in preparing to sell in a foreign country. The Small Business Association's Office of International Trade has links to many valuable sites. The Department of Commerce offers services for small businesses that want to sell abroad. Contact its Trade Information Center, 1-800-USA-TRADE, or its Export Center (http://www.export.gov).

CONCEPT CHECK

1. How does the small-business owner's role change over time?
2. How does managing a small business contribute to its growth?
3. What are the benefits to small firms of doing business internationally, and what steps can small businesses take to explore their options?

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1.2.7: Small Business, Large Impact

What Are the Advantages and Disadvantages Facing Owners of Small Businesses?

An uncertain economy has not stopped people from starting new companies. The National Federation of Independent Businesses reports that 85 percent of Americans view small businesses as a positive influence on American life. This is not surprising when you consider the many reasons why small businesses continue to thrive in the United States:

- *Independence and a better lifestyle:* Large corporations no longer represent job security or offer the fast-track career opportunities they once did. Mid-career employees leave the corporate world—either voluntarily or as a result of downsizing—in search of the new opportunities that self-employment provides. Many new college and business school graduates shun the corporate world altogether to start their own companies or look for work in smaller firms.
- *Personal satisfaction from work:* Many small-business owners cite this as one of the primary reasons for starting their companies. They love what they do.
- *Best route to success:* Business ownership provides greater advancement opportunities for women and minorities, as we will discuss later in this chapter. It also offers small-business owners the potential for profit.
- *Rapidly changing technology:* Technology advances and decreased costs provide individuals and small companies with the power to compete in industries that were formerly closed to them.
- *Major corporate restructuring and downsizing:* These force many employees to look for other jobs or careers. They may also provide the opportunity to buy a business unit that a company no longer wants.
- *Outsourcing:* As a result of downsizing, corporations may contract with outside firms for services they used to provide in-house. Outsourcing creates opportunities for smaller companies that offer these specialized goods and services.
- *Small businesses are resilient:* They are able to respond fairly quickly to changing economic conditions by refocusing their operations.

There are several cities and regions that are regarded as the best locations for start-up businesses and entrepreneurs. Among them are Tulsa, Oklahoma; Tampa, Florida; Atlanta, Georgia; Raleigh, North Carolina; Oklahoma City, Oklahoma; Seattle, Washington; Minneapolis, Minnesota; and Austin, Texas.

Why Stay Small?

Owners of small businesses recognize that being small offers special advantages. Greater flexibility and an uncomplicated company structure allow small businesses to react more quickly to changing market forces. Innovative product ideas can be developed and brought to market more quickly, using fewer financial resources and personnel than would be needed in a larger company. And operating more efficiently keeps costs down as well. Small companies can also serve specialized markets that may not be cost-effective for large companies. Another feature is the opportunity to provide a higher level of personal service. Such attention brings many customers back to small businesses such as gourmet restaurants, health clubs, spas, fashion boutiques, and travel agencies.

Steve Niewulis played in baseball's minor leagues before an injury to his rotator cuff cut short his career. Niewulis decided to combine his love of the game with a clever idea that has elevated him to the big leagues. The fact that players had trouble keeping their hands dry while batting inspired his big idea: a sweat-busting rosin bag attached to a wristband so that a player can dry the bat handle between pitches. In less than two years, Niewulis's Fort Lauderdale, Florida, company, Tap It! Inc., sold thousands of Just Tap It! wristbands. The product, which retails for $12.95, is used by baseball players, basketball players, tennis players, golfers, and even rock climbers. His secret to success? Find a small distribution network that allows small companies, with just one product line, to succeed.

On the other hand, being small is not always an asset. The founders may have limited managerial skills or encounter difficulties obtaining adequate financing, potential obstacles to growing a company. Complying with federal regulations is also more expensive for small firms. Those with fewer than 20 employees spend about twice as much per employee on compliance than do larger firms. In addition, starting and managing a small business requires a major commitment by the owner. Long hours, the need for owners to do much of the work themselves, and the stress of being personally responsible for the success of the business can take a toll.

But managing your company's growing pains doesn't need to be a one-person job. Four years after he started DrinkWorks (now Whirley DrinkWorks), a company that makes custom drinking cups, Richard Humphrey was logging 100-hour weeks. "I was concerned that if I wasn't there every minute, the company would fall apart." Humphrey got sick, lost weight, and had his engagement fall apart. When forced by a family emergency to leave the company in the hands of his five employees, Humphrey was amazed at how well they managed in his absence. "They stepped up to the plate and it worked out," he says. "After that, the whole company balanced out."

CONCEPT CHECK

1. Why are small businesses becoming so popular?
2. Discuss the major advantages and disadvantages of small businesses.

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1.2.8: The Small Business Administration

How Does the Small Business Administration Help Small Businesses?

Many small-business owners turn to the **Small Business Administration (SBA)** for assistance. The SBA's mission is to speak on behalf of small business, and through its national network of local offices it helps people start and manage small businesses, advises them in the areas of finance and management, and helps them win federal contracts. Its toll-free number—1-800-U-ASK-SBA (1-800-827-5722)—provides general information, and its website at http://www.sba.gov offers details on all its programs.

Financial Assistance Programs

The SBA offers financial assistance to qualified small businesses that cannot obtain financing on reasonable terms through normal lending channels. This assistance takes the form of guarantees on loans made by private lenders. (The SBA no longer provides direct loans.) These loans can be used for most business purposes, including purchasing real estate, equipment, and materials. The SBA has been responsible for a significant amount of small-business financing in the United States. In the fiscal year ending on September 30, 2017, the SBA backed more than $25 billion in loans to almost 68,000 small businesses, including about $9 billion to minority-owned firms and $7.5 billion in loans to businesses owned by women. It also provided more than $1.7 billion in home and business disaster loans.

Other SBA programs include the New Markets Venture Capital Program, which promotes economic development and job opportunities in low-income geographic areas, while other programs offer export financing and assistance to firms that suffer economic harm after natural or other disasters.

More than 300 SBA-licensed **Small Business Investment Companies (SBICs)** provide about $6 billion each year in long-term financing for small businesses. The SBA's website suggests seeking angel investors and using SBA-guaranteed loans as a way to fund the start-up. These privately owned and managed investment companies hope to earn a substantial return on their investments as the small businesses grow.

SCORE-ing with Management Assistance Programs

The SBA also provides a wide range of management advice. Its Business Development Library has publications on most business topics. Its "Starting Out" series offers brochures on how to start a wide variety of businesses—from ice-cream stores to fish farms.

Business development officers at the Office of Business Development and local Small Business Development Centers counsel many thousands of small-business owners each year, offering advice, training, and educational programs. The SBA also offers free management consulting through two volunteer groups: the Service Corps of Retired Executives (SCORE), and the Active Corps of Executives (ACE). Executives in these programs use their own business backgrounds to help small-business owners. SCORE has expanded its outreach into new markets by offering email counseling through its website (http://www.score.org). The SBA also offers free online resources and courses for small-business owners and aspiring entrepreneurs in its Learning Center, located on the SBA website under the "Learning Center" tab.

Assistance for Women and Minorities

The SBA is committed to helping women and minorities increase their business participation. It offers a minority small-business program, microloans, and the publication of Spanish-language informational materials. It has increased its responsiveness to small businesses by giving regional offices more decision authority and creating high-tech tools for grants, loan transactions, and eligibility reviews.

The SBA offers special programs and support services for socially and economically disadvantaged persons, including women, Native Americans, and Hispanics through its Minority Business Development Agency. It also makes a special effort to help veterans go into business for themselves.

CONCEPT CHECK

1. What is the Small Business Administration (SBA)?
2. Describe the financial and management assistance programs offered by the SBA.

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1.2.9: Trends in Entrepreneurship and Small-Business Ownership

What Trends are Shaping Entrepreneurship and Small-business Ownership?

Entrepreneurship has changed since the heady days of the late 1990s, when starting a dot-com while still in college seemed a quick route to riches and stock options. Much entrepreneurial opportunity comes from major changes in demographics, society, and technology, and at present there is a confluence of all three. A major demographic group is moving into a significantly different stage in life, and minorities are increasing their business ownership in remarkable numbers. We have created a society in which we expect to have our problems taken care of, and the technological revolution stands ready with already-developed solutions. Evolving social and demographic trends, combined with the challenge of operating in a fast-paced technology-dominated business climate, are changing the face of entrepreneurship and small-business ownership.

Into the Future: Start-ups Drive the Economy

Did new business ventures drive the economic recovery from the 2001–2002 and 2007–2009 to recessions, and are they continuing to make significant contributions to the U.S. economy? The economists who review Department of Labor employment surveys and SBA statistics think so. “Small business drives the American economy,” says Dr. Chad Moutray, former chief economist for the SBA’s Office of Advocacy. “Main Street provides the jobs and spurs our economic growth. American entrepreneurs are creative and productive.” Numbers alone do not tell the whole story, however. Are these newly self-employed workers profiting from their ventures, or are they just biding their time during a period of unemployment?

U.S. small businesses employed 57.9 million people in 2016, representing nearly 48 percent of the workforce. The number of net new jobs added to the economy was 1.4 million.

The highest rate of growth is coming from women-owned firms, which continues to rise at rates higher than the national average—and with even stronger growth rates since the recession. There were an estimated 11.6 million women-owned businesses employing nearly 9 million people in 2016, generating more than $1.7 trillion in revenue.

Between 2007 and 2017, women-owned firms increased by 114 percent, compared to a 44 percent increase among all businesses. This means that growth rates for women-owned businesses are 2.5 times faster than the national average. Employment growth was also stronger than national rates. Women-owned businesses increased 27 percent over the past 20 years, while overall business employment has increased by 13 percent since 2007.

These trends show that more workers are striking out on their own and earning money doing it. It has become very clear that encouraging small-business activity leads to continued strong overall economic growth.

Changing Demographics Create Entrepreneurial Diversity

The mantra, “60 is the new 40,” describes today’s Baby Boomers who indulge in much less knitting and golf in their retirement years. The AARP predicts that silver-haired entrepreneurs will continue to rise in the coming years. According to a recent study by the Kauffman Foundation, Baby Boomers are twice as likely as Millennials to start a new business. In fact, close to 25 percent of all new entrepreneurs fall between the ages of 55 and 64. This has created a ripple effect in the way we work. Boomers have accelerated the growing acceptance of working from home, adding to the millions of U.S. workers already showing up to work in their slippers. In addition, the ongoing corporate brain drain could mean that small businesses will be able to tap into the expertise of seasoned free agents at less-than-corporate prices—and that seniors themselves will become independent consultants to businesses of all sizes.

The growing numbers of Baby Boomer entrepreneurs has prompted some forward-thinking companies to recognize business opportunities in technology. At one time there was a concern that the aging of the population would create a drag on the economy. Conventional wisdom says that the early parenthood years are the big spending years. As we age, we spend less and, because Boomers are such a big demographic group, this was going to create a long-term economic decline. Not true, it now appears. The Boomer generation has built sizable wealth, and they are not afraid to spend it to make their lives more comfortable.

Minorities are also adding to the entrepreneurial mix. As we saw in Table 1.2.2.3, minority groups and women are increasing business ownership at a much faster rate than the national average, reflecting their confidence in the U.S. economy. These overwhelming increases in minority business ownership paralleled the demand for U.S. Small Business Administration loan

products. Loans to minority business owners in fiscal year 2017 set a record—more than $9.5 billion, or 31 percent, of SBA's total loan portfolio.

The latest Kauffman Foundation Index of Startup Activity found that immigrants and Latinos have swelled the growing numbers of self-employed Americans in recent years, increasing the diversity of the country's entrepreneurial class. Overall, minority-owned businesses increased 38 percent. The SBA notes that the number of Hispanic-owned businesses has increased more than 46 percent between 2007 and 2012.



Figure 1.2.9.1: The popularity of home businesses such as Rodan+Fields, eBay, and other e-commerce sites has given rise to a new kind of entrepreneur: the "mompreneur." Typically ex-corporate professionals, these web-driven women launch home businesses specializing in the sale of antiques, jewelry, thrift-store fashions, and other items. Aided by digital photography, wireless technology, and friendly postal workers, these savvy moms are one of the fastest-growing segments of entrepreneurs building successful businesses on the web. Why are many professional women leaving the workplace to start entrepreneurial ventures online? *(Credit: Amanda nobles/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

How Far Will You Go to Get Rich?

With enough intelligence and determination, people can get rich almost anywhere in the United States. Whether you own chains of dry cleaners in Queens, car dealerships in Chicago, or oil wells in West Texas, fortunes have been made in every state in the Union. There are some places, however, where the chances of creating wealth are much greater than others. That is the reason why people who hope to strike it rich move to places such as Manhattan or Palo Alto. It's not because the cost of living is low or the quality of life as a struggling entrepreneur is fun. Whether starting a software or soft-drink company, entrepreneurs tend to follow the money

But not all companies follow the herd. Guild Education, founded in 2015 by Rachel Carlson and Brittany Stich at Stanford University, left San Francisco due to the high cost of living that could slow down the company's growth. "We have a lot of women who are executives and department heads here, starting with myself and my co-founder," CEO Rachel Carlson said. "So when we left, we deliberately chose a place where you can have a family." Guild Education's mission is to help large employers offer college education and tuition reimbursement as a benefit to the 64 million working-age adults who lack a college degree.

Since moving to Denver, Guild Education has raised another $21 million in venture capital, bringing the total funding to $31.5 million with a company valuation of $125 million. The company headquarters in Denver is next door to a Montessori school and employs 58 employees. "We were joking that we're the polar opposite of Apple," said Carlson. "Remember when the new 'mothership' came out? Every single parent noticed that it had a huge gym but not a daycare."

According to PwC's quarterly venture capital study, "MoneyTree Report," the top regions in the United States for venture-backed deals in the third quarter of 2017 were San Francisco ($4.1 billion), New York Metro ($4.2 billion), Silicon Valley (Bay Area $2.2 billion), and New England ($1.8 billion).

In 2017, equity financing in U.S. start-ups rose for the third straight quarter, reaching $19 billion, according to the PwC/CB Insights "MoneyTree Report Q3 2017." "Financing was boosted by a large number of mega-rounds," says Tom Ciccolella, Partner, U.S. Ventures Leader at PwC. Twenty-six mega-rounds of $100 million in companies such as WeWork, 23andMe, Fanatics, and NAUTO contributed to the strong activity levels in the first three quarters of 2017. The top five U.S. industry sectors with the most deals and funding were Internet, Healthcare, Mobile and Telecommunications, Software (Non-Internet/Mobile), and Consumer Products.

CONCEPT CHECK

1. What significant trends are occurring in the small-business arena?
2. How is entrepreneurial diversity impacting small business and the economy?
3. How do ethics impact decision-making with small-business owners?

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SECTION OVERVIEW

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2.1.1: Prelude to the Ethical and Social Responsibilities of Entrepreneurs

Martin Shkreli, an aspiring pharmaceutical entrepreneur and former hedge fund manager, made headlines in 2015 when he capitalized on a profitable and controversial business opportunity. As the founder and CEO of Turing Pharmaceuticals, Shkreli obtained the expired patent for a lifesaving drug used to combat HIV. He raised the US market price overnight from $13.50 to $750 per pill—a 5,000 percent increase. When criticism by the medical community, the public, and politicians led to demands for a return to the original pricing, Shkreli defended his decision as a smart business practice that contributed to his firm's bottom line. Eventually, he agreed to reverse the price but later reneged on his promise, offering instead to provide discounted pricing to hospitals.

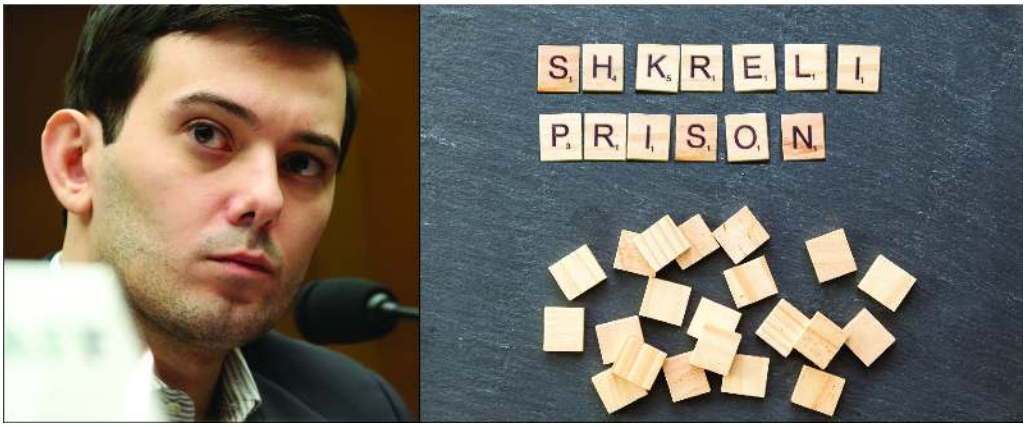


Figure 2.1.1.1: Photo of Martin Shkreli (left). Scrabble tiles spelling SHKRELI PRISON (right). *(Credit (left): modification of "Martin Shkreli 2016" by House Committee on Oversight and Government Reform/Wikimedia Commons, Public Domain; credit (right): modification of "Martin Shkreli sentenced to seven years in prison for defrauding investors" by Marco Verch/Flickr, CC BY 2.0)*

The damage to Shkreli's reputation, however, was already complete. The BBC described him as the "most-hated" CEO in America due to his business decisions, obnoxious behavior, and negative social media rants. Infectious disease specialists and patient advocates rejected Shkreli's argument that his "price adjustment strategy" was helpful for patients since those being treated would need the drug long after being released from the hospital. Although the pricing strategy was not illegal, Shkreli was eventually investigated and found guilty of securities fraud that involved falsely raising money from hedge fund investors and stealing money from his drug company to repay investors.

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2.1.2: Ethical and Legal Issues in Entrepreneurship

Learning Objectives

By the end of this section, you will be able to:

- Develop the ability to identify ethical and legal issues
- Develop an approach to resolve ethical/legal dilemmas once identified

What does it mean to be both ethical and socially responsible as an entrepreneur? When Martin Shkreli decided to increase the price overnight of a lifesaving HIV drug from $13.50 to $750 per pill, the public immediately characterized his actions as unethical. However, he viewed his position as responsible behavior that served the best interests of his company and his shareholders. Although Shkreli's decision to raise prices was within legal limits, his actions were critically judged in the court of public opinion.

As an entrepreneur, should Shkreli's concerns be with ensuring the sustainability of his business or with providing patients with a more affordable (less profitable) lifesaving drug? This fundamental question raises a number of related questions about the ethics of the situation. Was the decision to raise the price of the HIV drug by 5,000 percent in the best interest of the business? Was Shkreli aware of all aspects (ethical, legal, financial, reputational, and political) of the decision he made? To critically examine the decisions of an individual such as Shkreli, one needs an enhanced awareness of the multitude of stakeholders to be considered, as opposed to only shareholders.

Stakeholders

A comprehensive view of business and entrepreneurial ethics requires an understanding of the difference between shareholders, a small group who are the owners (or stockholders), and stakeholders, a large group that includes all those people and organizations with a vested interest in the business. Serving the needs of the shareholders, as perhaps Shkreli thought he was doing, is based on a limited view of organizational purpose. This view, known as the "shareholder primacy" doctrine, stems from a famous Michigan Supreme Court case involving the Ford Motor Company and two shareholders named the Dodge brothers (who would go on to form the Dodge Motor Company). This case established a precedent that lasted for decades, built on the premise that the only thing that should matter to a CEO and their company is shareholder profits. However, this concept has gradually been replaced by a more progressive viewpoint, mandating the consideration of all stakeholders when making key business decisions that have potentially far-reaching consequences. As an example of this new awareness, the Business Roundtable, a group of CEOs from the biggest and most successful companies in the US, recently released a new statement addressing business ethics. The CEOs prefaced this statement saying, "Together with partners in the public, private and non-profit sectors, Business Roundtable CEOs are committed to driving solutions that make a meaningful difference for workers, families, communities and businesses of all sizes."

WORK IT OUT

Business Roundtable Official Statement on the Purpose of a Corporation

Read the following statement on the purpose of a corporation from *Business Roundtable:* ""Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all." "Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide healthcare; generate and deliver energy; and offer financial, communications and other services that underpin economic growth." "While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:"

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.

- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.
- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

"Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.""

- Question: Does it appear that Shkreli, in the preceding pharmaceutical example, considered all the stakeholders as the Business Roundtable Statement recommends, or did he follow the older shareholder primacy doctrine approach?

The aim of this chapter is twofold: first, to assist entrepreneurs in understanding the significance of ethics and the role that entrepreneurs play in developing an ethical and responsible organization. This includes the ability to recognize and identify both ethical dilemmas and legal issues that might arise. Second, we want to enable entrepreneurs to develop a moral compass that allows them to lead their business organization in a manner consistent with ethical and legal principles. An example of an ethical business organization is one that follows the Statement of Purpose by the *Business Roundtable*. This means creating a business environment in which each member of the organization is encouraged, enabled, and supported to develop the ethical capabilities to habitually and systematically differentiate between right or wrong. This also means that the organization, as a total system, provides consistent, meaningful, and timely consequences for unethical behavior and irresponsible actions.

LINK TO LEARNING

Read this article from *Forbes* to see a list of companies recently deemed the most ethical in the world.

Being an Ethical Entrepreneur

Whenever you think about the behavior you expect of yourself, in both your professional and personal life, you are engaging in a philosophical dialogue with yourself to establish the standards of behavior you choose to uphold—that is, your **ethics**. You may decide you should always tell the truth to family, friends, customers, clients, and stakeholders, and if that is not possible, you should have very good reasons why you cannot. You may also choose never to defraud or mislead your business partners. You may decide, as well, that while you are pursuing profit in your business, you will not require that all the money earned comes your way. Instead, there might be sufficient profits to distribute a portion of them to other stakeholders in addition to yourself—for example, those who are important because they have helped you or are affected one way or another by your business. This group of stakeholders might include employees (profit sharing), shareholders (dividends), the local community (time), and social causes or charities (donations).

Being successful as an entrepreneur may therefore consist of much more than simply making money and growing a venture. Success may also mean treating employees, customers, and the community at large with honesty and respect. Success may come from the sense of pride felt when engaging in honest transactions—not just because the law demands it, but because we demand it of ourselves. Success may lie in knowing the profit we make does not come from shortchanging others. Thus, **business ethics** guides the conduct by which entrepreneurs and their companies abide by the law and respect the rights of their stakeholders, particularly their customers, clients, employees, and the surrounding community and environment.

LINK TO LEARNING

Read the Ten Principles of the United Nations Global Compact that urges corporations to develop a "principled approach to doing business." The principles cover human rights, labor, the environment, and corruption.

Nearly all systems of moral, ethical, spiritual, and/or religious beliefs stress the building blocks of engaging others with respect, empathy, and honesty. These foundational beliefs, in turn, prepare us for the codes of ethical behavior that serve as ideal guides for

business. Still, we need not subscribe to any particular faith to hold that ethical behavior in business is necessary. Just by virtue of being human, we all share obligations to one another, and principal among these is the requirement that we treat others with fairness and dignity, including in our commercial transactions.

For this reason, we use the words *ethics* and *morals* interchangeably in our discussion. We hold that "an ethical person" conveys the same sense as "a moral person." Ethical conduct by entrepreneurs/business owners is not only the right way to behave, but it also burnishes our own professional reputation as business leaders of integrity.

Integrity—that is, unity between what we say and what we do—is a highly valued trait. But it is more than just consistency of character. Acting with **integrity** means we adhere strongly to a system of ethical values. Such values often serve as the foundation for the creation of ethical codes, or codes of conduct. A code of ethics acts to guide conduct and may be derived from a variety of sources. It could be a personal, internal code of conduct, or an official code adopted by a business organization. Or it could be an external code based on one's profession (e.g., CPAs, attorneys, CFPs, and others have professional codes of ethics), or a more broadly applicable external code such as that of the Business Roundtable or Business for Social Responsibility. Being a professional of integrity means consistently striving to be the best person and professional that you can be in all your interactions with others. Integrity in business brings many advantages, not the least of which is that it is a critical factor in allowing businesses and society to function properly. It is also a fundamental basis for developing and maintaining trust, which is vital to all contractual and informal commitments between businesses and all their key stakeholders.

Successful entrepreneurs and the companies they represent will take pride in their enterprise if they engage in business with transparency, intentionality, and integrity. To treat customers, clients, employees, and all those affected by a venture with dignity and respect is ethical. In addition, ethical business practices serve the long-term interests of businesses because customers, clients, employees, and society at large will be much more willing to patronize a business and work hard on the business's behalf if that business is perceived as caring about the community it serves. And what type of firm has long-term customers and employees? One whose track record gives evidence of honest business practices.

Research on the performance of the World's Most Ethical Companies (WMEC) indicates a positive association between ethical conduct and successful long-term financial performance. These businesses often outperform their market expectations, both in periods of market growth and decline. The WMEC list of companies shows an average annual excess return of more than 8 percent higher than expected profitability. This may be due to a variety of reasons, including what researchers term a positive effect on business culture, stakeholders, and reputation. In other words, being ethical beneficially influences employees, investors, and customers.

ARE YOU READY?

Which Corporate Culture Do You Value?

Imagine that upon graduation, you have the good fortune to face two entrepreneurial opportunities. The first is with a startup known to value a hard-nosed, no-nonsense business culture in which keeping long hours and working intensely are highly valued. At the end of each year, the company plans to donate to numerous social and environmental causes. The second entrepreneurial opportunity is with a nonprofit recognized for a very different culture based on its compassionate approach to employee work-life balance. It also offers the chance to pursue your own professional interests or volunteerism during a portion of every workday. The earnings plan with the first opportunity pays 20 percent more per year.

- Which of these opportunities would you pursue and why?
- In what ways might company contributions to a cause carry more power to impact the cause? In what ways might individual contributions be more powerful? Think of examples for each scenario.
- How important an attribute is income, and at what point would a higher income override for you the nonmonetary benefits of the lower-compensated opportunity?

Many people confuse ethical and legal compliance. However, these concepts are not interchangeable and call for different standards of behavior. The law is needed to establish and maintain a functioning society. Without it, our society would be in chaos. Compliance with legal standards is mandatory. If we violate these standards, we are subject to punishment as established by the law. Therefore, compliance generally refers to the extent to which a company conducts its business operations in accordance with

applicable regulations, statutes, and laws. Yet this represents only a baseline minimum. Ethical observance builds on this baseline and reveals the principles of an individual business leader or a specific organization. Ethical acts are generally considered voluntary and personal—often based on our individual perception of what is right and wrong.

Some professions, such as medicine and the law, have traditional and established codes of ethics. The Hippocratic Oath, for example, is embraced by most professionals in healthcare today as an appropriate standard always owed to patients by physicians, nurses, and others in the field. This obligation traces its lineage to ancient Greece and the physician Hippocrates. Businesses are different in not having a mutually shared standard of ethics. This is changing, however, as evidenced by the array of codes of conduct and mission statements many companies have adopted over the past century. These beliefs have many points in common, and their shared content may eventually produce a code universally claimed by business practitioners. What central point might constitute such a code? Essentially, a commitment to treat with honesty and integrity customers, clients, employees, and others affiliated with a business.

The law is typically indebted to tradition and precedent, and compelling reasons are needed to support any change. Ethical reasoning often is more topical and reflects the changes in consciousness that individuals and society undergo. Often, ethical thought precedes and sets the stage for changes in the law.

Behaving ethically requires that we meet the mandatory standards of the law, but that is not enough. For example, an action may be legal that we personally consider unacceptable (consider how many viewed Shkreli's legal price hike). Entrepreneurs today need to focus not only on complying with the letter of the law but also on going above and beyond that basic mandatory requirement to consider their stakeholders and do what is right.

WORK IT OUT

The Equifax Data Breach

In 2017, from mid-May to July, hackers gained unauthorized access to servers used by Equifax, a major credit reporting agency, and accessed the personal information of nearly one-half of the US population. Equifax executives sold off nearly $2 million of company stock they owned after finding out about the hack in late July, weeks before it was publicly announced on September 7, 2017, in potential violation of insider trading rules. The company's shares fell nearly 14 percent after the announcement, but few expect Equifax managers to be held liable for their mistakes, face any regulatory discipline, or pay any penalties for profiting from their actions. To make amends to customers and clients in the aftermath of the hack, the company offered free credit monitoring and identity-theft protection. On September 15, 2017, the company's chief information officer and chief of security retired. On September 26, 2017, the CEO resigned, days before he was to testify before Congress about the breach. Numerous government investigations and hundreds of private lawsuits have been filed as a result of the hack. Equifax will pay at least $650 million, with the possibility of more, to resolve most claims stemming from the data breach. The settlement covers 147 million consumers, just under one-half of the population of the United States.

- Which elements of this case might involve issues of legal compliance? Which elements illustrate acting legally but not ethically? What would acting ethically and with personal integrity in this situation look like?

To return to the case of Martin Shkreli, let's examine it through some foundational theoretical lenses, based on ethical theories. Normative theories of ethics are primarily concerned with establishing standards or criteria that delineate what is considered ethical behavior. Common examples of normative ethical theories are utilitarianism, duty-based ethics (also known as Kantian ethics and/or deontology), and virtue ethics. These ethical theories, discussed in the following paragraph, provide a systematic means of examining and evaluating business conduct.

From an ethical theory perspective, Kantian or duty-based ethics emphasizes the underlying intent or reason behind a decision and whether that decision is good or bad. For example, if the decision to raise the price of a lifesaving drug by 5,000 percent is moral and if it is intended to add value, then an individual is obligated to raise the price. *Utilitarian ethics* focuses on the usefulness or utility of the decision. If the decision to raise the price adds value and usefulness for shareholders, then that decision should be made. The *Protestant work ethic* looks at the decision from the viewpoint of capitalism, free markets, and a sense of duty to ensure maximum return on investment. If the decision deals with a change that is financially sound and beneficial, if there are an adequate number of customers that need and value the HIV product and are willing to pay that price, then that decision should be made.

Proponents of *virtue ethics* claim that ethics consists of a series of innate but latent virtues that an individual needs to develop over time. These virtues consist of trust and derivatives of trust such as truthfulness. In this perspective, if the price hike is fair and equitable, if it is responsible to behave in this way, and if it does not cause harm to the society, then the price should be raised.

While it remains with the courts to determine the underlying intent, legal implications, and consequences of Shkreli's decision, evidence from this and other case studies shows that some corporate leaders have not developed ethical capabilities, or they have not internalized a moral compass that enables them to differentiate between right and wrong.

Developing a Moral Compass

A moral compass is a state of mind where an individual has developed the needed capabilities to differentiate between right and wrong, or between just and unjust in challenging circumstances. When individuals are able to act in an ethical manner systematically, habitually, and without struggling to decide how to act or what to do in difficult situations, they have internalized that moral compass. It can be said that these individuals possess a good character, are able to earn trust, and have qualities that are deemed necessary for leadership.

To develop and internalize a moral compass, an entrepreneur and the members of the organization need to continually exercise and develop their ethical "muscles." These ethics-based muscles include qualities such as trust, truthfulness, respect, responsibility, commitment, care, love, and justice. However, as you will learn, an entrepreneur needs to first provide the organizational framework and foundation in which individuals and business units regularly exercise these qualities. This framework and foundation include that everyone receive the right training, be given the opportunity to identify and close gaps in their behavior, receive recognition and incentives that reinforce good ethical behavior, and receive consistent, timely, and substantial consequences when they fail to act responsibly. These and other actions begin to help individuals develop and internalize an ethical compass.

LINK TO LEARNING

A white-collar criminal convicted of fraud, this interview with Mark Faris shows his admission that greed, arrogance, and ambition were motivating factors in his actions. He also discusses the human ability to rationalize our behavior to justify it to ourselves. Note his proposed solutions: practicing ethical leadership and developing awareness at an individual level via corporate training.

Legal Issues in Entrepreneurship

Unlike working in a large corporate environment with an established structure, entrepreneurs often create and operate a new business venture by their own rules. The pressure to create a new venture, within constraints and limitations, inspires entrepreneurs to find innovative ways to meet potential market demands. At the same time, the challenge to meet these expectations can create temptations and ethical pressures as entrepreneurs make a variety of decisions. Common areas rife with potential legal issues include contracts, torts, employment, intellectual property, conflicts of interest, full disclosure/truthfulness in product or service claims and performance, and antitrust/competition law (Figure 2.1.2.1).



Figure 2.1.2.1: There are many legal issues facing entrepreneurs, including intellectual property, contracts, antitrust laws, fraud, employment, and torts. *(CC BY 4.0; Rice University & OpenStax)*

Intellectual Property: Patents, Copyrights, and Trademarks

There are multiple reasons why an entrepreneur should be aware of intellectual property rights under the law. For example, if a new startup business comes up with a unique invention, it is important to protect that intellectual property. Without such protection, any competitor can legally, even if not ethically, copy the invention, put their own name or company brand on it, and sell it as if it were their own. That would severely curtail the entrepreneur's ability to make money off a product that s/he invented. Intellectual property (IP) rights are created by federal law and protect small businesses from problems such as this. IP law also helps establish brand awareness and secure secondary revenue streams.

Intellectual property (IP) is the output or result of the creative work of one or more individuals to turn a unique idea into a practical and value-added product/service; this manifestation of original ideas is legally protected. IP applies to anything that is the exclusive right of a firm, will help differentiate that organization, and will contribute to a sustained competitive advantage. This creative work can result in a product idea, a new invention, an innovative pivot, or an improvement in an existing product or service. IP can take the form of a patent, a copyright, a trademark, or a variation thereof called a trademark secret.

To develop a sustained competitive advantage, an entrepreneur is responsible to protect, provide the needed safeguards, and continually grow a firm's IP. These responsibilities include understanding, differentiating between, and dealing with the different types and technical aspects of a firm's IP. It also means that the entrepreneur should be concerned with the nontechnical aspect of IP, which is to develop a culture of creativity that enables the organization to deliver a continuous stream of new IP.

From a technical aspect, there are two different types of patents: utility and design patents (Figure 2.1.2.2). A **utility patent** protects a brand-new product idea or invention under US law for a period of twenty years. A few examples of utility patents would be Nikola Tesla's electric magnetic motor, dynamo-electric machine, electrical transmission of power, and his system of electrical distribution patents. A **design patent** protects the ornamental aspects of a product idea. Examples include the design of a new font, a soft drink bottle, or the design features of Apple's iPhone. In the US, design patents are typically protected for a period of fourteen years.

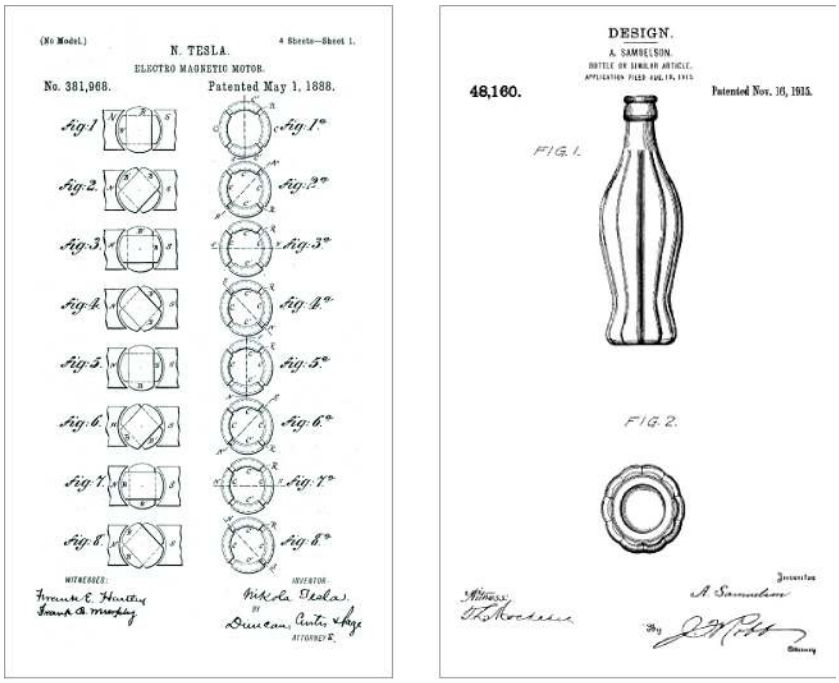
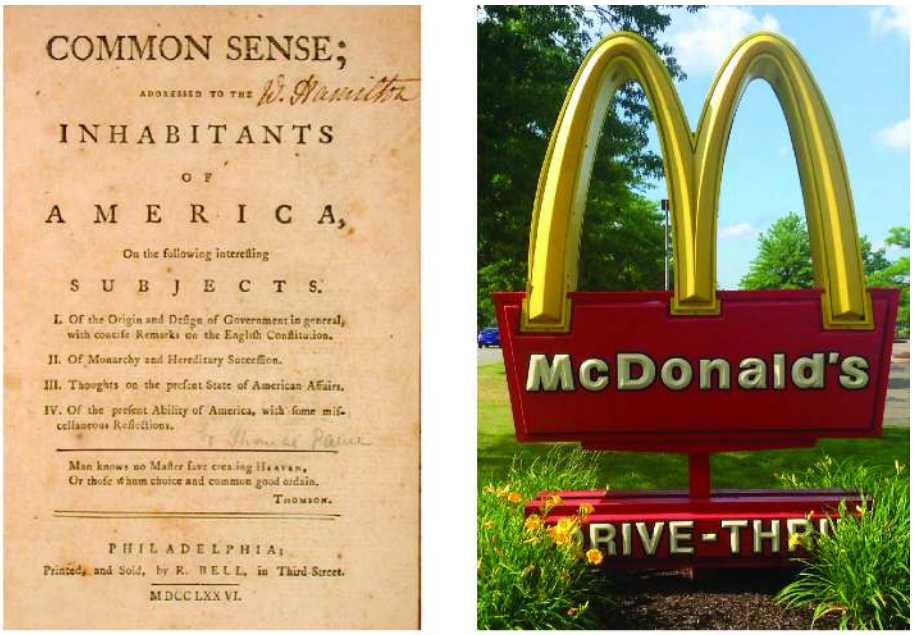


Figure 2.1.2.2: (a) This drawing of Nikola Tesla's alternating-current motor was granted U.S. Patent 381968 and represents a utility patent. (b) The design of the Coca-Cola soft drink bottle was granted a design patent. *(Credit (a): modification of modification of "US Patent US381968A" by Nikola Tesla/Google Patents, Public Domain; credit (b): modification of "Coke bottle patent" by Unknown/Wikimedia Commons, Public Domain)*

Copyrights and trademarks are also protected IP (Figure 2.1.2.3). A **copyright** grants the creator of a work the exclusive right to reproduction of the work for a specified period of time (usually the life of the author plus seventy years). A **trademark** is a registration that provides the owner the ability to use a name, symbol, jingle, or character in conjunction with a specific product or service, and prevents others from using those same symbols to sell their products. A trademark can be protected for an unlimited number of ten-year renewable terms as long as it is still in use. Finally, there is a special category of IP known as a **trade secret**. This concept refers to proprietary information, processes, or other internal knowledge that contribute to an organization's competitive advantage in a market. However, unlike patents, copyrights, and trademarks, a trade secret is not included as a protected category under federal IP law. A trade secret is dependent on being kept a secret by the business that owns it and is enforced through contract law.

Entrepreneurs should pay especially close attention to the legal implications of how patent law can affect a business. Patent laws are strictly enforced and are intended to protect inventions. This protection is afforded because a continuous stream of innovations can be a major source of revenue for a firm as well as a vehicle for developing a sustained competitive advantage. A legal patent gives an exclusive right to its patent holder or proprietor to use the invention in any shape or form they deem necessary. It also gives the patent holder the exclusive right to block or withhold access to others, or to sell the right to use the patent. This period of protection ranges from fourteen to twenty years, and is essentially a government-granted monopoly, after which, protection usually expires and competition is opened up to anyone (e.g., generic drugs).

Regardless of its type, a firm has the exclusive rights to the ownership of its IP. To protect those rights, it is important that a firm meticulously and immediately document each IP, the process and timeline by which each IP was developed, the resources used to develop the IP, the details of who owns and has access to the IP, and how others can obtain and use the IP.



(a) (b)

Figure 2.1.2.3: (a) Published texts and artwork are granted a copyright, which will expire over time (usually a long period), as is the case with Thomas Paine's seminal work *Common Sense*. (b) McDonald's iconic golden arches are a trademarked symbol, which usually do not expire unless abandoned. *(Credit (a): modification of "Commonsense" by Niki K/Wikimedia Commons, Public Domain; credit (b): modification of work by "JeepersMedia"/Flickr, CC BY 2.0)*

An entrepreneur should consider these questions when growing and protecting a firm's IP.

- Is IP law relevant to my business, and if so, how can it help me?
- How do we identify what IP to protect?
- What are the steps we need to take to get protection?

Less formally, the development of a culture of creativity and innovation is one of the most important responsibilities of an entrepreneur. This responsibility will enable the entrepreneur to develop a sustained competitive advantage. This means you should not be satisfied with an occasional spark of creativity from a designated individual, department, or functional area within your organization (such as research and development). You need to nurture an environment in which every member of your organization is able to be creative, add value, and be engaged in the continuous improvement of the firm. One example of this dynamic is the culture of continuous improvement at Toyota (Kaizen). In this culture, every member of the organization is expected to be creative and continually improve the processes they are engaged with on a daily basis.

The story of Nikola Tesla—a Serbian-American inventor, engineer, and physicist—offers a cautionary tale for why entrepreneurs need to be attuned to both the technical aspects of a venture's IP and its culture of creativity. Having filed 300 patents, Tesla is considered by many to be one of the fathers of modern electricity. After immigrating to the United States, Tesla was employed by the Continental Edison Company and began to develop AC technology. However, Edison preferred DC technology and was not supportive of Tesla's ideas. Tesla had to quit, teaming up with Westinghouse to open the Tesla Electric Light company, bringing his valuable creativity and ideas with him to his new venture. Eventually, Tesla's AC became the American standard, not Edison's DC.

Contracts and Torts

Every entrepreneur enters into contracts, usually on a regular basis, and thus should have an understanding of basic contract concepts. Likewise, most businesses are likely to have some involvement with tort law: that area of law that protects the rights of people not to be harmed physically, financially, or in any other way, such as a breach of privacy. Some areas of the business world involve a combination of tort law and contract law, such as litigation involving the wrongful termination of an employee.

Contracts can be formal or informal agreements. Ideally, you should use written contracts whenever you enter into a substantial transaction with another party. Oral agreements are enforceable in most situations; however, proving their terms can be difficult. If you are in the midst of a startup, chances are you are moving quickly. Perhaps you don't have the time, or the money, to hire a

lawyer to prepare a formal written contract. In that event, you should at least follow-up with all parties via traditional mail or email to document the key terms of your agreement. That way, if a dispute arises, you'll have documentation to fall back on.

Torts are a potential area of risk for entrepreneurs. Financial liability often results from the assumption of and exposure to risk; therefore, this is an important issue for entrepreneurs to manage. This is especially true for the concept of vicarious liability, which is the area of the law that imposes responsibility upon one person for the failure of another, with whom the person has a special relationship (e.g., employer and employee) to exercise reasonable care. Most employers understand they run a risk that their employees may commit a tort, and that they are responsible when employees cause harm to others (customers or coworkers) while on duty, working on company property, and using company equipment. However, many employers are not aware that employers can actually be liable for harm caused by an employee if that employee caused harm within the scope of his or her job duties. For example, if an employer asks an employee to drop something off at FedEx or UPS after work hours, and that employee negligently causes an auto accident, even if the employee is driving their personal vehicle and not a company car, the employer could be liable for damages. It is an all-too-common situation that could have serious liability consequences for an entrepreneurial business if adequate insurance is not procured.

Antitrust

Antitrust laws (or competition laws) were developed to ensure that one competitor does not abuse its position and power in the market to exclude or limit competitor access to the market. A few examples of antitrust laws are the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Bayh-Dole Act. These acts were created to encourage competition and provide options for consumers. In effect, these laws make it illegal for a competitor to make agreements that would limit competition in the market.

The antitrust concept is important to the entrepreneur's ability of entrepreneurs to form new startup businesses that are able to compete with larger, more established corporations (which may try to discourage competition). Table 2.1.2.1 summarizes the contributions of these acts to supporting antitrust efforts. It is important to note that any deviation from these laws may result in long and costly legal problems.

Table 2.1.2.1: Antitrust Acts

Antitrust Act	Protection
Sherman Act (1890)	Prohibits attempts to monopolize
Clayton Act (1914)	Prohibits price fixing, related practices
Federal Trade Commission Act (1914)	Prohibits unfair business practices
Bayh-Dole Act (1980)	Encourages development of inventions

An example of illegal competition would be the competition and patent war between Intel Corporation and American Micro Devices (AMD). In 2009, AMD filed a suit against Intel claiming that the company had used "leveraging dominance" to exclude AMD from effectively competing in the marketplace through exclusionary pricing, discounts, and similar practices. This claim was later settled by the two firms and resulted in Intel paying AMD $1.25 billion in damages.

Conflict of Interest

A **conflict of interest** occurs when an individual (or company) has interests in multiple areas (financial investments, work obligations, personal relationships), and the interests may conflict with each other. Employees, for example, have an interest in producing expected work for their employer. A conscious or deliberate attempt to avoid, ignore, or marginalize that which is rightfully due an employer by addressing other interests would be a conflict of interest. This could be as simple as using company time or resources to work on a personal project that has not been sanctioned and will not add value to the company. It could also mean using the tangible and intellectual resources of a company on something that will benefit your private interests instead of your employer's. This action is unethical since you are not giving the employer what they are due, which are your time, talents, and services in exchange for agreed-upon compensation. Consider the example of Mike Arrington, a Silicon Valley lawyer and entrepreneur who created a blog called TechCrunch. Arrington became the go-to source for tech enthusiasts and investors. His coverage of Silicon Valley-based startup companies could help ensure the successful launch of a new business or product. However, he was criticized for routinely covering stories about the companies he invested in and consulted for. Although he

provided full disclosures of his interests, rival critics challenged his conflicts of interest. How could he simultaneously be both an investor and an independent journalist blogging about the very companies in which he had a financial interest? He was in a classic conflict of interest position. Similar cases involving business reporters and potential conflicts of interest include *The Wall Street Journal*, *Business Week*, *Time* magazine, and the *L.A. Herald Examiner*.

Another situation in which potential conflicts arise is in the area of professional services, which attracts many young potential business owners. Perhaps you want to start your own CPA accounting firm, or CFP financial advisory firm, or IT consulting firm. A professional must be very cautious about conflicts of interest, especially in areas in which you owe a fiduciary duty to your clients. This requires a very high duty of conduct and full disclosure, one that prohibits being involved in both sides of a transaction. For example, as an IT consultant, do you recommend to a client that they buy a software product, when unknown to them, you own stock in that company? Or as a financial advisor, are you getting commissions on both ends of a transaction?

Fraud: Truthfulness and Full Disclosure

Ethical entrepreneurs consistently strive to apply ethics-based concepts in practice, including truthfulness and full disclosure. These two concepts are not only part of an ethical approach to doing business but are also underlying requirements of several areas of law including fraud. A business that makes/sells a product or service has responsibility for fully disclosing the truth about its products/services.

The underlying facts, reality, and evidence behind something are the **truthfulness** of a matter. An individual who is being truthful is exercising the capability of being factual about a subject matter, dealing with reality, and aware of evidence. Truthful individuals earn a level of credibility and reliability over time because what they say and what they do are in alignment. A corollary of truthfulness is fairness, which means to be impartial, unbiased, and in compliance with rules and standards of right and wrong behavior. **Fairness** deals with doing what is right, just, and equitable. From the standpoint of application, the quality of being truthful forms the foundation for fairness.

Disclosure describes sharing the needed facts and details about a subject in a transparent and truthful way. This information should be adequate, timely, and relevant to allow the recipient to understand the purpose and intent behind a product/service and to make a good decision about the value of that product/service. Any deliberate attempt to hide, change, or bend the truth is an unethical and irresponsible action subject to criminal investigation.

One example of a firm that has repeatedly run into several serious, embarrassing, and costly legal issues is Eli Lilly. In one instance, this company admitted in court that they had illegally marketed Zyprexa, which was primarily intended and approved by the US Food and Drug Administration office (FDA) to treat depression, to be used for off-label (not cleared by FDA to market and advertise) ailments such as sleep disorders, Alzheimer's disease, and dementia. As a result, in 2009, Eli Lilly was fined $1.4 billion by the office of criminal investigation of the US Department of Justice.

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2.1.3: Corporate Social Responsibility and Social Entrepreneurship

Learning Objectives

By the end of this section, you will be able to:

- Define and describe corporate social responsibility (CSR) and social entrepreneurship
- Identify types of social entrepreneurship ventures, and the key values accompanying them

To understand the role of a socially responsible entrepreneur, it is important to first look at the major tenets of corporate social responsibility (CSR) and the underlying reason why this concept was conceived. Few directives in business can override the core mission of maximizing shareholder wealth, and today, that particularly means increasing quarterly profits. Such an intense focus on one variable over a short time (i.e., a short-term perspective) leads to a short-sighted view of what constitutes business success.

Measuring true profitability, however, requires taking a long-term perspective. We cannot accurately measure success within a quarter of a year; a longer time is often required for a product or service to find its market and gain traction against competitors, or for the effects of a new business policy to be felt. Satisfying consumers' demands, going green, being socially responsible, and acting above and beyond the basic requirements all take time and money. However, the extra cost and effort will result in profits in the long run. If we measure success from this longer perspective, we are more likely to understand the positive effect ethical behavior has on all who are associated with a business.

Corporate Social Responsibility (CSR)

If you truly appreciate the positions of your various stakeholders, you will be well on your way to understanding the concept of **corporate social responsibility** (CSR). CSR is the practice by which a business views itself within a broader context: as a member of society with certain implicit social obligations and environmental considerations and issues. As previously stated, there is a distinct difference between legal compliance and ethical responsibility, and the law does not fully address all ethical dilemmas that businesses face. CSR ensures that a company is engaging in sound ethical practices and policies in accordance with the company's culture and mission, above and beyond any mandatory legal standards. A business that practices CSR cannot have maximizing shareholder wealth as its sole purpose, because this goal would necessarily infringe on the rights of other stakeholders in the broader society. For instance, a mining company that disregards its CSR may infringe on the right of its local community to clean air and water if it pursues only profit. In contrast, CSR places all stakeholders within a broader contextual framework.

An additional perspective of CSR is that ethical business leaders opt to do *good* at the same time that they do *well*. This is a simplistic summation, but it speaks to how CSR plays out within any corporate setting. The idea is that a corporation is entitled to make money, but it should not only make money. It should also be a good civic neighbor and commit itself to the general prospering of society as a whole. It ought to make the communities of which it is part better at the same time that it pursues legitimate profit goals. These ends are not mutually exclusive, and it is possible—indeed, praiseworthy—to strive for both. When a company approaches business in this fashion, it is engaging in a commitment to CSR.

An interesting example of an entrepreneurial company that is committed to CSR is the New Belgium Brewing Company (NBBC), maker of Fat Tire Beer, among other brands. The NBBC is 100 percent employee-owned, which makes this company different from the more traditional corporation in which investors own the company rather than the employees. This type of company with employee ownership means that the workers benefit directly from the profits generated by their efforts for the company, a sort of democratized capitalism. The NBBC is focused on sustainability. It has a brewery in Fort Collins, CO, where the brewery produces almost 20 percent of its own electricity—a large percentage for a commercial factory—through solar panels and wastewater. It makes a corporate commitment to contribute to causes related to sustainability, for example, to bicycle-related organizations supplying people with green personal transportation options. According to the company's director of CSR, the NBBC considers social and environmental well-being to be a high priority of the company.

From a historical perspective, the development of CSR has been somewhat like a rollercoaster ride, characterized by low points with extreme ethical failures (see Table 2.1.3.1) followed by high points in which corporate conduct improved, largely as a result of statutory laws and/or agency regulations enacted in response to failures. After such scandals, we also saw a number of voluntary ethics-based ideas begin to find their way into the corporate world, such as CSR and corporate citizenship. While these concepts

have provided strategies and tools to strengthen the ethical foundations of businesses, scandals do continue, and new approaches to address them emerge. Ethical failures such as the Michael Milken/Drexel Burnham Lambert scandal, the Enron collapse, and many others, including the recent 2008/2009 mortgage industry/derivatives scandal, led Congress to enact new laws. Examples of statues enacted by the federal government in response to ethical failures include laws such as the Sarbanes-Oxley Act, the Insider Trading and Securities Fraud Enforcement Act, and the Dodd-Frank Act.

In addition to the enactment of statutory reforms, various government agencies have also promulgated new regulations in an attempt to prevent companies from engaging in unethical, illegal, and otherwise damaging activities. Examples of agencies that have created new regulations in response to ethical failures in the business sector include the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), the Consumer Financial Protection Bureau (CFPB), and the Financial Industry Regulatory Authority (FINRA).

The concept of doing what's right ethically, following the law, and giving back to society are closely related concepts (see Table 2.1.3.1).

Table 2.1.3.1: Corporate Social Responsibility, Ethics, and Law

Area of Responsibility	Desired Outcome	Compliance
Legal	Comply with laws/regulations	Required by government
Financial	Profits	Required by shareholders
Ethical	Act fairly/avoid doing harm	Expected by stakeholders
Social/philanthropic	Be a good "corporate citizen"	Desired by society

Notice which duties, or responsibilities, are mandatory versus discretionary.

Examples of organizations that have experienced ethical lapses causing serious and costly multi-billion-dollar problems can be seen in Table 2.1.3.2. Each has had a profound and far-reaching impact on the lives of individuals, on the communities and society in which they operate, and/or on the global environment. These problems—which have resulted in loss of lives, loss of jobs, property damage, depletion of life savings, and environmental devastation—resulted from issues of quality and ethics.

Table 2.1.3.2: Examples of Multi-Billion Dollar Corporate Responsibility Problems

Organization	Area of Failure
Chevron Corporation	Amazonian toxic waste disposal disaster
Volkswagen Group	Diesel emissions scandal
Takata Corporation	Defective airbag problems
General Motors	Defective ignition switch problem
Wells Fargo Financial Services	Unethical banking practices
BP P.L.C. (British Petroleum)	Gulf of Mexico oil spill disaster
ENRON Corporation	Illegal accounting practices
Union Carbide India	Bhopal chemical disaster
Pfizer, Elli Lilly	Fraudulent marketing practices
US Corps of Engineers	Hurricane surge protection disaster
Toyota Motor Corporation	Uncontrollable vehicle acceleration
Nike Corporation	Breach of code-of-conduct/labor laws
Intel Corporation	European union antitrust case
Flint Michigan	Flint, Michigan, water disaster
Phar-Mor, Inc.	Largest accounting fraud
Bernard L. Madoff Investment Securities, LLC	Madoff Ponzi scheme

One vulnerability in the corrective measures discussed to address the scandals listed in Table 2.1.3.2 is that they do not necessarily prevent the repeat of ethical deviations because they are primarily compliance and fear-based. In some instances, instead of preventing unethical activity, the system has enabled unethical leadership to take minimum actions and merely pay fines rather than correct their actions or change their approach.

WORK IT OUT

General Motors' Failure to Consider Stakeholders

General Motors (GM) has struggled with its brands and its image. Over the years, it has jettisoned some of its once-popular brands, including Oldsmobile and Pontiac, sold many others, and climbed back from a 2009 bankruptcy and reorganization. The automaker was hiding an even bigger problem, however: The ignition switch in many of its cars was prone to malfunction, causing injury and even death. The faulty switches caused 124 deaths and 273 injuries, and GM was finally brought to federal court. In 2014, the company reached a settlement for $900 million and recalled 2.6 million cars.

The case exemplifies the tension between the concept that "the only goal of business is to profit, so the only obligation that the business person has is to maximize profit for the owner or the stockholders" on one hand, and the ethical obligations a company owes to its other stakeholders on the other. GM's failure to consider its stakeholders and consumers when choosing not to report the potential for malfunction of the ignition switches led to an ethical breakdown in its operations and cost the company and its customers dearly. In addition, by treating customers as only a means toward an end, the company turned its back on a generation of loyal buyers.

- What virtues and values shared by its long-time customers did GM betray by failing to disclose an inherent danger built into its cars?
- How do you think that betrayal affected the company's brand and the way car buyers felt about the firm? How might it have affected its shareholders' views of GM?

In recent years, many organizations have embraced CSR, in which the company's expected actions include not only producing a reliable product, charging a fair price with fair profit margins, and paying a fair wage to employees, but also caring for the environment and acting on other social concerns. Many corporations work on prosocial endeavors and share that information with their customers and the communities in which they do business. CSR, when conducted in good faith, is beneficial to corporations and their stakeholders. This is especially true for stakeholders that have typically been given low priority and little voice, such as the natural environment and community members who live near corporate sites and manufacturing facilities. CSR in its ideal form focuses managers on demonstrating the social good of their new products and endeavors. It can be framed as a response to the backlash that corporations face for a long track record of harming the environment and communities in their efforts to be more efficient and profitable.

The trend to adopt CSR may represent an opportunity for greater engagement and involvement by groups mostly ignored until now by the wave of corporate economic growth reshaping the industrialized world.

Social Entrepreneurship

Social entrepreneurship describes ventures launched by entrepreneurs who are first and foremost advocates or champions for a social cause. However, they are able to leverage that cause as a platform to develop and maintain an economically viable organization. These individuals are primarily driven and motivated by a higher vision or grander purpose. This new breed of entrepreneur leverages the power of their position, their standing in the community, and the potential synergy and wealth-creation power of an enterprise as a vehicle or platform to advance their social goals and personal agenda. These social causes often include a solution for a costly and chronic social problem or pain, a social wrong or injustice that must be corrected, or a global issue that has been either overlooked or marginalized by society or organizations.

While the primary goal and end-state for a socially responsible entrepreneur is to generate wealth, the dominant goal for a social entrepreneur is to serve a specific cause as they generate wealth to support that cause. This means a social entrepreneur works to advance society instead of accumulating greater wealth for the shareholder. Social entrepreneurs often share qualities such as a selfless attitude, a sense of obligation and responsibility towards someone or something, a strong commitment to make a change, and a resilience to withstand failure.

There are numerous examples of companies that have embraced the concept of CSR. In fact, some entrepreneurs have created startups based primarily on the idea of giving back, many of whose ventures have become well-known. The list includes, to name a few, TOMS Shoes (discussed in a feature box in this chapter), Bombas Socks, and Warby Parker Eyewear. Each of these companies follows a CSR approach and donates one product for each one purchased, (shoes, socks, glasses). Some companies go the extra mile and become officially certified as B-corporations, which is a CSR-type of designation.

Environmental Entrepreneurship

Similar to social entrepreneurship, **environmental entrepreneurship** advocates for a meaningful and beneficial social cause that is also economically viable. This environmental focus deals with such initiatives that preserve our ecosystem such as clean and renewable energy, waste management, programs to counteract climate change, improved water supplies, protection of biodiversity, and reduction of environmental degradation and deforestation. These initiatives are financially sound from a business standpoint and, at the same time, don't pollute, waste, destroy, and leave a negative environmental footprint.

There are multiple ways in which an entrepreneur can demonstrate a commitment to environmental awareness. One way is to own a company that directly helps clean up the environment, such as Ocean Cleanup, the nonprofit started by a twenty-five-year-old entrepreneur to clean up the Great Pacific Garbage Patch. Another option is to own a traditional private sector company that pledges to operate in an environmentally responsible way, such as Patagonia, committed to responsible sourcing and other initiatives. A third option is to become part of an advocacy organization, an example of which is E2. E2 is "a national, nonpartisan group of business leaders, investors and others who advocate for smart policies that are good for the economy and good for the environment." This group strives to influence policies at the state, regional, and federal levels dealing with energy, climate, oceans, water, transportation, and smart growth. These policies are primarily intended to improve air, water, public health, as well as job creation in these areas. One example of an initiative that has resulted from this group deals with passing the nation's first automobile emissions standards.

In recent decades, corporations have responded to stakeholder concerns about the environment and sustainability. In 1999, Dow Jones began publishing an annual list of companies for which sustainability was important. Sustainability, in this context, is the practice of preserving resources and operating in a way that is ecologically responsible in the long term. The Dow Jones Sustainability Indices "serve as benchmarks for investors who integrate sustainability considerations into their portfolios." There is a growing awareness that human actions can, and do, harm the environment. Destruction of the environment can ultimately lead to reduction of resources, declining business opportunities, and lowered quality of life.

Enlightened entrepreneurs realize that profit is only one positive effect of business operations. Operating a successful business creates opportunities for entrepreneurs to give back to society in responsible ways. In addition to safeguarding the environment, other ethical contributions that entrepreneurs can consider include establishing schools and health clinics in impoverished neighborhoods and endowing worthwhile philanthropies in the communities in which companies have a presence.

During the last few decades, there has been an explosion of studies on how business activities affect our planet. In one study, Tony Juniper points out that population growth, with its accompanying demand for natural resources and the impact of environmental disasters, has had a profound and lasting impact on the planet. Juniper states that we have increased our consumption of natural resources tenfold, increased grain production fourfold, increased freshwater usage fivefold, increased fish capture fourfold, doubled our consumption of earth's renewable production, and increased the concentrations of greenhouse gases in the atmosphere.

In prior sections, we briefly discussed the devastating environmental impact of oil companies such as Texaco and Chevron. When you drill for oil in one of the most biodiverse corners of the world, the Ecuadorian rainforest of the Amazon, and dump 18.5 billion gallons of oil byproducts and waste into the Amazon's rainforest and streams, you are definitely leaving a negative footprint on our planet. If you meticulously study the local wildlife, vegetation, and other natural characteristic of a region before clearing a region to conduct your business (e.g., harvest the trees for lumber, plants for medication, or drill for oil) and then restore the region to its original natural form when done, you are neutralizing your footprint on the planet. However, if you enhance and strengthen the region, open up schools, provide jobs, educate the local population to preserve and strengthen their natural resources, and take other actions to improve the region, you are in fact leaving a positive footprint on the planet. Entrepreneurs should learn the impact made by all aspects of their company, weigh the choices, and consider adopting a policy that does no harm and possibly leaves a positive footprint on the planet.

LINK TO LEARNING

Elon Musk, founder of the electric car manufacturer Tesla and other companies, recently spoke at a global conference held at the Panthéon-Sorbonne University in Paris. Watch this video of Musk explaining the effects of carbon dioxide emissions on climate change in clear and simple terms.

Sustainability

Sustainability deals with actions and a way of life that considers the continuity of future generations. It is deeply rooted in doing what is moral/ethical. For example, it is unjust to take actions that benefit the current generation at the detriment of future generations. What this means is that a sustainable entrepreneur is also driven by and is an advocate for a socially responsible approach to owing and running a business, leveraging the economic potential of renewable and readily available resources to add value to the world in which it operates. However, sustainability means more than just environmental awareness. A simple definition of **sustainability** is the ability to be maintained at a certain rate or level. This means not only the environment, but also natural resources, human resources, product supply chains, and multiple related concepts. Thus, as an entrepreneur aware of issues related to sustainability, one would want to consider a wide range of issues. Examples might include the responsible use of electricity or water, or participating in supplier diversity/responsible sourcing programs, or funding worker wellness initiatives. The idea of sustainability, at its root, is to think long term as opposed to short term.

Given the prominence of the sustainable environment movement worldwide, no well-managed business today should be conducted without an awareness of the tenuous balance between the health of the environment and corporate profits. It is quite simply good business practice for executives to be aware that their enterprise's long-term sustainability, and indeed its profitability, depend greatly on their safeguarding the natural environment. Ignoring this interrelationship between business and the environment not only elicits public condemnation and the attention of lawmakers who listen to their constituents, but it also risks destroying the viability of the companies themselves. Virtually all businesses depend on natural resources in one way or another.

Responsible Entrepreneurs and Social Entrepreneurship Opportunities

The ability to establish a new venture is an exciting opportunity and privilege. To intentionally plan and establish a new venture in a responsible manner promotes the continuation of a better world. Development of a new venture that supports an awareness and sensitivity to immediate and long-term impacts reflects upon the entrepreneur's personal and organizational values and goals.

Some entrepreneurs start businesses with a community project in mind. A community project venture leverages the available power, synergy, talents, capabilities, and resources of the community to add value and change the world in a positive way. This approach uses the creativity, viewpoints, and feelings of community members to innovate and add value to the local area. An example is that of an entrepreneur who started a company with the idea of giving back to the community.

ENTREPRENEUR IN ACTION

The Story of the TOMS Shoes Entrepreneur in His Own Words by Blake Mycoskie

Read Blake Mycoskie's own telling of how he founded TOMS Shoes: ""In 2006 I took some time off from work to travel to Argentina. I was twenty-nine years old and running my fourth entrepreneurial startup: an online driver's education program for teens. Argentina was one of the countries my sister, Paige, and I had sprinted through in 2002 while we were competing on the CBS reality program The Amazing Race." "I met a woman volunteering on a shoe drive who explained that many kids lacked shoes, even in relatively well-developed countries like Argentina, an absence that didn't just complicate every aspect of their lives—including essentials like attending school and getting water from the local well—but also exposed them to a wide range of diseases. Her organization collected shoes from donors and gave them to kids in need. Their complete dependence on donations meant that they had little control over their supply of shoes." "My first thought was to start my own shoe-based charity, but instead of soliciting shoe donations, I would ask friends and family to donate money to buy the right type of shoes for these children on a regular basis. I have a large family and lots of friends, but it wasn't hard to see that my personal contacts could dry up sooner or later. And then what? These kids needed more than occasional shoe donations from strangers." "Then I began to look for solutions in the world I already knew: business and entrepreneurship. An idea hit me: Why not create a for-profit business to help provide shoes for these children? Why not come up with a solution that guaranteed a constant flow of shoes, not just whenever kind people were able to make a donation?" "And for every pair I sell, I'm going to give a pair of new shoes to a child in need. There will be no percentages and no formulas. It was a simple concept: Sell a pair of shoes today, give a pair of shoes tomorrow." "Something about the idea felt so right, even though I had no experience, or even connections, in the shoe business. I did have one thing that came to me almost immediately: a name for my new company. I called it TOMS. I'd been playing around with the phrase "Shoes for a Better Tomorrow," which eventually became "Tomorrow's Shoes," then TOMS. (Now you know why my name is Blake but my shoes are TOMS. It's not about a person. It's about a promise—a better tomorrow.)" "I got a break with an article about my new startup, TOMS, in the *LA Times*, it was a headline story. By the end of that day, we'd received 2,200 orders. That was the good news. The bad news was that we had only about 160 pairs of shoes left sitting in my apartment. On the website, we had promised everyone four-day delivery. What could we do?" "Craigslist to the rescue. I quickly posted an ad for interns and soon I had selected three excellent candidates, who began working with me immediately. We ended up selling 10,000 pairs of shoes that first summer—all out of my Venice apartment.""

There are multiple types of business entities that function with a social purpose in mind. *Nonprofit* organization entrepreneurs (as well as those starting for-profit companies such as the TOMS story) have the potential to look beyond their own financial gains. These organizations typically partner with federal, state, or local government organizations, public and private institutions, foundations, or individuals with financial means and community standing to serve the greater public. One example of a nonprofit initiative is the National Kidney Foundation of Arizona. This organization seeks solutions for kidney and urinary diseases through education, prevention, and treatment.

A *cooperative venture* leverages the talents, finances, and intellectual resources of the members of an organization to operate and deliver value to the members of the organization. One difference between a cooperative and a nonprofit corporation is how money flows back into the community. In a nonprofit organization, the managers cannot distribute profits to members or investors; the remaining money stays in the nonprofit. In contrast, a cooperative generally can distribute profits to members based on member participation/temporary ownership. One example of a cooperative would be the Unity One Credit Union, which is a member-owned, not-for-profit cooperative, working for its members' benefit.

Two other types of entities that are essentially the same are known as *social enterprises* or *social purpose businesses*. These entities are primarily driven by a meaningful social cause. Social entrepreneurs are able to meet their strategic organizational goals and objectives by delivering a value-added product/service that closes a gap, addresses a problem or pain, or corrects a social injustice. A social enterprise is typically designed to be financially self-sufficient. One example of a social entrepreneur and a social enterprise is the Grameen Bank founded by Muhammed Yunus, a Nobel Peace Prize laureate who defined the term micro-lending and micro-finance. Grameen Bank thrives on giving small loans to those individuals who have very little to no collateral and wish to start a business to support their family.

A social purpose business is often referred to as a B- or benefit Corporation. The process of becoming a certified B-corporation is a formal process that involves compliance with various standards and an audit of this compliance (managed by the B-Corp organization). The essence of these new B-corporations is that "they recognize the imperative to do no harm and create positive impact throughout the value chain." According to the B-Corp organization, these certified businesses are legally required to consider the impact of their decisions on their workers, customers, suppliers, community, and the environment. As of 2019, there are approximately 3,000 certified B-corps in 65 countries, covering 150 different industries.

One example of a certified B- (or benefit) corporation is Kickstarter, the crowdfunding website. Kickstarter is one of the world's largest funding communities for creative projects—everything from films, games, restaurants, and music to art, design, and technology—and offers entrepreneurs a way to raise funds when they cannot borrow from a bank.

A *hybrid venture* uses a combined business strategy to enable the organization to deliver profitable and socially valued products and services. The hybrid business model attracts different investors and capitalizes on a variety of investment opportunities, while supporting a mission centered on a socially meaningful cause and grander purpose. One example is Embrace Innovations, a manufacturer of incubators for infants born prematurely, originally established as a nonprofit entity. Embrace, an example of a relationship between academic and business, was started as part of a special course at Stanford University. The Stanford Design for Extreme Affordability Program consists of a course for student teams seeking further support (the Social Entrepreneurship Lab and the Design Lab). This project was launched in 2007, the company was formed in 2008, and the first version of the product launched in 2011. The product is currently being distributed to clinics in India, where dozens of babies have already benefited. Partnerships have been formed with several multinational organizations to distribute the product.

LINK TO LEARNING

Female entrepreneur Stacey Edgar started Global Girlfriend on a very small budget and a larger social cause. Through hard work by a team of people, she built a business organization founded on the premise of wanting to have a social impact. The company eventually supported up to 100 different women-led organizations in over thirty countries. Her goal was for the company not only to touch the lives of end customers, but also change the supply chain of retail apparel distribution. It is an example of a successful entrepreneurial startup spreading the message of women's empowerment.

When launching a social enterprise, you need to consider both the technical aspects of launching an enterprise as well as the underlying cause or purpose that has driven you to launch a social enterprise. As you develop your business model, marketing strategy, and other elements to support your venture, it is crucial to ensure your grander purpose remains the foundation of your business planning and decisions.

Identifying Your Values and Mission

The values we choose to honor are the essence of ourselves, and we carry them with us wherever we live, work, and play. As we noted, the entrepreneurial path you choose should reflect your values, whether you create a for-profit or nonprofit organization. It also is possible that you might establish a for-profit company and volunteer extensively on your own or on behalf of your firm in the nonprofit sector. Whatever your entrepreneurial path, it remains important not to let your well-considered values be diminished by others who do not prize loyalty or industriousness, for instance. Entrepreneurship is not a contest in which the person who finishes with the biggest portfolio or fastest jet skis wins anything other than an empty prize. It is far better to treat others with integrity and respect, and be surrounded by the true emblems of a successful career—family, friends, and colleagues who will attest to the dignity with which you have worked. In the final analysis, if you achieve a life of honor, then you have succeeded.

How do you keep personal values like integrity, fairness, and respect close at hand? The best way is by writing them down, prioritizing them, and fashioning them into a personal mission statement. Most companies have mission statements, and people can have them, too. Yours will guide you on your path, clear away distractions on the road, and help you correct any missteps. It should be flexible, too, to account for changes in yourself and your goals. Your mission statement is not a global positioning system so much as a compass that guides you toward discovering who you are and what drives you (Figure 2.1.3.1).



Figure 2.1.3.1 : Entrepreneurs should develop a personal mission statement to avoid straying from the path they have set for themselves. A personal mission statement can serve as an ethical/moral compass, guiding an individual through his or her professional and personal life.

(Credit: modification of "Adventure Compass Hand Macro" by "Pexels"/Pixabay, CC0)

Let us write your mission statement. Because it will reflect your values, start by identifying a handful of values that matter most to you. You can do this by answering the questions in Table 2.1.3.3; you may also find it beneficial to keep a journal and update your answers to these questions regularly. Additionally, the US Department of Labor has a free online self-assessment called the Interest Profiler. The Interest Profiler can help you find out what your interests are and how they relate to the world of work. The Interest Profiler can help you focus on avenues of interest that you might want to explore as an entrepreneur.

LINK TO LEARNING

Click on the O*Net Profiler link and take the self-assessment. It's quick, fun, and easy.

Table 2.1.3.3: Identifying Your Values

1. Of all the values that matter to you (e.g., honesty, integrity, loyalty, fairness, honor, hope), list the five most important.
2. Next, write down where you believe you learned each value (e.g., family, school, sports team, belief community, work).
3. Write a real or potential challenge you may face in living each value. Be as specific as possible.
4. Commit to an action in support of each value. Again, be specific.

Now you can incorporate these values into your business mission statement, which can take the form of a narrative or action. There are many formats you can follow, but the basic idea is to unite your values with the goals you have set for your life and career. You can, for instance, link the benefit you want to create, the market or audience for which you want to create it, and the outcome you hope to achieve. Keep your statement brief. Richard Branson, founder of the Virgin Group, wants "to have fun in [my] journey through life and learn from [my] mistakes." Denise Morrison, CEO of Campbell Soup, aims "to serve as a leader, live a balanced life, and apply ethical principles to make a significant difference." Your own statement can be as simple as, for instance, "to listen to and inspire others," or "to have a positive influence on everyone I meet."

LINK TO LEARNING

Read this blog, "The Ultimate Guide to Writing Your Own Mission Statement," by Andy Andrews for more information about creating a personal mission statement.

Watch the TEDx talk "How to Know Your Life Purpose in Five Minutes" about the self and identifying values to learn more.

Putting Your Values and Mission Statement to the Test

There may be no better place to put your personal values and mission to the test than in an entrepreneurial role. Startups cannot be run on concepts alone. More than almost any other kind of venture, they demand practical solutions and efficient methods. Entrepreneurs usually begin by identifying a product or service that is hard to come by in a particular market or that might be abundantly available but is overpriced or unreliable. The overall guiding force that inspires the startup then is the execution of the company's mission, which dictates much of the primary direction for the firm, including the identification of underserved customers, the geographic site for operations, and the partners, suppliers, employees, and financing that help the company get off the ground and then expand. In a brand-new organization, though, where does that mission come from?

The founder or founders of a firm develop the company's mission directly from their own personal beliefs, values, and experience; this is particularly true for nonprofits. Sometimes the inspiration is as simple as the recognition of an unmet need, such as the rising global demand for food. Bertha Jimenez, an immigrant from Ecuador who was studying engineering at New York University, could not help but be concerned that while craft breweries were riding a wave of popularity in her adopted city, they were also throwing away a lot of barley grain that still had nutritional value but that no one could figure out how to reuse it. After a few attempts, Jimenez and two friends, also immigrants, finally hit on the idea of making flour out of this barley grain, and thus was born the Queens, New York-based startup Rise Products, whose website proclaims that "Upcycling is the future of food."

Rise Products supplies local bakers and pasta makers with its protein- and fiber-packed "super" barley flour for use in products from pizza dough to brownies. It has also sent product samples on request to Kellogg, Whole Foods, and Nestlé, as well as to a top chef in Italy. Jimenez and her fellow co-founders say, "In the long term, we can bring this to countries like ours. We want to look at technologies that won't be prohibitive for other people to have."

If we were to diagram the relationship between founders' values and the entrepreneurial mission, it would look something like this:

personal values → personal mission statement → entrepreneurial mission statement

Just as a personal mission statement can change over time, so can the company mission be adapted to fit changing circumstances, industry developments, and client needs. TOMS Shoes, profiled earlier, is an example of a business that has expanded its mission to also offer eyeglasses and improved access to clean water to people in developing countries, in addition to its original mission of shoes for the needy. It calls itself the "One for One" company, promoting founder Blake Mycoskie's promise that "With every product you purchase, TOMS will help a person in need."

The point is, if you have clarified your personal values and mission statement, there is almost no limit to the number of ways you can apply them to your business goals and decisions to "do good and do well" in your entrepreneurial career. The purpose of business is relationships, and the quality of relationships depends on our acceptance of self and concern for others. These are developed through the virtues of humility on one hand and courage on the other. The demanding but essential task of life is to practice both. In that way—perhaps *only* in that way—can we be truly human and successful business professionals.

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2.1.4: Developing a Workplace Culture of Ethical Excellence and Accountability

Learning Objectives

By the end of this section, you will be able to:

- Describe workplace challenges in an entrepreneurial culture
- Distinguish between reactive and proactive approaches to managing ethics
- Describe the foundations and framework of an organizational culture of ethical excellence
- Define the components of an ethical workplace

Successful entrepreneurs understand that the workplace of 2020 is quite different from that of 2000, just twenty years ago. As the heading to this section suggests, progressive entrepreneurs want to create a workplace culture of ethical excellence. However, doing that means understanding a changing workforce, both in terms of demographics and values. Millennials, born between 1983 and 1995, now outnumber baby boomers in the workforce, and by 2025, will compose three-quarters of all workers on a global basis. Entrepreneurs and managers who are in a position to hire and supervise millennial workers must adjust to the differing expectations and demands of a mid-twenty-first century workplace. This is especially true with regard to CSR/ethics. What matters most to millennials, according to a recent *New York Times* article, is that work aligns with their values.

Approximately 60 percent of millennial workers would agree to work for 15 percent less money just for the chance to work for a company whose business values parallel their personal values. It turns out that millennials don't just want a job, they want a job that matters—one in which they can do rewarding work that achieves a worthwhile outcome. In other words, they want the work they do to mean something. Furthermore, according to an article in the *Texas Bar Journal* by career coach and consultant Martha Newman, millennial workers place a high value on workplace policies that promote open communication, collaboration, and participation in short- and long-term decision-making with their employer. Newman also says that millennials expect a degree of work-life balance; career isn't all that matters in their life.

What this means for entrepreneurs who manage employees is that they must adjust. For example, an owner can create a workplace in which there is a culture ensuring that people matter as much as money, where there is work-life balance with things like flexible scheduling, and where good work is recognized and rewarded. There's an adage that says, "People don't quit their job, they quit their bosses." If you don't want a very high turnover rate among your workforce, be the kind of boss that millennials want to work for and with.

Entrepreneurial Culture

A fairly common characteristic of successful startups is charismatic, driven founders with competitive mentalities. After all, it takes a thick skin and powerful ego to get through the inevitable disappointments that confront a startup leader. Often, however, companies discover that a different leadership ethos is necessary as they grow. Could entrepreneurs still succeed if they also embraced a humanistic leadership style at the outset, or would this invariably undermine the already low initial odds of success? It is a difficult problem with which many firms wrestle. Dedicated employees may be put off by demanding leaders who are harsh, giving little back to loyal workers even after achieving success. New employees may decide the working climate is less congenial than they anticipated and simply leave.

One question an ethical entrepreneur should ask is this: Do my employees feel like they can speak freely? In reality, at many companies, according to SHRM (Society for Human Resource Management), human resources departments often find it difficult to get employees to complete employee workplace climate (satisfaction) surveys. Workers often believe that if management really wants to find out who said what, they easily could, although the surveys are supposed to be anonymous. The difference between ethical and unethical entrepreneurial management is whether they want to find out. Whether it involves small, mid-size, or large companies, management should encourage employees to speak out, whether as an anonymous whistleblower or in-person to their supervisor. Absence of this type of encouragement often allows unethical business practices to flourish, such as was seen in the Wells Fargo case example.

LINK TO LEARNING

Although no single set of traits identifies the ideal startup leader, a demanding, driven nature is a fairly common characteristic. Consider these brief profiles of entrepreneurs: first, a profile on Walt Disney and then video showing a contrasting view from Kerrie Laird at Vodafone.

After watching the videos, consider this thought experiment: Suppose the cult of the charismatic—but dogmatic—entrepreneurial leader such as Walt Disney or Steve Jobs were replaced by one steeped in a commitment to employee empowerment that Kerrie Laird claims for Vodafone? Could this change the culture at startups? If it could, do you believe that change would be for the better or worse?

These observations identify what may be unique to entrepreneurial culture. This is a combination of personality and management style often identified with those business leaders who strike out on their own, bring a startup to life, and shape its initial business practices and culture on the job. If the enterprise is successful, the principles and philosophy of the founder become enshrined in the lore of the company, so that long after his or her departure, succeeding leaders find themselves beholden to the management philosophy exemplified from the early days of the firm. As *you* seek the right leadership style to implement in your entrepreneurial plans, begin by asking precisely what kind of leader you would prefer to work for if you were not the boss. The answer you provide may very well be the best model to follow as you develop your own leadership personality.

The first employees of a startup realize what is at stake as the company tiptoes into new entrepreneurial waters. The founder may be the boss, but those associated with him or her sense a collaborative spirit that directly joins them to the founder as well as to each other. There can be a genuine fraternity among those who have been with the firm since day one or shortly thereafter. Founding members of an entrepreneurial business are also often willing to undergo the strains and rigors attached to a startup in return for an ownership stake in the company that allows them to profit handsomely from its later growth and success.

Newer staff, however, may not share this mindset. They may simply be seeking a secure position with a growing business rather than a chance to get in on the ground floor of a risky startup. They will not necessarily have the tolerance for the demanding hours, chaos, and abrasive personalities that can characterize the early days of an enterprise. Can entrepreneurial founders shape a company's culture so that it can accommodate talented employees who are looking for a corporate culture that supports some work-life balance?

Consider also the ethical practices of an entrepreneur and the ethical expectations of employees. Suppose that one of the distinguishing features woven into the fabric of the startup is the respect extended to customers or clients. An entrepreneur typically promises always to hold customers in the highest regard, never lie to them, and serve them well. Furthermore, suppose this entrepreneur successfully instills this same ethos among all employees from the outset. Respect for customers is intended to become a distinguishing feature of the business; even if it causes monetary loss to the company, this entrepreneur will neither cheat a client nor misrepresent the company's services. Finally, presume that this ethos is embedded into the culture of the company while it is still in startup mode.

Now suppose the company becomes successful. This may signal the hardest time of all for the entrepreneur. Growth often accompanies success, and growth means, among other things, more employees. Not all these new hires will be as committed to the same degree of responsibility for customers. They will not necessarily set out to cheat clients, but they might lack the founder's enthusiasm for the most honorable treatment of customers. How can an entrepreneur ensure that the initial commitment carries over to the second generation of leadership? He or she cannot simply order it to happen—human nature usually does not respond so easily. So entrepreneurs must do their best to ensure that their version of customer service, one that prioritizes respect for clients, is passed along to new employees. It may be ingrained in the longest-serving employees, but it must be nurtured to the point where it has the same significance for the newest hires.

As a leader, you need to plan and follow-up to ensure your organization follows the values and ethical principles you uphold. This planning process goes beyond taking a few simple actions such as hiring the right people, providing consequences, or setting expectations. It goes beyond communicating a few niceties and encouraging sound bites such as establishing trust and working with uncompromising integrity. It needs more than the application of a few popular concepts and slogans such as CSR, conscious capitalism, or servant leadership. It also needs more than the effective communication of a few success criteria and expectations.

There are effective techniques that can support the infusion of ethical principle into the daily work life of employees. Sometimes known as **anchoring strategies**, ethical values can become part of the business culture through the implementation of employee training, and reward/recognition programs. The Society for Human Resource Management (SHRM) website has a toolkit for entrepreneurs and managers that provides useful ideas on infusion and anchoring strategies.

LINK TO LEARNING

View the toolkit for understanding and developing organizational culture to learn more.

While the use of popular management approaches can be successful, they can be inadequate to stop unethical behavior. Instead, you need a plan to nurture and develop a culture where ethical qualities and capabilities such as truthfulness, justice, responsibility, and compassion are developed and internalized as a moral compass. It also demands that these qualities and capabilities are infused into the fabric of organization, adhered to habitually, and are integrated into the organization's daily operations.

Proactive Versus Reactive Approaches

Creation of an ethical workplace environment has both reactive and proactive components. The reactive side enables an entrepreneur to identify and address reckless behavior, irresponsible actions, and ethical deviations as they occur. However, there may be times that a reactive approach, which can be heavy-handed, may not be the best approach for addressing ethical deviations.

In contrast, a proactive approach to developing an ethical workplace strives to prevent reckless behavior, irresponsible actions, and ethical deviations by establishing and nurturing a culture of ethics, responsibility, and compliance. It also demands that you establish a workplace environment of ethics where every member of the organization is able to proactively develop, internalize, and apply a moral compass. This approach serves to operationalize popular—but often silent or nebulous—concepts such as truthfulness, fairness, trust, integrity, commitment, innovation, and excellence, leading to a sustained competitive advantage.

Developing the Foundation and Framework of an Ethically Responsible Organization

An entrepreneur must build a foundation for developing an organization grounded in ethics and responsibility. Foundational building blocks enable an entrepreneur to systematically add the greatest value to society, and to do so responsibly. Additionally, for entrepreneurs modifying their businesses or taking over new ventures, building a foundation of ethical conduct should neither disrupt normal business operations nor add significant overhead, since the main concepts are infused into the fabric of the organization.

To develop an organization's foundation for ethics and a framework for management, an entrepreneur needs to incorporate three essential ethical qualities—trust, fairness, and excellence—into the organization's core values (see Table 2.1.4.1). Additional ethical qualities, dependent on the enterprise's specific goals, might include responsibility, commitment, compassion, and so on. The entrepreneur should infuse these qualities into all aspects of organizational governance and daily operations, and track these values to ensure they are being integrated into planning, and are met and enforced by all business units. The application and implementation of these three core qualities will begin to shape the framework and establish a foundation of ethics and responsibility.

Table 2.1.4.1 illustrates and approach to building a foundation for ethics-based behaviors, principles, and effective collaboration.

Table 2.1.4.1: Ethical Entrepreneurs/Managers Foundational Qualities

Excellence	• Have a grander purpose • Create a culture that eliminates internal competition • Focus on excellence
Fairness	• Foster openness • Demonstrate impartiality • Protect the welfare of all stakeholders • Maintain a system of accountability
Trust	• Provide and expect feedback • Base decisions on truth and consensus • Clash different ideas, not different individuals • Listen with patience and respect • Separate yourself from your thoughts and views

Second, the organization should consider what ethical principles it wants to prioritize. Examples of ethical principles might include:

- Service and advancement of society
- Collaborative excellence
- Gender equity
- Elimination of prejudices

Once the framework and foundation for an ethical and high-performing organization has been established, other qualities and principles can easily be integrated as needed to further strengthen this framework, differentiate the organization, and develop a sustained competitive advantage. It also enables leadership to align other aspects of organizational governance with ethics and responsibility. For example, if leadership wants to leverage the power of diversity to develop a sustained competitive advantage, they would adopt the principles of equality of sexes, the elimination of prejudices, and the principle of oneness of humanity. If leadership wants to develop and use teamwork and collaboration as a strategic competitive advantage, they would integrate the behaviors and principles for collaborative excellence and working cohesively as one.

The framework and foundation of ethics and responsibility will enable the entrepreneur to consistently manage the needed qualities and principles for success in all aspects of daily operations. These aspects include research and development, engineering, manufacturing, sales, marketing, planning, decision-making, problem-solving, conflict management, and other aspects of organizational governance. To demonstrate what this means in practice, the leadership of each of functional area could serve as role models, raise awareness, and encourage individuals to internalize a line of ethical reasoning, asking questions such as, “Is my decision right or wrong (good or bad)?” “Am I dealing with factual information or is conjecture?” “What is the consequence of my action?” “Is my decision fair and equitable?” “Did I give the individual what they are due?” “Would I want to be treated this way?” “Will this action help me achieve the best results for the collective?” This mindset, line of reasoning, and congruence between individual and organizational ethics is often lacking, which leads to ethical deviations. Establishing the foundation outlined here enables each member of the organization to exercise sound moral judgment, develop ethical capabilities, and internalize a moral compass. It also allows employees to be aligned with the company’s grander purpose, vision, mission, and values that then translates into actions.

Develop a Grander Purpose

Once the entrepreneur has designed and configured the organization to develop a sustained competitive advantage in a responsible manner, he/she needs to develop a higher vision or a grander purpose for the organization. This grander purpose is not the same as a mission or vision (although they may overlap). It is not financially motivated, it is not product/service-centric, and it is not shareholder-driven. Instead, the grander purpose defines and highlights the reasoning for a firm’s long-term existence and success; it provides guidance and direction during decision-making, problem-solving, and conflict resolution; it provides the motivation for individuals to achieve excellence and the sense of urgency for social change; and it enables individuals to be part of a larger cause. For example, the integration of the right grander purpose into the operations of an organization could have prevented the

manufacturing of toys made with lead-based paint or the poisoning of the Flint, Michigan, water supply. The grander purpose provides a mechanism to help individuals calibrate their day-to-day activities against a more meaningful and stable target.

Develop a Culture of Collaborative Excellence

The establishment of a framework and foundation for ethical behavior opens up the organization for effective and meaningful teamwork and collaboration. Many existing approaches to collaboration, while demonstrating successes and benefits, also are sometimes inadequate in addressing complex group interactions dealing with mistrust, competition, politics, and ideological differences. A successful culture of collaboration should convince individuals to find the best ideas, leverage diversity, grow new solutions, gain wholehearted support, develop champions of change, nurture a safe environment, and encourage people to express all ideas.

An effective process for encouraging collaboration takes time to build; however, it's worth it because it will provide the inspiration and motivation needed to accomplish tasks and exceed expectations. The organization should also have consequences in place for ineffective collaboration, which may be evidenced in gossip, backstabbing, self-centered behavior, and biases or prejudices. Such consequences could include probation plans and one-on-one meetings that work to determine the root cause and identify steps forward.

Creativity is also key for a team to think differently. There must be freedom in the workplace for creativity to blossom. When developing a culture of creativity, entrepreneurs should consider these issue and challenges:

- How can we creative a culture of creativity and innovation?
- How can we encourage the members of the organization to collaborate and leverage each other's creativity?
- How can we reward and recognize people for their creativity?

Human Resources Development

A human resources development plan enables a company to continually grow its intellectual resources, enables individuals to develop ethical capabilities, strengthens individual creativity and organizational innovation, provides a steady stream of capable human resources for its leadership pipelines, and enables the firm to leverage and harvest those human resources to advance society in a responsible manner. This is achieved by providing a new employee assessment process where every member of the organization is given the needed opportunities and is expected to collaborate with their superior(s) to own and manage their lifelong development plan (LDP). At a minimum, an LDP should:

- Include short-term and long-term career goals and objectives
- Help identify, continually develop, and leverage individual strengths
- Enable individuals to identify and measurably close gaps in deliverables, behavior, and professional improvement
- Clarify major deliverables and success indicators

In sum, an LDP becomes the primary instrument to assist individuals to achieve excellence by raising performance, closing gaps in assessment, and aligning the individual with the grander purpose, vision, mission, goals, needs, and objectives.

WORK IT OUT

Growing Collaboration and Creativity

Entrepreneurs are entrusted with the growth and development of their people. This growth and development should not be stopped, delayed, or marginalized in any shape or form. Instead, an entrepreneur needs to learn how to use the available resources to systematically train, develop, and deliver a steady stream of responsible individuals who are able to grow within the company as well as grow the company. List three strategies an entrepreneur could use to achieve the following major objectives:

1. Develop the best, the brightest, and most creative and motivated people who have a strong sense of right and wrong
2. Develop individuals who have a strong sense of ownership, responsibility, and commitment to achieve and sustain a competitive edge
3. Leverage these intellectual forces and the synergy within the organization to generate the greatest value and wealth for all stakeholders.

Develop Ethical and Responsible Leadership/Management

Significant research shows that the culture of the organization is mostly shaped by its leadership values—by how leaders develop the bonds of trust, by how they motivate their people, by their responsible decisions and actions, and by how they empower, delegate, and monitor tasks. A recent *Harvard Business Review* article, by a group of professors and entrepreneurs, synthesized the research of experts including Edgar Schein, Shalom Schwartz, Geert Hofstede, and other leading scholars on this topic. The article indicates that the attributes of a business's leaders define that organization's culture. A business's culture is essentially defined as the social order within an organization that helps shape attitudes and behaviors—delineating what type of behavior is encouraged and/or discouraged.

While it is possible for a company to hire individuals who possess these attributes, the organization should have a plan in place to systematically train and develop responsible leaders. At minimum, this should include the development and management of a leadership pipeline, the nurturing of ethical and intellectual capabilities, and rewards and consequences that enable a leader to develop and internalize a moral compass.

WHAT CAN YOU DO?

Entrepreneurs Must Not Just Talk the Talk but Walk the Walk

As both a leader and an entrepreneur, you need to have a good understanding of ethics and responsibility, and be able to apply the major tenets of concepts such as CSR. To build and maintain trust, it is important that these concepts not start and end with mere empty words and gestures. Rather, entrepreneurs need to exemplify and model these concepts, and apply them through meaningful, consistent, and timely actions. In sum, an entrepreneur needs to live the values they wish to see in others. They need to become the embodiments of trust, respect, responsibility, commitment, and other key qualities. These core values need to be infused into the fabric of the organization.

Entrepreneurs have been placed in a position of power and responsibility. They need to use their position, power, social standing, and the synergy of the vast financial and intellectual resources at their disposal to move and shake the world in a meaningful way. For example, imagine for a moment using the resources of companies such as Apple, Google, Microsoft, Amazon, and Facebook, whose combined worth is estimated to be close to $2.2 trillion, to address complex and difficult global issues dealing with education, poverty, hunger, and other chronic problems.

Develop Internal/External Organizational Alignment and Cohesion

Key to ethical organizational success is the alignment and cohesion between individuals, groups, and the enterprise as a whole. This alignment starts with the development of a grander purpose that enables the entrepreneur and the organization to serve, add value, and advance the society in which it operates. It ensures individuals and units within the company understand the grander purpose, mission, vision, and the goals and objectives of the company, and it provides each member or the organization the opportunity to serve and fit into that grander purpose, mission, and vision. It is further strengthened by asking individuals to achieve excellence in their own right instead of competing with each other. It sets clear expectations about how people are to treat and deal with each other to deliver results. It deals with the alignment of corporate values with the espoused values, and the alignment between what leadership says and does. When combined, these and other alignments can enable individuals and groups to stay on track and reach the company's goals efficiently.

ENTREPRENEUR IN ACTION

Unilever "Enhancing Livelihoods" through Project Shakti

According to management guru Peter Drucker, whose ideas significantly contributed to the foundations of thought about the workings of the modern business corporation, workers "need to know the organization's mission and to believe in it." How do organizations ensure this commitment? By satisfying workers' values. A program undertaken by Unilever, the Dutch-British multinational company co-headquartered in Rotterdam and London, illustrates the kind of values-oriented corporate endeavor Drucker describes. Project Shakti is a Unilever CSR initiative in India that links CSR with financial opportunities for local women. It is considered a leading example of micro-entrepreneurship, and it expands the concept of sustainability to include not only environmental issues but also economic opportunities and financial networking in underdeveloped areas.

The goal, according to Unilever, is to give rural Shakti women the ability to earn money for themselves and their families as micro-entrepreneurs. Unilever's subsidiary in India, Hindustan Lever, has started training programs for thousands of women in small towns and villages across India to help them understand how to run their own small sole proprietorships as distributors of the company's products. With support from a team of rural sales managers, women who had been unable to support themselves are now becoming empowered by learning how a supply chain works, what products Hindustan Lever produces, and how to distribute them. The sales managers also act in a consulting capacity to help with business basics, money management, negotiations, and related skills that help the women run their businesses effectively.

Project Shakti has enlisted more than 100,000 rural participants, which includes about 75,000 women. The project has changed their lives in ways that are profound, and not only because of the income earned. The women now have increased self-esteem based on a sense of empowerment, and they finally feel they have a place in Indian society. According to the Unilever Sustainable Living Plan, Project Shakti is one of the best and most sustainable ways the company can address women's social concerns. It allows Unilever to conduct business in a socially responsible manner, helping women help themselves while extending the reach of its products.

- Do you believe Unilever sponsors the Shakti program to help women, boost its own profits, or both? Explain your answer.
- How is this program an example of both corporate and personal sustainability?

Develop a Culture of Creativity and Innovation

The next building block is developing a culture of creativity and innovation. This means going beyond a spark of creativity from select individuals or business units, and instead nurturing a culture where every member of the organization is continually creative and the organization is innovative. This also means providing the means and opportunities for individuals to be engaged, creative, and contributing members on a full-time basis. What makes this possible results from the prior building blocks. Innovation requires good leadership and management; a meaningful and effective process for teamwork and collaboration; a culture of learning and improvement; a consistent and measurable process to encourage, recognize, compensate, and track innovation; and company-wide focus on the training and development of the sense of creativity.

Develop a Culture of Delivering Responsible Results

Measurable results compose the final building block of a framework for ethics and responsibility. This involves developing systems and indicators that will demonstrate how your business is achieving ethical standards and progressively improving as it adds value to society. While the details of which indicators to select is left up to the discretion of the entrepreneur, this building block defines success in terms of ten dimensions of business excellence, shown in Figure 2.1.4.1.



Figure 2.1.4.1 : Delivering responsible results involves multiple considerations. (attribution: Copyright Rice University, OpenStax)

Figure 2.1.4.1 serves as an easy-to-understand guide for entrepreneurs seeking to create a culture of excellence. Focusing on these ten dimensions can help a business achieve excellence, from which a company may derive multiple benefits. Examples of reasons why a company strives to achieve excellence include strengthening alignment between company values and those of stakeholders, balancing goals versus measures of success, clarifying strategic focus versus operational concerns, selecting areas within the company wherein improvement is needed, and shifting from a preoccupation with daily activities and processes to focus on outcomes. Companies seek excellence with regard to internal and external outcomes, both of which are important. Thus, whether examining internal aspects such as finance and operations, or external aspects such as product quality and customer service, each of these ten areas is an ingredient of company excellence.

Creating an Ethical and Responsible Workplace Environment

A safe, healthy, and productive workplace is an environment in which an individual has a high level of trust and confidence that if they give their best, they will see a number of results and be afforded a number of things in exchange for their hard work. This concept resembles an employer-employee contract. This contract includes the following employee expectations:

1. They are treated with the respect, dignity, and courtesy they deserve as a human being.
2. They are given the needed support, equal opportunities, and resources to excel.
3. They are given what they deserve and what they are due in a fair and equitable way.
4. They are provided a safe, secure, and prejudice-free work environment.
5. They are not pushed, pressured, or expected to behave irresponsibly.

This type of workplace environment enables individuals to continually grow and develop to their full potential and then leverage that potential to add value to their own lives, careers, and society. This type of environment is one in which individuals are not afraid to speak their mind; they feel safe to discuss problems and concerns, and feel free to question and reject that which is wrong.

Prejudice

Prejudice is often thought of as a negative attitude and/or feeling toward an individual based solely on one's membership in a particular group. Prejudice is common against people who are members of unfamiliar cultural groups. In employment, it can be the root cause of unfair discrimination. One factor essential to the development of a safe and healthy work environment is that it strives to be a place free of prejudice. This is an environment where everyone is treated with the respect and dignity they deserve and are

afforded equal opportunities for growth, development, and advancement both within and outside of the organization. For example, it is important to look at the merit or value of the work done by an individual and the manner by which those results have been delivered. It is unethical to treat people differently based on their race, gender, age, nationality, and other differentiating factors. To develop trust and respect, everyone needs to be afforded the same opportunities.

Competition and Collaboration

Effectively managing a workforce includes a systematic approach to appraisal of employee performance. A manager/entrepreneur must decide how to do this within their company. A forced ranking system is one in which scoring employee performance is competitive and can pit employees against each other instead of fostering a collaborative work environment. Some employers have switched to a system that does not require forced rankings and attempts to downplay the competitive nature of assessment, focusing instead on individual continuous improvement. There is a legitimate difference of opinion on this issue. According to a *Wall Street Journal* article by the accounting and consulting firm Deloitte, executives are split on whether it is an effective practice. Jack Welch, former CEO at General Electric, was a proponent of it, whereas others see it as counterproductive. Companies that have discontinued the process include Microsoft and GE.

In an environment of collaborative excellence, individuals are encouraged to express their ideas and viewpoints in an unfettered and respectful way, where the merit of each idea is weighed against the merit of other ideas. In this environment, individuals are not reprimanded for being creative, taking calculated and reasonable risks, or challenging management or leadership.

WORK IT OUT

Anonymous Whistleblower Hotlines

Most large companies now have anonymous hotlines that employees may call to report ethical violations. What are some other concrete and actionable ways you can develop a safe environment where every member of your organization is able to question authority, point out a wrong, and stop an unethical decision/action?

One example of a problem that can arise in an overly competitive environment or culture created by an organization would be the faulty ignition switch scandal at GM. According to Valdes-Depena, and Yellin, GM knew about this problem in 2001. However, it took the company over twelve years, more than 100 deaths, and 30 million vehicles being recalled to finally admit that there was a problem. In 2014, GM admitted that a faculty ignition switch may result in the engine of a vehicle being shut down while in drive, resulting in accidents, severe injuries, or death. If GM had developed an effective environment of collaboration, individuals from leadership, management, sales, marketing, engineering, manufacturing, and human resources, as well as major stakeholders, might have collaborated and prevented the ignition switch problem.

Diversity

Entrepreneurs need to appreciate, respect, and learn to effectively leverage the unique and diverse qualities that each individual brings to the table. These qualities can be used to innovate, make better decisions, solve complex problems/conflicts, move an organization cohesively in a single direction, or rapidly change direction when needed. If used correctly, these differences enable an entrepreneur to develop a sustained competitive advantage by looking at the different thoughts, ideas, and viewpoints to make better and more informed decisions.

Diversity, in terms of a legal concept, deals with innate characteristics such as an individual's sex, color, race, national origin, religion, and age. It might also include educational background, cultural background, socioeconomic background, and potentially even political affiliations. However, diversity in terms of an ethical concept rather than purely a legal one also deals with a number of not-so-obvious characteristics such as the diversity of behavior, thought-process, comprehension, attitudes, temperaments, and learning styles. Combined, these differences can be beneficial to a business organization and result in high-level performance by the workforce as a whole.

Diversity may be an actual legal requirement depending upon what type of business an entrepreneur enters. For example, if you plan on doing any government contracting work, whether local, state, or federal, the chances are that your business will have to meet a diversity standard. Many private companies also have diversity clauses in the supply chain contracts related to supplier diversity initiatives.

WORK IT OUT

Building Diversity

For each of the following, identify two examples of a concrete action or activity an entrepreneur could implement to achieve the stated goal.

1. Introduce the concept of diversity and highlight the significance, the value, and the benefits of a diverse work environment.
2. Set clear expectations for individuals to value diversity, the concept of unity in diversity, and show how others can leverage the power of diversity to innovate.
3. Exemplify, role model, and live good ethical behavior that strengthens diversity such as the elimination of prejudice of all kinds and expect others to do the same around you.
4. Ensure that you design the hiring process, including job descriptions, recruiting, interview questions, and other related steps, with diversity in mind.
5. Provide training to educate people on the concept of prejudice, the different forms of prejudices, and the negative aspects of prejudices.
6. Provide opportunities for building ethical capacities such as becoming truthful, trustworthiness, and a just individual.
7. Provide consistent, meaningful, substantial, and timely consequences for prejudicial behavior in organizations.

Gender Equality

As an entrepreneur, you need to recognize the significance, value, and impact of the principle of equality of men and women on developing a sustained competitive advantage. Then you need to incorporate this principle into the fabric of your organization. Aside from being the right thing to do, one reason why this principle is so important is that close to one-half of the planet is female (and has traditionally been marginalized in the business world). If you overlook this fact, you will also be potentially overlooking one-half of the talent that can help you excel and develop a sustained competitive advantage. In turn, this will result in a loss of trust and confidence. A second and more important reason would be that any deviation from this principle goes against the whole concept of ethics and responsibility. Moreover, this principle will help your organization attract the best and brightest employees.

The principle of gender equality does not deny differences between men and women. This principle primarily asks that we give each member of society fair and equal opportunities for growth, development, and advancement. It also recognizes that women have been historically marginalized or excluded from the business world. This claim holds true today and is applicable to even to the most advanced countries in the world (e.g., the discrepancy of pay between women and men in Western societies). Therefore, women need to be afforded the same opportunities for education, rewards, recognitions, and promotions as men.

Trust and Ethical Accountability

Finally, the development of safe environments also deals with an environment where individuals are able to develop unbreakable bonds of trust, where they don't feel they have to constantly watch their backs, where individuals are free to point out misconduct without being reprimanded, and where individuals feel they will be given what they are due or deserve. This dimension of the development of a safe work environment deals with making sure individuals feel they are being treated in a fair and equitable manner and that their need for the development of an ethical and moral work environment is being met.

WORK IT OUT

Sherron Watkins and Enron

Enron is one of the most infamous examples of corporate fraud in US history. The scandal that destroyed the company resulted in approximately $60 billion in lost shareholder value. Sherron Watkins, an officer of the company, discovered the fraud and first went to her boss and mentor, founder and chairperson Ken Lay, to report the suspected accounting and financial irregularities. She was ignored more than once and eventually went to the press with her story. Because she did not go directly to the SEC, Watkins received no whistleblower protection. (The Sarbanes-Oxley Act was not passed until after the Enron scandal. In fact, it was Watkins's circumstance and Enron's misdeeds that helped convince Congress to pass the law.)

Now a respected national speaker on the topic of ethics and employees' responsibility, Watkins talks about how an employee should handle such situations. "When you're faced with something that really matters, if you're silent, you're starting on the

wrong path…go against the crowd if need be," she said in a speech to the National Character and Leadership Symposium (a seminar to instill leadership and moral qualities in young men and women).

Watkins talks openly about the risk of being an honest employee, something employees should consider when evaluating what they owe their company, the public, and themselves. "I will never have a job in corporate America again. The minute you speak truth to power and you're not heard, your career is never the same again."

Enron's corporate leaders dealt with the looming crisis by a combination of blaming others and leaving their employees to fend for themselves. According to Watkins, "Within two weeks of me finding this fraud, [Enron president] Jeff Skilling quit. We did feel like we were on a battleship, and things were not going well, and the captain had just taken a helicopter home. The fall of 2001 was just the bleakest time in my life, because everything I thought was secure was no longer secure."

- Did Watkins owe an ethical duty to Enron, to its shareholders, or to the investing public to go public with her suspicions? Explain your answer.
- How big a price is it fair to ask a whistleblowing employee to pay?

Ideally, it is best that entrepreneurs exemplify good ethical behavior, expect their people to do the same, and help the members of the organization develop a moral compass. However, it is equally as important that business owners take action and put in place the right checks and balances that verify that the organization's people are complying with its policies and principles of ethical behavior.

Organizations should set up systems that monitor compliance. In addition, you should develop a leadership pipeline that ensures that individuals would be placed in the pipelines only if they exhibit good ethical behavior, working with each business unit manager to ensure this is happening. Individual assessments should clearly assess ethical behavior and provide rewards, recognitions, and promotions for good ethical behavior, and consequences and training/solutions for actions that do not meet company standards. You should provide meaningful, substantial, and timely consequences for lack of acceptable behavior, such as removing an executive from a leadership pipeline when it has been established that they will not govern responsibly.

Importantly, members of the organization should not be intimidated to blindly follow or accept the existing monitoring system without question. An entrepreneur needs to cultivate an environment where they expect, support, and encourage every member of their organization to be inquisitive, be creative, question authority, and search for the underlying truth in all matters. It must be noted that questioning authority does not mean anything goes; it simply means that employees are expected to think on their own. Accountability should be encouraged; it is both an ethical and legal issue.

An example of a system of accountability that is appropriate for entrepreneurs is one proposed by an article in the *Harvard Business Review*. A sound approach to accountability requires a multistep process that includes establishing expectations, ensuring employees have the capability to do it, measurement of results, feedback, and consequences for unethical behavior. In addition to an ethical approach, remember that there are federal laws mandating accountability. The most well-known of these is the Sarbanes-Oxley Act, discussed elsewhere in this chapter, and other chapters in this text. Also called the Corporate and Auditing Accountability, Responsibility, and Transparency Act, the Sarbanes-Oxley Act requires publicly traded companies to have an internal system of control that emphasizes transparency and accountability.

If You Make a Mistake

If you or your organization makes a mistake or misstep, you must decide how to address it. In general, you are faced with the choice of paying now or paying a hundredfold later. A closer look at the largest, most expensive, and most devastating corporate failures of our times shows that these failures have resulted in the loss of life, property, and/or monumental environmental disasters. For the most part, these corporate failures have been caused by one or more ethical deviations on behalf of leadership. To combat these problems, entrepreneurs need to start by first being responsible, accepting their failures, and admitting when they have made mistakes. This admittance needs to be genuine, transparent, prompt, truthful, and authentic if they wish stakeholders to accept and believe their remorse. Once that first step is taken, they need to take immediate steps to proactively address the problems they have caused. Many leaders or entrepreneurs have learned the hard way that they need to be open and transparent with their stakeholders at the outset. Failure to rapidly admit mistakes can and has resulted in paying a very steep price when exposed. The actions that an entrepreneur needs to take include:

1. Admitting their mistakes, failures, and shortcomings to all stakeholders
2. Effectively communicating the nature of the problem to major stakeholders
3. Informing the stakeholders of the impact, side effect, and causes of the problem
4. Taking necessary and immediate steps to address the issue and stop the bleeding
5. Conducting a thorough and unbiased root-cause analysis to identify the underlying cause
6. Addressing any people and systemic gaps that caused the problem in the first place
7. Putting in place measures that will prevent the repeat of the same mistakes

To summarize, the best approach is that you admit your mistakes and shortcomings, pay the price, fix and uproot the problem, and systematically prevent the repeat of the same mistakes. A few examples of corporate mistakes and shortcomings that were quickly addressed before turning into severe problems would be the Tylenol poisoning and the customer accounts stolen at Target. A few examples of a problem that were not handled correctly and resulted in multi-billion-dollar problems are GM's faulty ignition switch problem, Volkswagen's emission control fraud, and Wells Fargo's account fraud.

ENTREPRENEUR IN ACTION

Taking the Ethical High Road

To go beyond a glowing commitment report, a shining website, or a few meaningless words in a code-of-conduct on corporate responsibility, an entrepreneur needs to follow the rule of law, the spirit of the law, and do the right thing at all times and under all circumstances. To achieve this, entrepreneurs need to develop and internalize a moral compass that prevents them from doing the wrong and unethical thing despite the consequences.

One classic example of doing the right thing which has been studied as a case study in business schools is attributed to Johnson & Johnson (J&J). In 1982, J&J found out that someone had tampered with and laced their Tylenol capsules with potassium cyanide. To address this problem, safeguard their brand name, and prevent negative press, J&J removed all of their Tylenol products from the shelves.

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2.1.5: Key Terms

anchoring strategies
in the ethical context, the process of making ethics a foundation (anchor) of your business so that decision makers act keeping in mind key ethical considerations

antitrust laws
prevent companies from abusing position or power in the market through exclusion or limitation of competitor access to the market

business ethics
conduct by which companies and their agents abide by the law and respect the rights of their stakeholders, particularly their customers, clients, employees, and the surrounding community and environment

conflict of interest
when an individual or organization has interests in multiple areas that come into conflict with each other

copyright
grants the creator of a work the exclusive right to reproduce the work, typically for a specified period of time

corporate social responsibility (CSR)
practice in which a business views itself within a broader context, as a member of society with certain implicit social obligations and responsibility for its own effects on environmental and social well-being

design patent
protects product design

disclosure
sharing the needed facts and details about a subject in a transparent and truthful way

diversity
inclusion of many types of employees, regardless of differences (race, religion, gender, disability, LGTBQ, socioeconomic, cultural)

environmental entrepreneurship
entrepreneurial ventures focused on identifying an environmental problem and creating a product or process to solve that problem

ethics
standards of behavior to which we hold ourselves in our personal and professional lives

fairness
impartial, unbiased compliance with rules and standards of what is right, just, and equitable

integrity
adherence to a code of moral values implying trustworthiness and incorruptibility because there is unity between what we say and what we do

intellectual property
legally protected result of creative work to turn a unique idea into a product or service

prejudice

way of thinking about or treating employees in a manner that favors or hinders one person or group over another, usually in a way considered to be unfair

social entrepreneurship
entrepreneurial ventures focused on identifying a societal problem and creating a product or process to solve that problem

sustainability
practice of preserving resources and operating in a way that is ecologically responsible in the long term

trade secret
proprietary information, processes, or other internal knowledge that contribute to an organization's competitive edge in a market

trademark
registration that provides the owner the ability to use a name, symbol, jingle, or character in conjunction with a specific product or service, and prevents others from using those same symbols to sell their products

truthfulness
underlying facts, reality, and evidence on a matter

utility patent
protects product ideas

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2.1.6: Summary

Ethical and Legal Issues in Entrepreneurship

The first section of this chapter explores the relationship between entrepreneurship, ethics, social responsibility, and the law. At times, ethical conduct and legal conduct may seem intertwined; in other circumstances, they are quite different. This section discusses how ethical considerations can provide a moral compass for entrepreneurs seeking to find a balance between making money and doing the right thing. Keep in mind, however, that unlike legal mandates, following ethical business practices is more often a voluntary matter for business owners and operators. On the other hand, laws are important to follow, or you and your business might well be held legally liable (civilly or criminally). Sometimes, making a mistake is only an ethical lapse; other times, the mistake also constitutes a violation of the law (e.g., the Equifax case discussed).

Corporate Social Responsibility and Social Entrepreneurship

This section explored examples of entrepreneurship in which social responsibility plays a key role in the organization. Causes such as sustainability/environmental awareness are often important to an entrepreneur and his/her workforce. Most startup businesses want to make money, and in fact, as this section demonstrates, it's quite possible to make money and carry out a social responsibility goal simultaneously. Some social entrepreneurship companies go the extra mile and become certified B-corporations, as opposed to C-corps or S-corps, which are tax distinctions. If an entrepreneur elects to become a B-corporation, it means that it has satisfied an outside organization's audit, proving that he/she truly acts in a socially responsible manner.

Developing a Workplace Culture of Ethical Excellence and Accountability

This section of the chapter covers the area of employment. We explored how entrepreneurs can make their company one for which people want to work: where being ethical is a highly regarded trait. This type of approach to employment includes both ethical and legal considerations, such as no discrimination, fair pay, encouraging/rewarding ethical behavior, and creating an atmosphere of collegial teamwork. This approach to creating a socially responsible workplace requires a long-term commitment to being an ethical employer, which is not always easy. For example, it may mean, even though you are the boss or owner, admitting you made a mistake, accepting responsibility for it, and correcting it. You do not want to be the type of boss who can never say I got that wrong, and I'll do better next time.

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2.1.7: Review Questions

1. Full and truthful disclosure _____.
    a. Is often required under tort law
    b. Is a matter of ethics, not a legal requirement
    c. Is a risky business practice because it helps the competition
    d. Is a strictly personal choice
2. Common IP law-mandated periods of protection are _____.
    a. Copyrights are protected for twenty years
    b. Patents are protected for fifty years
    c. Trademarks are protected for renewable ten-year periods
    d. Trade secrets are protected for fifteen years
3. Acting ethically includes acting with which of the following?
    a. Integrity
    b. Disclosure
    c. Transparency
    d. All of these options are correct.
4. Antitrust law:
    a. May help small entrepreneurs by ensuring big companies do not have monopolies
    b. May hurt small entrepreneurs by requiring them to disclose trade secrets
    c. Only applies to businesses with over 500 employees
    d. None of these options are correct.
5. Patents _____.
    a. Are similar to trade secrets under IP law
    b. Allow a temporary monopoly for an invention
    c. Are protected under IP law for a period of ninety-nine years
    d. None of these options are correct.
6. An example of a company(s) that have been fined millions of dollars for legal/ethical violations includes _____.
    a. Enron
    b. TOMS
    c. British Petroleum
    d. a and c
7. The B-corporation moniker _____.
    a. Requires government certification
    b. Requires no certification
    c. Can only be used after an audit and certification by the B-corp organization
    d. Is a social media concept used primarily for marketing purposes
8. What differentiates a social entrepreneurial enterprise from a traditional entrepreneur?
    a. Commitment to reduce pollution
    b. Pledge to undertake sustainable supply chain sourcing
    c. Effort to recycle water, waste, and other byproducts
    d. All of these options are correct.
9. Core qualities for building a foundation of ethics-based behaviors include _____.
    a. Trust
    b. Fairness
    c. Excellence
    d. All of these options are correct.

10. Millennial workers _____.
    a. Often do not place salary as their first priority
    b. Want work-life balance
    c. Usually expect their employer to have an ethical value system
    d. All of these options are correct.
11. A diverse workforce _____.
    a. Is always optional
    b. Is usually required for government contracting
    c. Is always required under Title VII
    d. Is never required

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2.1.8: Discussion Questions

1. How can ethics-based concepts such as truthfulness and fairness be integrated into the fabric of the organization?
2. How can we nurture an environment where each member of the organization develops and internalizes a moral compass?
3. Evaluate how an entrepreneurial business startup might benefit from the enforcement of antitrust laws against a large competitor.
4. Discuss ways in which intellectual property, such as trademarks, can add value to a small business. How would you protect your ability to monetize intellectual property?
5. In this section of the chapter, there is an example of a customer data breach via computer hacking. Discuss the biggest risks of storing customer or company information online. What are some of the steps you would take to prevent a data breach?
6. Can a social enterprise work on a social issue and at the same time be profitable?
7. How will you ensure that your organization learns to develop and deliver products and services that reduces your carbon footprint?
8. Referring to Table 2.1.3.2 listing cases of corporate fraud, which company example do you think is one of the worst examples of unethical conduct? Is this because it involved the most money stolen, the most people cheated, or the most devious methods?
9. If an entrepreneur values sustainability and environmental awareness, does that mean the bottom line will suffer? Alternatively, is there a way to protect the environment and still make a profit?
10. You have learned about B-corporations. If you started a new business, would you commit to the rather stringent audit process necessary to become a B-corporation? Why or why not?
11. How can an entrepreneur maximize the benefits of a diverse workforce to develop a competitive advantage?
12. How can you combat the negative impact of biases and prejudices in your organization?
13. What would you do, as an entrepreneur, to make your employees feel you value their input and that they are free to speak honestly?
14. Explain why diversity is something that should matter to an owner. What would you do to try to achieve it?
15. Some small entrepreneurs do not have the budget for a full-fledged human resources department; however, that makes compliance with employment laws challenging. What steps would you take to comply with federal and state employment law if you do not have a full-time attorney or human resources specialist on staff?

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2.1.9: Case Questions

1. In 2017, it became apparent that Wells Fargo had created over 2 million falsified customer accounts without the customers' consent, approval, or knowledge. John Stumpf, Wells Fargo CEO, who resigned amid this scandal, denied any leadership involvement and wrongdoing. He blamed his employees and fired over 5,300 employees over this scandal. Research this case and answer the following questions.
    - What organizational and company-culture factors convinced employees to create false accounts?
    - Why did the employees not question leadership?
2. In 2017, the US Environmental Protection Agency found that Volkswagen had installed a "defeat device"—software in the vehicle that detects that an emissions test is in progress, controls the engine, reduces emissions, and enables the vehicle to pass the test for US emissions standards. Martin Winterkorn, CEO of Volkswagen, denied any wrongdoing, was later forced to resign, and admitted they had cheated. Research this case and answer the following questions.
    - What organizational and cultural factors convinced Volkswagen employees to cheat?
    - Why did the workforce not question leadership?
3. If you were to create a top-ten list of the world's greatest corruption scandals, the problems of Petrobras (*Petróleo Brasileiro*) in Brazil surely would make the list. The majority state-owned petroleum conglomerate was a party to a multibillion-dollar scandal in which company executives received bribes and kickbacks from contractors in exchange for lucrative construction and drilling contracts. The contractors paid Petrobras executives upward of 5 percent of the contract amount, which was funneled back into slush funds. The slush funds, in turn, paid for the election campaigns of certain members of the ruling political party, *Partido dos Trabalhadores*, or the Workers Party, as well as for luxury items like race cars, jewelry, Rolex watches, yachts, wine, and art. The original investigation into these practices was known as Operation Car Wash (*Lava Jato*) and began in 2014 at a gas station and car wash in Brasília, where money was being laundered. It has since expanded to include scrutiny of senators, government officials, and the former president of the republic, Luiz Inácio Lula da Silva. The probe also contributed to the impeachment and removal of Lula's successor, Dilma Rousseff. Lula and Rousseff are members of the Workers Party. The case is complex, revealing Chinese suppliers, Swiss bank accounts where money was hidden from Brazilian authorities, and wire transfers that went through New York City and caught the eye of the US Department of Justice. In early 2017, the Brazilian Supreme Court justice in charge of the investigation and prosecution was mysteriously killed in a plane crash. It is hard to imagine a more tragic example of systemic breakdown and individual vice. The loss of trust in government and the economy still affects ordinary Brazilians. Meanwhile, the investigation continues.
    - Is this Brazilian company scandal unique to that culture?
4. In the fall of 2016, Samsung Electronics experienced a massive public relations disaster when its Galaxy Note 7 smartphones started exploding due to faulty batteries and casings. Initially, the company denied there were any technical problems. Then, when it became obvious the exploding phones posed a safety and health threat (they were banned from airplanes), Samsung accused its suppliers of creating the problem. In reality, the rush to beat Apple's iPhone 7 release date was the most likely reason corners were cut in production. Samsung finally owned up to the problem, recalled more than two million phones worldwide, and replaced them with new, improved Galaxy Note 7s. The company's response and its replacement of the phones went a long way toward defusing the disaster and even boosting the company's share price. Samsung focused on the customer (i.e., customer safety and satisfaction) with the motive of doing the ethically responsible thing.
    - Although some might argue the company could have done far more and much more quickly, perhaps it still acted reasonably. What do you think?
5. Sometimes engaged employees go above and beyond in the interest of customer service, even if they have no "customers" to speak of. Kathy Fryman is one such employee. Fryman was a custodian for three decades at a 100-year-old school in the Augusta (KY) Independent School District. She was not just taking care of the school building, she was also taking care of the people inside. Fryman fixed doors that would not close, phones that would not ring, and alarms that did not sound when they should. She kept track of keys and swept up dirty floors before parents' night. That was all part of the job of custodian, but she did much more. Fryman would often ask the nurse how an ill student was doing. She would check with a teacher about a kid who was going through tough times at home. If a teacher mentioned needing something, the next day it would show up on his or her desk. A student who needed something for class would suddenly find it in his or her backpack. Speaking of Fryman,

district superintendent Lisa McCrane said, “She just has a unique way of making others feel nurtured, comforted, and cared for.” According to Fryman, “…I need to be doing something for somebody.” Fryman’s customers were not there to buy a product on which she would make a commission. Her customers were students and teachers, parents and taxpayers. Yet she provided the kind of service that all employers would be proud of, the kind that makes a difference to people every day.

- Is there a way for a manager to find, develop, and encourage the next Fryman, or is the desire to “do something good for somebody” an inherent trait in some employees that is missing in others?
- Employees who display Fryman’s zeal often do so for their own internal rewards. Others may simply want to be recognized and appreciated for their effort. If you were the superintendent in her district, how would you recognize Fryman? Could she, for example, be invited to speak to new hires about opportunities to render exceptional service?

6. Please view the video ABC Nightline-IDEO Shopping Cart on YouTube. This video demonstrates how an entrepreneurial mindset combined along with a collaborative process can be used to deliver the most innovative products.
   - After watching the IDEO YouTube video, list the different factors that has enabled IDEO to become an industry example for corporate innovation.
   - What top principles and behaviors that has contributed to the development of a culture of collaborative excellence?

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2.1.10: Suggested Resources

Ethical and Legal Issues in Entrepreneurship

SBREFA Small Business Resource Center. This is a great site for help with understanding legal requirements and regulatory compliance.

https://www.dol.gov/agencies/oasam/b...nce-assistance

US Department of Labor, Office of the Assistant Secretary for Administration & Management.

Corporate Social Responsibility and Social Entrepreneurship

List of Social Enterprise Business Models or Frameworks: http://www.thesedge.org/socent-spotl...business-ideas

TedTalk video: Carol Sanford at TEDxBerkeley 2014. “The Responsible Entrepreneur: Four Game Changing Archetypes”: www.youtube.com/watch?v=Dqza5Uo1cFE

Global Entrepreneurship Monitor (GEM): www.gemconsortium.org

Social Enterprise and Entrepreneurship (SEE) the Change: https://seethechange.ca

Developing a Workplace Culture of Ethical Excellence and Accountability

Society for Human Resource Management: https://www.shrm.org

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2.2: Ethics

Learning Objectives

- Define ethics
- Explain business ethics
- Describe small business ethics
- Understand why a small business should have an ethics policy

Ethics are about doing the right thing. They are about well-based standards of right and wrong that prescribe what humans ought to do—usually in terms of rights, obligations, benefits to society, fairness, or specific virtues. They serve as guidelines for making decisions about how to behave in specific situations; they also guide us in evaluating the actions of others. Hopefully, they will provide us with a good understanding of how to react to situations long before those situations occur.

What Ethics Are Not

It is important to understand what ethics are *not*.

- **Ethics are not the same as our feelings.** Our feelings are not always accurate indicators about a particular action being unethical (e.g., taking a long lunch or spending too much personal time on the Internet while at work). We all develop defense mechanisms to protect ourselves, so we may not feel badly about a particular unethical act. Some people may actually feel good about behaving unethically.
- **Ethics are not the same as religion.** Most religions champion high ethical standards, but not everyone is religious. Ethics apply to everyone.
- **Ethics are not necessarily synonymous with the law.** There will be instances in which ethical behavior and the law are the same (e.g., in the cases of murder, discrimination, whistleblower protection, and fraud). Such instances are illustrative of a good legal system. There will, however, be times when the law takes a different path than ethics—the result being ethical corruption that serves only the interests of small groups.
- **Ethics are not about following cultural norms.** Following cultural norms works only for ethical cultures. Although most cultures probably like to see themselves as ethical, all societies have been and will be plagued with norms that are unethical (e.g., slavery in the United States prior to the Civil War and sweatshops in developing countries).
- **Ethics are not synonymous with science.** Science cannot tell us what to do. The sciences can provide us with insights into human behavior, but ethics provides the reasons and the guidance for what we should do.
- **Ethics are not the same as values.** Although values are essential to ethics, the two are not synonymous. **Values** are enduring beliefs that a given behavior or outcome is desirable or good. They create internal judgments that will determine how a person actually behaves. Ethics determine which values should be pursued and which should not.

Why Ethics Are Important

Ethics are important because they provide structure and stabilization for society. They help us to understand what is good and bad, and this helps us to choose between right and wrong actions. Without ethics, our actions would be “random and aimless, with no way to work toward a goal because there would be no way to pick between a limitless number of goals.” Ethics do not provide easy answers to hard questions, but they do provide a framework within which to seek the answers.

Business Ethics

Business ethics is applying the virtues and discipline of ethics to business behavior. They set the standard for how your business is conducted and define the value system of how you operate in the marketplace and within your business. They are relevant to any and all aspects of business conduct: workplace issues, product and brand, corporate wrongdoing, professional ethics, and global business ethics. They apply equally to the individual who works for the company and to the company itself because all ethical and unethical business behavior eventually finds its way to the bottom line. It is almost a certainty that someone will encounter an ethical dilemma at some point in his or her professional life.

Asking whether business ethics pay may be the wrong question to ask. Behaving ethically should happen because it is the right thing to do. However, companies large and small are in the business of making money, so the question is not an unreasonable one. Good ethics carry many benefits, not the least of which is financial good health. Companies that "out-behave" the competition ethically will also tend to outperform them financially. According to an Institute of Business Ethics report, companies with a code of conduct generated significantly more economic value added and market value added than those companies without a code, experienced less price to earnings volatility, and showed a 50 percent increase in average return on capital employed.

Do Business Ethics Pay?

Business ethics also pay in other ways that will improve the workplace climate and, ultimately, positively impact the bottom line. They can "reduce incidents of corruption, fraud, and other malpractices; enhance the trust of customers, suppliers and contractors; enhance the credibility of buyers and salespersons; and enhance the loyalty and goodwill of employees, shareholders and customers."

The Costs of Unethical Business Conduct

By contrast, the costs of unethical business behavior can be staggering. Some of the costs include the loss of physical assets, increased security, the loss of customers, the loss of employees, the loss of reputation, legal costs, the loss of investor confidence, regulatory intrusion, and the costs of bankruptcy. According to a report by the Josephson Institute, unethical business behavior has an adverse impact on sales, stock prices, productivity, the performance of highly skilled employees, efficiency, communication, and employee retention and recruiting plus the risks from scandal and employee fraud.

The costs of employee theft are particularly daunting. An estimated 75 percent of employees steal from the workplace, and most do so repeatedly. One-third of all US corporate bankruptcies are caused directly by employee theft; US companies lose nearly $400 billion per year in lost productivity due to "time theft" or loafing; and an estimated 20 percent of every dollar earned by a US company is lost to employee theft. Office supplies, money, and merchandise are the most frequently stolen items. Employee theft may be even more of a concern to small businesses because many small businesses operate so close to the margin. It has been estimated that theft by small business employees totals nearly $40 billion each year.

Video Clip: Business Ethics with Sound

A YouTube element has been excluded from this version of the text. You can view it online here.

Small Business Ethics

In business, it is common for there to be conflicts between business success and ethical behavior. When faced with an ethical dilemma, the decision may be unduly influenced by profits and legality. This challenge is particularly acute for small business owners because they are so much closer to the employees and the customers. The results of ethical decisions will be felt more immediately by the entire company.

Small-business owners will find themselves confronted more often with ethical choices because of the decision-making autonomy that they have; there is no need to answer to a large number of employees, corporate management, or a corporate board. The ethical choices that are made will likely impact a far greater number of people than will the ethical decisions of individual employees. Many business decisions will pose ethical challenges—examples being whether to use inferior materials to produce products because of competition with larger businesses, employee and workplace problems, product quality and pricing, legal problems, and government regulatory concerns. The pressure to make an unethical choice on behalf of the small business can be very powerful, especially when the health and vitality of the business may be at stake. Fortunately, the chances of an unethical decision being made in a small business are lower because the individual or individuals who are harmed will always be more visible. It is more difficult for the small business owner to be unethical. Ultimately, small business owners will behave in accordance with "their own moral compass, sense of fair play and inclination to deal in good faith."

According to one study, small businesses see norms and pressures from the community and peers as having more influence on their ethics than moral or religious principles, the anticipation of rewards, upholding the law, or the fear of punishment. This leads to the conclusion that small business is influenced significantly by the communities in which their businesses are located. Socially responsive behavior is visible and it is "rewarded or sanctioned by local residents through changes in employee morale, performance, and turnover; customer loyalty; and positive interactions with business service professionals, suppliers, local government officials, and business colleagues. These local sanctioning mechanisms [in turn affected] the success of the business."

Because of this community influence, customer relationships are and must be based on trust and the relatively immediate visibility of ethical behavior. It is perhaps not surprising that people in small business are ranked number one on ethical standards ahead of physicians, people in big business, and government officials.

Developing an Ethics Policy

The small business owner is in a unique position to set the ethical tone for the business. Employees will follow the lead of the owner when executing their duties and tending to their responsibilities, so it is critical that the owner establish an ethical work environment. Establishing an **ethics policy (code of conduct or code of ethics)** is an important step in creating that environment. Employees who work in companies with active ethics programs; who observe leaders modeling ethical behavior; and who see honesty, respect, and trust applied frequently in the workplace have reported more positive experiences that include the following:

- Less pressure on employees to compromise ethics standards
- Less observed misconduct at work
- Greater willingness to report misconduct
- Greater satisfaction with their organization's response to misconduct they report
- Greater overall satisfaction with their organizations
- Greater likelihood of "feeling valued" by their organizations

These positive work experiences would be even more notable in small businesses because of the smaller number of employees.

Employee perceptions of their organization's ethical leadership may well be the most important driver of employee trust and loyalty. Having an ethical culture should, therefore, be a top priority for every small business.

Many small business owners may feel that a code of ethics is unnecessary. However, the benefit of having such a code is higher employee morale and commitment, more loyal customers, and a more supportive community. Even the nonemployee small business benefits. A code of ethics puts your business in a more positive, proactive light, and it spells out to customers and employees what behavior is and is not appropriate.

There is no recipe for developing an ethics policy. Its development may involve no one other than the small business owner, but it should involve several people. The contents should be specific to the values, goals, and culture of each company, and it should be "a central guide and reference for users in support of day-to-day decision making. It is meant to clarify an organization's mission, values, and principles, linking them with the standards of professional conduct." Small-business owners must decide what will make the most sense for their companies. Jeff Wuorio offered the following eight guidelines:

1. **Focus on business practices and specific issues.** The content of one company's code of ethics will differ from that of another.
2. **Tailor it to fit your business.** One size does not fit all. Make sure your code of ethics reflects the values and mission of your company.
3. **Include employees in developing a code of ethics.** A mandate from the small business owner will not be effective. Get input from your employees whenever possible. They will be more accepting of the ethics policy.
4. **Train your people to be ethical.** The extent and nature of employee education and training will depend on the size of the small business. Even the smallest business, however, will benefit from some ethics training.
5. **Post your code of ethics internally and set up a reporting system.** Employees need a way to let someone know about ethics violations. Both an open-door policy and an anonymous reporting system will be helpful.
6. **Consider appointing a compliance person.** This would probably not be appropriate for the very small businesses. However, it would be worth considering if the business has fifty or more employees. Having someone to whom employees can report suspected ethical problems would make things much simpler.

7. **Follow up on any ethics violations you uncover.** Make sure that everyone understands the ramifications of ethics policy violations. Include an appeals process. If a small business owner fails to act on ethics violations, employees will not take the policy seriously.
8. **Live it from the top down.** The small business owner must walk the talk. No one should appear to be above the code of ethics. Good role modeling is critical.

The actual development of a code of ethics can be done by starting from scratch, hiring a consultant, or customizing a code from another organization. Before making a choice, it would be worth doing some research. A good place to start would be www.conductcode.com, a website that looks at codes of conduct from a practitioner approach. A search of the Internet will provide examples of codes of ethics, but there is a bias toward larger companies, so small business owners will have to pick and choose what will be best suited to their respective companies.

ETHICAL BEHAVIOR SURVERY

The Ethics Resource Center conducted a survey of employees at large and small businesses and found the following:

- Fifty-six percent of the employees had witnessed misconduct by other employees that violated the firm's ethics standards or policies or the law.
- Fifty-four percent of the employees who had witnessed misconduct believed that reporting the misconduct would not lead to corrective action.
- Forty-two percent of the employees who had witnessed misconduct reported it. The percentage rose to 61 percent for employees whose employers have a well-implemented ethics and compliance program.
- Thirty-six percent of the employees who had witnessed misconduct but did not report it cited fear of retaliation as their reason for not reporting it.

KEY TAKEAWAYS

- Ethics are about doing the right thing. They are about standards that help us decide between right and wrong. They are not the same as our feelings, religion, the law, cultural norms, science, or values.
- Ethics are important because they provide structure and stabilization for society.
- Business ethics are about applying the virtues and discipline of ethics to business behavior. They set the standard for how your business is conducted and define the value system of how you operate in the marketplace and within your business.
- Companies that "out-behave" the competition ethically tend to outperform them financially.
- Ethical behavior in business improves the workplace climate and will ultimately improve the bottom line. The cost of unethical behavior can be staggering.
- Small-business owners have the opportunity to set the ethical tone for their companies. Modeling ethical behavior is key. The community and peers heavily influence small business ethics.
- Establishing an ethics policy is critical for creating an ethical work environment. The contents of the policy should be specific to the values, goals, and culture of each company. One size does not fit all.

EXERCISES

1. MaryAnn's marketing team just presented a "Less Sugar" ad campaign to the cereal brand manager for three of her brands. The packages shouted "75% LESS SUGAR" in large and colorful type so that it would catch the parent's eye and increase sales. With all the recent attention about childhood obesity, the company thought that parents would purchase the cereal to help their children attain and keep a healthy weight. A side-by-side comparison of the less-sugar and the high-sugar versions of the cereals, however, revealed that the carbohydrate content of the cereals was essentially the same. At best, the less-sugar version had only ten fewer calories per bowl. It offered no weight-loss advantage. The brand manager correctly concluded that the marketing campaign was unethical. Was the campaign illegal? What should the cereal brand manager do?
2. An office supplies business with fifty employees has been doing well, but lately, there have been suspicions by some of the employees. No names are known, but it is known that merchandise has been disappearing without explanation, and expensive gifts have been accepted from some vendors. The owner thinks it is time to create and implement a code of

ethics. She has asked you for advice. You told her that it would be important to involve the employees in the development of the code, but you committed to doing two things for her in preparation for that involvement: (1) search the Internet for a code of ethics that could be tailored to her needs and (2) prepare a preliminary list of topics that should be included in the code. She thanked you and asked that you submit your ideas within the week. She reminded you that her business is small, so a code of ethics for a large corporation would not be suitable.

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SECTION OVERVIEW

2.3: Making Ethical Decisions and Managing a Socially Responsible Business

Learning Objectives

After reading this section, you should be able to answer these questions:

- What philosophies and concepts shape personal ethical standards?
- How can organizations encourage ethical business behavior?
- What is corporate social responsibility?
- How do businesses meet their social responsibilities to various stakeholders?
- What are the trends in ethics and corporate social responsibility?

2.3.1: Introduction

2.3.2: Understanding Business Ethics

2.3.3: How Organizations Influence Ethical Conduct

2.3.4: Managing a Socially Responsible Business

2.3.5: Responsibilities to Stakeholders

2.3.6: Trends in Ethics and Corporate Social Responsibility

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2.3.1: Introduction

EXPLORING BUSINESS CAREERS

Playing with a Purpose at Hasbro

Hasbro is a global play and entertainment company that takes corporate social responsibility (CSR) very seriously. Founded nearly a century ago in Rhode Island, Hasbro integrates its CSR efforts throughout the organization with the goal of helping to make the world a better place for children of all ages.

In 2017, the company achieved the number one spot in the "100 Best Corporate Citizens" rankings, published annually by *Corporate Responsibility* magazine. Hasbro is no stranger to this achievement; over the past five years, Hasbro has consistently been in the top five spots on this prestigious list—and that is no accident.

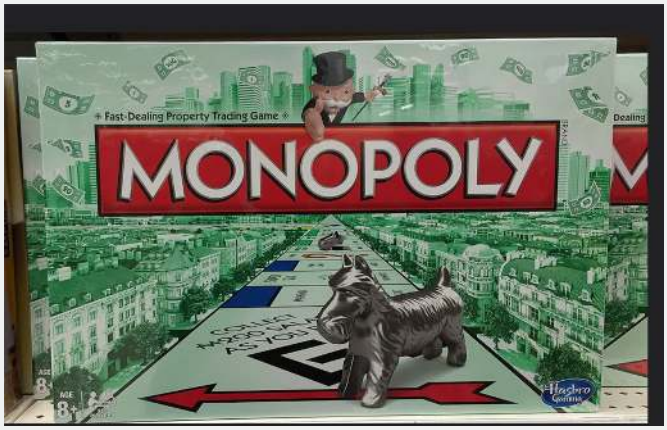


Figure 2.3.1.1: Hasbro's Monopoly game *(Credit: Ben Tsai/ Flickr/ Public Domain)*

With more than 5,000 employees, Hasbro relies heavily on its strategic brand blueprint to guide its efforts in CSR, innovation, philanthropy, and product development. With a business portfolio that includes such well-known brands as Nerf, Play-Doh, Transformers, Monopoly, and The Game of Life, the company focuses its CSR efforts on four key areas: product safety, environmental sustainability, human rights and ethical sourcing, and community.

According to the company, product safety is its highest priority. Hasbro uses a five-step quality assurance process that starts with design and then moves to engineering, manufacturing, and packaging. Another key part of product safety at Hasbro is incorporating continuous feedback from both consumers and retailers and insisting that these high standards and quality processes apply to all third-party factories worldwide that manufacture its products.

Hasbro is also committed to finding new ways to reduce its environmental footprint. Over the past several years, the company has reduced energy consumption, cut greenhouse gas emissions, and reduced water consumption and waste production in its production facilities. In addition, Hasbro has totally eliminated the use of wire ties in all of its product packaging, saving more than *34,000* miles of wire ties—more than enough to wrap around the earth's circumference.

Human rights and ethical sourcing remains a key ingredient of Hasbro's CSR success. Treating people fairly is a core company value, as is working diligently to make great strides in diversity and inclusion at all levels of the organization. Company personnel work closely with third-party factories to ensure that the human rights of all workers in the Hasbroglobal supply chain are recognized and upheld.

Philanthropy, corporate giving, and employee volunteering are key components of the Hasbro community. Through its various charitable programs, Hasbro made close to $15 million in financial contributions and product donations in 2016, which reached close to an estimated 4 million children around the globe. Several years ago the company started an annual Global Day of Joy as a way of engaging its employees worldwide in community service. In a recent year, more than 93 percent of Hasbro's employees participated in service projects in more than 40 countries.

Hasbro is in the business of storytelling, and its CSR efforts tell the story of an ethical, responsible organization whose mission is to create the world's best play experiences. Its ability to be accountable for its actions and to help make the world a better

> place one experience at time continues to make it a highly successful company.

Every day, managers and business owners make business decisions based on what they believe to be right and wrong. Through their actions, they demonstrate to their employees what is and is not acceptable behavior and shape the moral standard of the organization. As you will see in this module, personal and professional ethics are important cornerstones of an organization and shape its ultimate contributions to society in the form of corporate social responsibility. First, let's consider how individual business ethics are formed.

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2.3.2: Understanding Business Ethics

What Philosophies and Concepts Shape Personal Ethical Standards?

Ethics is a set of moral standards for judging whether something is right or wrong. The first step in understanding business ethics is learning to recognize an **ethical issue**. An ethical issue is a situation where someone must choose between a set of actions that may be ethical or unethical. For example, Martin Shkreli, former CEO of Turing Pharmaceuticals, raised the price of a drug used for newborns and HIV patients by more than *5000* percent, defending the price increase as a "great business decision."[1] Few people would call that ethical behavior. But consider the actions of the stranded, hungry people in New Orleans who lost everything in the aftermath of Hurricane Katrina. They broke into flooded stores, taking food and bottled water without paying for them. Was this unethical behavior? Or what about the small Texas plastics manufacturer that employed over 100 people and specialized in the Latin American market? The president was distraught because he knew the firm would be bankrupt by the end of the year if it didn't receive more contracts. He knew that he was losing business because he refused to pay bribes. Bribes were part of the culture in his major markets. Closing the firm would put many people out of work. Should he start paying bribes in order to stay in business? Would this be unethical? Let's look at the next section to obtain some guidance on recognizing unethical situations.

Recognizing Unethical Business Activities

Researchers from Brigham Young University tell us that all unethical business activities will fall into one of the following categories:

1. *Taking things that don't belong to you.* The unauthorized use of someone else's property or taking property under false pretenses is taking something that does not belong to you. Even the smallest offense, such as using the postage meter at your office for mailing personal letters or exaggerating your travel expenses, belongs in this category of ethical violations.
2. *Saying things you know are not true.* Often, when trying for a promotion and advancement, fellow employees discredit their coworkers. Falsely assigning blame or inaccurately reporting conversations is lying. Although "This is the way the game is played around here" is a common justification, saying things that are untrue is an ethical violation.
3. *Giving or allowing false impressions.* The salesperson who permits a potential customer to believe that cardboard boxes will hold the customer's tomatoes for long-distance shipping when the salesperson knows the boxes are not strong enough has given a false impression. A car dealer who fails to disclose that a car has been in an accident is misleading potential customers.
4. *Buying influence or engaging in a conflict of interest.* A conflict of interest occurs when the official responsibilities of an employee or government official are influenced by the potential for personal gain. Suppose a company awards a construction contract to a firm owned by the father of the state attorney general while the state attorney general's office is investigating that company. If this construction award has the potential to shape the outcome of the investigation, a conflict of interest has occurred.
5. *Hiding or divulging information.* Failing to disclose the results of medical studies that indicate your firm's new drug has significant side effects is the ethical violation of hiding information that the product could be harmful to purchasers. Taking your firm's product development or trade secrets to a new place of employment constitutes the ethical violation of divulging proprietary information.
6. *Taking unfair advantage.* Many current consumer protection laws were passed because so many businesses took unfair advantage of people who were not educated or were unable to discern the nuances of complex contracts. Credit disclosure requirements, truth-in-lending provisions, and new regulations on auto leasing all resulted because businesses misled consumers who could not easily follow the jargon of long, complex agreements.
7. *Committing improper personal behavior.* Although the ethical aspects of an employee's right to privacy are still debated, it has become increasingly clear that personal conduct outside the job can influence performance and company reputation. Thus, a company driver must abstain from substance abuse because of safety issues. Even the traditional company holiday party and summer picnic have come under scrutiny due to the possibility that employees at and following these events might harm others through alcohol-related accidents.
8. *Abusing power and mistreating individuals.* Suppose a manager sexually harasses an employee or subjects employees to humiliating corrections or reprimands in the presence of customers. In some cases, laws protect employees. Many situations, however, are simply interpersonal abuse that constitutes an ethical violation.

9. *Permitting organizational abuse.* Many U.S. firms with operations overseas, such as Apple, Nike, and Levi Strauss, have faced issues of organizational abuse. The unfair treatment of workers in international operations appears in the form of child labor, demeaning wages, and excessive work hours. Although a business cannot change the culture of another country, it can perpetuate—or stop—abuse through its operations there.
10. *Violating rules.* Many organizations use rules and processes to maintain internal controls or respect the authority of managers. Although these rules may seem burdensome to employees trying to serve customers, a violation may be considered an unethical act.
11. *Condoning unethical actions.* What if you witnessed a fellow employee embezzling company funds by forging her signature on a check? Would you report the violation? A winking tolerance of others' unethical behavior is itself unethical.[2]

After recognizing that a situation is unethical, the next question is what do you do? The action that a person takes is partially based upon his or her ethical philosophy. The environment in which we live and work also plays a role in our behavior. This section describes personal philosophies and legal factors that influence the choices we make when confronting an ethical dilemma.

Justice—The Question of Fairness

Another factor influencing individual business ethics is **justice**, or what is fair according to prevailing standards of society. We all expect life to be reasonably fair. You expect your exams to be fair, the grading to be fair, and your wages to be fair, based on the type of work being done.

Today we take justice to mean an equitable distribution of the burdens and rewards that society has to offer. The distributive process varies from society to society. Those in a democratic society believe in the "equal pay for equal work" doctrine, in which individuals are rewarded based on the value the free market places on their services. Because the market places different values on different occupations, the rewards, such as wages, are not necessarily equal. Nevertheless, many regard the rewards as just. A politician who argued that a supermarket clerk should receive the same pay as a physician, for example, would not receive many votes from the American people. At the other extreme, communist theorists have argued that justice would be served by a society in which burdens and rewards were distributed to individuals according to their abilities and their needs, respectively.

Utilitarianism—Seeking the Best for the Majority

One of the philosophies that may influence choices between right and wrong is **utilitarianism**, which focuses on the consequences of an action taken by a person or organization. The notion that people should act so as to generate the greatest good for the greatest number is derived from utilitarianism. When an action affects the majority adversely, it is morally wrong. One problem with this philosophy is that it is nearly impossible to accurately determine how a decision will affect a large number of people.

Another problem is that utilitarianism always involves both winners and losers. If sales are slowing and a manager decides to fire five people rather than putting everyone on a 30-hour workweek, the 20 people who keep their full-time jobs are winners, but the other five are losers.

A final criticism of utilitarianism is that some "costs," although small relative to the potential good, are so negative that some segments of society find them unacceptable. Reportedly, the backs of animals a year are deliberately broken so that scientists can conduct spinal cord research that could someday lead to a cure for spinal cord injuries. To a number of people, however, the "costs" are simply too horrible for this type of research to continue.

Following Our Obligations and Duties

The philosophy that says people should meet their obligations and duties when analyzing an ethical dilemma is called **deontology**. This means that a person will follow his or her obligations to another individual or society because upholding one's duty is what is considered ethically correct. For instance, people who follow this philosophy will always keep their promises to a friend and will follow the law. They will produce very consistent decisions, because they will be based on the individual's set duties. Note that this theory is not necessarily concerned with the welfare of others. Say, for example, a technician for Orkin Pest Control has decided that it's his ethical duty (and is very practical) to always be on time to meetings with homeowners. Today he is running late. How is he supposed to drive? Is the technician supposed to speed, breaking his duty to society to uphold the law, or is he supposed to arrive at the client's home late, breaking his duty to be on time? This scenario of conflicting obligations does not lead us to a clear ethically correct resolution, nor does it protect the welfare of others from the technician's decision.

Individual Rights

In our society, individuals and groups have certain rights that exist under certain conditions regardless of any external circumstances. These rights serve as guides when making individual ethical decisions. The term *human rights* implies that certain rights—to life, to freedom, to the pursuit of happiness—are bestowed at birth and cannot be arbitrarily taken away. Denying the rights of an individual or group is considered to be unethical and illegal in most, though not all, parts of the world. Certain rights are guaranteed by the government and its laws, and these are considered *legal rights.* The U.S. Constitution and its amendments, as well as state and federal statutes, define the rights of American citizens. Those rights can be disregarded only in extreme circumstances, such as during wartime. Legal rights include the freedom of religion, speech, and assembly; protection from improper arrest and searches and seizures; and proper access to counsel, confrontation of witnesses, and cross-examination in criminal prosecutions. Also held to be fundamental is the right to privacy in many matters. Legal rights are to be applied without regard to race, color, creed, gender, or ability.

CONCEPT CHECK

1. How are individual business ethics formed?
2. What is utilitarianism?
3. How can you recognize unethical activities?

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2.3.3: How Organizations Influence Ethical Conduct

How Can Organizations Encourage Ethical Business Behavior?

People choose between right and wrong based on their personal code of ethics. They are also influenced by the ethical environment created by their employers. Consider the following headlines:

- Investment advisor Bernard Madoff sentenced to 150 years in prison for swindling clients out of more than $65 billion.
- Former United Airlines CEO Jeff Smisek leaves the company after a federal investigation into whether United tried to influence officials at the Port Authority of New York.
- Renaud Laplanche, the founder of Lending Club, loses his job because of faulty practices and conflicts of interest at the online peer-to-peer lender.
- Wells Fargo CEO John Stumpf fired after company employees opened more than 2 million fake accounts to meet aggressive sales targets.

As these actual stories illustrate, poor business ethics can create a very negative image for a company, can be expensive for the firm and/or the executives involved, and can result in bankruptcy and jail time for the offenders. Organizations can reduce the potential for these types of liability claims by educating their employees about ethical standards, by leading through example, and through various informal and formal programs.

Leading by Example

Employees often follow the examples set by their managers. That is, leaders and managers establish patterns of behavior that determine what's acceptable and what's not within the organization. While Ben Cohen was president of Ben & Jerry's ice cream, he followed a policy that no one could earn a salary more than seven times that of the lowest-paid worker. He wanted all employees to feel that they were equal. At the time he resigned, company sales were $140 million, and the lowest-paid worker earned $19,000 per year. Ben Cohen's salary was $133,000, based on the "seven times" rule. A typical top executive of a $140 million company might have earned 10 times Cohen's salary. Ben Cohen's actions helped shape the ethical values of Ben & Jerry's.

Offering Ethics Training Programs

In addition to providing a system to resolve ethical dilemmas, organizations also provide formal training to develop an awareness of questionable business activities and practice appropriate responses. Many companies have some type of ethics training program. The ones that are most effective, like those created by Levi Strauss, American Express, and Campbell Soup Company, begin with techniques for solving ethical dilemmas such as those discussed earlier. Next, employees are presented with a series of situations and asked to come up with the "best" ethical solution. One of these ethical dilemmas is shown below. According to a recent survey by the Ethics Resource Center, more than 80 percent of U.S. companies provide some sort of ethics training for employees, which may include online activities, videos, and even games.

An Ethical Dilemma Used for Employee Training

Bill Gannon was a middle manager of a large manufacturer of lighting fixtures in Newark, New Jersey. Bill had moved up the company ladder rather quickly and seemed destined for upper management in a few years. Bill's boss, Dana Johnson, had been pressuring him about the semiannual reviews concerning Robert Talbot, one of Bill's employees. Dana, it seemed, would not accept any negative comments on Robert's evaluation forms. Bill had found out that a previous manager who had given Robert a bad evaluation was no longer with the company. As Bill reviewed Robert's performance for the forthcoming evaluation period, he found many areas of subpar performance. Moreover, a major client had called recently complaining that Robert had filled a large order improperly and then had been rude to the client when she called to complain.

Discussion Questions

1. What ethical issues does the situation raise?
2. What courses of action could Bill take? Describe the ethics of each course.
3. Should Bill confront Dana? Dana's boss?
4. What would you do in this situation? What are the ethical implications?

Establishing a Formal Code of Ethics

Most large companies and thousands of smaller ones have created, printed, and distributed codes of ethics. In general, a **code of ethics** provides employees with the knowledge of what their firm expects in terms of their responsibilities and behavior toward fellow employees, customers, and suppliers. Some ethical codes offer a lengthy and detailed set of guidelines for employees. Others are not really codes at all but rather summary statements of goals, policies, and priorities. Some companies have their codes framed and hung on office walls, included as a key component of employee handbooks, and/or posted on their corporate websites.

Do codes of ethics make employees behave in a more ethical manner? Some people believe that they do. Others think that they are little more than public relations gimmicks. If senior management abides by the code of ethics and regularly emphasizes the code to employees, then it will likely have a positive influence on behavior.

The "100 Best Corporate Citizens" as ranked by *Corporate Responsibility* magazine are selected based on seven categories, including employee relations, human rights, corporate governance (including code of ethics), philanthropy and community support, financial performance, environment, and climate change. The top corporate citizens in 2017 were:

1. Hasbro, Inc.
2. Intel Corp.
3. Microsoft Corp.
4. Altria Group, Inc.
5. Campbell Soup Company
6. Cisco Systems, Inc.
7. Accenture
8. Hormel Foods Corp.
9. Lockheed Martin Corp.
10. Ecolab, Inc.

CUSTOMER SATISFACTION AND QUALITY

Campbell's Adds CSR to Its Recipe

The Campbell Soup Company is no longer just about traditional cans of processed soup. Under the guidance of its management team, particularly its former CEO Denise Morrison (Morrison retired from Campbell's in July of 2018), Campbell's has undergone a transformation that includes a strong emphasis on organics and fresh food—and a large serving of corporate citizenship.

Named one of the Best Corporate Citizens by *Corporate Responsibility* magazine in 2017, Campbell's is working to make sustainability and transparency part of its business DNA, and this culture shift has had an important influence on the company's business strategies.

Morrison, who took over as CEO in 2011, is a firm believer in the company's central vision: real food that matters for life's moments. "We can make a profit and make a difference, and we are doing both through our business . . . in a way that's authentic, that's transparent, and that truly matters," she explains.

Under Morrison's watch, the company recently acquired several fresh food and organic companies, including Bolthouse Farms, one of the largest suppliers of fresh carrots in the United States, and Garden Fresh Gourmet, which produces a top line of fresh salsa and hummus. Tracking the strong change in consumer preference for healthier food, Campbell's also recently acquired Plum Organics, a line of organic baby food products, which should help solidify the company's reputation for fresh ingredients with millennials and their families.

The company's transformation from a processed food giant to a major competitor in the fresh food business has also had a positive influence on the company's bottom line. Campbell's shareholders have to be pleased with the 20 percent increase in the company's stock price over the past two years, as the markets, competitors, and consumers take notice of the company's strong commitment to sustainability.

Inherent in the company's reinvention is the strong emphasis on corporate citizenship—doing good and giving back seem to be top priorities for Campbell's. In addition to acquiring sustainable and fresh food companies, Campbell's has also made a

conscious decision to support the communities where their employees live and work. For example, the company launched a healthy communities initiative in Camden, New Jersey, where Campbell's is headquartered—an urban city that has seen its share of economic and social challenges in the past. In partnership with several local organizations, this initiative has helped fund community gardens, food pantries, nutrition education, and cooking classes that help build healthy communities. The Camden experience has been so successful that the company has expanded the program to other cities where it operates, including Detroit, Michigan, and Norwalk, Connecticut.

The company's ongoing commitment to fresh food, community involvement, and corporate social responsibility has helped change the narrative when it comes to being a sustainable and ethical organization.

Questions for Discussion

1. How does Campbell Soup Company's recent business acquisitions help support its CSR strategies?
2. Provide examples of how the company's transformation from a processed food giant to a purveyor of fresh ingredients can help attract a new group of customers.

Making the Right Decision

In many situations, there may be no simple right or wrong answers. Yet there are several questions you can ask yourself, and a couple of self-tests you can do, to help you make the right ethical decision. First, ask yourself, "Are there any legal restrictions or violations that will result from the action?" If so, take a different course of action. If not, ask yourself, "Does it violate my company's code of ethics?" If so, again find a different path to follow. Third, ask, "Does this meet the guidelines of my own ethical philosophy?" If the answer is "yes," then your decision must still pass two important tests.

The Feelings Test

You must now ask, "How does it make me feel?" This enables you to examine your comfort level with a particular decision. Many people find that, after reaching a decision on an issue, they still experience discomfort that may manifest itself in a loss of sleep or appetite. Those feelings of conscience can serve as a future guide in resolving ethical dilemmas.

The Newspaper or Social Media Test

The final test involves the front page of the newspaper or social media posts. The question to be asked is how an objective reporter would describe your decision in a front-page newspaper story, an online media site, or a social media platform such as Twitter or Facebook. Some managers rephrase the test for their employees: How will the headline read if I make this decision, or what will be the reaction of my social media followers? This test is helpful in spotting and resolving potential conflicts of interest.

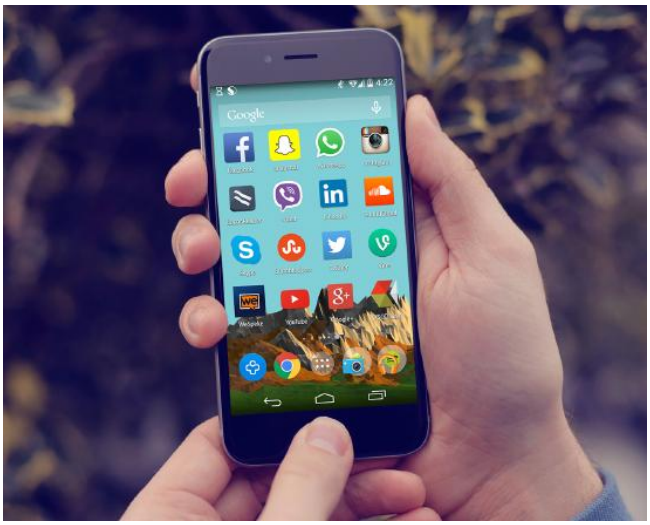


Figure 2.3.3.1: Making an ethical decision might come down to how you feel about the decision or to the newspaper or social media post test. The question to ask yourself is how the decision would make you feel if an objective reporter described the decision on the front page of a newspaper or via a social media post on Twitter or Facebook—all of which would be viewed by many, many people. Speaking of social media, it plays a pivotal role in ethical decision-making today, when people use the medium to share critical comments about friends as well as employers, business colleagues, and competitors. *Should companies view employees' social media pages on a regular basis, or is that information off-limits to employers?* (Credit: Mike MacKenzie/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

CONCEPT CHECK

1. What is the role of top management in organizational ethics?
2. What is a code of ethics?

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2.3.4: Managing a Socially Responsible Business

What is Corporate Social Responsibility?

Acting in an ethical manner is one of the four components of the pyramid of **corporate social responsibility (CSR),** which is the concern of businesses for the welfare of society as a whole. It consists of obligations beyond those required by law or union contract. This definition makes two important points. First, CSR is voluntary. Beneficial action required by law, such as cleaning up factories that are polluting air and water, is not voluntary. Second, the obligations of corporate social responsibility are broad. They extend beyond investors in the company to include workers, suppliers, consumers, communities, and society at large.

Figure 2.3.4.1 portrays economic responsibility as the foundation for the other three responsibilities. At the same time that a business pursues profits (economic responsibility), however, it is expected to obey the law (legal responsibility); to do what is right, just, and fair (ethical responsibility); and to be a good corporate citizen (philanthropic responsibility). These four components are distinct but together constitute the whole. Still, if the company doesn't make a profit, then the other three responsibilities won't matter.

Many companies continue to work hard to make the world a better place to live. Recent data suggests that Fortune 500 companies spend more than $15 billion annually on CSR activities. Consider the following examples:

- Starbucks has donated more than one million meals to local communities via its FoodShare program and alliance with Feeding America, giving 100 percent of leftover food from their seven thousand U.S. company-owned stores.
- Salesforce encourages its employees to volunteer in community activities and pays them for doing so, up to 56 paid hours every year. For employees who participate in seven days of volunteerism in one year, Salesforce also gives them a $1,000 grant to donate to the employee's nonprofit of choice.
- Employees who work for Deloitte, a global audit, consulting, and financial services organization, can get paid for up to 48 hours of volunteer work each year. In a recent year, more than 27,000 Deloitte professionals contributed more than 353,000 volunteer hours to their communities around the world.[6]

Understanding Social Responsibility

Peter Drucker, the late globally respected management expert, said that we should look first at what an organization does *to* society and second at what it can do *for* society. This idea suggests that social responsibility has two basic dimensions: legality and responsibility.

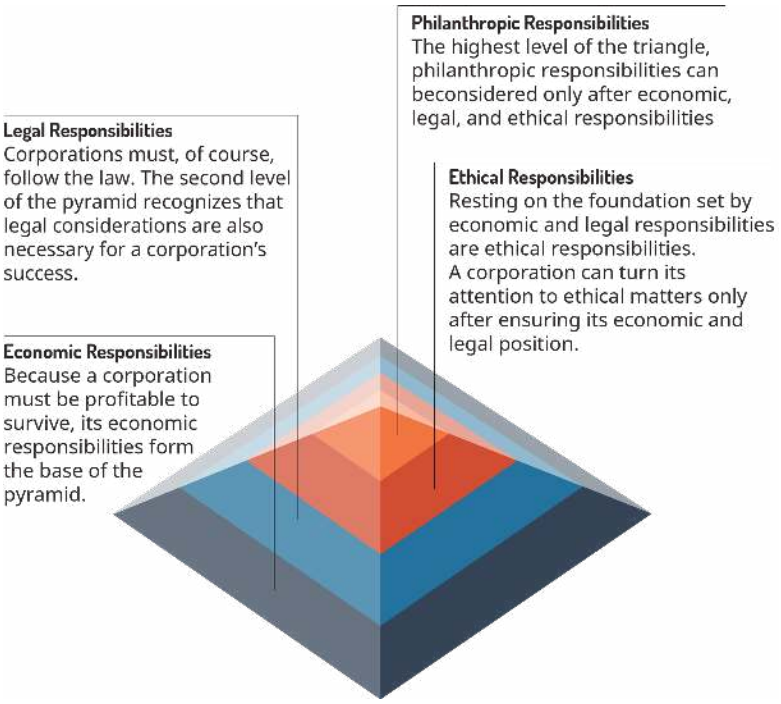


Figure 2.3.4.1: The Pyramid of Corporate Social Responsibility *(Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)*

Illegal and Irresponsible Behavior

The idea of corporate social responsibility is so widespread today that it is hard to conceive of a company continually acting in illegal and irresponsible ways. Nevertheless, such actions do sometimes occur, which can create financial ruin for organizations, extreme financial hardships for many former employees, and general struggles for the communities in which they operate. Unfortunately, top executives still walk away with millions. Some, however, will ultimately pay large fines and spend time in prison for their actions. Federal, state, and local laws determine whether an activity is legal or not. The laws that regulate business are discussed later in this module.

Irresponsible but Legal Behavior

Sometimes companies act irresponsibly, yet their actions are legal. For example, the Minnesota-based company that makes MyPillow was recently fined $1 million by the state of California for making unsubstantiated claims that the "most comfortable pillow you'll ever own" could help alleviate medical conditions such as snoring, fibromyalgia, migraines, and other disorders. The company's CEO countered that the claims were actually made by customers; these testimonials were posted on the company's website but later removed. In addition to the fine, the company faced several class-action lawsuits, and the Better Business Bureau has revoked MyPillow's accreditation.

CATCHING THE ENTREPRENEURIAL SPIRIT

Badger Company Founder Walks the Walk

As a carpenter, Bill Whyte was always looking for a solution to his dry, cracked hands, especially in the harsh New Hampshire winters. After trying many commercial lotions that didn't really work, Whyte experimented with olive oil and beeswax to come up with a soothing balm to help heal rough hands. Mixing up the concoction at home, Whyte came up with a product that seemed to work and was made from natural ingredients.

Originally called Bear Paw, the lotion became known as Badger Balm after a friend found a competing product already named Bear Paw. Whyte set up a production line at home to fill the tins. Soon he was pounding the pavement in the town of Gilsum, trying to sell the new product to hardware stores, lumber yards, and health food stores.

Fast-forward a little more than 20 years from his early days of experimentation, and Whyte (affectionately known as the "head badger") runs W.S. Badger Company with the same goals and passions he started with back in the mid-1990s. The company

uses only organic plant extracts, exotic oils, beeswax, and minerals to make the most effective products to soothe, heal, and protect the body. And the natural ingredients come from all over the world—for example, organic extra virgin olive oil from Spain, organic rose essential oil from Bulgaria, and bergamot oil from southern Italy.

Badger's homey culture is no accident. In fact, in the early days, Whyte made soup every Friday for the small staff. Today, Whyte and family members, including his wife Kathy, chief operating officer; daughter Rebecca, head of sustainability and innovation; and daughter Emily, head of sales and marketing, all embrace the ethical and social principles of this family business that have made the company a success.

To reinforce the commitment of being socially responsible and demonstrating transparency, W.S. Badger Company became a Certified Benefit Corporation, or B Corp for short. This certification requires companies to meet rigorous standards for transparency, accountability, and social and environmental performance. (Benefit Corporations are discussed in more detail later in this module.)

Becoming a B Corp. has helped the company organize how it operates. For example, pay for the highest-paid full-time employee is capped at five times that of the lowest-paid, which is now $15 an hour (more than double New Hampshire's minimum wage); a portion of company profits flows to employees via profit-sharing, and all employees participate in a bonus plan; and new parents are encouraged to bring their babies to work, a program that has helped foster a new style of teamwork for the entire organization, as well as increase employee morale. In addition, Badger donates 10 percent of its pre-tax profits annually to nonprofit organizations that focus on the health and welfare of children, matches employee contributions to charitable causes (up to $100 per employee), and donates an additional $50 to a nonprofit chosen by each employee on their birthday.

Badger staff, which now number more than 100, enjoy a living wage, great benefits, and a socially responsible work environment thanks to a visionary who found an eco-friendly way to soothe his rough hands and created an ethical business as part of his journey.

Discussion Questions

1. How does Badger's approach to social responsibility help attract and retain employees?
2. Does the company's certification as a Benefit Corporation provide Badger with a competitive advantage? Explain your reasoning.

Legal and Responsible Behavior

The vast majority of business activities fall into the category of behavior that is both legal and responsible. Most companies act legally, and most try to be socially responsible. Research shows that consumers, especially those under 30, are likely to buy brands that have excellent ethical track records and community involvement. Outdoor specialty retailer REI, for example, recently announced that it gave back nearly 70 percent of its profits to the outdoor community. A member cooperative, the company invested a record $9.3 million in its nonprofit partners in 2016.

CONCEPT CHECK

1. What are the four components of social responsibility?
2. Give an example of legal but irresponsible behavior.

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2.3.5: Responsibilities to Stakeholders

How Do Businesses Meet Their Social Responsibilities to Various Stakeholders?

What makes a company be admired or perceived as socially responsible? Such a company meets its obligations to its stakeholders. **Stakeholders** are the individuals or groups to whom a business has a responsibility. The stakeholders of a business are its employees, its customers, the general public, and its investors.

Responsibility to Employees

An organization's first responsibility is to provide a job to employees. Keeping people employed and letting them have time to enjoy the fruits of their labor is the finest thing business can do for society. Beyond this fundamental responsibility, employers must provide a clean, safe working environment that is free from all forms of discrimination. Companies should also strive to provide job security whenever possible.

Enlightened firms are also empowering employees to make decisions on their own and suggest solutions to company problems. Empowerment contributes to an employee's self-worth, which, in turn, increases productivity and reduces absenteeism.

Each year, in collaboration with Great Place to Work®, *Fortune* conducts an extensive employee survey of the best places to work in the United States. For 2017, the top companies included Google, Wegmans Food Markets, Edward Jones, Genentech, Salesforce, Acuity, and Quicken Loans. Some companies offer unusual benefits to their employees. For example, biotech company Genentech offers employee compensation for taking alternative methods of transportation to work at its South San Francisco campus. Employees can earn $12 per day for walking or biking to work, and those who drive a carpool or vanpool can earn $8 and $16, respectively. In addition, the company offers free commuter bus service for all employees via 27 routes around the Bay Area.

Responsibility to Customers

To be successful in today's business environment, a company must satisfy its customers. A firm must deliver what it promises, as well as be honest and forthright in everyday interactions with customers, suppliers, and others. Recent research suggests that many consumers, particularly millennials, prefer to do business with companies and brands that communicate socially responsible messages, utilize sustainable manufacturing processes, and practice ethical business standards.

Responsibility to Society

A business must also be responsible to society. A business provides a community with jobs, goods, and services. It also pays taxes that go to support schools, hospitals, and better roads. Some companies have taken an additional step to demonstrate their commitment to stakeholders and society as a whole by becoming Certified Benefit Corporations, or B Corps for short. Verified by B Lab, a global nonprofit organization, B Corps meet the highest standards of social and environmental performance, public transparency, and legal accountability and strive to use the power of business to solve social and environmental problems via an impact assessment that rates each company on a possible score of 200 points. To become certified as a Benefit Corporation, companies need to reach a score of at least 80 and must be recertified every two years. There are more than 2,000 companies worldwide that have been certified as B Corps, including Method, W.S. Badger Company, Fishpeople Seafood, LEAP Organics, New Belgium Brewing Company, Ben & Jerry's, Cabot Creamery Co-op, Comet Skateboards, Etsy, Patagonia, Plum Organics, and Warby Parker.

Environmental Protection

Business is also responsible for protecting and improving the world's fragile environment. The world's forests are being destroyed fast. Every second, an area the size of a football field is laid bare. Plant and animal species are becoming extinct at the rate of 17 per hour. A continent-size hole is opening up in the earth's protective ozone shield. Each year we throw out 80 percent more refuse than we did in 1960; as a result, more than half of the nation's landfills are filled to capacity.

To slow the erosion of the world's natural resources, many companies have become more environmentally responsible. For example, Toyota now uses renewable energy sources such as solar, wind, geothermal, and water power for electricity to run its facilities. When its new $1 billion North American headquarters opened in Plano, Texas, in May 2017, Toyota said the 2.1 million-

square-foot campus would eventually be powered by 100% clean energy, helping the auto giant move closer to its goal of eliminating carbon emissions in all of its operations.

ETHICS IN PRACTICE

This Fish Story Has a Tasting Ending

Duncan Berry has always been an environmentalist at heart. Brought up on the Oregon coast, he was a sea captain at an early age, spending nearly two decades on the ocean before going on to become a successful entrepreneur in the organic cotton industry. After selling the textile business at the age of 50, he retired back to the Oregon coast to work on a state initiative to preserve marine habitats.

He quickly discovered that the state's commercial fishing industry had gone into major disrepair since his seafaring adventure years earlier. Berry learned the majority of seafood consumed in the United States was being imported from other countries and more than 90 percent of U.S. seafood was being exported. In addition, great harm was being done to the ocean because it was being overfished.

Although several groups were already working to improve the commercial fishing industry, he observed that one key group was not part of the discussion: consumers. Berry decided a key component of change had to be involving consumers in the process. He spent more than a year meeting with everyone involved in the Oregon fishing industry—from fishermen to processors, distributors, truck drivers, chefs, and consumers—to gain perspective on why the industry was failing. His "aha" moment occurred when he realized the majority of fish is consumed in restaurants because consumers think preparing fish at home is too difficult and time-consuming. That's when he co-founded Fishpeople Seafood.

Started in 2012, Fishpeople has a mission of changing the way people think about seafood by being transparent about where the seafood comes from, how it is processed, and how it is handled. Berry believes the company's transparency helps consumers understand how the process translates into sustainable food that tastes good and is good for you. The company makes shelf-stable, ready-to-eat restaurant-quality seafood in the form of soups, meal kits, and fresh and frozen filets, complete with farm-to-table ingredients. On every package there is a code consumers can enter at the company's website that will tell them everything about the seafood's origin, down to the fisherman who caught it. Fishpeople also operates a processing plant in Toledo, Oregon, where workers are paid a livable wage and receive health insurance—benefits typically unheard of in the fishing industry.

Fishpeople's products are available in more than 5,000 stores nationwide, including Walmart, Whole Foods, Costco, Kroger, and other grocery stores and markets. Recently the company announced a merger with Ilwaco Landing Fishermen, which will help further the two groups' shared vision of supporting local fishermen and providing sustainable seafood to consumers.

Discussion Questions

1. How does Fishpeople's transparency contribute to the company's success?
2. What responsibility, if any, does Fishpeople have to the local fishing industry?

Corporate Philanthropy

Companies also display their social responsibility through corporate philanthropy. **Corporate philanthropy** includes cash contributions, donations of equipment and products, and support for the volunteer efforts of company employees. Recent statistics suggest U.S. corporate philanthropy exceeds more than $19 billion annually. American Express is a major supporter of the American Red Cross. The organization relies almost entirely on charitable gifts to carry out its programs and services, which include disaster relief, armed-forces emergency relief, blood and tissue services, and health and safety services. The funds provided by American Express have enabled the Red Cross to deliver humanitarian relief to victims of numerous disasters around the world. When Hurricane Katrina hit the Gulf Coast, Bayer sent 45,000 diabetes blood glucose monitors to the relief effort. Within weeks of the disaster, Abbott, Alcoa, Dell, Disney, Intel, UPS, Walgreens, Walmart, and others contributed more than $550 million for disaster relief.



Figure 2.3.5.1: Hybrid cars and all-electric vehicles such as Tesla models are turning heads and changing the way the world drives. Electric vehicles are more eco-friendly, but they are also more expensive to own. Analysts project that after charging, insurance, and maintenance costs, electric cars cost thousands of dollars more than conventional vehicles. Do the environmental benefits associated with electric cars justify the higher cost of ownership? *(Credit: Steve Jurvetson/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

Responsibilities to Investors

Companies' relationships with investors also entail social responsibility. Although a company's economic responsibility to make a profit might seem to be its main obligation to its shareholders, some investors increasingly are putting more emphasis on other aspects of social responsibility.

Some investors are limiting their investments to securities (e.g., stocks and bonds) that coincide with their beliefs about ethical and social responsibility. This is called **social investing**. For example, a social investment fund might eliminate from consideration the securities of all companies that make tobacco products or liquor, manufacture weapons, or have a history of being environmentally irresponsible. Not all social investment strategies are alike. Some ethical mutual funds will not invest in government securities because they help to fund the military; others freely buy government securities, with managers noting that federal funds also support the arts and pay for AIDS research. Today, assets invested using socially responsible strategies total more than $7 trillion.

Perhaps partly as the result of the global recession of 2007–2009, over the last several years companies have tried to meet responsibilities to their investors as well as to their other stakeholders. Recent research suggests that now more than ever, CEOs are being held to higher standards by boards of directors, investors, governments, media, and even employees when it comes to corporate accountability and ethical behavior. A recent global study by PwC reveals that over the last several years, there has been a large increase in the number of CEOs being forced out due to some sort of ethical lapse in their organizations. Strategies to prevent such missteps should include establishing a culture of integrity to prevent anyone from breaking the rules, making sure company goals and metrics do not create undue pressure on employees to cut corners, and implementing effective processes and controls to minimize the opportunity for unethical behavior.

CONCEPT CHECK

1. How do businesses carry out their social responsibilities to consumers?
2. What is corporate philanthropy?
3. Is a company's only responsibility to its investors to make a profit? Why or why not?

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2.3.6: Trends in Ethics and Corporate Social Responsibility

What are the Trends in Ethics and Corporate Social Responsibility?

Three important trends related to ethics and corporate social responsibility are strategic changes in corporate philanthropy, a new social contract between employers and employees, and the growth of global ethics and corporate social responsibility.

Changes in Corporate Philanthropy

Historically, corporate philanthropy has typically involved companies seeking out charitable groups and giving them money or donating company products or services. Today, the focus has shifted to **strategic giving**, which ties philanthropy and corporate social responsibility efforts closely to a company's mission or goals and targets donations to the communities where a company does business. Some of the top businesses recognized for their efforts in giving back to the communities in which they operate include technology giant Salesforce, San Antonio's NuStar Energy, insurance and financial services firm Veterans United, and software leader Intuit.

A Social Contract between Employer and Employee

Another trend in social responsibility is the effort by organizations to redefine their relationship with their employees. Many people have viewed social responsibility as a one-way street that focuses on the obligations of business to society, employees, and others. Now, companies recognize that the social contract between employer and employee is an important aspect of the workplace and that both groups have to be committed to working together in order for the organization to prosper. The social contract can be defined in terms of four important aspects: compensation, management, culture, and learning and development.

When it comes to compensation, companies today must recognize that most employees do not stay with one organization for decades. Thus, companies need to change their compensation structure to acknowledge the importance of short-term performance and to update their methods for determining compensation, including benefits and other nontraditional perks such as increased paid leave and telecommuting options.

In the current workplace environment, where employees are likely to jump to new jobs every couple years, managers need to take a more active and engaged approach to supervising employees and perhaps change the way they think about loyalty, which may be difficult for managers used to supervising the same group of employees for a long period of time. Engaging employees on a regular basis, setting realistic expectations, and identifying specific development paths may help retain key employees.

Thanks to today's tight labor market, some employees feel empowered to demand more from their employer and its overall culture via strategies such as increased flexibility, transparency, and fairness. This increased importance of the employee's role in the company's culture helps workers stay engaged in the mission of the organization and perhaps makes them less likely to look elsewhere for employment.

Finally, rapidly changing technology used in today's workplace continues to shift the learning and development component of the employer-employee contract, causing immense challenges to both companies and workers. It may be more difficult to identify the employee skills that will be critical over the next several years, causing employers either to increase training of current workers or to look outside the organization for other individuals who already possess the technical skills needed to get the job done.

Global Ethics and Social Responsibility

When U.S. businesses expand into global markets, they must take their codes of ethics and policies on corporate social responsibility with them. As a citizen of several countries, a multinational corporation has several responsibilities. These include respecting local practices and customs, ensuring that there is harmony between the organization's staff and the host population, providing management leadership, and developing a solid group of local managers who will be a credit to their community. When a multinational firm makes an investment in a foreign country, it should commit to a long-term relationship. That means involving all stakeholders in the host country in decision-making. Finally, a responsible multinational will implement ethical guidelines within the organization in the host country. By fulfilling these responsibilities, the company will foster respect for both local and international laws.

Multinational corporations often must balance conflicting interests of stakeholders when making decisions regarding social responsibilities, especially in the area of human rights. Questions involving child labor, forced labor, minimum wages, and workplace safety can be particularly difficult. Recently Gap, Inc. decided to publish the list of its global factories in an effort to provide transparency about its suppliers and the efforts the company continues to make to improve working conditions around the world. The company has partnered with Verité, a nongovernmental organization focused on ensuring that people work under safe, fair, and legal conditions. By soliciting feedback from factory workers making its products, Gap is hoping to improve working conditions and help these factories become leaders in their local communities.

CONCEPT CHECK

1. Describe strategic giving.
2. What role do employees have in improving their job security?
3. How do multinational corporations demonstrate social responsibility in a foreign country?

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3.1.1: Introduction

What do you plan to do with your life after graduating from school? This is one of the most common—and admittedly most terrifying—questions that students are asked on a regular basis. There are literally thousands of career choices and just as many pathways or options to reach them. How do you decide which career pathway is best for you? You might select a new career based on your major, a favorite high school subject, the advice of a family member or friend, or an inspirational summer or internship experience.

What if none of those options reflect the future that you see for yourself? It may mean that you are destined to create your own career path by becoming an entrepreneur. Regardless of the career pathway that you follow, your entrepreneurial journey begins with a single step.



Figure 3.1.1.1: College graduates face numerous choices and challenges when deciding which pathway will lead to career satisfaction and success. *(Credit: modification of "commencement graduation ceremony" by "Goodfreephotos_com"/Pixabay, CC0)*

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3.1.2: Overview of the Enterpreneurial Journey

Learning Objectives

By the end of this section, you will be able to:

- Explain the entrepreneurial journey to explore and discover entrepreneurship as a career choice
- Identify the steps, decisions, and actions involved in the entrepreneurial journey
- Recognize the rewards and risks of the steps in the entrepreneurial journey

Self-Employment as an Entrepreneurial Journey

When the economy and the job market are strong, the entrepreneur has a safety net that decreases the risks in creating a new **venture**, a startup company or organization that conducts business or is created to satisfy a need, and allows for a quick recovery if the venture is not successful. There are more new startups when there are high levels of confidence in both the venture's success and the entrepreneur's confidence in finding employment if the venture fails. People over 40 years of age account for most new startup activity, in part because of the continuing trend in which a business may choose not to hire an employee but instead hire an **independent contractor**, a person who provides work similar to an employee without being part of the payroll for the contracting business, and who is responsible for paying their own taxes and providing their own benefits. With previous knowledge and expertise, this group of entrepreneurs recognizes opportunities created by this move away from hiring full-time employees to more outsourcing to independent contractors. One contributor is the gig economy, which involves using temporary and often transitional positions hired on a case-by-case basis, rather than keeping a full staff of hired employees. Advantages for the employer include a decrease in cost of benefits and loyalties to specific employees. Advantages for the hired worker or independent contractor (sometimes called a freelancer) include no long-term commitment and flexibility in accepting contracts. From an entrepreneurial perspective, the creation of websites that support the gig economy offers opportunities for independent ventures. Many people today are becoming small entrepreneurs. This process goes by a variety of names, such as the sharing economy, the gig economy, the peer economy, or the collaborative economy. Maybe it means driving for a company such as Lyft, Uber, or GrubHub, or perhaps offering services through TaskRabbit, UpWork, or LivePerson. The projected numbers of independent contractors and on-demand workers are stated as 42 percent for small businesses by the year 2020, a growth of 8 percent from current figures. And a projection of greater than 50 percent of the workforce will be independent contractors by 2027 if this trend continues at the current pace. In the "Freelancing in America: 2019" report, the sixth annual study by UpWork and Freelancers Union, 57 million United States citizens are estimated to freelance, with income approaching 5 percent of US gross domestic product (GDP) at nearly $1 trillion and earning a median rate of $28.00 an hour, representing an hourly income greater than 70 percent of workers in the overall US economy. One report found that 94 percent of net job growth from 2005 to 2015 was in alternative work categories, with 60 percent due to independent contractors and contract company workers.

According to the US Bureau of Labor Statistics, the number of self-employed Americans is growing, with 9.6 million self-employed people at the end of 2016. That number is expected to grow to 10.3 million by 2026. A more recent study by FreshBooks' second annual "Self-Employment" report predicts that 27 million US employees will leave traditional work in favor of self-employment by 2020, tripling the current population of full-time self-employed professionals to 42 million. The main driver for this change in the workforce is a greater desire for control over one's career with the ability to have greater control over working hours and acceptance of work. Of course, self-employment is a broad category that includes small-business owners as well as entrepreneurial startups and freelance gig employees. Since 2016, there has been a downward slide in the number of employees working for self-employed businesses, which results from a variety of factors, including difficulties in finding qualified employees, qualified employees having more employment options, such as employment through the gig economy, outsourcing activities, and technology actions that decrease the need for employees, with entrepreneurial activity remaining steady.

Entrepreneurship around the World

In a 2017 *Business Insider* article, "America Needs Immigrant Entrepreneurs," David Jolley writes that immigrants constitute 15 percent of the US workforce and 25 percent of the country's workforce of entrepreneurs. Forty percent of startups include at least one immigrant. Jolley's article cites a study that identified immigrants as twice as likely to start a business as native-born Americans. In 2016, 40.2 percent of Fortune 500 companies were founded by at least one immigrant or a child of immigrant

parents. Dinah Brin, writing for *Forbes*, stated in a 2018 article that immigrants form 25 percent of new US businesses and that new immigrant-owned firms generated 4 to 5 million jobs.

These statistics and other findings have prompted countries such as Canada to revise their immigration policies to attract more entrepreneurial-minded immigrants. A World Bank report from May 2018 ranked the United States 53rd out of 190 countries for ease in starting a business, with higher scores representing greater ease. The same report ranks the United States eighth for ease of doing business. The difference in these rankings indicates that once a business is established, factors such as regulations, permits, access to credit, and infrastructure support the business owner's ability to continue the business, but actually starting the business is more challenging. For any given country, ease in starting a business and the country's interest in supporting entrepreneurial activity are crucial in both attracting entrepreneurial people and supporting their ability to open a business. Imposing restrictive regulations and processes on new ventures significantly decreases the number of new ventures.

According to a 2018/2019 report, the highest rate of entrepreneurial activity worldwide in 2018 was in Angola at 41 percent. Angola's low-income economy meant fewer employment opportunities, creating pressures to find other ways to earn an income. Guatemala and Chile reported 28 percent and 25 percent of entrepreneurial activity, respectively, with medium- and high-income economies. These percentages are quite high, considering that these economies offer employment opportunities in existing companies. In terms of innovation, India at 47 percent, and Luxembourg and Chile at 48 percent each, take the lead in offering new products and services not previously available. This entrepreneurial activity reflects the ease of starting a business. The Netherlands, Poland, and Sweden were reported as the easiest countries in which to start a new business, in part because many people in those countries view entrepreneurship as an attractive lifestyle. As you can see, both economic opportunities and a country's specific support for entrepreneurial behavior contribute to the number of people who enter entrepreneurial activities.

From a gender perspective, there are currently over 11 million woman-owned businesses in the United States. This number includes both small business owners and entrepreneurs. Thirty years ago, there were only 4 million woman-owned businesses. The number of woman-owned businesses has increased 45 percent between 2007 and 2016, five times faster than the national average, with 78 percent of new women-owned businesses started by women of color.

Starting Your Entrepreneurial Journey

How do you fit into this entrepreneurial journey? This chapter will help you to explore and discover your potential for entrepreneurship as a career choice. Think of this exploration and discovery experience as a way to map out a strategy to reach your goals or dreams. Let's imagine that your dream vacation is a hiking trip to Glacier National Park in the US state of Montana. Just as hikers have different levels of experience, so do entrepreneurs. Just as your plan for a wilderness hike would involve many stages, your entrepreneurial journey involves multiple levels of self-discovery, exploration, experiences, and accomplishments on your way to success. For our purposes, the term **entrepreneurial venture** means any type of new business, organization, project, or operation of interest that includes a level of risk in acting on an opportunity that has not previously been established. For each story of entrepreneurial success that is shared—such as that of Facebook or Airbnb—there are even more lesser-known entrepreneurial success stories such as Zipline, a company that delivers medical supplies in Rwanda and Ghana by drone. These entrepreneurs faced the same dilemmas in pursuing their passion, or opportunities, which led them to their entrepreneurial destiny. They courageously stepped out of their comfort zones to explore the possibilities that lie ahead. What is the difference between entrepreneurs and you? The main difference is taking that first step. Many people have ideas that fit into the definition of an entrepreneurial idea but never take that first step. Just as the Chinese philosopher Lao Tzu suggests, every journey begins with a single step.

ARE YOU READY?

Taking the First Step

Go to Fire Nation's website on taking the first step to learn more. Changing your mindset (your perception of yourself and your life situation) and encountering trigger events (significant external situations) can nudge you into taking the first step toward being an entrepreneur.

- Is there a venture you've always thought you should start but never did?
- Think about what factors are stopping you. Consider your mindset and how you might change your mindset so that your venture could become a reality.

- What are some possible trigger events that could make the difference between starting your venture and waiting to start your venture?

Opening your future to the possibility of starting your own venture brings new and exciting experiences (Figure 3.1.2.1). Every entrepreneur moves through several steps in considering the entrepreneurial journey. Once you understand this journey, the steps will help you define your path toward creating and starting your new venture. Each step of this process offers another level of understanding that prepares you for long-term success. How will you achieve this success? By taking one step at a time, exploring and learning, considering new ideas and expectations, and applying these experiences to achieve your personal outcome. Think of the entrepreneurial journey as a guide to knowing what is in store for you as you start your new venture.



Figure 3.1.2.1: For some, preparing for an entrepreneurial journey may seem like going on a river-rafting adventure that combines beautiful scenery with some exciting, but perhaps frightening, challenges. *(Credit: "Hands Up" by Jeramey Jannene/Flickr, CC BY 2.0)*

One benefit of outlining a step-by-step process is the opportunity to explore different paths or behaviors that may lead to an entrepreneurial venture. Think again of your dream visit to Glacier National Park. How would you get there? What equipment would you need? What kinds of experiences would you expect to have? Think of the Glacier National Park journey as your entrepreneurial journey, a metaphor intended to help you as you create your career as an entrepreneur.

What makes someone ready or willing to choose entrepreneurship over becoming an employee of an established business or a small business owner? It takes confidence, courage, determination, resilience, and some know-how to select entrepreneurship as a career as well as the recognition of the opportunity. An entrepreneur is defined as someone who not only recognizes an opportunity but who also is willing to act on that opportunity. Both actions are required. We might identify an opportunity, but many people do not act on the idea. Confidence, courage, and willingness are necessary to take that first step, as well as remembering the following:

- You are unique. Even if two similar people attempted to launch identical ventures, the results would likely not be the same. This is because each one of us has different ideas, approaches, available resources, and comfort levels, all of which influence the venture's development and eventual success.
- Although there are no hard and fast rules or theories of the best way to launch into entrepreneurship, we can gain wisdom from the lessons learned by experienced entrepreneurs.
- Selecting an entrepreneurial career requires honesty, reflection, and a tendency to be action-oriented. You will need to recognize your own strengths, limitations, and commitment as part of that honesty. Reflection is required for self-growth—seeking improvements in your own skills, interactions, and decision making—and commitment is required to maintain consistency in your willingness to make the new venture a top priority in your life. You will also need to understand that you cannot accomplish everything by yourself, and you may need to ask for help. It helps to be curious, open, and able to take calculated risks and to be resourceful and resilient when faced with challenges or obstacles.

ARE YOU READY?

Entrepreneurial Potential Self-Assessment

Take this quick Entrepreneurial Potential Self-Assessment to assess your potential to become an entrepreneur. After completing this self-assessment, what new information did you learn about yourself? Do you think your answers will change as you acquire more life experiences and education? Why or why not?

ARE YOU READY?

Optimizing Interest Areas

What are three areas that interest you? These could be hobbies, work activities, or entertainment activities. How would someone else describe your skills and interests, or what you are known for? Answering these questions provides insights into your strengths and interests. Next, what is one area that you are passionate about? What strengths could you bring to this passion to build your own business?

Keep an open mind in looking for an opportunity that fits your strengths and interests. If you decide to explore entrepreneurship, what would be your first step? What are your initial thoughts about being an entrepreneur? What would you review or search to find more information on your idea or area of interest? With whom would you first question or discuss this idea? Why?

The Entrepreneurial Journey as a Trip

The **entrepreneurial journey** is your exploration to discover if entrepreneurship is right for you. Every entrepreneurial journey is unique; no two individuals will experience it in the same way. Along the way, you will find opportunities and risks coupled with challenges and rewards. It's useful to think about the entrepreneurial journey as an exciting trip or other adventure. Most of the preparations and steps involved with planning a trip are like those for starting a venture. Just as you would plan and prepare for a trip—starting with inspiration and leading up to finally traveling on the trip—you might follow similar steps to launch a venture. And just as you would prepare for any challenges that you might encounter on a trip—bad weather, lost luggage, or detours—so you should consider potential obstacles or barriers along your entrepreneurial journey (Figure 3.1.2.2). Think of these difficulties as opportunities to learn more about the entrepreneurial process—and about yourself and how you manage challenges.



Figure 3.1.2.2: The entrepreneurial journey might also include potential obstacles and barriers that travelers on this path must overcome. *(Credit: "Flickr - The U.S. Army - Camp Taji obstacle course" by The U.S. Army/Wikimedia Commons, Public Domain)*

Developing a venture can be an exciting and active experience. It is also a lot of hard work, which can be equally rewarding and enjoyable. Here we present the entrepreneurial journey as seven specific steps, or experiences, which you will encounter along the road to becoming an entrepreneur. You'll find more information about the entrepreneurial journey in other chapters in this book.

- Step 1: Inspiration – What is your motivation for becoming an entrepreneur?
- Step 2: Preparation – Do you have what it takes to be an entrepreneur?
- Step 3: Assessment – What is the idea you plan to offer through your venture?
- Step 4: Exploring Resources – What resources and characteristics do you need to make this venture work?

- Step 5: Business Plan – What type of business structure and business model will your venture have?
- Step 6: Navigation – In what direction will you take your venture? Where will you go for guidance?
- Step 7: Launch – When and how will you launch your venture?

As you work through each step of the entrepreneurial journey you should prepare for significant aspects of this experience. You will meet with rewards and challenges, the consequences that result from the decisions made at various points along your journey. To visualize the steps of the entrepreneurial journey, imagine your possible hiking trip to Glacier National Park (Table 3.1.2.1). Just as hikers have different levels of experience, so do entrepreneurs. Compare the following aspects of preparing for a hike with aspects of your entrepreneurial journey.

Table 3.1.2.1: Hiking and Entrepreneurial Journey Metaphor

Type of Hiker	Mountain Hiking Skill Level	Entrepreneurial Journey Equivalent
Walker	• Basic or limited hiking experience	• New or limited entrepreneurial exposure • Never started a venture
Climber	• Moderate hiking experience • Special skills for adventure, difficult terrain	• Some entrepreneurial knowledge or experience • Exposure to entrepreneurship (family or friend in business)
Mountaineer	• Experienced hiker with technical skills for climbing hills and mountains	• Experienced entrepreneur • Attempted or launched a venture (solo or with a partner)

Step 1: Inspiration

When you think of being an entrepreneur, what is the inspiration for your venture? Just as you might have an inspiration for a hiking trip to Glacier National Park, you will have an inspiration behind the decision to become an entrepreneur. When you're planning a trip to a new and exciting place, one thing you might do is to imagine what you will experience along the journey and on arriving at your destination (Figure 3.1.2.3). This portion of the entrepreneurial journey includes imagining yourself as an entrepreneur or as part of an entrepreneurial team. For this stage, you need a creative, open, and innovative state of mind, also known as an entrepreneurial mindset. Dream *big* about your potential future and opportunities (Figure 3.1.2.4).



Figure 3.1.2.3: The journey to entrepreneurship is as important as reaching your destination. *(Credit: "raise challenge landscape mountain" by "mohamed_hassan"/Pixabay, CC0)*

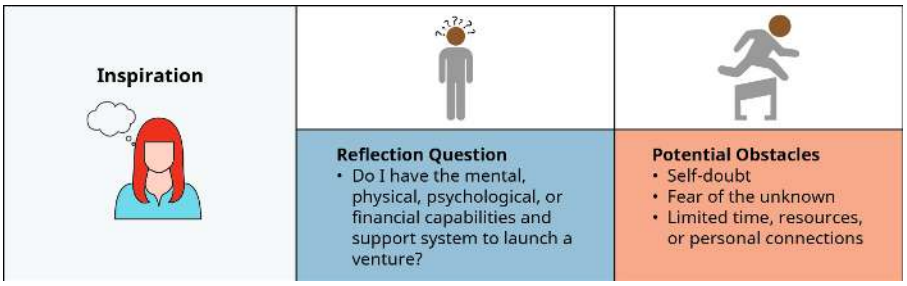


Figure 3.1.2.4: When inspired to start an entrepreneurial venture, one questions whether they can do it and identifies obstacles that might present challenges. *(CC BY 4.0; Rice University & OpenStax)*

Step 2: Preparation

Just as when you are preparing for a trip, you need a plan (Figure 3.1.2.5) to move forward on your entrepreneurial journey. Before your dream hiking trip, you might gather information about Glacier National Park from a trusted source, such as a good friend with travel experience, or you might conduct online research. Your friend's feedback could be just the motivation you need to try this experience yourself. Or you might use your research to determine if the trip is possible. You will need to look at maps, either online or on paper. Either way, you might also consider travel and accommodation options, such as booking a flight and finding a place to stay. You might want to create benchmarks to align your journey with your available resources, such as the amount of time and the amount of money you have to spend on the trip. **Benchmarking** is a method of tracking target expectations with actionable results by comparing one's own company's performance with an industry average, a leader within the industry, or a market segment. Benchmarking can help design the trip to meet incremental goals and timelines. From both a travel plan and an entrepreneurial perspective, although benchmarking is used as a control mechanism, we know that situations can arise that require an alteration in the plan, causing the benchmarked items to also need adjustments.



Figure 3.1.2.5: It is important to plan out your entrepreneurial journey, as you would plan out a trip. *(Credit: "#conservationlands15 Social Media Takeover, August 15th, Santa Rosa and San Jacinto National Monument in California" by Bureau of Land Management/Flickr, CC BY 2.0)*

LINK TO LEARNING

Which type of benchmarking will help you the most in beginning your entrepreneurial journey? Visit the American Society for Quality's resource page on benchmarking for help.

To plan for an entrepreneurial journey, you should first conduct some preliminary research regarding your venture idea. Your research must be honest and objective if it is to give you a clear picture of the venture. Next, you might organize and prioritize your research and thoughts. For instance, you might see an idea like yours online or on television, and feel disappointed that someone stole your great idea or beat you to the punch. This is a common occurrence in entrepreneurship, but it should not discourage you. Instead, use that knowledge and energy to find an overlooked or different aspect of your original idea. The difference might even be the focus on a different **target market**, a specific group of consumers for whom you envision developing a product or service.

Further, it is critical to maintain a fluid focus upon expanding the scope of a product or service to uniquely differentiate provisions of benefits apart from existing benefits or those offered by competitors. A focus on a different target market is exactly how the Jitterbug smartphone was created, because it targeted senior citizens. The Jitterbug smartphone offers a larger screen, larger buttons, and simpler features that make it easier for older people to make quick calls or send texts.

Preparation also includes opening space in your life to the time and energy commitment needed to support your new venture. Are the important people in your life willing to support the interest and passion you will need to dedicate the time, energy, and other resources to this new venture? Review the questions shown in (Figure 3.1.2.6) to consider your answers to these questions.

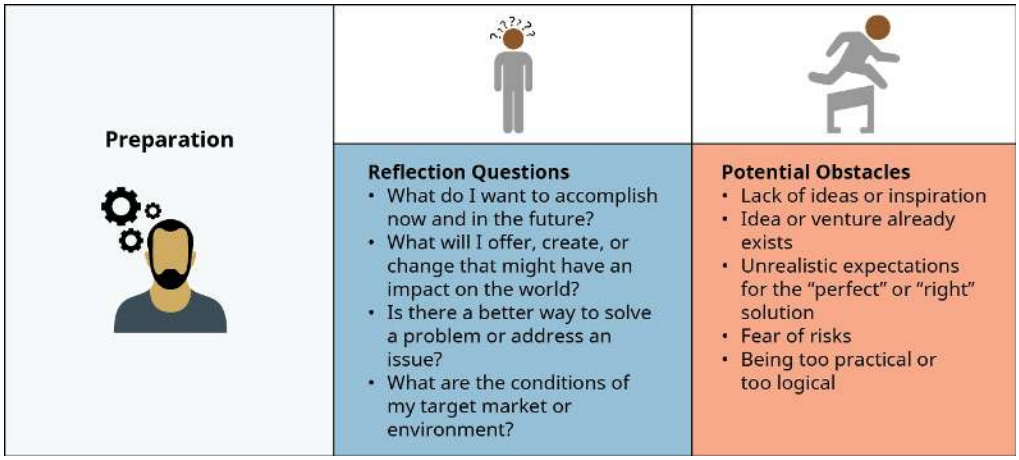


Figure 3.1.2.6: In preparing for your venture, you need to ask what you want to accomplish, what you want to offer, and who you want to target. You also need to consider what potential obstacles might present challenges. *(CC BY 4.0; Rice University & OpenStax)*

Step 3: Assessment

Now that you have decided where to go for your trip and have gathered information to prepare for it, the next action is to create and set your schedule. This action is simple but critical, because it involves connecting and coordinating information and resources that fit your lifestyle and needs. For example, you might schedule an early-morning Uber or Lyft to the airport and electronic delivery of your plane tickets to your smartphone. For the entrepreneurial journey, this phase might also include recognizing appropriate relationships and gathering needed resources. For many entrepreneurs, the opportunity to receive guidance from trusted advisors or mentors may provide valuable insights on how to manage the process. This step allows for reflection on your idea and intentions. After you've done your researching and gathering knowledge about your idea through the preparation step, is the idea still viable? Is the idea still interesting to you? With a better understanding of the industry, your idea, and your own interests that you gained in Step 2, is this idea something that you still want to explore?

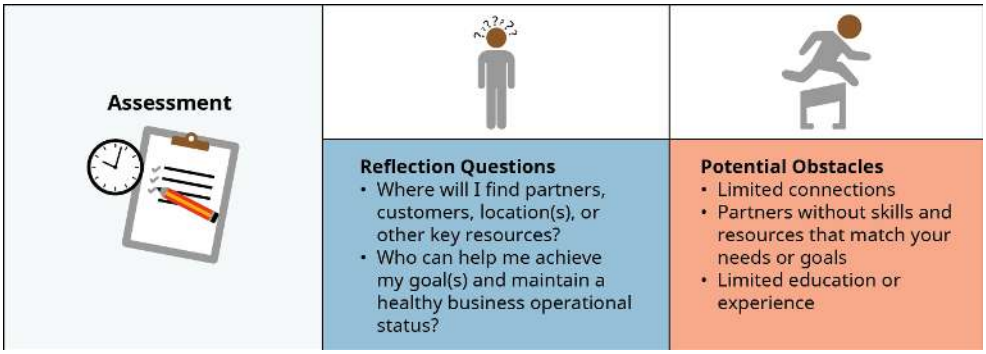


Figure 3.1.2.7: Assessing relationships and resources allows for reflection on your idea and intentions. *(CC BY 4.0; Rice University & OpenStax)*

Step 4: Exploring Resources

Regardless of where you might travel, you could not complete your trip without adequate resources such as available financing. There are many ways you might fund a hiking trip: savings, loan, pay-as-you-go, sponsorship (family or friends), or any

combination of these options, to name a few. No matter how you finance your trip, it might help to have a balance of available credit and cash on hand to support your day-to-day expenses and any extracurricular activities or even unforeseen emergencies. The US Small Business Administration (SBA) provides funding opportunities.

This scenario is mirrored in the entrepreneurial journey. Just as you wouldn't begin a trip without adequate resources, including access to cash, you wouldn't begin your entrepreneurial journey without the necessary resources, including cash. The options between funding a trip and funding a new venture are similar, but they have different names. For example, on a trip, you might use the cash you have on hand, from savings or a personal loan. For an entrepreneurial journey, you might address **cash management**—management of cash inflows and outflows to support cash needs of the venture—to include **bootstrapping**, a funding strategy that seeks to optimize use of personal funds and other creative strategies (such as bartering) to minimize cash outflows. Bootstrapping includes ideas like leasing instead of purchasing, borrowing resources, or trading unneeded resources for needed ones. Another example of cash management includes a business model that offers subscriptions rather than a payment received for an item purchased. Subscriptions provide the entrepreneur with cash upfront, with the buyer receiving benefits throughout the year. Consider the example of Amazon. Amazon offers Prime with a yearly subscription service, as well as Subscribe & Save, Amazon Instant Video, Amazon Mom, and Amazon Web Services, all based on a subscription business model.

According to Entrepreneur.com, other potential subscription-based models include services or products geared to older consumers, with 8,000 people turning sixty-five every day. A similar idea offers services to college students. Both ideas would offer family members a subscription that sends monthly gifts or products to either the elderly person or college student. We also see this model offered to pet owners who pay a monthly subscription to receive treats and toys for the family dog. Looking back at Amazon, we see the company offering the ease of repeat purchases for frequently used products such as vitamins and air filters.

ENTREPRENEUR IN ACTION

Prospurly

Prospurly is a subscription-based company that uses Cratejoy's subscription platform to sell small-batch artisanal products for bath, body, and home, marketing a natural lifestyle focused on the happiness of living a simple and appreciated life. Conduct your own research on Prospurly and other subscription-based businesses. Read the article, "How I Built a Subscription Business That's Made over 50k in 6 Months," on Cratejoy for more information about this company and Prospurly's move from ideation to profitability.

Other ideas for finding funding include applying for grant funding. The importance of cash and cash management requires in-depth coverage.

The idea of exploring resources includes many other options besides how to fund a new venture. In a trial run, you would offer your product or service for sale within a limited market on a test basis to evaluate what additional resources are needed to support the success of the venture (Figure 3.1.2.8). Examples of places where a trial run fits well, depending on your product, include farmers' markets, in-home sales, or through friends and family. The idea is to track the feedback you receive about your product or service. How do people react to the price, the quality of the product, the packaging? You can experiment by selecting one variable to adjust—changing the price, the packaging, the sales pitch, the presentation, or the quantity—to track reactions and make improvements based on this feedback. You may then decide to adjust other variables to gather more information, as well as considering what other resources are needed for the success of the new venture.

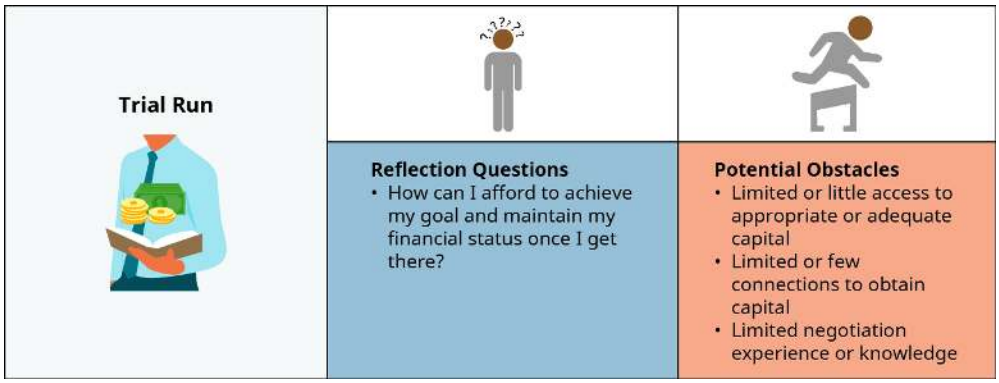


Figure 3.1.2.8: During a trial run, you can use a limited market to test your product or service. *(CC BY 4.0; Rice University & OpenStax)*

Step 5: Business Plan

The ability to travel and visit new locations is a privilege and a great opportunity to gain exposure to new experiences and opportunities. In addition to the work involved in preparing for a trip, the act and process of traveling involves constant decision-making to achieve your desired goals and outcomes. For instance, should you travel to one location in Glacier National Park and explore that area in depth? Or should you attempt to visit as many areas of the park as possible with your given resources and abilities?

The challenge at this step of your entrepreneurial journey is to remain focused on managing your resources to meet your goals and outcomes as you write your business plan for your new venture. You will need to focus on the skills, experience, and resources necessary for your venture, and the management and decision-making required to ensure success and adjust your plan based on changes and new information. Just as you might find a location in Glacier National Park where you want to stay for a couple of nights, a deviation from your original business plan will also require adjustments and changes based on new information and insights.

Be honest with yourself by running a reality check about your ability to manage a venture, especially from a personal-capacity perspective. For example, if you start a business, will it be a part-time or full-time venture? Will you start while in school? Or will you wait until after graduation? The timing of opening the venture can be the difference between success and failure. Consider the difference between hiking in Glacier National Park in the middle of winter, when the daytime temperature is thirteen degrees below zero, and hiking in the middle of summer, when the daytime temperature is seventy-nine degrees. The timing of your visit to the park is an important part of your enjoyment and success in reaching your destination. In planning for your trip, you would pay attention to your departure time to ensure enjoyment and success in your adventure. Similarly, as part of your business plan, you would also research the best time to open your venture.

Finally, during your travels, getting lost, overwhelmed, or sidetracked is always possible. If you get lost when traveling, you might refer to social navigation apps such as Google Maps, Waze, or HERE WeGo, to find turn-by-turn directions and information. Or you might refer to a weblink, a printed map, or a local expert or guide familiar with the area. The business plan is your map. You should identify decision points and **milestones**, significant key accomplishments, in your plan. Milestones could include points such as hitting your **breakeven point**, the point at which income from operations results in exactly enough revenue to cover costs. If the financial projections in your business plan are unattainable, what is your next move within the plan? If you don't reach the milestones identified in your business plan, what alternative choices can you make to redirect your venture? The business plan, in its first draft, should inform you whether your venture has a chance at success. If there are negative areas, what can you change? Building this plan before starting the business provides you with knowledge and insights about your idea. Make any necessary changes to the plan to strengthen the possibility of success. Then when you open the venture, track whether the reality of the venture aligns with your business plan's projections and expectations. The business plan functions as both a road map to help you see where you are going next in building your venture and as a checklist to track whether you are on course or need to make adjustments. When entrepreneurs get off track, they can check out self-help websites, speak with a business coach or counselor, or contact local agencies or organizations, including those affiliated with the federal SBA. Organizations that offer free (or low-cost) small business counseling, mentoring, and training, include:

- SCORE (Service Corps of Retired Executives): https://www.score.org/
- Small Business Development Center (SBDC): https://www.sba.gov/offices/headquar...sbdc/resources
- Women's Business Center (WBC): https://www.sba.gov/local-assistance...r&pageNumber=1
- US Export Assistance Center: https://www.export.gov/welcome
- Veterans Business Outreach Center (VBOC): https://veteransoutreachcenter.org/
- Other organizations include locally organized support such as pop-up entrepreneurial schools like PopUp Business School (https://www.popupbusinessschool.co.uk/) and https://www.pbs.org/newshour/show/th...t-without-debt

Look at the review questions and the discussion questions at the end of this section to prepare for creating your business plan.

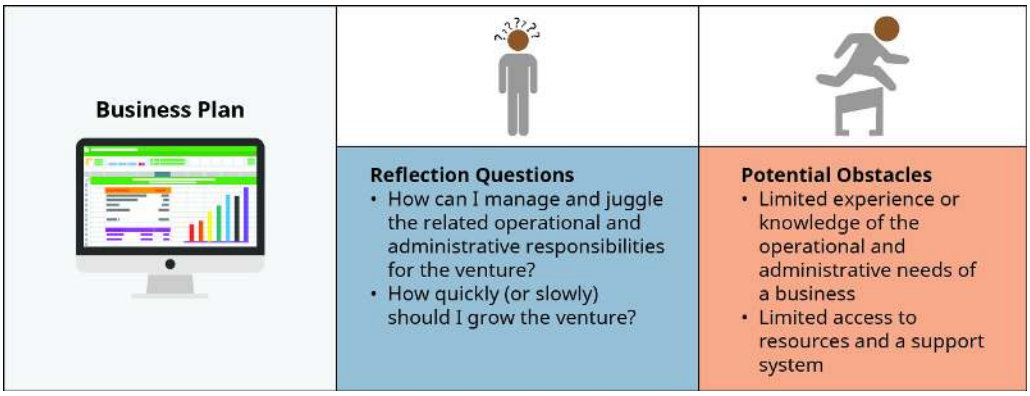


Figure 3.1.2.9: Writing a business plan before launching a venture can give you important insights into your idea and can help you modify your business before launch to give it a better chance of success. *(CC BY 4.0; Rice University & OpenStax)*

Step 6: Navigation

Once you've completed your trip, reflect on the experiences you had. No matter how well you feel you have planned, there is no way you can prepare for all of the potential challenges, changes, and obstacles that may occur: missed or changed flights, poor weather, an unexpected illness, a trail or road closed for repairs, or sudden good fortune. What parts of the trip went well? If you ran into a problem, how did you handle it? Was the problem something you could have anticipated and planned for? Or was it unexpected? What did you learn from the experience? If you were planning a trip to another national park, what would you do differently in your planning stage? Just as seasoned travelers adjust to their circumstances and learn from their experiences, so should you, as an entrepreneur, learn to adjust by meeting and managing challenges head-on.

After completing your business plan, you will probably need to adjust your plan (Figure 3.1.2.10). You might decide that you will not have enough resources to survive the time until your venture reaches the breakeven point, or you might determine that the location you selected is no longer available. There are multiple variables that require further exploration and research.

By nurturing an entrepreneurial mindset, you will be better prepared when opportunities, challenges, or obstacles surface. Although you won't be able to predict or plan for every potential scenario along the entrepreneurial journey, an entrepreneurial mindset helps you to be resourceful when opportunities, challenges, or disappointments occur. By unpacking, or by taking an inventory of your available resources, you can also get a better picture of what you may need to unload, retain, or discard, or even if a new direction is the best course of action. On your entrepreneurial journey, evaluating the experience or situation is a perfect opportunity for you to determine how realistic, overambitious, or shortsighted your dreams and goals for your venture may be. This chapter will explore your vision for your future and your venture. Does your vision include a level of flexibility when you discover new information that supports exploring a new area?

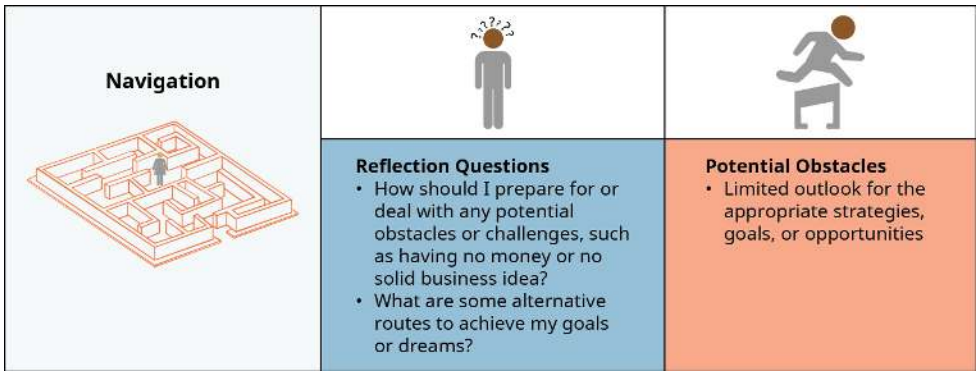


Figure 3.1.2.10: Navigation involves being prepared for and making changes when faced with obstacles. *(CC BY 4.0; Rice University & OpenStax)*

Step 7: Launch

The actual launch is the exciting event when you open your business. By this point, you have made improvements to your product through feedback received in your trial run; you've identified the value or benefits provided by your product; you've identified your target market; and you've identified the location of your launch, whether it is a geographical location or an Internet location.

Inc. magazine provides an analysis of the best locations to launch a new venture, with Austin, Texas, taking the lead (see "Surge Cities: These Are the 50 Best Places in America for Starting a Business"). Consider your target market and the resources necessary to support your venture when choosing the location for your launch. Advice from within the entrepreneurial world suggests that sometimes the launch should take place "under the radar," meaning in a location where you can make mistakes, fine-tune your business model and offerings, and even become successful without competitors noticing that you have created a disruption within the industry.

Even as you are launching your venture, many variables will require your attention, just as we covered in Step 7. Navigating through these variables as your venture grows requires constant attention as new potential opportunities arise.

ENTREPRENEUR IN ACTION

Sixto Cancel and Think of Us

Sixto Cancel successfully faced the harsh challenges of aging out of the foster-care system without adult support or guidance. He imagined a better foster-care system for young people then co-founded the firm Think of Us. Think of Us is a platform that helps young people in foster care build their own personalized digital advisory board of supportive adults who act as a virtual life-coaching group. The adults guide the young people through the foster-care system and ensure that they are able to become independent when they leave the system at age eighteen. For more information about this venture, visit www.thinkof-us.org.

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3.1.3: The Process of Becoming an Enterpreneur

Learning Objectives

By the end of this section, you will be able to:

- Describe the evolution of entrepreneurship through American historical periods
- Understand the nine stages of the entrepreneurial life cycle

Scholars of business and entrepreneurship have long debated how people become entrepreneurs. Are entrepreneurs born or made? That is, are some people born with the natural skills, talent, and temperament to pursue entrepreneurship? Or can you develop entrepreneurship skills through training, education, and experience? These questions reflect the classic debates known as "nature versus nurture" or "born versus made," which attempt to explain the determinants of a person's personality and character.

This debate has been around for centuries. In classical Greece, Plato supported the nature argument, whereas Aristotle believed in the nurture perspective. During the eighteenth-century Enlightenment period, Immanuel Kant (1724–1824; supported the supremacy of human reason) and John Locke (1632–1704; opposed authoritarianism) argued their views. Kant firmly believed that obedience was the expected and desired behavior, whereas Locke believed in allowing some degree of freedom and creativity. The focus of the aspects of this argument changed when late-nineteenth-century psychologists sought to understand how individuals obtain knowledge, and as modern psychologists concentrated on additional factors such as intelligence, personality, and mental illness.

Scott Shane, a professor of entrepreneurial studies at Case Western Reserve University, co-directed a study using identical twins and fraternal twins as the research subjects. Shane determined that entrepreneurs are about 40 percent born and 60 percent made, meaning that nature—that is, an individual's DNA—is responsible for 40 percent of entrepreneurial behaviors, whereas nurture is responsible for about 60 percent of entrepreneurial behaviors. Although "nature versus nurture" and "born versus made" are parallel arguments, researchers and experienced entrepreneurs suggest a combined viewpoint. You can unite your natural talents and abilities with training and development to achieve a well-rounded entrepreneurial experience and outcome. Once you determine that entrepreneurship is in your future, the next action is to establish a process to follow, such as identifying useful reading materials, attending classes or workshops, finding a mentor, or learning by doing through simulations or firsthand experiences. Firsthand experiences occur throughout our days and lives as we gain relevant experiences and as we develop a mindset to seek out opportunity-recognition behaviors. Completing coursework, such as reading this textbook, and reviewing the suggested resources provided within this textbook are actions that can support your knowledge and awareness of entrepreneurship as a valid option for your future.

ARE YOU READY?

Entrepreneurial Personality Test

Review Bill Wagner's article "What's Your Entrepreneurial Personality Type?" in *Entrepreneur* at this link: https://www.entrepreneur.com/article/84134. Then, go to The Entrepreneur Next Door at http://www.theentrepreneurnextdoor.com/ to take the Entrepreneurial Personality Test to find your personality type.

- Think about your results. Are you a generalist or a specialist?
- Once you know this information, what other entrepreneurial personality types do you fit into?
- How can you use this information in your pursuits as an entrepreneur?
- What does this information tell you about selecting members of your startup team?

Historical Perspective

The evolution of entrepreneurship in the United States has spanned centuries. Entrepreneurs have responded to and innovated within the political and economic conditions of their times. The United States' economic and industrial spirit has inspired generations of entrepreneurial Americans. Understanding this history might help you appreciate the importance of entrepreneurship as you consider your own entrepreneurial journey.

During the late 1700s, the Pembina Band of Chippewa Indians lived along the Red River of the North, which flows through North Dakota and Minnesota, and into Canada. European explorers established trading posts in this region and bargained with the Pembina and others for pemmican, a buffalo or fish jerky created by tribes for survival during harsh winters when food was scarce. The Pembina pemmican was exported internationally through trading with French, Canadian, British, and other explorers. The Pembina solved a problem of food scarcity, then leveraged the product to trade for other products they needed that were available through the trading posts.

In the late 1880s, Madam C. J. Walker, an African American hair-care entrepreneur, developed and marketed her products across the United States (Figure 3.1.3.1), hiring sales agents and founding the Madam C. J. Walker Hair Culturists Union of America and the National Negro Cosmetics Manufacturers Association in 1917. She started her company with a philosophy of "hair culture," which quickly became popular and eventually led to steady employment for African American women. Another African American, Charles Drew, established the national blood bank in the late 1930s, just before World War II gave rise to the need for quick access to blood. He researched transfusion medicine and saw a need that he wanted to fulfill. Drew applied the ideas from his doctoral thesis to create the blood bank and continued to innovate, developing mobile blood donation stations.



Figure 3.1.3.1: Madam C. J. Walker developed her own hair care line, which is still sold today. *(Credit: Collection of the Smithsonian National Museum of African American History and Culture, Gift from Dawn Simon Spears and Alvin Spears, Sr.)*

Many innovations and entrepreneurial activities are not achieved by one person acting alone. One example is the invention of the cotton gin in 1794, attributed to Eli Whitney, and possibly based on a design by Catherine Greene and African Americans working as slaves. Some scholars believe that the cotton gin had the unintended consequence of hardening the grip of slavery in the South. Eli Whitney, a descendant of a British immigrant, leveraged his status as the creator of the cotton gin to manufacture muskets for the US government, becoming known as a pioneer of American industry with a focus on standardization.

Colonial and Early America: 1607–1776

The earliest concept of an "entrepreneur" can be traced to this era, from the French *entreprendre*, which translates as "to do something" or "to undertake." Jean-Baptiste Say (1767–1832), a French philosopher, economist, and businessman, supported lifting restraints to encourage business growth, a highly liberal view in the late 1700s. "The entrepreneur shifts economic resources out of an area of lower and into an area of higher productivity and greater yield," is a concept attributed to Say, as is the word *entrepreneur*.

Entrepreneurial-minded persons included merchants, landowners, manufacturers in textile-related trades, shipbuilders, explorers, merchants, and world market traders. The first immigrants to the British colonies took advantage of several key inventions developed before this era, such as printing, double-entry bookkeeping, and improvements in ship design and navigational instruments. The first North American patent was granted in 1641 by the Massachusetts General Court to Samuel Winslow for a new process for making salt. The entrepreneurial spirit of the early colonists helped shape an economic landscape that lasted for generations. Some notable pioneering inventors and entrepreneurs are shown in Table 3.1.3.1 and (Figure 3.1.3.2).

Table 3.1.3.1: Notable Early US Inventors and Entrepreneurs

Inventor or Entrepreneur	Contribution(s)	Significance
Pierre-Esprit Radisson (1640–1710), French explorer	Founded Hudson's Bay trading company	Offered bartering of furs for textiles and guns
William Penn (1644–1718), colonist	Founded Commonwealth of Pennsylvania as a sanctuary for Quakers	Early social entrepreneur
Sybilla Masters (1676–1720), inventor	Invented method to clean and refine Indian corn grown by early settlers	Patent for a process for cleaning and milling Indian corn (1715)
Thomas Hancock (1703–1764), merchant	Founded trading house that furnished multiple goods	Sought alternative funding sources to finance business interests
Benjamin Franklin (1706–1790), inventor, publisher, statesman	Established printing franchises and an infrastructure for his apprentices to launch in other colonies	Epitome of an inventor and serial entrepreneur



(a) (b)

Figure 3.1.3.2: (a) William Penn founded the Commonwealth of Pennsylvania as a sanctuary for persecuted Quakers. This colony could be considered an early form of social entrepreneurship. Shown is his first draft of *The Frame of Government in Pennsylvania*. (b) As one of the country's founders, Benjamin Franklin contributed to the Declaration of Independence. His accomplishments as a printer, writer, postmaster, diplomat, and scientist (he contributed to the understanding of electricity) epitomize serial entrepreneurship. In this painting by Charles Mills, a young Ben Franklin is seen operating a printing press. *(Credit (a): modification of "William Penn - The First Draft of the Frame of Government - c1681" by University of Pennsylvania/Wikimedia Commons, Public Domain; credit (b): modification of "Franklin the printer" by Library of Congress/Wikimedia Commons, Public Domain)*

As entrepreneurship flourished in the American colonies, the economic structure also began to emerge. The prevailing view of economics was associated with the stockpiling of gold and silver. Colonists perceived imports as a reduction of metal wealth—gold and silver money—and felt that exports channeled these metals back to the colonies. To categorize the economic mindset of the time, the Scottish philosopher and economist Adam Smith (1723–1790) wrote *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). This influential treatise outlined the concepts of free trade and economic expansion through **capitalism**, a system in which individuals, people, and companies have the freedom to make decisions and own property as well as benefit from their own efforts, with government playing a secondary role in oversight. This book confirmed Smith as the "father of economics" and modern free trade. Among the most significant concepts that Smith proposed were the "invisible hand" theory of supply and demand in the marketplace; the use of the GDP to measure a country's level of production and commerce; and the self-interest concept, whereby individuals inadvertently help others as they pursue their own goals. The ability to gain personally from entrepreneurial activities is a key factor in supporting entrepreneurial behavior. Smith's concepts continue to influence modern economics and entrepreneurial activity.

As the colonies expanded, so did opportunities and interest in property ownership, manufacturing, inventions, and innovations. An **innovation** is any new idea, process, or product, or a change to an existing product or process. The understanding and acceptance of innovation developed around 1730, when the economist Richard Cantillon identified the first academic meaning and characteristics of "entrepreneurship" as the "willingness to bear the personal financial risk of a business venture." The First Industrial Revolution was notable for the explosion of inventive activities by the "great inventors," who pursued entrepreneurial opportunities to meet market needs, demands, and economic incentives.

An important thing to keep in mind is that dates of inventions don't necessarily reflect specific launch dates. Development of these inventions may have been ongoing for years or decades before they were considered market-viable products.

A plethora of inventors and their inventions transformed several industries and economic classes across the growing nation. During this era, the country benefited from inventions that created, expanded, or revolutionized industry and increased wealth and expansion. These revolutionary inventors included Eli Whitney (cotton gin, 1794), Elias Howe (sewing machine, 1845), and Samuel Morse (telegraph, 1830s–1840s) (Figure 3.1.3.3). Many other people contributed to these and other inventions.

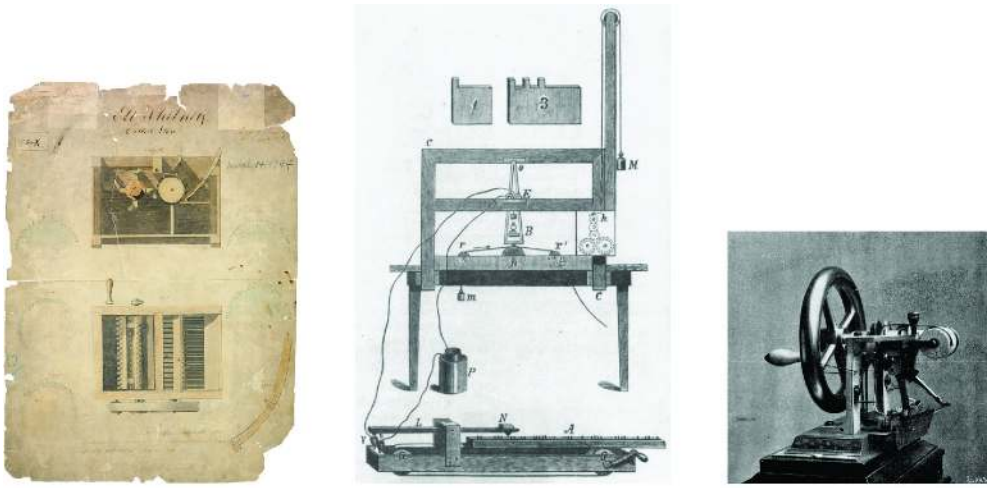


Figure 3.1.3.3: Inventions abounded during the First Industrial Revolution. (a) A US patent was granted to Eli Whitney in 1794 for the cotton gin. (b) This sketch shows Samuel Morse's telegraph. (c) Elias Howe invented the sewing machine. *(Credit (a): modification of "Patent for Cotton Gin (1794)" by "Gamaliel"/Wikimedia Commons, Public Domain; credit (b): modification of "Morse telegraph" by Unknown/Wikimedia Commons, Public Domain; credit (c): modification of "Elias Howe Sewing Machine 1846" by Unknown/Wikimedia Commons, Public Domain)*

Although he was not an inventor but an industrialist, Andrew Carnegie provides an interesting example. A manufacturer who focused on the value of innovations and how to implement them, Carnegie adopted newly developed techniques to improve steel production. He also was among the first to implement **vertical integration**, the strategy of gaining control over suppliers of raw materials and distributors of finished products to expand or control the relevant supply chain. He developed a reliable network of suppliers and distributors to support his steel factories. Carnegie also was one of the first magnates to practice philanthropy. He gave away much of his immense fortune to support community and public library systems, concert halls, museums, and scientific research.

These entrepreneurial pioneers, and many others like them, sought ways to earn a return on investment on an invention and to protect themselves legally through the patent process. A **patent** is a legal grant of protection for an inventor over the rights, usage, and commercialization of an invention for a set time period. An early US patent was issued in 1790 to Samuel Hopkins for his process of making potash as a fertilizer ingredient.

The innovations of women, African Americans (slaves or free persons), and other marginalized groups were crucial during this era. As we saw earlier, Sybilla Masters invented a method for grinding Indian corn. She received a patent from the English king in 1715. But because women were not allowed to file for patents or even to own property at that time, the patent was filed in her husband's name. Although the invention of the cotton gin is attributed to Eli Whitney, as we have seen, it may have been based on a design by Catherine Greene and African American slaves. Social and legal discrimination could limit or conceal the identities of

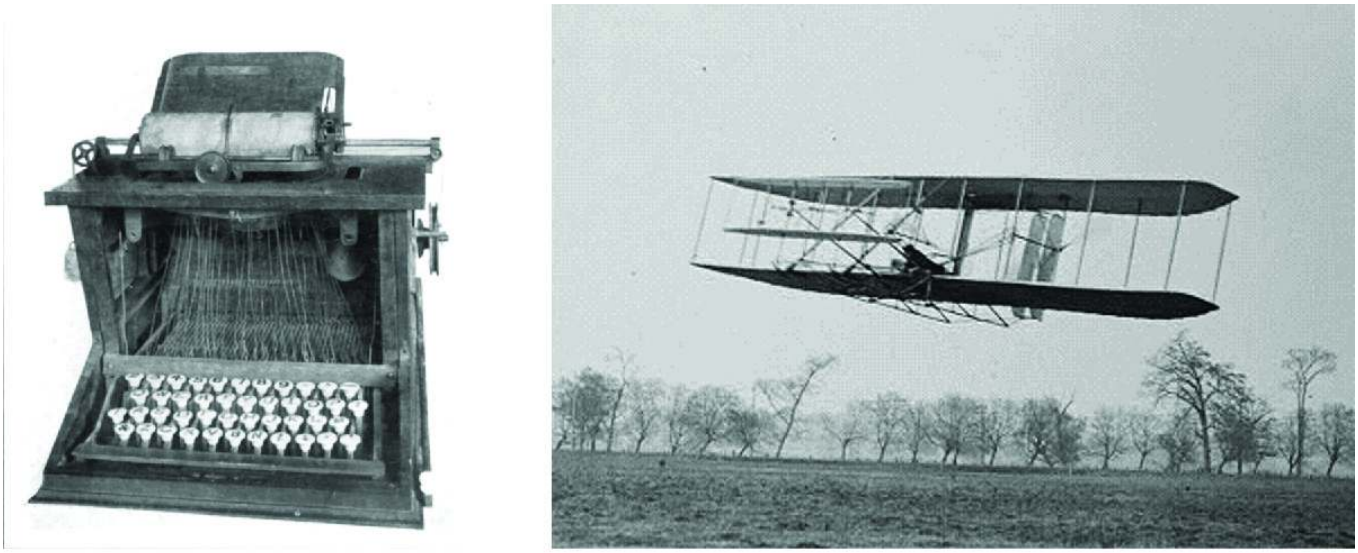
actual inventors, especially if they were women or slaves. Most patent applicants and awardees were white males. One exception was Mary Dixon Kies, who in 1809 became the first woman awarded a patent for her process of weaving straw with silk or thread. This was a key innovation for the hat industry, due to an embargo on European goods. Likewise, many slaves were extremely innovative, but laws and prejudice prevented them from filing independently for patents. Because slaves had no rights, many sought patent submissions under their owners' names but received no recognition or compensation for their efforts. It was not until 1820 that an African American, Thomas Jennings, was granted a patent for a process called "dry scouring" for cleaning fabric. As the successes and failures of inventors and innovations expanded, so did the consumer demand for better-performing products and services. This led to the Second Industrial Revolution.

The Second Industrial Revolution: 1865–1920

Although the First Industrial Revolution had a broad scope and a transformative impact, the Second Industrial Revolution helped shape consumer demand for the latest inventions and innovations developed by small and large businesses. The breakthroughs of this era brought applicable innovations in many fields, from chemistry to engineering to medicine.

The nineteenth-century economists Jean-Baptiste Say and John Stuart Mill (1806–1873) refined and popularized Cantillion's definition of an entrepreneur to capture the spirit of their era. Their definition of "entrepreneur" describes someone who creates value by effectively managing resources for better productivity, and someone who is a financial risk-taker.

After the US Civil War and into the 1870s, many industries flourished with improvements in production organization (petroleum refinery storage, mass production) and technological systems (electricity and the telephone). Additional inventions included improvements in steel production, chemical dyes, transportation (diesel and gasoline engines, the airplane), assembly-line production, agriculture and food-processing improvements (refrigeration), textiles, and the typewriter (Figure 3.1.3.4). As entrepreneurial activity, economic prosperity, and productivity demands increased, entrepreneurs and their inventions were highly regarded and sought after, contributing to the belief that the United States was a land of opportunity.



(a) **(b)**

Figure 3.1.3.4: Interwar and Postwar America: 1920-1975. (a) The first commercially successful typewriter was produced by Christopher Latham Sholes and Carlos S. Glidden; this is their 1873 prototype model. (b) The Wright brothers are among the best-known pioneers of early flight. In this photo, Orville flies over their air field in 1904. *(Credit (a): modification of "Sholes typewriter" by George Iles/Wikimedia Commons, Public Domain; credit (b): modification of "1904WrightFlyer" by "DonFB"/Wikimedia Commons, Public Domain)*

When World War I began, the US economy was in a recession, with Europeans purchasing US materials for the war. When the United States entered World War I in 1917, an economic boom ensued. Unemployment declined from 7.9 percent in 1914 to 1.4 percent in 1918 as the United States produced goods and equipment necessary to support the war efforts of the nation and its allies. From an entrepreneurial perspective, World War I contributed to military-related advancements, communication equipment, and improvements in production processes. The American economic landscape began to shift during this era from small independent companies to big corporations. The smaller businesses in the previous era either dissolved or were absorbed by larger

corporations. As the stock market crash of October 1929 and the Great Depression of the 1930s struck worldwide, innovation slowed. Consumer confidence waned as economic confidence and production declined, and unemployment rose.

LINK TO LEARNING

Visit the History site on the Great Depression or PBS's American Experience article on the Great Depression to understand the background and circumstances that led to the stock market crash of 1929, the Great Depression, and how the United States rebounded during this period.

After World War II ended in 1945, American society shifted from reliance on the traditional entrepreneur as a resource to reliance on large organizations that offered stability and job security. Corporations continued to buy up small firms to standardize innovative, large-scale mass production of goods, services, and jobs. The idea of being an entrepreneur gave way to the idea of the "corporate man" with job security and health benefits offered by big employers. Although entrepreneurship did not totally vanish, its growth slowed tremendously compared with previous years and shifted to **corporate entrepreneurship**, whereby large corporations funded the development of new ideas, opportunities, or ventures through formal research and development processes that focused on the corporations' own strategies and goals. Figure 3.1.3.5 lists some of the corporations that emerged during this period.

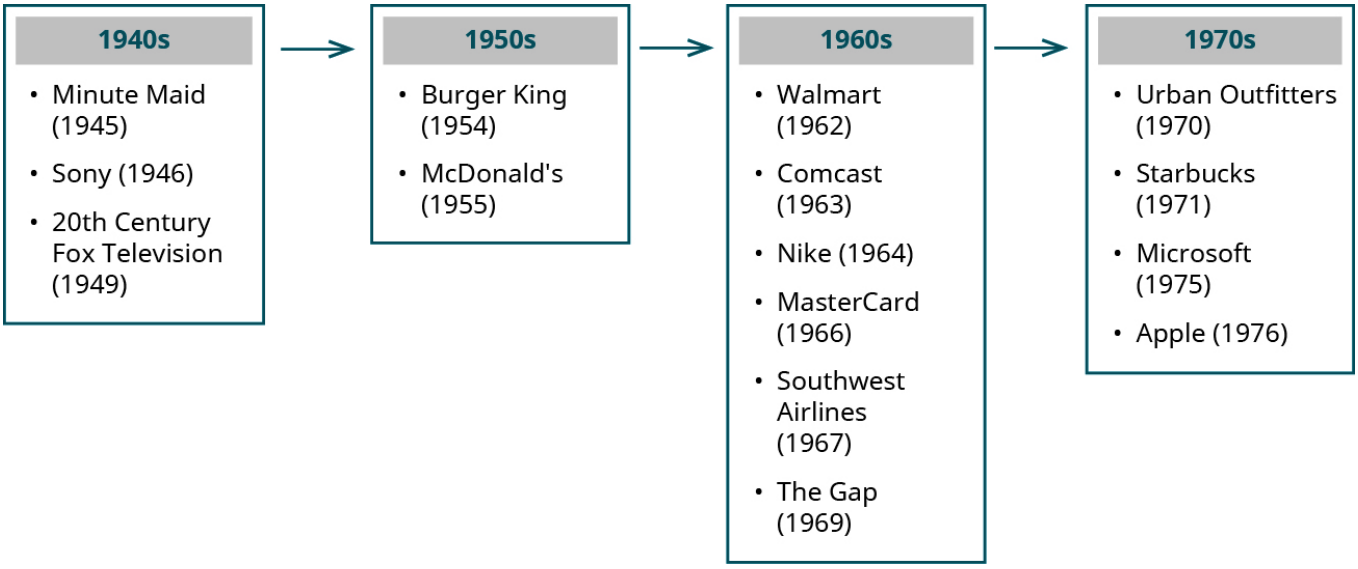


Figure 3.1.3.5: Many important corporations developed in the decades after World War I *(CC BY 4.0; Rice University & OpenStax)*

As economic views and confidence in how the United States might regain economic prosperity shifted, so did the scholarly meaning of entrepreneurship. One scholar and economist, Joseph Schumpeter (1883–1950), introduced theories and terminology that continue to influence modern entrepreneurial concepts and practices. He originated two critical phrases: **entrepreneurial spirit**, which is associated with those individuals who are productive self-starters and make things happen, and **creative destruction**, which he defined as the "process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." Schumpeter's theory that innovation would destroy established corporations to create new ones was not a popularly held or shared view at the time. The thought leaders of this era had different approaches to addressing the rise of corporations as part of the entrepreneurial fabric of the United States. Schumpeter theorized that corporations were better positioned than individuals to support the kinds of research and development that would result in innovations and have economic impact. To complement this view, he also proposed the concept that corporate support of entrepreneurs' visions would result in a sustainable "capitalistic financial system" to support and expand on the free-market system espoused by Adam Smith. In contrast, the sociologist and journalist William Whyte (1917–1999) argued that entrepreneurial culture had changed because "American business life had abandoned the old virtues of self-reliance and entrepreneurship in favor of a bureaucratic 'social ethic' of loyalty, security and 'belongingness.'"

Finally, it is critical to note that the growth of corporations and opportunities expanded beyond the borders of the United States. Corporations faced novel global experiences that supported Schumpeter's creative destruction theory, as other countries presented

new dynamics to address. The annually created Global Entrepreneurship Monitor (GEM) report is a scholarly examination that examines how a group of nineteen countries benefited from venture-capital investments and the factors affecting those investments for entrepreneurial activity. This study addressed the question of entrepreneurial opportunities, entrepreneurial capacity, and entrepreneurial motivation as parts of the engagement within all industries and the direct correlation between venture-capital investment and high-growth startups. The GEM report is created annually with timely and relevant information related to entrepreneurship and is available at this website: https://www.gemconsortium.org/. This cultural shift in the American entrepreneurial spirit generated new interest in the training and education of workers, ushering in the knowledge economy.

The Knowledge Economy: 1975 to Today

In the mid-1970s, the promises of corporate life began to lose their appeal to entrepreneurial-minded individuals. One change was established corporations' shift in focus on innovations from research and development departments to internal entrepreneurial activities by **intrapreneurs**. An intrapreneur is an employee who acts as an entrepreneur within an organization, rather than going solo. Intrapreneurs contribute entrepreneurial ideas, products, and services, using corporate work time and resources, but on a much less formal basis than past corporate contributions to innovation. Quickly evolving advances in technology have touched every industry, and people with tech know-how have become champions. Firms dominating the technological landscape include Apple, Microsoft, 3M, Alphabet (the parent company of Google), IBM, and Oracle. In today's David-versus-Goliath culture, these companies once were small startups, but now they command seemingly endless resources. New opportunities have arisen in the world of technology for those willing and able to compete with these giants. All companies, large and small, are interested in a more informed and educated workforce with specialized or advanced degrees in entrepreneurship and business administration. The new entrepreneurs are prepared to develop and lead firms that can become startup superstars. Viewed through our current lens, companies like Apple, Microsoft, Google, and others have become the new Goliaths, but in their startup days, these companies were the disruptors that fought to create new industries or reshape previously established ones.

The Entrepreneurial Process

Your approach to the **entrepreneurial process**, or the set of decisions and actions that you might follow (as in Figure 3.1.3.6) as a guide to developing or adjusting your venture, is fluid, not static. This is because your personal interests, background, experiences, resources, and connections are unique to you—but those areas may change over time. For instance, you and a friend might take an art class together for fun and both discover a hidden talent and eye for creating handcrafted jewelry that everyone loves. One day over lunch, you share some of your frustrations with your friend about an interest in potentially selling your unique creations to a local art gallery. Despite your research, you have few clues about where to start or how to get your art shown in a gallery. During your conversation, you are surprised to learn that your friend has already sold several pieces by following a mentor's advice. Through several referrals, she figured out that her best option was to create a presence on Etsy, an artisan-focused website for **e-commerce**, electronic transactions, particularly over the Internet, for the exchange of goods and services. Even though you both started at the same place with similar goals, your results differed because you followed different entrepreneurial pathways. In this case, your friend decided to enter the entrepreneurial process at a different stage than you did. This type of scenario occurs every day and clarifies why ventures differ: The decisions of the entrepreneur or the entrepreneurial team are the heart and success of the venture.



Figure 3.1.3.6: Your entrepreneurial process may involve changing directions many times. *(Credit: modification of "this way or that" by Robert Couse-Baker/Flickr, CC BY 2.0)*

If you decide to take the leap into entrepreneurship, you should follow a certain process before you launch your venture. What is that process? As we discussed previously in the steps of the entrepreneurial journey, you need to think through your goals, prepare and follow an action plan, make sound decisions and adjustments along the way, and persevere through challenges and crises to ensure a successful journey. If that sounds like you have some work to do, you are correct. However, if you follow or recognize the stages in the journey and keep track of the related elements, it could be the most satisfying work of your career. Many people find the entrepreneurial journey fulfilling, in part because they get to define their own paths. The plan to graduate, then find a career working hard to help a company or organization reach its goals, are even more satisfying when you can work for yourself to create your own path and purpose in the world.

Before you create your path, a key action in the entrepreneurial process is developing your entrepreneurial mindset. Recall that an entrepreneurial mindset is about being open, self-reflective, and honest about what you are willing to do and capable of doing to achieve success. For instance, are you comfortable with making sacrifices like spending an evening doing research instead of hanging out with friends or family?

The Entrepreneurial Process: Venture Life Cycle and Product Life Cycle

In general, the entrepreneurial process includes several key stages or some variation of these stages. Keep in mind that these stages do not always follow a sequential pattern, as circumstances and opportunities change. One popular method of understanding and connecting to this entrepreneurial process is to think of your new venture as similar to the human life cycle, the major stages that humans pass through in their life development, and the different growth processes in between.

As we can see in Figure 3.1.3.7 and Figure 3.1.3.8, the startup stage is similar to the birth of an infant. During the startup stage, or the birth of the idea, the venture requires resources to support the startup as the entrepreneur develops the idea, creates the prototype, and builds the infrastructure to support production. During the startup stage, cash supports building the venture. Meanwhile, the startup is seldom ready to generate sales. Planning for this situation, knowing that cash is needed but not replenished through sales, is an important consideration.

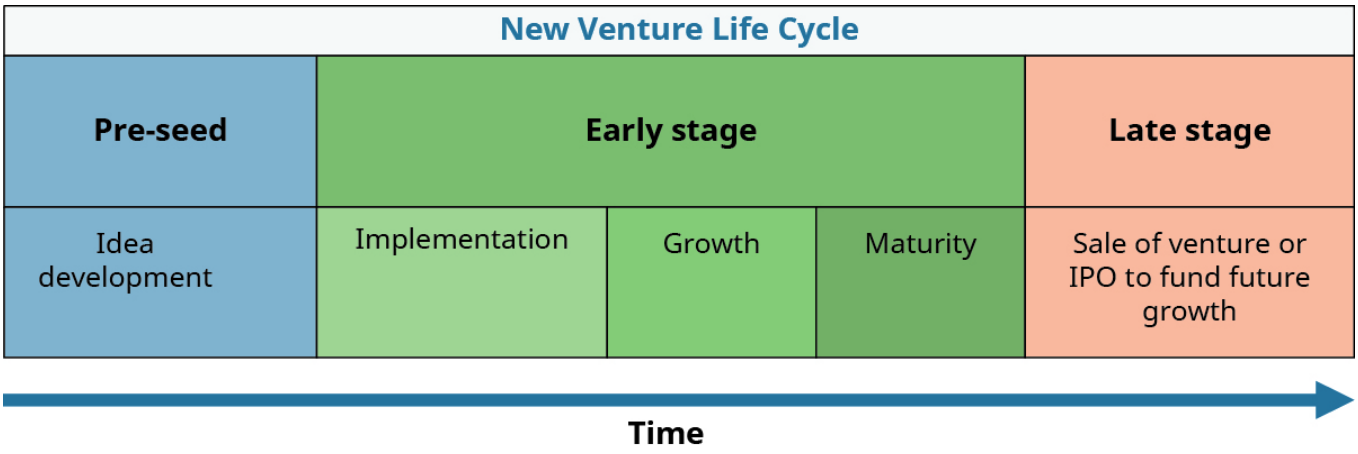


Figure 3.1.3.7: This image displays the phases that a new venture moves through as the idea is developed then created as a prototype. The prototype is then perfected in preparation for stage 4, when sales are generated. Stage 4 leads to the start of the growth stage, shown in Figure 3.1.3.8. Growth occurs through an increase in sales of the product. At this point, in the product life cycle, adding features or enhancements to the product will encourage increasing sales. *(CC BY 4.0; Rice University & OpenStax)*

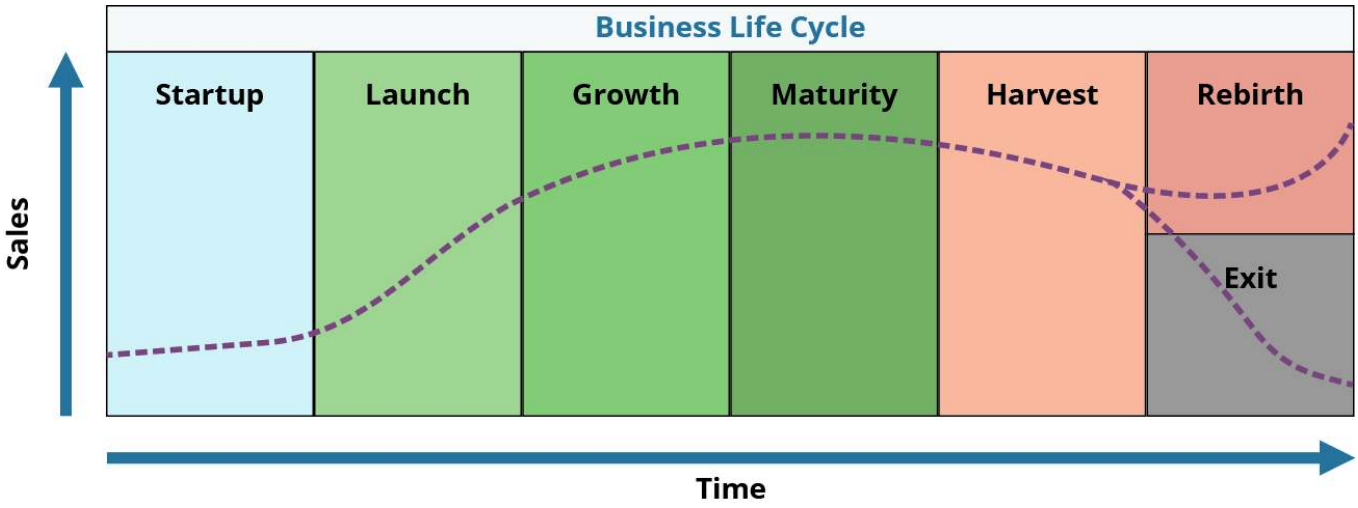


Figure 3.1.3.8: This image demonstrates the phases a business moves through from origination through the death of the business. The yellow line represents sales, or success of the business's products. We see the most sales dollars in the growth and maturity phases. At this point, the owner or entrepreneurial team must make decisions for the rebirth of the business, at which time the business returns to the growth phase. *(CC BY 4.0; Rice University & OpenStax)*

Just as a child grows rapidly in their early years, often a business venture experiences quick growth as the product or service becomes commercialized and experiences strong demand, reflected through increasing sales and stronger knowledge and access to the target market. Again, this stage requires resources to support growth. The difference between this stage and the startup stage is cash is generated through sales activity. In some entrepreneurial ventures, however, the growth stage is about building the venture, rather than generating sales. For ventures like YouTube, the growth stage entails increasing the inventory of videos as well as an increase in people accessing the videos.

Just as humans achieve maturity during their life cycle, the business might reach a point where growth slows and perhaps moves into a decline stage. In our human experience, we can take actions to improve or lengthen the maturity stage of our lives through better life choices, such as nutritious eating habits and exercise, to increase longevity and delay decline. We can also extend the maturity of the business and even move into a rebirth and a new growth phase through insightful decisions, such as adding new features to the product or service, or offering the product or service to a new target market. The goal in our lives, and in this analogy, is continued growth and success. Products can be altered or enhanced to extend the product's life cycle, which also extends the life cycle of the venture.

Examples of avoiding the decline and death of a business fit well into the concept of product life cycle and are prevalent in technology-related products such as the television, the personal computer, and the cell phone. For example, black-and-white

televisions underwent a growth stage after World War II. Color televisions were introduced in the 1950s. As technology improved, television manufacturers have repeatedly moved through the life cycle and avoided declines in sales with new features and adaptations with options such as plasma, LED, and smart technology. An example of a product that started and then quickly declined into the death stage of the business is the eight-track player, a music player available between the mid-1960s to the early 1980s. The eight-track player replaced the reel-to-reel tape recorder as a more accessible product for installation in moving vehicles, from cars to Lear jets, to offer individual music purchased by the vehicle owner for listening while traveling. Even as the eight-track player was becoming popular, moving from the introductory stage into the growth stage of the product life cycle, the compact cassette was being developed. In the early 1980s, the compact cassette format replaced the eight-track player, abruptly ending the product life cycle of the eight-track player.

Some products lend themselves more easily than others to managing the life cycle. The goal is to manage the product for continuous growth, whereas other products, such as the eight-track player, are based on technology that quickly becomes obsolete when a better option becomes available. Other examples of products with short life cycles are categorized as fads, like the hula hoop and pet rocks—fads from the past that were reintroduced to a new generation of consumers and that moved quickly through the product life cycle into the last stage—the death of the product with sales either nonexistent or so few that the product becomes a novelty item.

The life cycles of the venture and of the product are two different concepts but are closely related. The venture will need different resources during each stage of the cycle to support the growth and success of the venture. Knowing what stage of the life cycle the product is in assists in decision making. For example, a decrease in sales triggers the need to enhance the product's value to extend and continue strong levels of growth. From the venture's perspective, managing the product life cycle also supports the continued success of the venture.

A successful venture avoids decline or death with the potential to prepare for either the sale of the venture or a public offering of stock, known as an initial public offering (IPO), which gives the company access to significant funds for future growth. Two entrepreneurial IPOs in May 2019 were Zoom and Uber. Zoom is a company that offers video conferencing, web conferencing, webinars, and cross-platform access. Uber is a ride-sharing company. Both entrepreneurial ventures used IPOs to support their future plans for growth.

Think about some of the friends you've known since childhood compared with those you've met in recent years. Suppose you plan to work on a project together and want to figure out who should handle which parts of the work. You might learn some information about a newer friend's past experiences through conversations, observations, or other collaborations. Even so, it would not be possible—or necessary—to learn everything about their childhood and how they learned a specific set of skills or acquired certain connections. You would just start your interaction and work with your friend from the current time. The same is the case for a venture. You might start a venture from the idea-generation stage or from infancy as part of the pre-launch stage. Or you might join the process after someone else has already completed the early stages of the business—for example, by purchasing an existing business or entering into a partnership. You might not have been around when the business was launched, but you can continue with the development of the business from the present moment. Just as each stage of human experience involves different concerns and milestones, the same holds true for your venture. The venture is your responsibility to manage during each stage of the development process.

Figure 3.1.3.9 provides an overview of each stage and the associated decisions that you might consider or encounter for the entrepreneurial process.

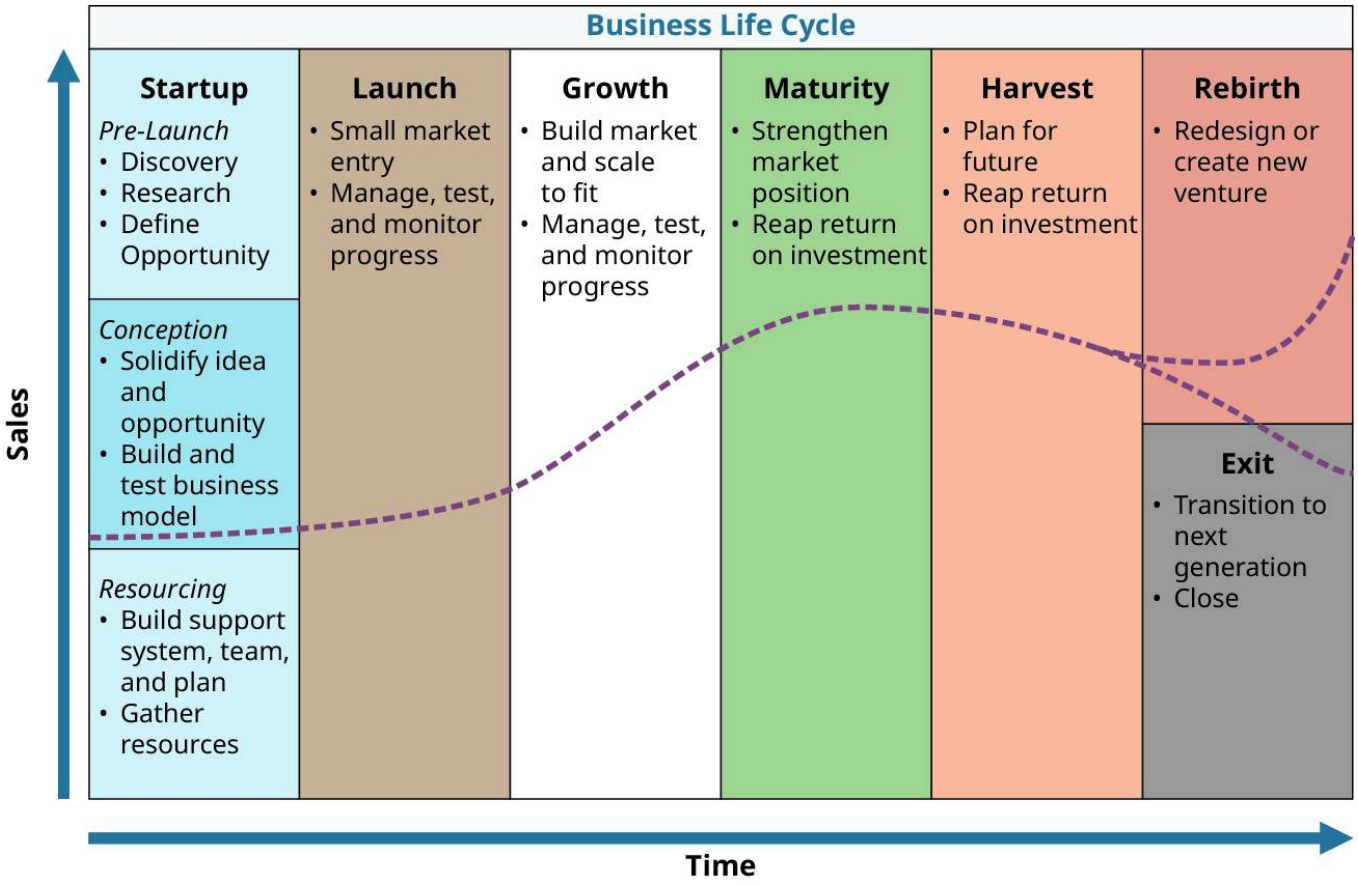


Figure 3.1.3.9: The life cycle of a venture roughly parallels the life cycle of a person through different stages that span pre-birth through infancy, youth, maturity, retirement, and then an end or a restart. However, unlike in the human life cycle, the venture stages do not have to be static or sequential. *(CC BY 4.0; Rice University & OpenStax)*

Stage 1: Startup

In stage 1, startup activities are related to your perceptions about a potential idea, how you develop your idea, and how you might recognize appropriate opportunities. At this stage, the crucial activity is defining the opportunity to develop your concept into a realizable business venture with a strong potential for success. In this stage, you work on developing the idea more thoroughly to determine whether it fits your current and future circumstances and goals. You will also work through exercises to distinguish ideas from viable opportunities. Each of these actions is addressed in greater detail in future chapters. The goal of this section is to introduce concepts for a greater understanding of these stages. Key actions or exercises in this stage include:

- Idea development
- Opportunity recognition
- Identification of a market opportunity
- Research and **due diligence**, or conducting the necessary research and investigation to make informed decisions that minimize risk, such as ensuring you are not duplicating an idea that already exists

Stage 2: Development

Now that you have confidence in your idea, it is time to develop a structure to determine what type of venture will work best for the idea. In Stage 2, you might select a business model and pull together a team to make your dream venture a reality. The **business model** identifies how a business will build revenue, deliver value, and receive compensation for that value. Some examples of business models include monthly subscriptions, pre-sale orders, kiosk sales, and other choices. Entrepreneurial decisions in the development stage include many options to consider, including bootstrapping, starting out with limited funds, receiving venture funding from external sources, licensing to receive royalties on a per-item basis, purchasing another business, inheriting a business, franchising either through the purchase of a franchise or building your company with the goal of eventually creating your own franchise, creating a virtual web-based company, using mobile apps that support your business or connect with other businesses,

founding a social venture to support a cause, consulting, or freelancing. Choosing among these options or creating your own unique approach to supporting the success of your business will change your results and success level.

Key activities in this stage include:

- Formulation or refinement of your concept
- Design of business model, plan, goals, launch team, and operational structure
- Creation of prototype product to fit market (sample or model for customer feedback)
- Further research and due diligence, as needed

Stage 3: Resourcing

Using the knowledge you gained in the first two stages, in the resource stage, you will evaluate the necessary resources to support your new venture. Resources include financial support; support and selection of a manufacturing location or facility (if you are producing a physical product); personnel talents, knowledge, and skills; possible political and community support; and family support, because the new venture will require time commitments that will cut into time with your family.

The key activities in this stage include:

- Gathering pertinent resources, such human and financial capital, investors, facilities, equipment, and transportation
- Establishing connections, networks, and logistics
- Further research and due diligence, as needed

Stage 4: Market Entry

Market entry—the launch of your venture—is often undertaken in a soft launch, or soft open, within a limited market to minimize exposure to unforeseen challenges. As an entrepreneur, you are presenting your new venture to a specific market to see how well it is received and supported. You might make last-minute adjustments at this stage, but the crucial part is to see how the market reacts to your venture. This is an excellent time to scrutinize all aspects of your business for solutions to unexpected problems and improvements in efficiencies, and to track customer reactions to your venture.

One of your most important responsibilities at this point is managing your **cash flow**, or the money coming into and going out of a business, as cash is essential for the success of the venture. In the early stages of the venture, you will need large amounts of cash to fund the operational activities, because your sales are not yet guaranteed. Production costs, payroll, supplies, inventory, lease payments, and marketing: All of these expenditures involve cash outflows from your venture as part of the startup costs. A successful business needs available cash as well as customers for its products and services, or it will not survive. Key activities at this stage include:

- Assessing management structure and needs, adjusting as necessary
- Managing cash flow
- Launching the entity
- Monitoring progress
- Further research and due diligence, as needed

Stage 5: Growth

The growth stage includes making decisions that support the future growth of your venture. In the growth stage, your decisions reflect the scalability of your venture. There is a big difference between a small-scale venture and a venture that must handle significant levels of sales. At this point, your organizational structure needs an update. You might need new functional levels, such as a finance department, or a human resources department, or perhaps an assistant manager. Other considerations include the size of your facilities. Is the current size, or capacity, appropriate for the growth of the venture? Other questions relate to the appropriateness of your suppliers or inventory providers. Are quality and delivery time meeting your needs? Is the payment system appropriate for your venture? In this stage, you should also monitor the growth of your venture and make appropriate adjustments. For instance, if your venture is not growing as expected, then you might go back to your business plan and see what adjustments you can make. Key actions in this stage include:

- Managing the venture
- Making key adjustments, as needed

- Further research and due diligence, as needed

Stage 6: Maturity

In the maturity stage, your venture has moved into the maintenance phase of the business life cycle. Entrepreneurs monitor how a venture is growing and developing according to the business plan, and its projections and expectations. Is your venture growing faster or slower than you expected? What milestones has it reached? What changes are needed to continue the success of the venture? How can you address those changes? Are you still able to maintain or meet the needs of the venture?

Depending on your situation, you still will need to take action to support the venture. Even if the venture is operating efficiently and in a predictable manner, external changes could compel you to change your venture, for example, by making improvements to the product or service, finding new target markets, adopting new technologies, or bundling features or offerings to add value to the product.

One of the key points to understand at this stage is that ventures can, and often do, fail. Entrepreneurship is about taking calculated risks to achieve a reward. Sometimes your venture may not turn out how you planned. Keeping an open mind and learning from experience presents new opportunities for either changes to the existing venture or even a new venture. Consider these examples of early entrepreneurial failures by people who later went on to achieve great success:

- Bill Gates's early Traf-O-Data company failed because the product did not work
- Walt Disney was told he lacked creativity and was fired from a newspaper job
- Steve Jobs was once fired by his own company, Apple
- Milton Hershey started three candy companies before he founded the successful Hersey Company

Key actions of this stage include:

- Strengthening market position
- Awareness and willingness to change
- Reaping return on investment (ROI)

Stage 7: Harvest

At some point, your company may outgrow your dreams, ambitions, or interests. At this stage, you are harvesting or collecting the most return on your investment while planning how to retire or make a transition away from this venture. Many entrepreneurs enjoy the excitement of starting and building a venture but are less interested in the routine aspects of managing a company. In the field of entrepreneurship, the entrepreneurial team creates a venture with the goal of harvesting that venture. Harvesting is the stage when all your hard work and ingenuity are rewarded through a sizable return on the invested money, time, and talents of the startup team, including any investors. During this stage, the entrepreneurial team looks for the best buyer for the venture to achieve both a return on investment and a match for the continued success of the venture. Key actions in this stage include:

- Identifying what the entrepreneurial team, and investors, want out of the venture, their ROI
- Planning for your future: What's next on your entrepreneurial journey?

Stage 8: Exit

The exit stage is the point at which your venture either has fulfilled its purpose as a harvested success that is passed along to the next generation of business owners or has not met your needs and goals. These two situations give rise to vastly different scenarios. In the harvesting of the venture, you might receive a sizable cash payment, or a combination of cash payment and a minority share of stock in the venture's buyout. In an exit that reflects the closing of the venture, your option is most likely liquidation of assets, which you would sell to pay off any remaining creditors and investors. In both harvesting and liquidation, the challenge for you as an entrepreneur can be to accept the emotional withdrawal from a venture that has consumed your thoughts, time, and energy. The time has come for you to step out of the picture and allow the venture to be cared for by a new "parent" or to close the venture completely. Key actions in this stage include:

- Exit strategy and plan
- Transition to the next generation of owners

Stage 9: Rebirth

For some entrepreneurs, the excitement of creating a new venture supersedes the financial gain from harvesting a successful venture. The thrill of transforming an idea into a realizable opportunity and then creating a thriving venture is difficult to find elsewhere. In the rebirth phase, the entrepreneur decides to seek out another new venture to begin the process all over again. As an experienced entrepreneur, you can create a new type of venture or develop a new spin-off of your original venture idea. At this point, you have become a **serial entrepreneur**, an entrepreneur who becomes involved in starting multiple entrepreneurial ventures. Key actions in this stage include:

- Redesigning or creating a new venture
- Bringing in a new entrepreneurial team or the team from the previous venture

LINK TO LEARNING

"Drop into" Man Crates to learn about this entrepreneurial venture. Who is their clientele? Does this company sell an experience, a product, or both? What life cycle stage is this business in now? Applying your assessment of the company's life cycle stage, pretend that you are the CEO of the company. What recommendations do you have for the company's continued success and growth?

Visit the Man Crates site to learn more.

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3.1.4: Enterpreneurial Pathways

Learning Objectives

By the end of this section, you will be able to:

- Understand how venture opportunities present different pathways to entrepreneurship
- Describe methods for finding your personal path to entrepreneurship

When you think of which career pathway (as in Figure 3.1.4.1) to follow, you might not think of being an entrepreneur in the same way that you would think of being a nurse, an attorney, or an engineer—but you should. Entrepreneurship offers you the chance to express your creativity and business acumen and to control your destiny. Conversely, if you were to earn an engineering degree, your employment options could involve working for an engineering company. Your job would be relatively secure and structured, with a paycheck and some perks. Or you could leverage your engineering degree into an entrepreneurial venture.

The entrepreneurial journey includes multiple experiences and decisions that will help you reach your entrepreneurial goals. For example, some individuals inherit a family business. If your chosen career proves not so ideal or available as planned, entrepreneurship may be an attractive option. However, a growing number of people intentionally choose business ownership as a vehicle for fulfilling their career goals and interests. If you reach this crossroads in selecting your ideal vocation, how do you successfully navigate the entrepreneurial pathway as a career option? Your entrepreneurial journey might travel several paths, each presenting obstacles, twists, and turns before you reach your destination. Many of today's entrepreneurs have followed different pathways—sometimes conventional, sometimes not—that have led to the creation of various business structures matched to each entrepreneur's spirit. These businesses include established or adapted business models that met a need, solved a problem, or developed a social solution.

Regardless of the type of entrepreneurial venture you may choose, many pathways can take you to your goal. Venture types differ in their missions and visions. Their purposes range from earning income (for profit) to meeting a community need through tax-exempt status (nonprofit) to solving a social or environmental problem (social enterprise) to combinations of these types (hybrid).

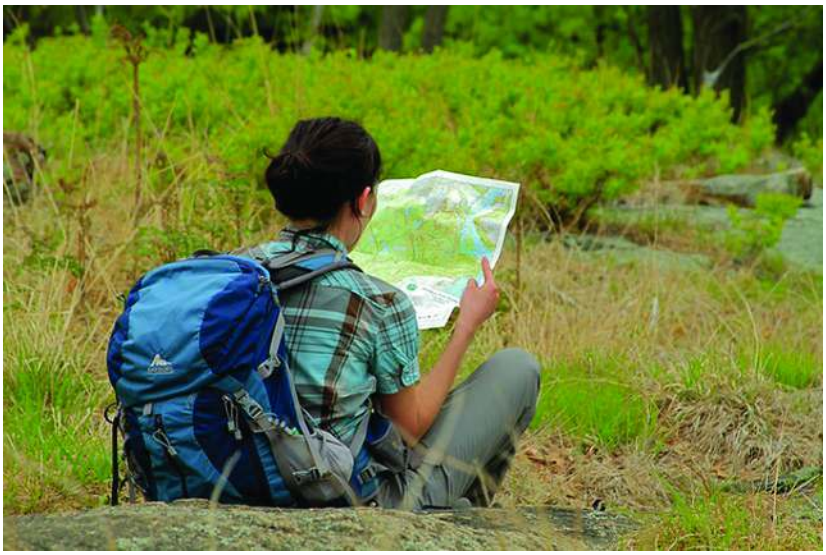


Figure 3.1.4.1: There are many different pathways you can take on your entrepreneurial journey. *(Credit: "Explorer" by Sakeeb Sabakka/Flickr, CC BY 2.0)*

For many established businesses, the pathway is not always as clear as the entrepreneurial process suggests. This is because entrepreneurs are opportunists, leaders, and initiators: They take calculated risks to create or adapt something to solve a problem or create a response for potential financial gain or intrinsic value. The reality is that these situations or opportunities do not always occur in a logical sequence or order. Instead, entrepreneurial-focused individuals might encounter opportunities, offers, or options that spark a new venture.

Opportunities and Options

If you are ready to launch a venture, you will find numerous situational opportunities to pursue your interests. A **situational opportunity** is one that becomes available, depending on factors such as where you work, your family obligations, your idea or invention, your unique creative expression, or a recent career search or job change. The evolution of entrepreneurship, your own receptiveness to entrepreneurial thinking, and many existing and emerging platforms make this possible.

As you plan your venture, you should consider opportunities in these areas:

- On the Job. Some workplaces offer intrapreneurial opportunities, or ventures created within the company, for entrepreneurial-minded individuals. The firm 3M, for example, has historically nurtured employee creativity and promoted innovative opportunities for employees. This environment inspired an employee project that resulted in the invention of Post-it notes. Even if a company does not support venture creation, there is also the possibility of taking the entrepreneurial idea out of the company to create your own venture.
- Family Obligations. You might work in a family-owned business or take over after family members retire or transfer ownership to other family members.
- Franchises. You might purchase an existing **franchise**, a license granted to an entrepreneur to operate under the franchise's name.
- Web-Based Venture. You might launch a product venture through Etsy, Shopify, or another e-commerce website.
- Work for Hire, or Independent Contractor. You might launch a consulting business or work as an independent contractor to gain clients, experience, and income on a flexible schedule.
- Unemployment. Being underemployed or unemployed might make entrepreneurship a pathway to economic freedom.
- Purchase. You might purchase an existing business from a retiree, your current company, or a family that owns a business. As a business owner's life situations change, due to aging or new interests, the business becomes available for new ownership. Working for a company can offer the option of buying out the current owner to become the new owner. Purchasing an existing company provides historical financial data and decisions that support future successes. If you are employed by the company, you have the opportunity of learning details about how the business is managed, an advantage that could support your success in purchasing and managing the company.
- Frustration. You might encounter a currently existing product or situation that needs improvement or a solution, and decide to tackle the situation yourself.
- Serendipity. This is a situation in which various pieces come together to support the creation of a new company or product. The "Entrepreneur in Action: Gordon Moore and Fairchild Semiconductor" box below describes how Gordon Moore (creator of Moore's Law on the exponential growth of a single silicon chip doubling every year) was working for Shockley Semiconductor in 1956. At that time, he had little-to-no knowledge of semiconductors. However, he quickly learned about semiconductors by applying his PhD in chemistry and physics from Caltech to the semiconductor industry. After one year of employment, Moore and seven other employees left to form Fairchild Semiconductor, financed by Sherman Fairchild. During his eleven-year employment with Fairchild Semiconductor, Moore published a paper describing what we now know as Moore's Law. His next move was based on recognizing the importance of the microprocessor in transforming the computer and related industries. After frustrations with Fairchild's lack of support for this new direction, Moore, along with a colleague from Fairchild Semiconductor, Robert Noyce, formed Intel, the second-largest semiconductor chip manufacturing company in the world.

ENTREPRENEUR IN ACTION

Gordon Moore and Fairchild Semiconductor

Sometimes the path to entrepreneurship doesn't occur as you might plan or think. Consider the story of Gordon Moore, a co-founder of Fairchild Semiconductor: "Like many other scientists and engineers who have ended up founding companies, I didn't leave Caltech as an entrepreneur. I had no training in business; after my sophomore year in college, I didn't take any courses outside of chemistry, math, and physics. My career as an entrepreneur happened quite by accident. There is such a thing as a natural-born entrepreneur… But the accidental entrepreneur like me has to fall into the opportunity or be pushed into it. Most of what I learned as an entrepreneur was by trial and error, but I think a lot of this really could have been learned more efficiently."[43]

The combination of diversity in educational background and skills, the serendipity of being in the right place at the right time, and facing frustrations with the current situation can combine into recognizing an entrepreneurial opportunity. For Gordon Moore, learning about semiconductors, and creating the company Intel, was the furthest idea of what he pictured for his future. The serendipity of his experiences, knowledge, and intelligence combined to support the creation of Intel. Gordon Moore is reported to have a net worth as of October 2019 of $10.6 billion.

One core concern of entrepreneurship is how you will fund your venture and where you will find the necessary resources. Although some businesses require significant startup funding, it might surprise you to learn that many ventures have been launched by entrepreneurs who used their own capital, labor, connections, or other resources to start—an approach known as bootstrapping. Some savvy bootstrapping strategies include launching a venture part-time while maintaining a full-time job, using personal savings, bartering for services and materials, and securing pre-orders. Some entrepreneurs seek financial support for their venture through funding from angel investors, venture capitalists, or traditional loans or debt.

Finding Your Entrepreneurial Path

The process and pathways to entrepreneurship can be overwhelming. With so many choices and decisions involved, entrepreneurial choices can seem intimidating, and the route you follow may sometimes produce some anxiety. Before you get consumed with the technical aspects of launching a venture, it is important to start with the most important foundation: finding your personal path to entrepreneurship.

Your Personal Path through Self-Reflection

Your decision to launch a venture should not be taken lightly. Entrepreneurship requires a lot of energy, decision-making skills, tenacity, resourcefulness, and flexibility. As you consider entrepreneurship as a career, you should complete some self-reflection to figure out how, why, and when entrepreneurship may be the right professional path for you. For example, if your personality is introverted—that is, you often find it most energizing to be alone—you might consider a venture that capitalizes on that scenario. It might be helpful to study or meet other entrepreneurs with a venture you find interesting.

WORK IT OUT

Startup Ideas

Visit Medium.com to check out this "Top 10 Business Ideas for Startups" article and then review the startup ideas for introverted personality types at Small Business Trends. Review the lists of ideas. Next, create a list of five or more of your own startup ideas. Often, we gain new insights by reading through other ideas. Your idea might be a spin-off of an original idea. Or the information you gain could trigger a brand-new idea.

Your Personal Path through Research and Experiments

A key step to finding your personal pathway to entrepreneurship is to conduct research and try out roles related to your desired venture. Researching the potential industry or entrepreneurial options available to you will provide some level of comfort and validate your decisions about what you might do next. One concrete way to do this is to "shadow" a professional in your desired field. This means arranging to be an observer during a standard workday to see firsthand what is involved in running that type of business. You may also be able to secure some experience by serving as an apprentice, intern, or lab assistant, or as an independent contractor or freelancer, an individual who contracts to offer professional services or tasks for a negotiated fee. Informational interviews—whether informal chats with new or established business owners at a trade show or networking event, or a formal question session—can also provide insight.

Your Personal Path through a Soft Launch

One sure pathway to entrepreneurship is to jump in with both feet and experience the process by launching a venture. Although this may seem like a big leap or you may feel you are not ready, remember that entrepreneurship is an experiential discipline that can be understood fully only through hands-on experiences. Launching a venture for a limited time frame or audience to gain experience, insights, and feedback about the target market or consumer—a process known as a **soft launch** (or soft open)—will provide valuable feedback on how to meet the consumer's needs or improve on your product to ensure success. You might explore a soft launch by creating a sketch or sample of what you plan to offer and asking friends and potential customers what they think, or by

creating a website or app prototype to share with a limited number of people to see if it works as planned (sometimes called a beta test) and get feedback.

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3.1.5: Frameworks to Inform Your Enterpreneurial Path

Learning Objectives

By the end of this section, you will be able to:

- Identify common frameworks used to shape an entrepreneurial venture
- Compare how some frameworks better fit certain venture types
- Define an action plan and identify tools available for creating an action plan
- Describe some common types of entrepreneurs

In designing a venture that is sustainable or capable of being self-funded, it is helpful to use specific tools to manage information. One such tool is a **framework**—a structure or outlined process that can be used to accomplish entrepreneurial goals through problem-solving, idea generation and validation, and brainstorming.

Selecting a Framework

You can choose any of several popular frameworks to help with the design and integration of your business experience and entrepreneurial thinking. The most widely used frameworks that have been developed as integrative tools to support entrepreneurial thinking include:

- Business Model Canvas (BMC) offers a simple, one-page tool used to design an innovative business model that can be presented to key stakeholders (Figure 3.1.5.1).

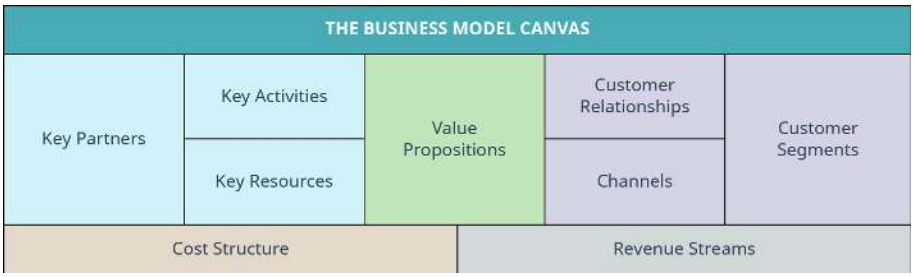


Figure 3.1.5.1: Here is an example of a Business Model Canvas with a framework to identify key components of the venture. *(CC BY 4.0; Rice University & OpenStax)*

- Lean Strategy Canvas is a spinoff of the BMC that introduces a potential customer feedback loop for continuous product or idea improvement to meet the market's needs (Figure 3.1.5.2).

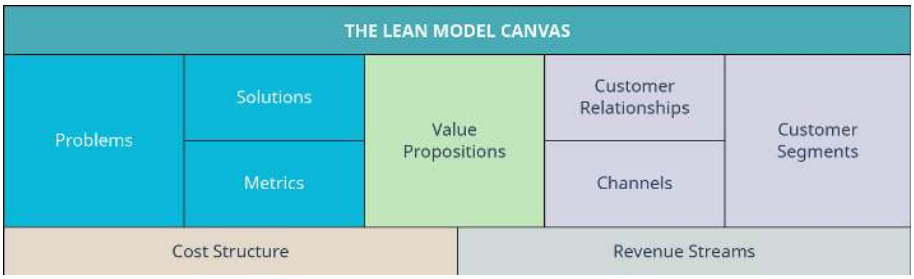


Figure 3.1.5.2: Here is an example of Lean Strategy Canvas, a framework to assist in developing the business model, and competitive advantage and related areas aligning the product and market for the venture. *(CC BY 4.0; Rice University & OpenStax)*

- Design Thinking Process supports a systematic, logical approach for addressing and solving problems with multiple solutions (Figure 3.1.5.3). Design thinking was first applied in relation to STEM fields—science, technology, engineering, and mathematics. Due to the success of this process, design thinking has become popular in many other areas.

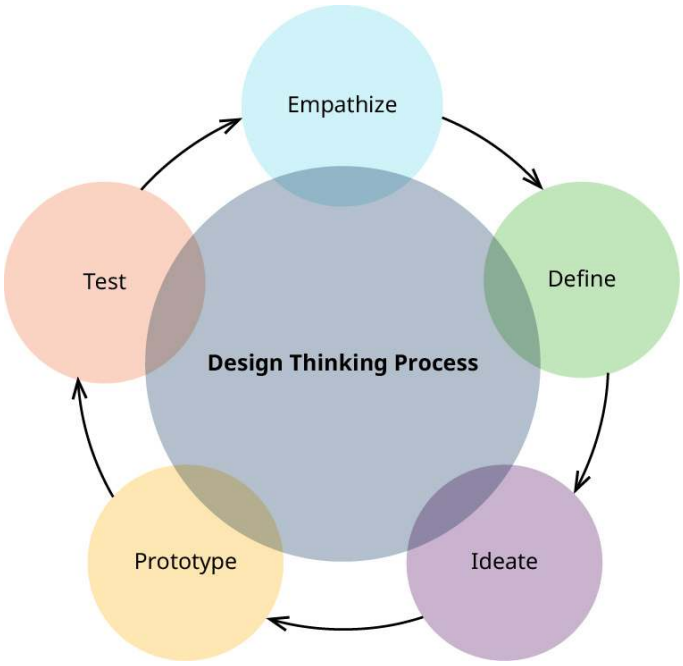


Figure 3.1.5.3: The design thinking process is a systematic approach for solving problems. *(CC BY 4.0; Rice University & OpenStax)*

Design thinking approaches problem-solving or the creation of a new venture from the perspective of the customer. For example, Amazon provides easy-to-open packages after observing the challenges customers had in opening the delivered products.

- Four Lenses Strategic Framework is used for the development of social enterprises; assesses four strategic areas (stakeholder engagement, resource mobilization, knowledge development, and culture management) to address a social problem and provide sustainable social impact (Figure 3.1.5.4).

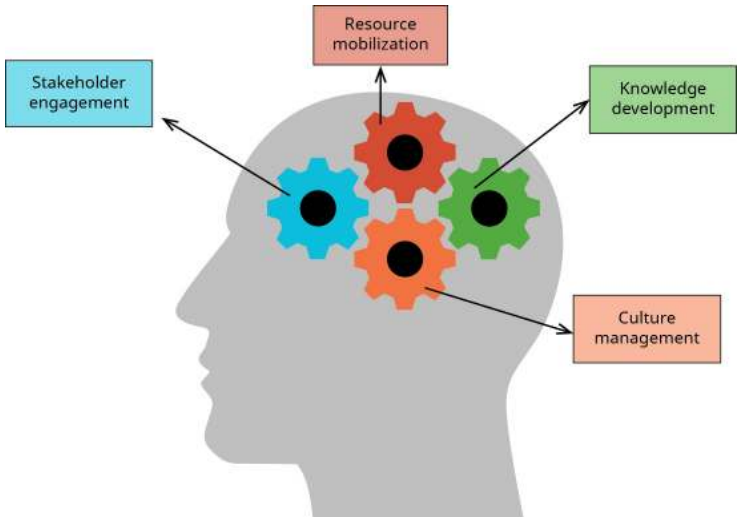


Figure 3.1.5.4: The Four Lenses Strategic Framework involves stakeholder engagement, culture management, resource mobilization/application, and knowledge development, and can provide synergies and insights in building compatible and aligned actions. *(CC BY 4.0; Rice University & OpenStax)*

The typical application of each framework is shown in Table 3.1.5.1. The process of selecting the most appropriate framework for your entrepreneurial interests might help you understand how to develop your idea. We recommend that you try all four frameworks before selecting one. Even though each framework is identified for a general class of venture, each one provides a different perspective for developing your venture.

Table 3.1.5.1: Frameworks

Framework	Description	Typical Use
Business Model Canvas	A one-page tool that maps out nine basic building blocks that are necessary for a successful business model	Helps prepare a sustainable business model
Lean Startup	Outlines a quick feedback loop through customer input	Used for fast-paced industries and quick idea validation
Design Thinking Process	Outlines a systematic, results-oriented process to address and solve problems	Used for the development of STEM fields with expansion into entrepreneurial ventures, products, and processes; applicable to all areas
Four Lenses Strategic Framework	A practitioner-driven model that considers four perspectives to support and develop a client-focused ecosystem	Used for the development of social ventures

Applying the Framework through an Action Plan

At some point during your venture development process, it becomes critical to capture your thoughts and intentions in a meaningful and productive way. Creating a customized **action plan**—an organized, step-by-step outline or guide that pulls together the ideas, thoughts, and key steps necessary to help set the stage for entrepreneurial success—at an early stage will make the entrepreneurial process much smoother and potentially more successful in the long run. Applying an appropriate framework will provide you with a visible, tangible, strong foundation for your future venture. In completing the framework, you should identify gaps as well as ideas for further development, then add both to your action plan. Just as you can choose from several types of frameworks, you can apply any of a variety of action plans. This section introduces some widely used action-planning tools but is not exhaustive. These selected action plans are presented as a way to jumpstart your thinking for the venture creation process.

Action Plans

You may have heard stories about potential entrepreneurs who hesitated to start a venture, largely out of fear of creating a business plan. Historically, business plan creation has required significant amounts of time, resources, and research. Although business plans are still enormously valuable, some useful business-plan-like tools have emerged: These are essentially variations on the development, content, and structure of a traditional business plan or one of its components. One other concern about business plans is how entrepreneurs use them once they are completed. In many cases, when the venture is launched, the entrepreneurial team discovers that the business plan does not reflect the realities that the team faces. A wide range of variables can often negate the value of the business plan. The true benefit of completing the business plan is that it forces the entrepreneurial team to think through their decisions as reflected in the plan. Even if the venture and the business plan change, the process of creating the business plan encourages critical thinking and improved decisions. In real-time, you will need to make changes to your business plan and your venture. Throughout the venture's life span, you should continue your background research and projections to adapt the business plan.

Unlike with the business plan, the purpose of an action plan is to pull together the ideas, thoughts, and actions necessary to help you set the stage for entrepreneurial success. Consider what kind of action plan you need to prepare a holiday meal. We have a vision of the end result—friends and family gathered together to share a delicious, festive meal. We will need to select the right location for the holiday meal, identify the guests to invite, and create a financial budget for the related costs of the holiday meal. Then we would need to create our action plan—similar to a business plan—to identify what actions are necessary to support the event. In our action plan, we would include inviting guests to the event, drawing up a menu and a grocery list, designing a timeline to ensure that all the dishes of the holiday meal are completed in the correct sequence: We want all the food to be ready at the right time. Our action plan would also include the clean-up process and any after-dinner activities that we want at our event. As you can see, both the business plan and the action plan are necessary for success.

Once you select a framework and an action plan, you have the basic tools and information you need to outline the path of your venture. The framework offers a big picture of what you want to create and the resources required for that goal, whereas the action

plan provides you with concrete actions for starting along your entrepreneurial path and, later, for supporting the business plan.

Action plans can also result from using the tools listed in Table 3.1.5.2. These tools can help you visualize the process necessary to reach your end goal by clarifying the necessary actions. They are also tangible guidelines for innovating, exploring, and creating solutions to entrepreneurial problems or opportunities. You might also use your action plan to get "unstuck" during any challenging phase of the entrepreneurial process. One word of caution regarding these tools: You need to use them to get results. So be sure you are realistic about your interests, abilities, and availability when you create your plans. For example, wireframing is a technique for webpage design used early in the development process in which content, layout, and functionality are identified prior to the actual creation of the webpage. Coincidentally, this is another application of design thinking through the focus on the end user's interaction with the website. As you can see from this example, searching for popular tools used within specific industries will provide you with support in building your framework. Table 3.1.5.2 provides a few examples of action planning tools that are used to delve into the specific topic.

Table 3.1.5.2: Action Plan Support Tools

Tool	Description	Use
Vision or Dream Board	A visual tool to present the ideal situation that you are working towards achieving	Wireframing
Storyboard	A scene-by-scene visual of the activity process from start to finish	Downloading method (IDEO)
Mind map	A visual tool that assists with categorizing brainstorming types of ideas	Brainstorming
Hypothesis	A proposition or statement as a basis for further testing or investigating	Interviewing
Logic Map	Visual representation of relationships between various components or variables	Questionnaires

The action plan support tools presented in Table 3.1.5.2 are a sample list of representative tools that are useful in motivating, inspiring, identifying, and clarifying needed actions. This list is not exhaustive; if you have something that works for you, then use it. Several apps are also available to help you capture ideas to create action plans. The idea is to find and use a visual or tangible tool that inspires you to get focused, organized, and committed to taking the actions necessary to turn your entrepreneurial dream into a reality. Let's say you know that you want to start a venture that helps people recover after some type of disaster. You could use one of these action plan support tools, such as a mind map, to help you brainstorm possible needs resulting from a disaster in a city (Figure 3.1.5.5). You can categorize the ideas to help people and animals, or to repair the city's infrastructure. After completing the mind map, you would then consider which areas fit your interests, passions, and skills. From this point, you could identify the type of venture you want to create and the necessary actions to move forward with your idea. Using these types of tools assists in identifying actions that need to be addressed in your action plan.



Figure 3.1.5.5: From this mind map of disasters that occur and actions to take, we could focus on one action area that matches our interests, passions and skills. After selecting an area of interest, we could create another mind map focused on our area of interest to identify solution sets. Next, we could apply one of the frameworks listed in Table 3.1.5.1. From there we could create an action plan of actions needed to become more informed about the idea or solutions. As you can see, an action plan fits into multiple areas. *(CC BY 4.0; Rice University & OpenStax)*

Types of Entrepreneurs

For some people, the entrepreneurial pathway is clear-cut and logical. For example, a career in a biomedical lab may involve research and clinical trials that lead to patent applications for a product to sell in the marketplace, leading to a new venture. Others experience the entrepreneurial pathway through nontraditional methods, as when an unexpected opportunity arises. As the global marketplace continues to evolve, new entrepreneurial opportunities will open for individuals who are open to opportunities that build on creativity and innovation.

Traditional entrepreneurs were perceived as individuals who did not fit in a typical organizational structure or as people who had the brains, creativity, imagination, and money to launch out on their own. However, this perception is changing with increasing support to reduce barriers to enable access to entrepreneurship for all demographic groups. According to a 2018 Capitol Hill discussion on women, minorities, and entrepreneurship, the current entrepreneurial demographics show that only 12 percent of US innovators are women and that US-born minorities accounted for 8 percent, with African Americans making up only one-half of 1 percent of this group. According to a National Academies of Sciences report, as cited in the same Capitol Hill discussion, women- and minority-owned small businesses received less than 16 percent of all Small Business Innovation Research (SBIT) program awards. Even though women account for 51 percent of the US population and own 29 percent of businesses, they received only 6 percent of SBIT awards.

Also cited at the Capitol Hill briefing, a 2015 report by the US Department of Commerce showed that women-owned small businesses have a 21 percent lower rate of winning federal contracts. One result from this Capitol Hill briefing was the passage of the Promoting Women in Entrepreneurship Act to require the National Science Foundation to encourage entrepreneurial programs to recruit and support women in commercial activities rather than purely laboratory-based activities. Some of the challenges identified in this discussion for groups other than the traditional entrepreneurs described include life choices such as childbearing, access to funding, and lack of support and follow-through to support women and minorities in their interests related to potential entrepreneurial activities.

Other findings drawn from the Census Bureau data and reported by the Kauffman Foundation found that over 70 percent of Asian, Hispanic, and African American entrepreneurs relied on personal and family savings as their main source of startup capital. Women also face challenges in funding, receiving just 2.2 percent of venture capital funding in 2018. A bill called the Support Startup Businesses Act, reintroduced in the US Senate in 2019, would address these challenges by increasing overall funding to help startups, creating more flexibility in funding, and expanding services for startups. The panelists ended the Capitol Hill discussion

by noting that “bro culture” has proliferated at the expense of women- and minority-based entrepreneurial ideas. Cultural barriers, including historical disenfranchisement of women, minorities, and immigrants, arise from biases, with one speaker noting that investors ask more difficult and probing questions of male entrepreneurs but pose more skeptical questions to women.

Today, opportunities have expanded for businesses and organizations that respond to current challenges, which may include trying to improve a negative situation or finding a need in a positive situation, with an increasing awareness of the benefits provided through entrepreneurial activities. As more global, cultural, and economic issues and opportunities arise, more individuals will explore entrepreneurship as a response to these challenges. For example, noting the challenges that women and minorities face in starting a new venture, Alan Donegan and his team train people on how to turn their entrepreneurial visions into a reality through his PopUp Business School. The point is that opportunities should be available to everyone, as long as we keep an open mind when considering how change contributes to new venture creation.

WHAT CAN YOU DO?

Barriers to Funding

Given this list of cultural factors and economic factors, what can you do to assist in solving the challenges related to biases? Consider how Alan Donegan’s responded to the need to educate people on how to start their own business. He created a company to address this need. You may also consider reading statistical information such as census data and news reports to identify unique target markets and potential needs that could result in a new venture.

The Kauffman Foundation reports these issues, summarized in Table 3.1.5.3.

Table 3.1.5.3: Potential Barriers to Entrepreneurial Funding

Potential Barrier	Challenges
Geographical barriers	Close to 80 percent of about $21.1 billion in venture-capital funding in the first quarter of 2018 was disbursed in five regional clusters—San Francisco (North Bay Area), Silicon Valley (South Bay Area), New England, New York City metro, and LA/ Orange County—with slightly more than 44 percent in the North and South Bay Areas.
Gender bias	Women are substantially less likely to start businesses than men. In 1996, the rate of new entrepreneurs for women was 260 per 100,000 people, compared to 380 per 100,000 for men. In 2017, the rate of new entrepreneurs for women was 270 per 100,000 for men.
Racial and ethnic bias	The landscape of entrepreneurship in the United States is marked by significant differences across racial and ethnic groups. Minority-owned firms are found to face significant barriers to capital. For example, minority-owned firms are disproportionately denied when they need and apply for additional credit. One study compared sources of finance and found that new black-owned businesses start with almost three times less in terms of overall capital than new white-owned businesses, and that this gap does not close as firms mature.
Lack of initial wealth	Low-income individuals without initial (pre-existing) wealth also face significant barriers to capital. Research on liquidity constraints showed that the top ninety-fifth percentile of wealthy individuals in the United States is more likely to start businesses than other income groups, and that personal and household wealth are important drivers of entry. Research at the neighborhood level found that in New York City, the richer third of neighborhoods had more than twice the rate of self-employment than the poorest third. A higher household net worth of a founder is linked to larger amounts of external funding received, even after accounting for human capital, venture characteristics, and demand for funds.
Shift in the banking industry	Large banks have become larger, while there are fewer small and medium-size banks. Larger banks survived the Great Recession with balance sheets restored, while small banks—the ones more likely to lend to entrepreneurs—were limited by both economic conditions and new regulatory barriers
Information asymmetry	The persistence of information asymmetry in capital markets between the supply of capital (investors) and the demand for capital (entrepreneurs) gives rise to barriers faced by entrepreneurs. Entrepreneurs face a larger challenge than established businesses in accessing capital because established businesses can leverage their longer track records and existing relationships.

- What challenges do you face in these areas?
- What steps might you take to help mediate those challenges?

As the traditional view of entrepreneurship evolves, different types of entrepreneurship are emerging and are worth noting as you contemplate your entrepreneurial journey. The types presented here are among the most common today, each with its own unique opportunities and challenges.

- College Entrepreneur: As the cost of higher education continues to rise, more college students are seeking ways to reduce reliance on tuition loans by launching a venture. The college entrepreneur might launch an enterprise while attending or after graduating from college. Entrepreneurship courses might require a student to create and launch a venture as part of the curriculum, and this can turn into an actual earnings opportunity.
- Corporate Intrapreneur: If you work for a progressive company that seeks innovative solutions for growth and opportunities, you can become an intrapreneur by organizing the necessary resources to pursue a venture of organizational interest.
- Franchise Entrepreneur: Since a franchise grants a license to an entrepreneur to trade under the franchise's name, a franchise entrepreneur gains a head start in an industry by launching the franchise.
- Immigrant Entrepreneur: With increasing global unrest, more immigrants are traveling to new countries. In the United States, ethnic communities of immigrants welcome their compatriots and assist them in becoming independent through entrepreneurship. These communities pool together the necessary resources to support the new immigrant until the business is self-sustaining.
- Internet Entrepreneur: As access to technology and its related platforms increases, so do opportunities for Internet-based businesses. Internet entrepreneurs utilize social media platforms, smartphones and tablets, applications (apps), and any other form of accessible technology as their product or venture. The critical structure for these ventures is the inclusion of an e-commerce or online payment processing capability.
- Woman or Minority Entrepreneur: Women have a unique perspective and potential to capitalize on new or already existing niches in many entrepreneurial fields. Many cultural groups, such as Haitians, Cubans, or Jamaicans, also have unique marketplace skills and demands.
- Part-time Entrepreneur: In response to economic downturns, underemployment, and unemployment, more individuals are supplementing income through part-time activities, casually referred to as "side hustles." These individuals may launch businesses through multilevel marketing firms, such as Avon, Mary Kay, Stella & Dot, and others. This category may also include self-employed freelancers. Examples include writers, graphic designers, artists, web developers, and massage therapists.
- Social Entrepreneur: Some entrepreneurs are driven to offer innovative solutions to existing and emerging social problems, such as poverty, hunger, human trafficking, and environmental degradation. Most social enterprises are structured as nonprofit entities. However, increased interest in for-profit entities that marry business and social goals has given rise to a subcategory has emerged known as a B-corp, or benefits corporation. The B-corp designation is a voluntary certification that is managed by the nonprofit group B Lab to ensure that corporations adhere to specific guidelines, rules, and accountability.

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3.1.6: Key Terms

action plan
organized, step-by-step outline or guide that pulls together the ideas, thoughts, and key steps necessary to help set the stage for entrepreneurial success

benchmarking
comparing one's own company's performance with an industry average, a leader within the industry, or a market segment

bootstrapping
funding strategy that seeks to optimize use of personal funds and other creative strategies (such as bartering) to minimize cash outflows

breakeven point
level of operations that results in exactly enough revenue to cover costs

business model
plan for how venture will be funded; how the venture creates value for its stakeholders, including customers; how the venture's offerings are made and distributed to the end users; and the how income will be generated through this process

capitalism
system in which individuals, people, and companies have the freedom to make decisions and own property as well as benefit from their own efforts, with government playing a secondary role in oversight

cash flow
money collected by the business through revenue and funding versus money disbursed by the business through expenses

cash management
management of cash inflows and outflows to support cash needs of the venture

corporate entrepreneurship
development of new ideas, opportunities, or ventures through formal research and development processes that focused on the corporation's strategy and goals

creative destruction
theory developed by Joseph Schumpeter stating that entrepreneurial innovation is the disruptive force that creates and sustains economic growth, though in the process, it destroys established companies and disrupts employment

due diligence
conducting the necessary research and investigation to make informed decisions that minimize risk

e-commerce
electronic transactions, particularly over the Internet, for the exchange of goods and services

entrepreneurial journey
your exploration to discover if entrepreneurship is right for you

entrepreneurial process
set of decisions or actions that can be outlined and followed as a guide to developing or adjusting a venture

entrepreneurial spirit
describes a quality of those individuals who are productive self-starters focused on making changes happen

entrepreneurial venture

entrepreneurial venture
any business, organization, project, or operation of interest that includes a level of risk in acting on an opportunity that has not previously been established

framework
structure or outlined process that can be used to accomplish entrepreneurial goals through problem solving, idea generation and validation, and brainstorming

franchising
form of licensing that allows the business (franchisor) to share its business model to expand through various distributors (franchisees) for a fee

independent contractor
(also, freelancer) people or businesses that provide work similar to an employee without being part of the payroll for the contracting business, and who pay their own taxes and pay for their own benefits

innovation
new idea, process, or product, or a change to an existing product or process

intrapreneur
employee who acts as an entrepreneur within an organization, rather than going solo

milestone
significant decision point or significant accomplishment

patent
legal grant of protection for an inventor over the rights, usage, and commercialization of an invention for a set time period

serial entrepreneur
entrepreneur who becomes involved in starting multiple entrepreneurial ventures

situational opportunity
one that becomes available, depending on factors such as where you work, your family obligations, your idea or invention, your unique creative expression, or a recent career search or job change

soft launch
(also, soft open) launching a venture for a limited time frame or audience to gain experience, insights, and feedback about the target market or consumer

target market
specific group of consumers for which a company seeks to provide a good or service

venture
startup company or organization that conducts business or is created to satisfy a need

vertical integration
strategy of gaining control over suppliers of raw materials and distributors of finished products to expand or control the relevant supply chain

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3.1.7: Summary

3.1.2 Overview of the Entrepreneurial Journey

As you prepare for your journey into entrepreneurship, it is critical to consider the multiple aspects associated with preparing for, experiencing, and completing a journey unique to you. The key is an honest and introspective assessment of how you can make a journey that brings your desired outcomes and results. The seven steps outlined in this section will provide you with a perspective of what you might encounter on your entrepreneurial venture.

3.1.3 The Process of Becoming an Entrepreneur

The entrepreneurial process provides a flexible guideline for launching a venture with an individualized approach. This process should be a fluid, not static, exercise that adjusts to market needs and demands until you achieve an appropriate fit to reap the rewards of your investment. The material in this section will be covered in greater depth as you progress through the rest of the chapters. For now, gaining a perspective on the entire process provides you with a background understanding of what an entrepreneurial venture involves, from ideation through creating the venture to harvesting the venture with the potential to begin the process all over again with a new idea.

3.1.4 Entrepreneurial Pathways

Your pathway to entrepreneurship might arise out of necessity, opportunity, or a combination of situations. Being open to the idea of becoming an entrepreneur provides you with the potential to identify a unique opportunity that fits your interests and goals. Entrepreneurs learn to recognize when an opportunity presents itself and how and when it fits with their goals and dreams.

3.1.5 Frameworks to Inform Your Entrepreneurial Path

You can connect your background, training, and discipline with your entrepreneurial pathway by using frameworks that capture your developmental activities. To achieve your goals, you need some type of plan that outlines the steps you need to take to reach them. Just as there are many types of ventures, there are many versions and types of plans and tools that can assist you in developing the plan that best fits you. As more global issues and opportunities continue to arise, many different types of entrepreneurs have emerged, offering innovative solutions. The diversity of entrepreneurial types provides unique niches for opportunities that might not fit the mainstream or traditional route to entrepreneurial success.

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3.1.8: Review Questions

1. Why is interest in entrepreneurship growing among those entering or re-entering the workforce?
2. What is an entrepreneurial mindset?
3. What does the phrase “entrepreneurial venture” refer to?
4. What does the process of “cash management” entail for a business?
5. Why is the entrepreneurial process considered a fluid process rather than a rigid step-by-step guide?
6. What does the term “creative destruction” mean?
7. What is the difference between a corporate entrepreneur and an intrapreneur?
8. What are situational opportunities?
9. What does an entrepreneurial journey entail?
10. Under which circumstances might a person choose to bootstrap a venture?
11. What is an independent contractor?
12. What does the term “framework” mean in terms entrepreneurship?
13. What is an action plan? How is it different from a framework?
14. Why are action plans useful in the development or improvement of a venture?
15. What are the characteristics associated with traditional entrepreneurship?
16. What are some biases that minorities and women face in acquiring funding?

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3.1.9: Case Questions

1. Review the story of Sixto Cancel and his journey to developing the social venture Think of Us.
    a. Consider Sixto's entrepreneurial journey and the development of Think of Us. What types of challenges or obstacles do you think he had to overcome to complete his journey?
    b. Discuss some of the advantages and disadvantages related to Sixto Cancel's background and his experiences in developing an organization and board.
    c. Consider how Sixto Cancel developed his organization. Discuss how he followed or skipped any steps of an entrepreneurial journey.
2. Explore the websites of Cratejoy and Prospurly. How did these venture founders follow the entrepreneurial journey?
3. After researching Man Crates, explain how Man Crates has followed the model in Figure 3.1.3.9?
4. What additional ideas can you think of for starting your own business, using Man Crates as a source of inspiration?
5. Go back to the Work It Out: Startup Ideas Feature Box in 3.1.4: Entrepreneurial Pathways. Select either an idea that you've created or an idea listed on either of the websites. Where could you go to gain more information about this idea? This might mean finding a business where you could shadow someone, or perhaps an internship, or research conducted in some other manner.
6. Return to the Work It Out: Startup Ideas Feature Box in 3.1.4: Entrepreneurial Pathways and revisit the links to business ideas, using the same idea that you identified in Question 1. What are five other businesses that could be spinoff ideas from your one new idea?
7. Refer to the case questions in 3.1.4: Entrepreneurial Pathways. Select one of the framework tools discussed in this section and apply that framework to your idea.
8. Why did you select this framework over another framework?
9. By applying the framework to your idea, what new information did you learn and what information is lacking, or needs further development?

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3.1.10: Suggested Resources

3.1.2 Overview of the Entrepreneurial Journey

View the YouTube video “The Jitterbug Smart phone” at www.youtube.com/watch?v=tRGAL42gWco to see an example of a product endorsement that geared to a specific target market.

Visit the SBA website to learn more about the local organizations that might assist you to launch or manage a venture: https://www.sba.gov/tools/local-assistance

Caron Beesley. “8 Things You Can Do to Be Taken Seriously as a Young Entrepreneur”: https://kitsapscore.org/2017/08/26/8...-entrepreneur/

“Surge Cities: These Are the 50 Best Places in America for Starting a Business”: https://www.inc.com/surge-cities/bes...-business.html

“How I Built a Subscription Business That’s Made over 50k in 6 Months”: https://www.cratejoy.com/sell/blog/c...on-business-2/

National Association of Women Business Owners: https://www.nawbo.org/resources/wome...ner-statistics

Are you ready to start your entrepreneurial venture? Visit the SBA site and take the Small Business Readiness Assessment: https://eweb1.sba.gov/cams/training/...assessment.htm

3.1.3 The Process of Becoming an Entrepreneur

Are entrepreneurs BORN or MADE? (Lord Sugard #AND Robert Greene): www.youtube.com/watch?v=HNHUbrVcpRA

Learn about how Man Crates was created: https://www.mancrates.com

For more information about the Pembina tribe and entrepreneurial behavior: https://www.ndstudies.gov/gr4/fronti...er-fur-traders

For more information about Dr. Charles Drew: https://nmaahc.si.edu/blog-post/color-blood

For more information about the creation of the cotton gin: https://www.history.com/topics/inven...nd-eli-whitney

For more information on how to start a business: https://www.pbs.org/newshour/show/th...t-without-debt

For more information on Global Entrepreneurship: https://www.gemconsortium.org/

Take the Myers Briggs test to discover your personality type: https://www.idrlabs.com/test.php

3.1.4 Entrepreneurial Pathways

50 Business Ideas for Introverted Entrepreneurs: https://smallbiztrends.com/2016/09/b...ntroverts.html

3.1.5 Frameworks to Inform Your Entrepreneurial Path

YouTube Video: Business Model Canvas Explained: www.youtube.com/watch?v=QoAOzMTLP5s

The Four Lenses Strategy Framework website: www.4lenses.org

Evernote, a cross-platform app that allows you to create, update, and synch notes: https://evernote.com/about

YouTube Video: We have a dream, B-corp overview and mission: www.youtube.com/watch?time_c...&v=V-VFZUFJwt4

Business Model Canvas Strategyzer: https://www.strategyzer.com/canvas

For more information on the diversity of entrepreneurs in the United States: https://www.entrepreneur.com/article/286574

For more information on entrepreneurship and resource providers supporting entrepreneurship: www.kauffman.org/eship-summi...17/overview#1g

For a list of resources available to support entrepreneurship: https://www.kauffman.org/what-we-do/...data-resources

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SECTION OVERVIEW

3.2: Identifying Entrepreneurial Opportunity

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3.2.3: Researching Potential Business Opportunities

3.2.4: Competitive Analysis

3.2.5: Key Terms

3.2.6: Summary

3.2.7: Review Questions

3.2.8: Discussion Quetions

3.2.9: Case Questions

3.2.10: Suggested Resources

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3.2.1: Introduction



Figure 3.2.1.1: Chris Johnson, CEO and founder of California-based company Rapid Brands, invented the Rapid Ramen Cooker and has since grown his offerings to a line of successful products. (credit: photo provided by Rapid Brands Inc.)

Like many college students, Chris Johnson ate a lot of ramen noodles, and like many college students, cooking meant microwaving something in his dorm room. At the time, ramen noodle companies did not print microwave instructions on the package, and there was a lack of microwave cookware in which to prepare the popular college food fare.

Many entrepreneurial ideas aim to solve small everyday problems. In his quest to find a better way to prepare ramen noodles, Chris Johnson invented the Rapid Ramen Cooker.

Johnson is now the CEO of Rapid Brands. He founded his company in 2013 with the Rapid Ramen Cooker. Johnson pitched his idea on the TV show *Shark Tank*. Although he negotiated with investor Mark Cuban for an ownership stake in the company, Johnson wound up not taking the deal. Instead, he made a deal with Walmart to position the Ramen cooker on the retailer's shelves. Rapid Brands sold more than 4 million Rapid Ramen Cookers in its first two years at Walmart and other retailers. Johnson has since introduced several new products, including cookers for eggs, hot dogs, and brownies.

Finding an entrepreneurial opportunity and persisting until your business becomes successful is not easy and involves risk. But whether you start a new venture because you came up with an idea to solve an everyday problem, or whether you are deliberately searching for an opportunity because you want to start your own business, doing the research beforehand will help mitigate risk and determine the venture's likelihood of success.

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3.2.2: Entrepreneurial Opportunity

Learning Objectives

By the end of this section, you will be able to:

- Define entrepreneurial opportunity
- Discuss Joseph Shumpeter's theories of opportunity
- Identify key drivers of opportunity

Aspiring entrepreneurs can come up with ideas all day long, but not every idea is necessarily a good idea. For an idea to be worth pursuing, we must first determine whether the idea translates into an *entrepreneurial opportunity*. **Entrepreneurial opportunity** is the point at which identifiable consumer demand meets the feasibility of satisfying the requested product or service. In the field of entrepreneurship, specific criteria need to be met to move from an idea into an opportunity. It begins with developing the right mindset—a mindset where the aspiring entrepreneur sharpens his or her senses to consumer needs and wants, and conducts research to determine whether the idea can become a successful new venture.

In some cases, opportunities are found through a deliberate search, especially when developing new technologies. In other instances, opportunities emerge serendipitously, through chance. But in most cases, an entrepreneurial opportunity comes about from recognizing a problem and making a deliberate attempt to solve that problem. The problem may be difficult and complex, such as landing a person on Mars, or it may be a much less complicated problem such as making a more comfortable pillow, as entrepreneur Mike Lindell did by inventing My Pillow.

Theories of Opportunity

In the twentieth century, economist Joseph Schumpeter, as shown in Figure 3.2.2.1, stated that entrepreneurs create value "by exploiting a new invention or, more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way, by opening up a new source of supply of materials or a new outlet for products, by reorganizing an industry" or similar means.

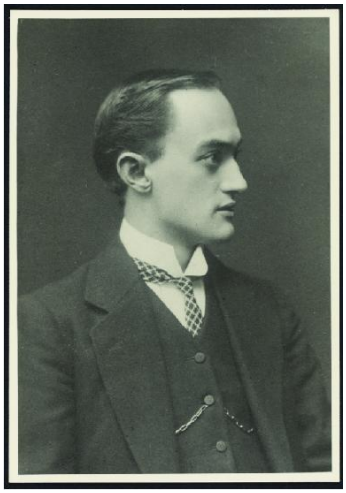


Figure 3.2.2.1: Schumpeter believed that entrepreneurs create value in an economy. (credit: Joseph Alois Schumpeter, ca. 1910: HUGB S276.90 p (2), olvwork369436. Harvard University Archives)

According to Schumpeter, entrepreneurial innovation is the disruptive force that creates and sustains economic growth, though in the process, it can also destroy established companies, reshape industries, and disrupt employment. He termed this force **creative destruction**. Schumpeter described business processes, including the concept of downsizing, as designed to increase company efficiency. The dynamics of businesses advances the economy and improves our lifestyle, but the changes (sometimes through technology) can make other industries or products obsolete. For instance, Schumpeter provided the example of the railroad changing the way companies could ship agricultural products quickly across the country by rail and using ice "cold cars," while at

the same time, destroying the old way of life for many ranchers who wrangled cattle from one location to their intended commercial destination.

Today, we might think of the displacement of taxi drivers by ride-sharing services such as Uber and Lyft as a modern-day example of this concept. To own and operate a New York City cab, for instance, one must buy what is called a taxi medallion, which is basically the right to own and operate a cab. Drivers take out loans to buy these medallions, which cost hundreds of thousands of dollars. But now, ride-sharing services have eaten in to the taxi industry, all but destroying the value of the medallions, and the ability of taxi drivers to make the same money they were before the popular services existed. This change has left many taxi drivers in financial ruin. Schumpeter argued that this cyclic destruction and creation was natural in a capitalist system, and that the entrepreneur was a prime mover of economic growth. To him, the goal was to progress, and progression starts with finding new ideas. He identified these methods for finding new business opportunities:

1. Develop a new market for an existing product.
2. Find a new supply of resources that would enable the entrepreneur to produce the product for less money.
3. Use existing technology to produce an old product in a new way.
4. Use an existing technology to produce a new product.
5. Finally, use new technology to produce a new product.

We can understand theories of opportunity as related to supply or demand, or as approaches to innovations in the use of technology. The first situation is a demand opportunity, whereas the remaining situations are supply situations. The final three incorporate technological innovations. *Supply* and *demand* are economic terms relating to the production of goods.

Supply is the amount of a product or service produced. **Demand** is the consumer or user desire for the outputs, the products, or services produced. We can use the ideas from Schumpeter to identify new opportunities. Our focus is on identifying where the current or future supply and the current or future demand are not being met or are not aligned, or where technological innovation can solve a problem.

More recent research has expanded on the concept of technological entrepreneurial opportunities, identifying several areas: creating new technology, utilizing technology that has not yet been exploited, identifying and adapting technology to satisfy the needs of a new market, or applying technology to create a new venture.

Regardless of which of Schumpeter's paths entrepreneurs pursue, before investing time and money, the business landscape requires a thorough investigation to see whether there is an entrepreneurial opportunity. Remember, entrepreneurial opportunity is *the point at which identifiable consumer demand meets the feasibility of satisfying the requested product or service*. "Feasibility" in this definition includes identifying a sizable target market interested in the product or service that has sufficient profitability for the venture's financial success.

ENTREPRENEUR IN ACTION

Chester Carlson

Chester Carlson, a physicist, inventor, and patent attorney, spent ten years searching for a company to develop and manufacture a new photographic machine for office use to make copies faster and for less money. Carlson went on to found the XEROX Corporation, the company that made the first photocopy machines. Can you imagine a school or office today without a photocopy machine? The companies that Carlson approached with his invention missed the opportunity to invest. For Carlson, it was the beginning of a technology product development company that has been granted more than 50,000 patents worldwide.

Today, Xerox continues to innovate. Visit the innovation section of its website (www.xerox.com/en-us/innovation) and consider how one of the inventions it's developing now could spur creative destruction in an industry, according to Schumpeter's theory.

Identifying Opportunity

A good place to begin your entrepreneurial quest is to read as much as you can, especially with new technology developments, even outside the field you work in. Remember that as technologies start to emerge, we often do not yet understand their commercial potential. For example, microwave technology was first applied in radars to track military submarines. But, thanks to a

curious man named Percy Spencer and the accidental melting of a peanut bar in his pocket one day while tinkering with the technology, the microwave was born. It would take a few decades for it to be produced at a price the mass market could afford.

Think of drones, too. When they were invented, the multiple uses for this technology were not yet identified. Now, drone technology is being used by real estate firms, package delivery services, agriculture, underwater search and scientific research, security, surveillance, and more. Being tuned in to new experiences and information can lead to identifying opportunities. Entrepreneur Fred Smith found a system to solve the problem of overnight package delivery in founding Federal Express. As a college student, he wrote a paper for an economics class where he discussed his business idea. He earned only a C on his paper, by the way. He received his bachelor's degree in 1966 and went on to found Federal Express a few years later, which, in 2019, generated almost $70 billion in revenue. Prior to starting Federal Express, Smith was in the US Marine Corps serving in Vietnam where he observed the military's logistics systems. This is where he honed his interest in shipping products while in the military. Many entrepreneurs start their business after working for someone else and seeing a better way to operate that business, and then start their own competing business.

Note that entrepreneurs need to be careful about starting competing businesses. Some entrepreneurs, like Smith, conduct research as an idea percolates, paying attention to new experiences and information to further advance their idea into an entrepreneurial opportunity. However, they must ensure that the existing product, service, or business process is not covered by any active and protected intellectual property (patent, trademark, copyright, or trade secret).

Identifying consumer needs may be as simple as listening to customer comments such as "I wish my virtual orders could be delivered more quickly." or "I can never seem to find a comfortable pillow that helps me sleep better." You can also observe customer behavior to gather new ideas. If you are already in business, customer feedback can be a simple form of market research.

When purchasing an existing business or franchise, the process is a bit different. The first step will usually be searching for a business that suits your experience, personal preferences, and interests. You will still want to conduct research to understand the industry, the local market, and the business itself. Then, you will begin to examine all available company financial data. If purchasing a franchise, you may want to contact other franchise owners and discuss their experience in working with the franchisor.

ENTREPRENEUR IN ACTION

How Spanx Founder Developed Resilience and Persistence

Another entrepreneur, Sara Blakely (Figure 3.2.2.2), admits that for the seven years she spent selling fax machines in the 1990s, many times, she became so frightened of approaching sales prospects that she would burst into tears and then have to drive around the block to collect herself before she could complete the next sales call.



(a) (b)

Figure 3.2.2.2: (a) Spanx, a new product that was created to solve an everyday problem, was invented by (b) Entrepreneur Sara Blakely (far right). (credit (a): "Spanx" by Mike Mozart/Flickr, CC BY 2.0; credit (b): "Ed Bastian and Sara Blakely at the Fast Company Innovation Festival" by Nan Palmero/Flickr, CC B 2.0)

One day in 1998, she was putting on pants and looked in the mirror and did not like how she looked. So, Blakely came up with the idea to wear a pair of control-top pantyhose underneath—but she cut the feet out. Blakely liked the look and comfort of the footless hose and decided to patent her own body-shaping footless version. Just a few years later, Blakely founded her

company, Spanx, Incorporated, which since has gone on to launch more than 200 styles of body-shaping garments. This is another case of an entrepreneurial company born out of a simple way to solve an everyday problem.

Blakely is also a master of resilience, which is a quality of many successful entrepreneurs. When she was sixteen years old, right around the time her parents separated, she witnessed a good friend get hit and killed by a car. Her father gave her a set of motivational tapes to listen to: *How to Be a No-Limit Person* by Wayne Dyer. She found the tapes so helpful that she memorized all of them and still gives copies of the tapes as gifts.

As a child, her father encouraged his children to respect the valuable lessons we can learn through failure. Obviously, it helped Blakely at a young age develop persistence and determination. That persistence and determination helped her develop a business idea into a billion-dollar enterprise.

- Was Blakely's idea a demand or a supply idea?
- What industry information would Blakely need as she was researching this idea?

When researching supply and demand, you should also consider political factors. For example, changes in tax laws can inform decisions. One example is a tax credit that encourages alternative energy use, such as electric or hybrid vehicles. For 2019, the IRS tax credit is between $2,500 and $7,500 per new electric vehicle, with a concurrent phase-out of the plug-in electric vehicle tax credit. Changes in the tax code can therefore influence buyer behavior or the demand for vehicles. Another example is the Residential Energy Efficient Property Credit of up to $4,000 for solar electronic appliances such as solar water heaters and solar panels and for small wind turbines, through the end of 2021. Tax incentives do not usually last more than a few years (the tax subsidy for corn farmers to produce ethanol, an ingredient in automotive fuels, is a notable exception due to heavy lobbying by the farming industry), so it is important that entrepreneurs do not rely on these incentives as a permanent "pillar" of their value proposition and business model.

Let's say you have an interest in machinery and art. Taking these two areas of interest, and knowing about this tax credit, you recognize that you have the talents to create artistic backyard wind turbines to create energy for a homeowner. Of course, you will still need to determine whether this is merely an idea, or if the conditions are in place to move forward in translating this idea into an entrepreneurial opportunity.

Drivers of Opportunity

Some recent drivers for change in the entrepreneurial space include new funding options, technological advancements, globalization, and industry-specific economics.

- Increased access to capital through social media sources like crowdsourcing is having a significant impact on entrepreneurship in that it enables underserved people and communities—such as women, veterans, African Americans, and Native Americans, who otherwise might not be able to start and own a business—to become entrepreneurs.
- Technological advancements continue to provide new opportunities, ranging from drones to artificial intelligence, advancements in medical care, and access to learning about new technology. For example, drone technology is being used to map and photograph real estate, deliver products to customers, and provide aerial security and many other services. Cell phones have spawned many new business opportunities for a wide range of cell phone accessories and related products, ranging from cell phone cases to apps that help make our cell phones faster for business and personal use.
- Increased globalization drives entrepreneurship by allowing importing and exporting to flourish. Globalization also helps spread ideas for new products and services to a world market instead of a local or regional market. Combined with the Internet and computer technology, even small businesses can compete and sell their products around the globe.
- Economic factors could include a strong economy that fuels other businesses. For example, growth in the housing market fuels growth for many housing-related products and services, ranging from interior decorating to landscaping as well as furniture, appliances, and moving services.

David Pridham, CEO of the patent advisory board and transaction firm Dominion Harbor Group in Dallas, cites six reasons that current conditions are excellent for startups:

1. Venture capital investment has surged to the highest level ever, totaling $148 billion in 2018.
2. The concern over patent protection is improving with better trade protection of intellectual property rights.

3. Artificial intelligence could be a tremendous opportunity based on a McKinsey report projection, estimating artificial intelligence to become a $13 trillion industry by 2025.
4. The explosive growth in freelance workers has been a boon to startups and small businesses.
5. Another hot sector is technology-driven advancements such as self-driving vehicles.
6. Intellectual property now accounts for 38.2 percent of our total Gross Domestic Product (GDP) in the United States. That totals $6 trillion per year, more than any other nation's GDP except for China.

In addition, Silicon Valley Bank (SVB) Financial Group surveyed new startup businesses in 2017 and found that 95 percent indicated they believe that business conditions will be the same or better. In addition, 83 percent plan to increase their workforce, and 24 percent found fundraising not to be a challenge. These numbers represent the highest levels of optimism among entrepreneurs over the most recent five-year period.

Some other economic indicators favor entrepreneurship. According to the 2019 Goldman Sachs Economic Outlook, consumer confidence is up, business confidence is up, interest rates remain reasonable and steady, more people are working, and wages are higher. When the economy is strong, there are generally more opportunities available and more potential customers with money to purchase your products and services; but of course, there are no guarantees.

LINK TO LEARNING

There are debates about so-called kill zones—markets that the tech giants like Facebook and Amazon control through aggressive anti-competitive tactics. Some argue that these zones have frightened off investors and stifled competition. But others maintain that investment in young tech startups is as strong as ever and that the creative effects of big tech companies outweigh their destructive forces.

Read this article on how tech giants make it difficult for startups from *The Economist* and then this blog post refuting the idea that tech giants kill startups from The American Enterprise Institute and see what you think about the issue.

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3.2.3: Researching Potential Business Opportunities

Learning Objectives

By the end of this section, you will be able to:

- Describe opportunity screening
- Identify common sources of research data
- Explain how to research and verify business opportunities
- Identify industry and consumer sources of opportunities

In order to discover how reasonable your business idea is, you need to research many aspects of the concept. **Opportunity screening** is the process by which entrepreneurs evaluate innovative product ideas, strategies, and marketing trends. Focusing on the viability of financial resources, the skills of the entrepreneurial team, and the competition, this screening helps determine the potential for success in pursuing the idea and can help refine planning.

Common Sources of Research Data

As you embark on researching whether your idea is viable, a good place to start is with the sources recommended by the US Small Business Administration. These include US Census data (www.census.gov/academy), which provides insight into the population in your market area, such as the metropolitan statistical area data, as well as statistics on the economy and trade. For most entrepreneurs, research will also include asking potential customers, specifically your target customers, questions about products they like and don't like, how a product or service could be improved, how the customer buying experience could be improved, and even where customers might go to purchase products and services instead of your business.

Small business marketers can use several no-cost or low-cost methods, including surveys, questionnaires, focus groups, and in-depth interviews. Of course, you do not need to be an expert in these areas. Business assistance is available to you from the Small Business Administration, the Service Corps of Retired Executives (SCORE), and your local Small Business Development Center. You may also have a local college or university business department that provides assistance to local area businesses.

LINK TO LEARNING

The Small Business Administration website and SCORE website are rich resources of information for entrepreneurs.

You will likely begin with **secondary research**—that is, data that are already available through some published source. There may be articles, research reports, or reliable Internet sources where you can research information about your industry, products, and customers. If you have the funds, you can also purchase research reports from firms that specialize in gathering research on certain topics or products. Secondary research has the advantage of being quickly available. However, secondary research often is not specific enough to provide all the details you need to know about your idea. For example, secondary research (this is research that has been developed from primary sources that is almost as useful as primary, direct research) might report how often consumers purchase shampoo, where they purchase shampoo, and what brands of shampoo they purchase. But if you want to understand the details of how people shampoo—for example, whether they shampoo then repeat, use a separate conditioner, or use a combination shampoo/conditioner product—then you would want to conduct primary research. Primary research is needed when secondary research does not address the questions you want to explore while investigating your business idea.

Primary research gathers data that do not yet exist. The information is specific to the business, product, or consumer. It takes time and money to obtain primary data. Some of the methods used to gather primary research data include developing a survey questionnaire, using secret shoppers, or using focus groups. Survey questionnaires can be simple, such as a customer comment card included on a receipt, or extensive, including dozens of detailed questions. Secret shoppers can be used by hiring a shopping service or using friends, family members, and even your customers. One local small business owner gave a friend gift certificates that could be used at his ice cream business in exchange for the friend reporting back on product quality, service, and other key issues.

Researching and Verifying the Entrepreneurial Opportunity

Whether you start your own business, buy an existing business, or purchase a franchise, researching the industry, your target market, and examining the economic and funding options are all part of performing due diligence. Due diligence is the process of taking reasonable steps to verify that your decisions are based on well-researched and accurate information. It means thoroughly researching potential pursuits, asking detailed questions, and verifying information.

Different industries have different meanings for due diligence. For example, in the legal industry, due diligence involves understanding the terms of a transaction and contract. In business finance, due diligence refers to raising capital or the work involved in merger and acquisition transactions. In the entrepreneurship field, research is necessary to verify whether the idea is really an opportunity, considering the entire process of starting the venture and funding the venture.

One of the more common questions entrepreneurs must ask is whether *now* is a good time to start a business. This question of timing is addressed in the investigation to determine whether the idea is merely interesting or fits the criteria of being an entrepreneurial opportunity.

An idea can move to a recognized opportunity when the following criteria are met. Figure 3.2.3.1 shows these three factors:

- Significant market demand
- Significant market structure and size
- Significant margins and resources to support the venture's success

Significant market demand means that the idea has value by providing a solution to a problem that the target market is willing to purchase. This value can result from a new product or service that fills an unmet need, a lower price, improved benefits, or greater financial or emotional value. This value can also result from capitalizing on "nonconsumption." For example, in the 1980s, the Disney Corporation realized that it was losing an opportunity to entice visitors to come to their theme parks from 9 p.m. to 9 a.m. when they were closed. So the company started having "school nights" when schools and students could use the parks at a discount.

Significant market structure and size involve growth potential and drivers of demand for the product or service. Barriers to entry are manageable, meaning that entering the industry or creating a new industry is not exceptionally difficult. If the industry already exists, there must be room within the industry for your venture to gain market share by providing a value that creates a competitive advantage.

Significant margins and resources involve the potential for achieving profit margins at a high-enough level that the work of starting the venture (including the entrepreneur's time and energy) is worth the risks involved. If the operating costs are too high and the profit margin is too low, it is important to analyze whether the idea is truly feasible. Significant margins also include the capital requirements—how much money is needed to start the venture—as well as the technical requirements, the complexity of the distribution system, and similar resources.

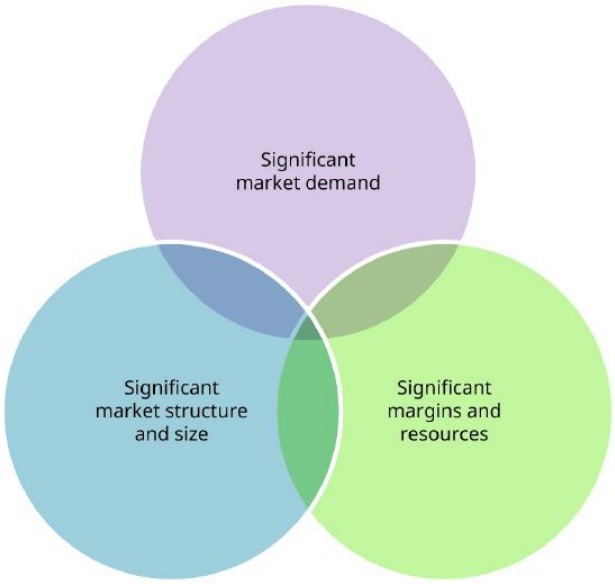


Figure 3.2.3.1: When these criteria are met, an idea is recognized as an opportunity. (CC BY 4.0; Rice University & OpenStax)

Determining whether an idea has significant market demand, significant market structure and size, and significant margins and resources to support the venture's success represents the most basic concerns when screening a business idea as an entrepreneurial opportunity.

Keep in mind that these three criteria are based partially on creating a for-profit venture. If your entrepreneurial venture is focused on solving a societal problem, you want to know that the identified problem is realistic and that there is a need for solving it. In a for-profit venture, significant market structure and margins relate to the expectation that the venture will have significant sales with significant profit margins to sustain and grow. There are also examples of profitable entrepreneurial ventures, like YouTube, that did not have any sales, but there was still an expectation that harvesting or selling YouTube would result in a significant profit for the entrepreneurial team. You can read more about Google's purchase of YouTube.

After confirming that a business idea is an entrepreneurial opportunity, the entrepreneur should ask more detailed questions in the next phase of screening the business. Here are some examples:

- Would other people value your product or service?
- Does your product or service solve a significant problem?
- Is the market for the product definable/specific?
- Does the market have unique needs or expectations that align with your entrepreneurial opportunity?
- Is the timing right to start the venture?
- Are there infrastructure or supporting resources that need to be commercialized or created prior to your launch of the venture?
- What resources are needed to start the venture?
- What is the competitive advantage your venture offers within the industry and is this competitive advantage sustainable?
- What is the timeline between starting the venture and the first sale?
- How long before the venture becomes profitable and do you have the resources to support this timeline?

A good starting point in your opportunity screening research is to begin learning about the demographics of the market you are targeting (your target market). **Demographics** are statistical factors of a population, such as race, age, and gender.

The government collects census data demographics, which can provide a snapshot of the population in your city or town. Census data include the total population, a breakdown of the population by age, gender, race, and income, and some other useful data.

LINK TO LEARNING

The US Census website and your local chamber of commerce can help you learn more about the demographics of your target market or region.

For example, if you were considering opening a new ice cream store with unique flavors preferred by children, census data could tell you the number of children living in the area, the ratio of boys to girls, their ages, and the general income levels of the families in town. The census data would help you determine the size of the market and potential target market, local market growth, income levels, and key demographics that might fit the potential customer profile. Of course, there is other information you might want to collect, such as the percentage of the population that had lactose intolerance. If you found that a significant portion of your market was lactose intolerant, this could be your identified opportunity: You could create a lactose-free ice cream store or expand with a variety of lactose-free flavors. The census data also help identify where to locate your entrepreneurial venture. For example, if your lactose-free ice cream was expensive because of the necessary ingredients, you would not want to open your store in a low-income area.

There is a vast amount of data and information available through the Internet that can support your success in making informed decisions as you explore the feasibility of opening a successful venture. Or you can purchase more detailed consumer data through providers such as Claritas Research, which gathers information on demographics, consumer lifestyles, attitudes, and behaviors (https://claritas360.claritas.com/myb...egments/?ID=70). For many small business startups that cannot afford sophisticated research data, the entrepreneur will probably have to rely on census data along with information that the local economic development council is able to provide.

WORK IT OUT

T-Shirt Startup

Create your own t-shirt line to target your classmates.

- What would be the theme?
- How much would you charge?
- Where would you sell the shirts?
- What are the expected sales of the business?
- What are the resources needed to get started?

After analyzing demographic data, the entrepreneur can then develop and conduct some basic research, which could range from observing customers to shopping at potential competitors. Entrepreneurs can also uncover business opportunities by asking questions of, and listening to, their customers, if they are working within the industry or looking for new entrepreneurial opportunities with a similar target market. Sometimes an easy and inexpensive customer survey can uncover problems and opportunities. Entrepreneurs can also gather information using their social media accounts and customer sales records.

For example, imagine a men's clothing store in Denver that maintained a detailed customer database that they used primarily to order the colors and sizes their customers were most likely to purchase. A marketing consultant begins researching customer data and finds a number of former customers who had not shopped at the store for a year or more. The consultant uncovers some lapses in service that had cost the store thousands of dollars in sales. Store management, working with the information from the consultant, develops a direct marketing campaign that helps bring back former customers and adds new customers, resulting in a substantial sales increase.

The lesson here is that research is important at all stages of the business—before you start your business and consistently thereafter. Markets change as new people move in or out of an area, styles and preferences change over time, and new technology can radically impact what customers want to buy. We all know of businesses like Blockbuster or Xerox that ignored evolving technology, to the detriment of their success. Constantly tracking changes in the external environment and competitive arena is an ongoing activity that supports the continued success of the venture.

A popular tool for market analysis is a product from Claritas Research called Potential Rating Index for Zip Markets (PRIZM), which characterizes census data according to certain lifestyle traits, even down to the neighborhood level. As an example, let's see how PRIZM can help us better understand the consumer market of a small town in Massachusetts. Oxford, Massachusetts (zip code 01540), has a population of 11,653, with slightly more half being female; a median income of $70,444; and a median age of 42.3 years. PRIZM data give us a better understanding of consumers than census data do in Oxford by examining the five dominant lifestyle segments from within PRIZM's sixty-six segments. The PRIZM segments are based on socioeconomic rank determined by

characteristics such as income, education, occupation, and home value. A thorough analysis of available data could suggest the most likely products and sources consumers in this zip code market would likely purchase.

Entrepreneurs might also obtain data from economic development agencies, the local chamber of commerce, the state small business development center, or industry associations. Of course, lots of data can be found with a good search on your computer. Your university reference librarian can tell you what resources they have available and which resources would best fit your research question(s) and area of focus for your idea.

ENTREPRENEUR IN ACTION

Elon Musk's SpaceX

There have been many instances in which products have been promised but fail in their implementation. Space travel—think Elon Musk's venture SpaceX (Figure 3.2.3.2)—is an example of a bold concept that is still in the feasibility phase. Is it even possible to send humans to Mars? This is an extreme but interesting example for considering product feasibility.

Another application of the SpaceX technology is to develop satellite-based Internet access that can provide service to billions of people who do not already have Internet service. However, the project will require new satellite networks, and it may take twenty years to fully develop.

- What short-term and long-term considerations are necessary in the project?
- As the concept will take twenty years of satellite development, how can technological changes be incorporated into the development of the idea?
- Given the description of an entrepreneurial opportunity, does this idea fit that definition?



Figure 3.2.3.2: SpaceX operations are centered in these headquarters. (credit: "Iridium-4 Mission (25557986177)" by Official SpaceX Photos/Wikimedia Commons, CC0 1.0)

What should you do if your idea does not fit these criteria—significant market demand, market structure and size, and margins and resources—and your passion to develop the idea into an opportunity and new venture is still strong? This is also part of the entrepreneurial process. You, as the lead entrepreneur, are charged with the task of identifying the obstacles to turning your idea into an opportunity and what actions are necessary to overcome these. This could mean adjusting the idea, adding new features, or even removing some features. Adding new features should focus on increasing the value or benefit offered by the product or service, or creating a tighter alignment with the needs of the target market. Removing features could decrease the production costs or even the complexity in using the product.

As part of your research to verify whether your idea is truly an entrepreneurial opportunity, researching your state's laws and regulations is essential. Conduct an Internet search for your state's business regulations applicable to your business. You will need to comply with these laws, as well as purchase any licenses and permits necessary for your business. You should also check with your local or county government for additional local regulations, including zoning and signage laws. Remember that laws vary by

state, so what is legal in one state may not be legal in another, or there might be stricter regulations. For emerging industries, the regulations and laws can fluctuate as industries evolve. This is especially true for emerging industries such as the sale and distribution of medical marijuana.

ARE YOU READY?

Getting a License or Permit to Start a Business

When starting a business, be sure that you have all the required licenses and permits, keeping in mind that you may need licenses from federal, state, county, and local government agencies. You can start with the SBA website. Another helpful resource is Fundera, an online financial resource that provides information about obtaining business licenses in all fifty states and links to essential government organizations for each state. And try nav.com as well.

States regulate a larger number of business activities than the federal government. Business activities that are regulated locally include auctions, construction, dry cleaning, farming, plumbing, restaurants, retail, and vending.

- Select a business in a regulated industry and research what would be needed to start the venture in a specific locale.

Many estimates indicate that half of all new businesses will no longer exist within the first five years, but good research can help you avoid your business becoming a statistic.[16] On the surface, this fact can be daunting. However, there are many reasons why a business no longer exists that can reflect a positive outcome, such as the sale of a business or a merger with another business. Another example is when an entrepreneur intentionally starts a venture knowing that there is a short-term timeline for success, with the expectation that new technology will replace the gap that the venture originally filled. Most entrepreneurs are not big risk-takers but understand that there are no guarantees in starting a new business venture. Instead, entrepreneurs tend to take calculated business risks based on the best research they can gather. At some point, however, the entrepreneur recognizes that despite all the good research they have gathered, they still need to take a leap of faith when starting their new venture.

WHAT CAN YOU DO?

Why Small Businesses Fail

Why do half or more of new small businesses no longer exist after the first five years? In many cases, it is failure of the business. The Small Business Institute at Thomas College in Maine has cited factors in Table 3.2.3.1 as the most common reasons for small business failures. Many business development agencies have compiled similar lists.

Table 3.2.3.1: Ten Reasons for Small Business Failure. Understanding some of the factors that lead to business failure can help you be aware of those as you research your idea and opportunity.

Reason	Description
Low sales	Entrepreneurs may have overestimated sales, assuming they could take sales away from established competitors.
Lack of experience	Running a business is hard, and a new business can be especially challenging, as it is difficult to prepare adequately for the unexpected.
Insufficient capital	When calculating how much money you will need to start your new business venture, be sure to account for the time it will take before your business breaks even and be sure also to allow for some contingency funds for when the unexpected happens.
Poor location	For some types of businesses, location is critical. Of course, location may be less important for a home-based business and not at all important for an Internet business.
Poor inventory management	Too much inventory results in the business becoming cash-strapped and unable to buy advertising or other important goods and services.
Overinvestment in fixed assets	Especially when starting a business, it is usually less expensive to lease or purchase used equipment, thereby saving cash for meeting operational expenses.
Poor credit arrangement management	Start your venture small and limit the amount of money you need to borrow. Work with your banker from the beginning by sharing your business plan and vision for the business with the banker and, most important, show that you are proactive in planning for when you will need to borrow money.
Personal use of business funds	The owner should pay him/herself a minimal salary and not dip into business funds. If the business has done well, the owner will earn additional funds at the end of the year.
Unexpected growth	Surprisingly, some businesses fail because the business owner cannot manage growth. Growing a new venture, especially if the growth is at a higher rate than expected, can create surprising challenges. For example, if creating a product, you need to consider the capacity of the factory where you are producing the product. If you are at 100 percent capacity and your orders increase, you will need to think about what actions can support this increase in demand. If you cannot meet the demand, you will have unhappy customers and negative publicity that will reflect negatively on your leadership and managerial skills. Your lack of planning for this surge in sales may open opportunities for someone else to start a competing business.
Competition	Many small business owners underestimate their competition. Remember, if there is money to be made, there will be competition! Larger competitors can beat you every day of the week on price, so find another way to challenge competitors.

- Given the preceding reasons for small business failure, what can be done to head off such failure?
- Why is it necessary to assemble a team of professional advisors to address financial, personnel, legal, accounting, and other business issues?

- Why is it vital to identify suppliers and personnel to be able to provide a product or service?
- What factors are important when considering whether a product should be manufactured internally or outsourced to a third party?

Let us analyze, as an example, opportunity recognition displayed by a company called Sweet Beginnings. Eddie Griffin, Kevin Greenwood, and Tiffany Chen were all residents of Chicago who were seeking jobs and a fresh start on life after serving time in prison. They wanted a chance to rebuild their lives and the ability to support themselves financially. Unfortunately, the odds were against them in their North Lawndale community: There was a 40 percent unemployment rate, 57 percent of residents had criminal histories, the average annual income was only $25,000, and the area was known for drugs, sex workers, and gangs. Statistically, they were destined to return to the criminal justice system.

But fate intervened in the form of Brenda Palms Barber, who knew all of these statistics. Palms Barber was the Executive Director of the North Lawndale Employment Network (LEN). When employers refused to hire Griffin, Greenwood, and Chen, whom she had coached, she researched what it would take to open various businesses, including a temp agency, a landscaping company, and a delivery service, with the intent to offer employment to LEN clients. A recommendation from a board member's connection led her to consider, of all things, raising bees. It was not until she learned that the ins and outs of the apiary profession are passed on by word of mouth that she felt it was ideal for her clients who often faced learning challenges due to limited academic experience.

In 2005, Palms Barber founded Sweet Beginnings, a social enterprise that employs former inmates and teaches them job skills by running an apiary business directly in the heart of North Lawndale. The Sweet Beginnings brand, Bee Love (shown in Figure 3.2.3.3), sells honey and honey-infused skincare products in airports, hotels, and supermarkets, including Whole Foods. Palms Barber recognized that the skills her potential employees learned in the streets were transferrable to running and managing the business.



Figure 3.2.3.3: Bee Love products are part of a social entrepreneurship venture. Founder Palms Barber researched the opportunity carefully and has found success. (credit: "Bee Love" by Alisha McCarthy/Flickr, CC BY 4.0)

Palms Barber also realized that a product gap existed between customer needs and products offered. She identified the niche market of customers who wanted all-natural skincare products and liked the idea of purchasing them from a social enterprise. Bee Love positioned itself for success as an appealing, high-end natural product to environmentally conscious consumers willing to pay a premium for it.

Palms Barber recognized an opportunity when she identified the societal problem of employment for people who had experienced incarceration. In seeking solutions to this problem, she encountered roadblocks from employers' resistance to hiring ex-prison inmates. She then researched other possible solutions including business startups. The idea of raising bees at first seemed an unusual solution to the problem of employment for her unique clients. In her due diligence, she identified a gap between customer preferences for all-natural skincare products and currently available offerings. Combining these ideas resulted in the opening of Bee Love. The fits between the clientele of ex-inmates, apiary, and skincare products supported the opening of this unique venture.

Exploring the gaps was part of the process of finding the right solution and realizing that the idea of starting a business to support ex-inmates was an actual opportunity worth developing into a new venture.

Industry Sources of Opportunity

Your research process should include learning everything you can about the industry you plan to enter. This will help you to identify opportunities. An excellent source for industry information is the business reference section of your college library. Industry averages are available in reference books and can also be found at Dun & Bradstreet/Hoovers (www.hoovers.com/industry-analysis.html). The industry analysis contains important information including a brief description of the industry and its characteristics, the competitive landscape, along with products, operations, and technology.

Industry sources reveal knowledge about a specific industry from the perspective of identifying unmet needs or areas for improvement within that industry. For example, Airbnb reshaped the hotel industry by connecting travelers with property owners, so that the travelers could rent the property when the owner was not using it. As Airbnb has grown, the company has made improvements to their offerings in meeting the needs of the traveler's demand based on property location and in categorizing the supply (the homeowner's property) for increased efficiency, meeting the needs of both the property owner and the traveler. Researching specific industries from supply and demand perspectives, and noticing unused supplies, as we saw in the Airbnb example, also applies to other industries, such as a sandwich shop. What happens to the unsold bread at the end of the day when there is an excess supply? For Stacy Madison and her pita sandwich food cart, unsold bread presented an opportunity to create pita chips by turning an oversupply into sliced and seasoned pita chips.

Almost every industry is worth investigating from the perspective of identifying unused resources or extra resources that could be restructured for what are known as a *shared economy* or a *gig economy*. A **shared economy** considers that there are times when an asset in not in use. This downtime when the asset is not in use provides an opening for someone else to use that asset, like Airbnb. Other companies, like Uber, Lyft, DoorDash, and Postmates, support the gig economy in aligning a person's choices for when they want to work with the flow of the work demand. A **gig economy** is an open or fluid market system with temporary positions made up of independent short-term workers. In these examples, we can see the alignment of supply and demand. The entrepreneurial opportunity happens in providing a platform to assist in connecting the supply and demand.

The tech sector, for example, is continually adapting to change. Items such as 3D printers and mobile devices are making the technology landscape expand. As new products come to market, the need for applications and increased efficiency abound. Several other industries are experiencing growth, including health care and nutrition. According to Global Market Insights (2019), the clinical nutrition market will exceed $87,530.7 million dollars by 2025. This same source reported that this industry was valued at over $10,562.7 million in 2018, a significant increase over the previous seven years. Drivers in this industry include sedentary lifestyles and related health issues, such as obesity. The result of these societal changes is an increase in clinical nutrition products and home healthcare services. According to business management author, professor, and corporate consultant, Peter Drucker, entrepreneurs excel at finding and developing potential business opportunities created by social, technological, and cultural changes.

Consumer Sources of Opportunity

Consumer sources of opportunities relate to changes in our society, such as new habits or behaviors brought about by exposure to new information. For example, most people feel the pressure related to having less free or unrestricted time. Figure 3.2.3.4 tracks the average number of hours worked by country per worker per year.

AVERAGE ANNUAL HOURS WORKED	
Country	**Annual Hours**
Mexico	2,246
South Korea	2,113
Greece	2,042
Chile	1,988
Russia	1,978
Turkey	1,832
United States	1,779
Italy	1,725
Japan	1,719
Canada	1,691
Spain	1,676
United Kingdom	1,674
Australia	1,665
France	1,482
Germany	1,371

Source: Niall McCarthy. "Who Works the Most Hours Every Year?" *Forbes*. January 8, 2018. Based on information from Statista and data from The Organization for Economic Co-Operation and Development (OECD).

Figure 3.2.3.4: This graph compares average annual hours worked by country. It does not distinguish between full-time and part-time employment. (CC BY 4.0; Rice University & OpenStax)

The International Labour Organization and Bureau of Labor Statistics report that most people in the United States work more than forty hours per week, work significantly more hours per year than workers in many other countries, and are vastly more productive than they were half a century ago.

Another consideration is tracking where our time is spent during commuting. The average commute time in major cities in the United States is twenty-six minutes, ranging from thirty-eight minutes in New York City to the shortest commute time of twenty minutes in Buffalo, New York. When we add in commute times, work hours, and other required activities like sleeping and eating, we find that people struggle to find time for relaxation and personal activities. This large trend leads to recognizing that our working population in the United States and other countries would value novel approaches to completing tasks and making life simpler. For instance, several businesses have looked at making life easier and saving the consumer time, such as Amazon's One-Click-Checkout, grocery delivery, and product recommendations. Other examples include mobile businesses like pet grooming that come to your home, or diaper delivery services that pick up used diapers, wash and dry them, and return clean diapers to your home. Understanding consumer needs and problems opens the possibility of creating a business that addresses those needs or problems.

Another consumer trend is the demand for affordable housing. One solution involves offering more affordable "tiny homes" that make homeownership more accessible (Figure 3.2.3.5). As one entrepreneurial opportunity materializes into a new product, spin-off ideas may also arise. The tiny home concept attracted the attention of groups that assist homeless veterans. The Veterans Community Project in Kansas City, has developed a community of forty-nine tiny homes for homeless veterans and the project is so successful that more than 500 cities around the country are building tiny home housing projects for veterans there.



Figure 3.2.3.5: These tiny homes cost as little as $10,000 to build and come complete with one or two bedrooms, a small kitchen, and bath. (credit: photo provided by Veterans Community Project)

ENTREPRENEUR IN ACTION

Vestergaard

Vestergaard has a mission to prevent diseases, especially for vulnerable populations around the world, and to contribute to a healthier and more sustainable planet through good actions.

LifeStraw is a product that Vestergaard launched in 2005, making water safe to drink in areas where clean water is not readily available and redefining beliefs around safe drinking water. LifeStraw uses a combination of a hollow fiber membrane, a filtration process, and in some products, a second filtration process to remove chemicals like chlorine, lead, and pesticides.

- Apply the concepts of supply and demand in describing LifeStraw from the perspective of an entrepreneurial opportunity.
- What are three drivers that support the creation of LifeStraw?

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3.2.4: Competitive Analysis

Learning Objectives

By the end of this section, you will be able to:

- Understand the elements of a competitive analysis
- Describe tools you can use to refine and focus your planning (three circles, SWOT, PEST)
- Recognize social media's role in saving time and money on research
- Understand how a business model helps determine the feasibility of an opportunity

Conducting a competitive analysis helps you focus your idea and identify your unique selling proposition and competitive advantage.

Competitive Analysis

A competitive analysis should provide the entrepreneur with information about how competitors market their business and ways to penetrate the market by entry through product or service gaps in areas that your competitors do not serve or do not serve well. More importantly, competitive analysis helps the entrepreneur develop a competitive edge that will help create a sustainable revenue stream. For example, a big company like Walmart primarily competes on price. Small companies typically cannot compete on price, since the internal efficiencies and volume sales available to large corporations like Walmart are not available to small companies, but they may be able to compete successfully against Walmart on some other important variable such as better service, better-quality products, or unique buying experiences.

When preparing the competitive analysis, be sure to identify your competitors by product line or service segment. For an entrepreneur, this activity can be difficult when the industry does not yet exist. In the case of Bee Love, Palms Barber didn't have direct competitors, but she did have related competitors of traditional skincare products. Her unique idea of all-natural, honey-based skin care products created a new market. The competitive analysis might need to focus on substitute products rather than direct competitors. There are two main tools used in analysis of competitors: a competitive analysis grid and the "three circles" approach.

Competitive Analysis Grid

The competitive analysis grid should identify your competitors and include an assessment of the key characteristics of the competitive landscape in your industry, including competitive strengths and weaknesses and key success factors.

Table 3.2.4.1 provides an example of what a competitive analysis might look like for a bicycle shop in a tourist locale.

Table 3.2.4.1: Competitive Analysis Grid for Sid's Cycle Shop in Branson, Missouri

Key Characteristics	Sid's Cycle	City Cycle	SpokeMasters	Target
Strengths	Product knowledge, Repair service	Repair service	High quality, Top brands	Price, hours (open seven days per week and online)
Weaknesses	Limited selection	Poor customer service	Pricing, no entry-level products	Low-end quality, no repair facilities
Product Quality Level	Low-middle	Middle-high	High-end	Entry-level
Price Point	Middle	Middle-high	High price	Lowest price
Location of the business	Suburban strip-mall on busy highway	Outskirts of town on route 280	Downtown side street	Branson Mall
Promotion	Weekly ad in local newspaper, some radio and Internet/social media	Advertising in local paper during season, Internet/social media	Sponsors major bike race in area, Internet, social media	Advertises online and in Sunday newspaper (seasonally), Internet)

This competitive analysis grid captures some of the main aspects of competitors within a given market.

As you complete an analysis for your venture's competitors, identify what contributes to the competitor's success. In other words, why do people purchase from the company? Some possible reasons include no nearby competitors, lower prices than competitors, a wider variety of products, offering services not offered elsewhere, or branding and marketing that appeals to the target market. Your analysis should inform you of a combination of key success factors within the industry (what it takes to be successful in the industry) and of what your competitors are not offering that is valued by your target market.

Another frequently used tool is a **SWOT analysis** (strengths, weaknesses, opportunities, and threats), which focuses on analyzing your venture's potential and builds on the knowledge gained from the competitive analysis grid and the three circles. You will need to identify the strengths your venture will need to support the competitive advantage identified through the competitive analysis tools. The weaknesses can be identified based on your current and foreseeable expectations. For a new venture, the opportunities and threats sections are based on current factors in the external environment that come from your research. In this context, opportunities are facts, changes, or situations within the external environment that could be favorably leveraged for the venture's success.

WORK IT OUT

Using SWOT Analysis to Evaluate Entrepreneurial Opportunity



Figure 3.2.4.1: A SWOT analysis can be used to identify the strengths, weaknesses, opportunities, and threats of a potential entrepreneurial opportunity. (CC BY 4.0; Rice University & OpenStax)

One way to evaluate a business idea is to prepare a SWOT analysis (Figure 3.2.4.1). Note that strengths and weaknesses are internal to the entrepreneur, while opportunities and threats are external factors. Strengths are capabilities and advantages of the entrepreneur, including education, experience, and personal or professional contacts. Weaknesses are disadvantages of the entrepreneur, which could include lack of knowledge or experience. Opportunities are positive events that the entrepreneur can develop to his or her benefit. This could include development of new technologies, changes in consumer tastes and preferences, market growth, and new laws and regulations. Threats can be anything that could potentially harm the business or prevent the business from becoming successful such as competition, negative changes in economic conditions, and new laws or regulations.

- If you were starting a new business venture, what strengths would you be able to leverage to help your business be successful?
- Provide some examples of personal or professional weaknesses an entrepreneur might face when starting a new business.
- Discuss three occurring events such as new laws and regulations, changes in consumer tastes and preferences, or developing new technologies that could provide business opportunity for a new business venture.

Another tool that can be used to analyze opportunities and threats section is called PEST analysis (political, economic, societal, technology). In this analysis, we identify issues in each of these categories. Figure 3.2.4.2 shows an example of the topics that could be placed in a PEST analysis.

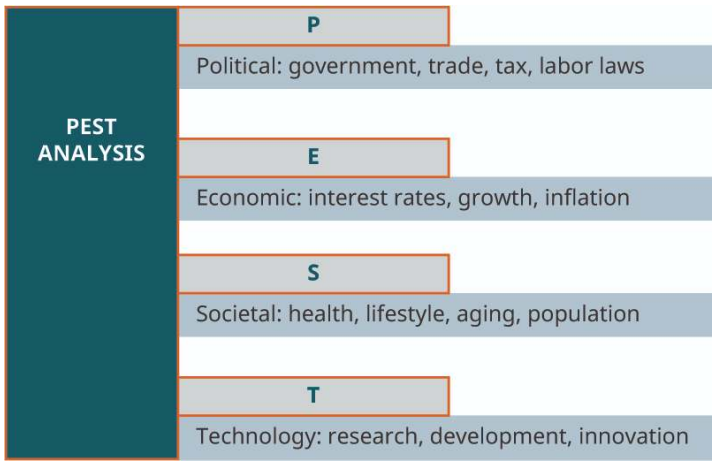


Figure 3.2.4.2: A PEST analysis can help identify opportunities and threats that can be used in a SWOT analysis. (CC BY 4.0; Rice University & OpenStax)

Each of these categories should be completed with relevant facts related to your entrepreneurial opportunity. After completing this analysis, you then determine if these facts, or factors, would be placed in the opportunity section or the threat section of the SWOT.

Three Circles Tool

Another tool that can be used in competitive analysis is the three circles tool (Figure 3.2.4.3). The goal is to identify competitors' strengths and competitive advantages with any overlaps among competitors. Then, you would identify values or features not offered by competitors. This gap in value or offered services helps to identify your **unique selling proposition** and thereby your competitive advantage.

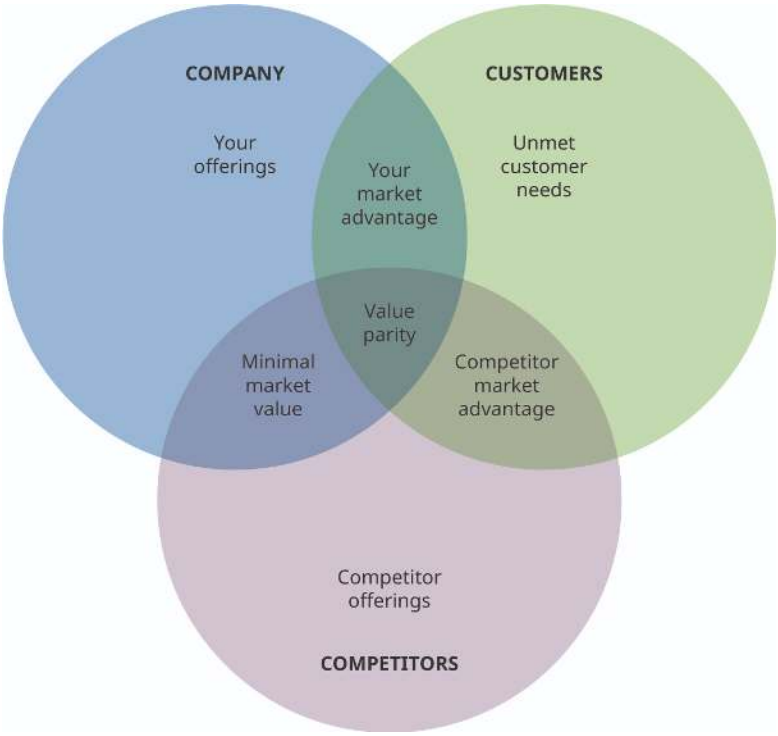


Figure 3.2.4.3: The three circles competitive analysis helps to identify where there is overlap and where there may be a gap in the market that a new venture could fill. The overlaps identify points of parity, the areas where competitors offer the same value with the important identification of the areas of unmet customer needs and how unique your competitive advantage is within the industry. (CC BY 4.0; Rice University & OpenStax)

The unique selling proposition is important to the marketing plan and is often used as a slogan. It should also align with the value communicated by the product or company brand. These concepts are different from your venture's competitive advantage; the **competitive advantage** describes your venture's unique benefit, which supports growth of the venture, whereas the unique selling proposition describes the product or service itself, rather than the venture. Although these concepts are different, there should be alignment between the concepts.

For example, Amazon has a competitive advantage in its virtual presence, knowledge of the market, knowledge and application of technology, and knowledge of the industry. Through these competitive advantages, Amazon offers unique combinations of benefits to their customers, such as one-click checkout and algorithm-based recommendations using data mining to track an individual customer's preferences. Amazon's unique selling proposition becomes making the purchase as easy and as accurate as possible, whereas their competitive advantage lies in their ability to foresee future advances and act on those predictions, even to the point of shaping the industry.

The competitive advantage results from the analysis of the strengths and unique aspects of a venture, an analysis of the industry, including competitor's advantages, customer needs, and what the venture provides within this competitive landscape. The unique selling proposition should support the competitive advantage, just as the competitive advantage needs to support the unique selling proposition.

Social Media's Role in Research

For almost all new business ventures, two key issues related to research are time and money. Large-scale research projects can take months or longer, and cost a significant amount of money. Social media can offer some opportunities to overcome these concerns. Ray Nelson, writing for *Social Media Today*, reports several ways that social media can provide speedy, low-cost market research: tracking trends in real-time, helping the entrepreneur "learn the language" of their potential customers, discovering unnoticed trends by engaging consumers, and performing market research using a very cost-efficient means. If the entrepreneur can perform social media research on his or her own, the cost will primarily be in terms of time. But the time it will take to conduct research through social media platforms such as Facebook or Twitter is usually well spent. This research should include learning the unique selling proposition of competitors, understanding their competitive advantage, and identifying what the customer values, which can be rather difficult. For example, before Amazon recognized that people are busy, were we aware that we wanted faster check-out processes for making purchases? Or were we aware that we wanted the package delivered to our home to be easier to unwrap? And yet, if we asked Amazon shoppers what they value in shopping at Amazon, we will receive answers that support an easier and faster process.

Another technique would be to read through customer reviews on Amazon (or another company related to your entrepreneurial venture) to find out what customers like and don't like about existing products and brands. You can also develop your own surveys on an app like SurveyMonkey and send them to customers and prospective customers. This usually works when sent to persons who have a strong interest in the product or issue rather than randomly sending out surveys.

Business Models and Feasibility

Part of the analysis in determining if your idea is an actual entrepreneurial opportunity is identifying a feasible business model. A **business model** is a plan for how the venture will be funded; how the venture creates value for its stakeholders, including customers; how the venture's offerings are made and distributed to the end users; and how income will be generated through this process. Basically, a business model describes how a venture will create a profit by describing each of these actions. The business model at this stage is composed of four components: the offering, customers, infrastructure, and financial viability (Figure 3.2.4.4).

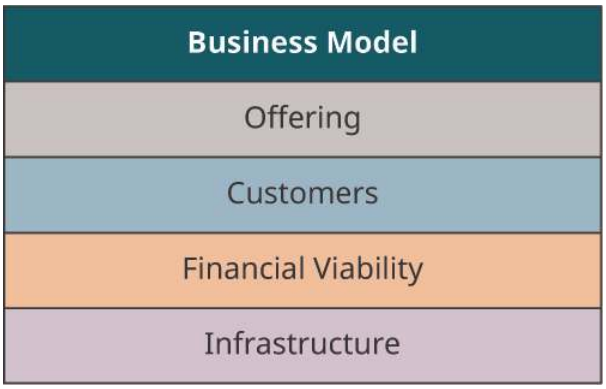


Figure 3.2.4.4: A business model has four components: the offering, customers, infrastructure, and financial viability. (CC BY 4.0; Rice University & OpenStax)

The **offering** refers to the product or service you will be selling, the value proposition, and how you will reach and communicate with your target customers. The customer value proposition includes a detailed description of the products and services you will offer to customers, and what benefits (value) the customer will derive from using your product or service. The customer benefit could be the ability to do something more easily, more quickly, or at a lower cost than customers could before. The benefit could also solve a problem no one else has solved.

ARE YOU READY?

Writing a Customer Value Proposition

It is helpful to write out your customer value proposition. Then you have a draft to review and tweak as your ideas develop. Here is a general structure you can follow:

- Start with a headline-style statement that describes how your offering benefits the customer.
- Provide a few sentences or a brief paragraph that explains the offering in more detail. Be sure to make clear what the offering is, who the customer is, and why you are offering it.
- Consider including a bulleted list or checklist highlighting 3–5 features of the product or benefits the customer will receive.
- If possible, add a graphic that engages interest or reinforces the idea.

Customers are the people you will be serving, including potential customers from one or more market segments, or subsections of the market categorized by similar interests or needs. Products seldom appeal to everyone, so the entrepreneur needs to determine, through high-level segmentation and targeting analysis, which segments of the market would make the most sense for the business, and the market environment and dynamics. Some products might appeal to market segments based on age or income, whereas other products might appeal to customers based on their lifestyle. A sign of a potential market opportunity is when a certain market is experiencing rapid growth. This could be a city with a fast-growing population, or it could be a style or consumer trend that is really taking off.

Infrastructure refers to all the resources the entrepreneur will need to launch and sustain the business venture. These include people, products, facilities, technology, suppliers, partners, and finances, all of which the entrepreneur must have to fulfill the customer value proposition.

Financial viability relates to the long-term financial sustainability of an organization to fulfill its mission. This goes back to our definition of an entrepreneurial opportunity. Knowing that the venture solves a sizable and significant problem that the target market is willing to purchase is a key piece in determining financial viability. This category also addresses how the venture will create profits.

For example, would a subscription-based business model fit the target market and venture's success? Currently, we see a significant growth in startups offering subscription services. What are the benefits to this sales method? For the venture, this model increases upfront cash to support the growth of the venture, especially when customers pay a year in advance for products that will be delivered over the subsequent twelve months. Receiving the payment prior to completing the sales provides the venture with operating cash to support current and future growth. The benefit to the customer in this situation is fewer transactions. The

customer knows that the payment covers the next twelve months' worth of benefits (the received product or service) with no further purchases until the subscription runs out.

Another choice involves deciding whether to have a physical location, a virtual location, or both. Financial viability means exploring the benefits and drawbacks of various methods in creating your business model.

WORK IT OUT

Researching Target Markets with Census Data

Practice conducting research by going to www.census.gov and two other sources to identify a specific target market for a product that interests you. Include the target market's:

- Disposable income. You might ask whether the target market has sufficient disposable income to purchase this product.
- Demographics
- Psychographics (the combination of buying personality behaviors and demographics)
- How you as the entrepreneur could reach this target market.

When you have a business idea that you have been researching and find that there is a large enough market that has a need that your idea meets, that this target market has the willingness and ability to satisfy the need through purchasing the provided solution, that you have access to the necessary resources to build an infrastructure for your business, that you have the right mix of products and services with a sound value proposition, and that you can secure funding, you have a real opportunity. This chapter has introduced you to all of these concepts. Further chapters delve into them in more depth.

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3.2.5: Key Terms

business model
plan for how venture will be funded; how the venture creates value for its stakeholders, including customers; how the venture's offerings are made and distributed to the end users; and the how income will be generated through this process

competitive advantage
describes your venture's unique benefits that poise it for growth

creative destruction
theory developed by Joseph Schumpeter stating that entrepreneurial innovation is the disruptive force that creates and sustains economic growth, though in the process, it destroys established companies and disrupts employment

customers
people the business will be serving, including potential customers from one or more market segments

demand
need or desire for the outputs, the product or services

demographics
statistical factors of a population or group, such as information about age, gender, income, race, or ethnicity

entrepreneurial opportunity
point at which identifiable consumer demand meets the feasibility of satisfying the requested product or service and meets the following conditions: significant market demand, significant market structure and size, significant margins, and resources to support the venture's success

financial viability
long-term financial sustainability of an organization to fulfill its mission

gig economy
market system in which independent contractors fill a variety of positions

infrastructure
all resources the entrepreneur will need in order to launch and sustain a business venture

offering
actual product or service, its value proposition, and how you will reach and communicate with your target customers

opportunity screening
process used to evaluate innovative product ideas, strategies, and marketing trends, focusing on financial resources, skills of the entrepreneurial team, and competition

primary research
research that involves gathering new data

secondary research
research that uses existing data

shared economy
economy in which some assets are not in use, which may present an entrepreneurial opportunity

supply

amount of a product or service produced

SWOT analysis

strategic analytical tool used to help a potential venture or existing company identify its strengths, weaknesses, opportunities, and threats related to business competition

unique selling proposition

marketer’s rationale as to why a product or service is different/better than the competitor’s products

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3.2.6: Summary

3.2.2 Entrepreneurial Opportunity

Entrepreneurial opportunity exists when consumer demand meets the feasibility of bringing the product or service to market. Joseph Schumpeter, an early scholar of entrepreneurship, identified creative destruction—when innovation is disruptive and creates potential entrepreneurial opportunities. Schumpeter's focus on economics led him to categorize potential opportunities based on supply, demand, or changes in how technology is used.

Burgeoning entrepreneurs should be engaged with industries of interest to remain informed and aware of opportunities to research. Additionally, they should be attentive to drivers of opportunity, such as emerging funding options, technological advancements, and economic factors.

3.2.3 Researching Potential Business Opportunities

Researching the viability of your entrepreneurial idea will help you determine whether the venture is currently worth pursuing. Use primary and secondary research to determine whether there is adequate demand, market structure and size, and the needed margins and resources to launch and sustain the enterprise. Entrepreneurs researching options should also be aware of industry and consumer sources of opportunities.

3.2.4 Competitive Analysis

A competitive analysis helps determine the viability of your idea by considering how feasible it is within a specific competitive landscape. Tools such as a competitive analysis grid, a SWOT analysis, a PEST analysis, and the three circles approach can help you further examine issues and refine your plans.

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3.2.7: Review Questions

1. What is entrepreneurial opportunity?
2. What are five methods through which an entrepreneur can create new economic opportunities, according to Joseph Schumpeter?
3. What are some factors that might indicate it is a good time to start a business?
4. When should an entrepreneur explore opportunities?
5. What should a potential entrepreneur research before starting a business?
6. What kind of information is available in census data and how might that data be useful?
7. Compare and contrast supply-based opportunities and demand-based opportunities.
8. How can using a PEST analysis contribute to discovering new patterns of trends for recognizing entrepreneurial opportunities?
9. What is a SWOT analysis and how is it useful?
10. What is a unique selling proposition?
11. What is a business model?

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3.2.8: Discussion Quetions

1. Explain the difference between an idea and an entrepreneurial opportunity. Why is it important to recognize if your idea is truly an entrepreneurial opportunity or only an idea?
2. Is now a good time to start a business? Why or why not?
3. If you were thinking about starting a clothing store for teens and young women in your hometown, what census information do you think would be useful to you?
4. What new patterns or behaviors have you noticed within your society or the country's society?
5. What unused resources are present in your own life that could be translated into a shared economy idea for a new venture?
6. What spin-off ideas can you think of that support a gig economy? For example, what services or products might gig employees value or gig employers value?
7. What are some of the reasons for business failures? If you were starting a business, what are some actions you could take to increase your potential for success?
8. Many entrepreneurs like Chris Johnson, who invented the ramen noodle cooker and Palms Barber had ordinary problems they were trying to solve. What are some examples of ordinary problems you could solve if you could invent a product?
9. How do social enterprises like Bee Love help the community? What problem was Palms Barber trying to solve? What problems did the company end up solving?

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3.2.9: Case Questions

1. Mandy Tillman was a high school student who lived in a rural area of Oklahoma. Mandy was only fourteen years old but wanted to make some extra money for her family's trip to the Grand Canyon the following summer. While shopping with her parents, she noticed there was only one place in town to buy flats with flowers and vegetables for spring planting, and there was not much of a selection. Mandy made a note of the various types of plants and flowers the store sold and how much they sold for. When Mandy got home from shopping with her parents, she went online to see how much the seeds and equipment would cost. Her parents liked the idea of Mandy earning some money of her own to spend on vacation and made a large area in the basement available for her to start her plants.
    a. What else should Mandy know about this business before getting started?
    b. What else do you think Mandy needs to start this business?
    c. Do you see any potential problems with this business idea?
    d. What are some ways Mandy can sell her plants?
    e. Is this a business idea or an entrepreneurial opportunity?
2. Research the eyeglass company Warby Parker.
    a. What is Warby Parker's business model?
    b. What is the value proposition offered by Warby Parker?
    c. Describe Warby Parker's target market? What resources did you use to identify their target market?
    d. If Warby Parker did not exist and you decided that you wanted to open a direct to consumer eyeglass company, what would be the top five factors you would research to determine if your idea was truly an entrepreneurial opportunity?
3. Travis and Katelyn loved backpacking and had hiked the Appalachian Trail twice. Although they had been backpacking for several years, each time they went out on the trail, they learned something new. Almost every backpacker they met was quick to offer a good tip on the best clothing or equipment for the trail. Travis and Katelyn decided to start a backpacker's blog and sell advertising space to manufacturers and retailers of backpacking gear.
    a. If you were launching a company to help backpackers trek through the wilderness, what products would you provide and what would be their unique selling propositions?
    b. What benefit would you build into your website that would attract backpackers to your website? Consider how you would distinguish your website from competitor websites.
    c. Using PEST around your knowledge of backpacking and interest in starting a business related to backpacking, identify one fact for each of the PEST categories that could be useful in identifying new information or patterns to support this business.
    d. How would you change your business model based on your answers to the previous question?

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3.2.10: Suggested Resources

American Fact Finder (market research): http://factfinder2.census.gov/main.html

FedStats (statistics from more than 100 federal agencies): https://www.usa.gov/statistics

FindLaw Small Business Center (business forms): https://smallbusiness.findlaw.com/

National Federation of Independent Business: https://www.nfib.com/business-resources

The Small Business National Center: https://sites.google.com/a/uca.edu/sbanc/home

The U.S. Small Business Administration (SBA): www.sba.gov

Top Franchises of 2019: https://www.entrepreneur.com/franchise500/2019

U.S. patent and Trademark Office: https://www.uspto.gov/

General Business Statistics: https://www.census.gov/eos/www/naics/, http://www.census.gov/library/public...tab/131ed.html

Consumer Statistics: https://www.federalreserve.gov/releases/G19/, https://www.cpsc.gov/Research--Statistics

Demographics: https://factfinder.census.gov/faces/...es/index.xhtml, http://www.bls.gov/bls/demographics.htm

Economic Indicators: https://www.bls.gov/cpi/, bea.gov

Employment Statistics: https://stats.bls.gov/bls/employment.htm

Income Statistics: https://www.bls.gov/cps/earnings.htm, https://www.bls.gov/data/#employment

Money and Interest Rates: https://www.federalreserve.gov/releases/h15/, https://www.federalreserve.gov/data.htm

Production and Sales Statistics: https://www.bea.gov/data/consumer-spending/main,

Trade Statistics: https://www.bea.gov/data/economic-ac...ernational#bop, https://usatrade.census.gov/

Statistics of specific Industries: https://www.census.gov/eos/www/naics/, https://www.census.gov/programs-surveys/susb.html

https://www.sba.gov/business-guide/p...ction-header-5

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3.3: Ready, Set, Start Your Own Business

What are the First Steps to Take if you are Starting Your Own Business?

You have decided that you'd like to go into business for yourself. What is the best way to go about it? Start from scratch? Buy an existing business? Or buy a franchise? About 75 percent of business start-ups involve brand-new organizations, with the remaining 25 percent representing purchased companies or franchises. Franchising may have been discussed elsewhere in your course, so we'll cover the other two options in this section.

Getting Started

The first step in starting your own business is a self-assessment to determine whether you have the personal traits you need to succeed and, if so, what type of business would be best for you. Table 3.3.1 provides a checklist to consider before starting your business.

Finding the Idea

Entrepreneurs get ideas for their businesses from many sources. It is not surprising that about 80 percent of *Inc.* 500 executives got the idea for their company while working in the same or a related industry. Starting a firm in a field where you have experience improves your chances of success. Other sources of inspiration are personal experiences as a consumer; hobbies and personal interests; suggestions from customers, family, and friends; industry conferences; and college courses or other education.

Table 3.3.1

Checklist for Starting a Business
Before you start your own small business, consider the following checklist: • Identify your reasons • Self-analysis • Personal skills and experience • Finding a niche • Conduct market research • Plan your start-up: write a business plan • Finances: how to fund your business

An excellent way to keep up with small-business trends is by reading entrepreneurship and small-business magazines and visiting their websites. With articles on everything from idea generation to selling a business, they provide an invaluable resource and profile some of the young entrepreneurs and their successful business ventures (Table 3.3.2).

Table 3.3.2: Successful Entrepreneurs

Name and Age	Company and Description
Philip Kimmey, 27	Kimmey's dog-sitting and dog-walking network, Rover.com, raised almost $100 million in venture capital and was valued at $300 million in 2017.
Max Mankin, 27	Mankin cofounded Modern Electron and raised $10 million in venture capital to create "advanced thermionic energy converters" that will generate "cheap, scalable, and reliable electricity." Modern Electron will turn every home into a power station.
Alexandra Cristin White, 28	In her early 20s, White founded Glam Seamless, which sells tape-in hair extensions. In 2016, her self-funded company grossed $2.5 million.
Steph Korey, 29; Jen Rubio, 29	Korey and Rubio founded Away, selling "first-class luggage at a coach price" in 2015. They raised $31 million in funding and grossed $12 million in sales in 2016.
Allen Gannet, 26	Gannet founded TrackMaven, a web-marketing analytics company, in 2012; by 2016, his company was grossing $6.7 million a year.
Jake Kassan, 25; Kramer LaPlante, 25	Kassan and Kramer launched their company, MVMT, through Indiegogo, raising $300,000, and in 2016 grossed $60 million, selling primarily watches and sunglasses.
Brian Streem, 29	Streem's company, Aerobo, provides drone services to the film industry, selling "professional aerial filming and drone cinematography." Aerobo grossed $1 million in 2016, its first full year of business.
Natalya Bailey, 30; Louis Perna, 29	Accion Systems began in 2014, raised $10 million in venture funding, and grossed $4.5 million in 2016, making tiny propulsion systems for satellites.
Jessy Dover, 29	Dover is the cofounder of Dagne Dover, a company making storage-efficient handbags for professional women. She and her cofounders grossed $4.5 million in 2016 and debuted on Nordstrom.com in 2017.

These dynamic individuals, who are already so successful in their 20s and 30s, came up with unique ideas and concepts and found the right niche for their businesses.

Interesting ideas are all around you. Many successful businesses get started because someone identifies a need and then finds a way to fill it. Do you have a problem that you need to solve? Or a product that doesn't work as well as you'd like? Raising questions about the way things are done and seeing opportunity in adversity are great ways to generate ideas.

Choosing a Form of Business Organization

A key decision for a person starting a new business is whether it will be a sole proprietorship, partnership, corporation, or limited liability company. As discussed earlier, each type of business organization has advantages and disadvantages. The choice depends on the type of business, number of employees, capital requirements, tax considerations, and level of risk involved.

Developing the Business Plan

Once you have the basic concept for a product or service, you must develop a plan to create the business. This planning process, culminating in a sound **business plan**, is one of the most important steps in starting a business. It can help to attract appropriate loan financing, minimize the risks involved, and be a critical determinant in whether a firm succeeds or fails. Many people do not venture out on their own because they are overwhelmed with doubts and concerns. A comprehensive business plan lets you run

various “what if” analyses and evaluate your business without any financial outlay or risk. You can also develop strategies to overcome problems well before starting the business.

Taking the time to develop a good business plan pays off. A venture that seems sound at the idea stage may not look so good on paper. A well-prepared, comprehensive, written business plan forces entrepreneurs to take an objective and critical look at their business venture and analyze their concept carefully; make decisions about marketing, sales, operations, production, staffing, budgeting and financing; and set goals that will help them manage and monitor its growth and performance.



Figure 3.3.1: Each year, a variety of organizations hold business plan competitions to engage the growing number of college students starting their own businesses. The University of Essex and the iLearn entrepreneurship curriculum developed by the University of Texas in Austin, which partnered with Trisakti University in Jakarta, Indonesia, and the U.S. embassy to help run an entrepreneurship course and competition are examples of such competitions. Seven students from “iLearn: Entrepreneurship” were selected as finalists to pitch their business plans to a panel of Indonesian business leaders and embassy representatives. The winning business plan, which was an ecotourism concept, earned $1,000 in seed money. What research goes into a winning business plan? *(Credit: University of Essex /flickr/ Attribution 2.0 Generic (CC BY 2.0))*

The business plan also serves as the initial operating plan for the business. Writing a good business plan takes time. But many businesspeople neglect this critical planning tool in their eagerness to begin doing business, getting caught up in the day-to-day operations instead.

The key features of a business plan are a general description of the company, the qualifications of the owner(s), a description of the products or services, an analysis of the market (demand, customers, competition), sales and distribution channels, and a financial plan. The sections should work together to demonstrate why the business will be successful, while focusing on the uniqueness of the business and why it will attract customers. Table 3.3.3 describes the essential elements of a business plan.

A common use of a business plan is to persuade lenders and investors to finance the venture. The detailed information in the plan helps them assess whether to invest. Even though a business plan may take months to write, it must capture potential investors’ interest within minutes. For that reason, the basic business plan should be written with a particular reader in mind. Then you can fine-tune and tailor it to fit the investment goals of the investor(s) you plan to approach.

Table 3.3.3

Key Elements of a Business Plan
Executive summary provides an overview of the total business plan. Written after the other sections are completed, it highlights significant points and, ideally, creates enough excitement to motivate the reader to continue reading.
Vision and mission statement concisely describe the intended strategy and business philosophy for making the vision happen. Company values can also be included in this section.
Company overview explains the type of company, such as manufacturing, retail, or service; provides background information on the company if it already exists; and describes the proposed form of organization—sole proprietorship, partnership, or corporation. This section should include company name and location, company objectives, nature and primary product or service of the business, current status (start-up, buyout, or expansion) and history (if applicable), and legal form of organization.
Product and/or service plan describes the product and/or service and points out any unique features, as well as explains why people will buy the product or service. This section should offer the following descriptions: product and/or service; features and benefits of the product or service that provide a competitive advantage; available legal protection—patents, copyrights, and trademarks.
Marketing plan shows who the firm's customers will be and what type of competition it will face; outlines the marketing strategy and specifies the firm's competitive edge; and describes the strengths, weaknesses, opportunities, and threats of the business. This section should offer the following descriptions: analysis of target market and profile of target customer; methods of identifying, attracting, and retaining customers; a concise description of the value proposition; selling approach, type of sales force, and distribution channels; types of marketing and sales promotions, advertising, and projected marketing budget; product and/or service pricing strategy; and credit and pricing policies.
Management plan identifies the key players—active investors, management team, board members, and advisors— citing the experience and competence they possess. This section should offer the following descriptions: management team, outside investors and/or directors and their qualifications, outside resource people and their qualifications, and plans for recruiting and training employees.
Operating plan explains the type of manufacturing or operating system to be used and describes the facilities, labor, raw materials, and product-processing requirements. This section should offer the following descriptions: 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.
Financial plan specifies financial needs and contemplated sources of financing, as well as presents projections of revenues, costs, and profits. This section should offer the following descriptions: historical financial statements for the last 3–5 years or as available; pro forma financial statements for 3–5 years, including income statements, balance sheets, cash flow statements, and cash budgets (monthly for first year and quarterly for second year); financial assumptions; breakeven analysis of profits and cash flows; and planned sources of financing.
Appendix of supporting documents provides materials supplementary to the plan. This section should offer the following descriptions: management team biographies; the company's values; information about the company culture (if it's unique and contributes to employee retention); and any other important data that support the information in the business plan, such as detailed competitive analysis, customer testimonials, and research summaries.

But don't think you can set aside your business plan once you obtain financing and begin operating your company. Entrepreneurs who think their business plan is only for raising money make a big mistake. Business plans should be dynamic documents, reviewed and updated on a regular basis—monthly, quarterly, or annually, depending on how the business progresses and the particular industry changes.

Owners should adjust their sales and profit projections up or down as they analyze their markets and operating results. Reviewing your plan on a constant basis will help you identify strengths and weaknesses in your marketing and management strategies and help you evaluate possible opportunities for expansion in light of both your original mission and goals, current market trends, and business results. The Small Business Administration (SBA) offers sample business plans and online guidance for business plan preparation under the "Business Guide" tab at https://www.sba.gov.

Financing the Business

Once the business plan is complete, the next step is to obtain financing to set up your company. The funding required depends on the type of business and the entrepreneur's own investment. Businesses started by lifestyle entrepreneurs require less financing than growth-oriented businesses, and manufacturing and high-tech companies generally require a large initial investment.

Who provides start-up funding for small companies? Like Miho Inagi and her Tokyo bagel shop, 94 percent of business owners raise start-up funds from personal accounts, family, and friends. Personal assets and money from family and friends are important for new firms, whereas funding from financial institutions may become more important as companies grow. Three-quarters of *Inc*. 500 companies have been funded on $100,000 or less.

The two forms of business financing are **debt**, borrowed funds that must be repaid with interest over a stated time period, and **equity**, funds raised through the sale of stock (i.e., ownership) in the business. Those who provide equity funds get a share of the business's profits. Because lenders usually limit debt financing to no more than a quarter to a third of the firm's total needs, equity financing often amounts to about 65 to 75 percent of total start-up financing.



Figure 3.3.2: FUBU started when a young entrepreneur from Hollis, Queens, began making tie-top skullcaps at home with some friends. With funding from a $100,000 mortgage and a later investment from the Samsung Corporation, CEO Daymond John, turned his home into a successful sportswear company. The FUBU brand tops the list for today's fashionistas who don everything from FUBU's classic Fat Albert line to swanky FUBU suits and tuxedos. How do start-ups obtain funding? *(Credit: U.S. Embasy Nairobi/ flickr/ Attribution 2.0 Generic (CC BY 2.0))*

One way to finance a start-up company is bootstrapping, which is basically funding the operation with your own resources. If the resources needed are not available to an individual, there are other options. Two sources of equity financing for young companies are angel investors and venture-capital firms. **Angel investors** are individual investors or groups of experienced investors who provide financing for start-up businesses by investing their own money, often referred to as "seed capital." This gives the investors more flexibility on what they can and will invest in, but because it is their own money, angels are careful. Angel investors often invest early in a company's development, and they want to see an idea they understand and can have confidence in. Table 3.3.4 offers some guidelines on how to attract angel financing.

Table 3.3.4

Making a Heavenly Deal

You need financing for your start-up business. How do you get angels interested in investing in your business venture?

- Show them something they understand, ideally a business from an industry they've been associated with.
- Know your business details: Information important to potential investors includes annual sales, gross profit, profit margin, and expenses.
- Be able to describe your business—what it does and who it sells to—in less than a minute. Limit PowerPoint presentations to 10 slides.
- Angels can always leave their money in the bank, so an investment must interest them. It should be something they're passionate about. And timing is important—knowing when to reach out to an angel can make a huge difference.
- They need to see management they trust, respect, and like. Present a competent management team with a strong, experienced leader who can explain the business and answer questions from potential investors with specifics.
- Angels prefer something they can bring added value to. Those who invest could be involved with your company for a long time or perhaps take a seat on your board of directors.
- They are more partial to deals that don't require huge sums of money or additional infusions of angel cash.
- Emphasize the likely exits for investors and know who the competition is, why your solution is better, and how you are going to gain market share with an infusion of cash.

Venture capital is financing obtained from *venture capitalists*, investment firms that specialize in financing small, high-growth companies. Venture capitalists receive an ownership interest and a voice in management in return for their money. They typically invest at a later stage than angel investors. We'll discuss venture capital in greater detail when discussing financing the enterprise.

Buying a Small Business

Another route to small-business ownership is buying an existing business. Although this approach is less risky, many of the same steps for starting a business from scratch apply to buying an existing company. It still requires careful and thorough analysis. The potential buyer must answer several important questions: Why is the owner selling? Does he or she want to retire or move on to a new challenge, or are there problems with the business? Is the business operating at a profit? If not, can this be corrected? On what basis has the owner valued the company, and is it a fair price? What are the owner's plans after selling the company? Will he or she be available to provide assistance through the change of ownership of the business? And depending on the type of business it is, will customers be more loyal to the owner than to the product or service being offered? Customers could leave the firm if the current owner decides to open a similar business. To protect against this, many purchasers include a *noncompete clause* in the contract of sale, which generally means that the owner of the company being sold may not be allowed to compete in the same industry of the acquired business for a specific amount of time.

You should prepare a business plan that thoroughly analyzes all aspects of the business. Get answers to all your questions, and determine, via the business plan, whether the business is a sound one. Then you must negotiate the price and other terms of purchase and obtain appropriate financing. This can be a complicated process and may require the use of a consultant or business broker.

Risky Business

Running your own business may not be as easy as it sounds. Despite the many advantages of being your own boss, the risks are great as well. Over a period of five years, nearly 50% percent of small businesses fail according to the Kauffman Foundation.

Businesses close down for many reasons—and not all are failures. Some businesses that close are financially successful and close for nonfinancial reasons. But the causes of business failure can be interrelated. For example, low sales and high expenses are often directly related to poor management. Some common causes of business closure are:

- Economic factors—business downturns and high interest rates
- Financial causes—inadequate capital, low cash balances, and high expenses
- Lack of experience—inadequate business knowledge, management experience, and technical expertise
- Personal reasons—the owners may decide to sell the business or move on to other opportunities

Inadequate early planning is often at the core of later business problems. As described earlier, a thorough feasibility analysis, from market assessment to financing, is critical to business success. Yet even with the best plans, business conditions change and unexpected challenges arise. An entrepreneur may start a company based on a terrific new product only to find that a larger firm with more marketing, financing, and distribution clout introduces a similar item.

The stress of managing a business can also take its toll. The business can consume your whole life. Owners may find themselves in over their heads and unable to cope with the pressures of business operations, from the long hours to being the main decision-maker. Even successful businesses have to deal with ongoing challenges. Growing too quickly can cause as many problems as sluggish sales. Growth can strain a company's finances when additional capital is required to fund expanding operations, from hiring additional staff to purchasing more raw material or equipment. Successful business owners must respond quickly and develop plans to manage its growth.

So, how do you know when it is time to quit? "Never give up" may be a good motivational catchphrase, but it is not always good advice for a small-business owner. Yet, some small-business owners keep going no matter what the cost. For example, Ian White's company was trying to market a new kind of city map. White maxed out 11 credit cards and ran up more than $100,000 in debt after starting his company. He ultimately declared personal bankruptcy and was forced to find a job so that he could pay his bills. Maria Martz didn't realize her small business would become a casualty until she saw her tax return showing her company's losses in black and white—for the second year in a row. It convinced her that enough was enough and she gave up her gift-basket business to become a full-time homemaker. But once the decision is made, it may be tough to stick to. "I got calls from people asking how come I wasn't in business anymore. It was tempting to say I'd make their basket but I had to tell myself it is finished now."

CONCEPT CHECK

1. How can potential business owners find new business ideas?
2. Why is it important to develop a business plan? What should such a plan include?
3. What financing options do small-business owners have? What risks do they face?

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3.4: Franchising - A Popular Trend

What Makes Franchising an Appropriate Form of Organization for Some Types of Business, and Why Does it Continue to Grow in Importance?

When Shep Bostin decided to buy a franchise, he researched the usual suspects: Jiffy Lube, McDonald's, and Quiznos Subs. Bostin, then 38, was a top executive at a dying Gaithersburg, Maryland, technology firm, but instead of becoming another McDonald's franchisee, Bostin chose to remain a geek, albeit one who wheeled around in the signature black PT Cruiser of Geeks On Call, a company that provides on-site computer assistance via a large pool of experienced techies. Bostin made residential and commercial "house calls" for more than a decade as a Geeks On Call franchisee. There are approximately 123 independently owned and operated Geeks On Call franchise territories in 50 states serving over 250,000 customers.

Choosing the right franchise can be challenging. Franchises come in all sizes and demand different skills and qualifications. And with somewhere around 2,500 different franchised businesses in the United States, Bostin had a lot to choose from—from cookie-bouquet peddlers and dog trainers to acupuncture specialists. Table 3.4.1 shows the top franchises for 2017 from various sources. *Entrepreneur*'s rankings utilize among other factors costs/fees, brand strength, support, and financial strength. *Franchise Business Review* focuses on owner satisfaction, whereas *Franchise Gator* utilizes a formula with factors such as financial stability and engagement.



Figure 3.4.1: Chance the Rapper was a big winner at the 2017 Grammy Awards. His win was also validation for a new business model. Chance the Rapper does not have a deal with a traditional record label but instead releases his music through streaming services. How might this approach benefit other aspiring music artists to gain footing and become a force in the music industry? *(Credit: Julio Enriquez/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

Table 3.4.1

Top 10 Franchises for 2017	
Entrepreneur Top 10	
Franchise	**Initial investment**
1. 7-Eleven Inc.	$37K to $1.6M
2. McDonald's	$1M to $2.2M
3. Dunkin' Donuts	$229K to $1.7M
4. The UPS Store	$178K to $403K
5. Jimmy John's Gourmet Sandwiches	$330K to $558K
6. Dairy Queen	$1.1M to $1.9M
7. Ace Hardware Corp.	$273K to $1.6M
8. Wingstop Restaurant Inc.	$303K to $923K
9. Sport Clips	$189K to $355K
10. RE/MAX LLC	$38K to $224K
Franchise Business Review Top 10	
Franchise Name/ Industry	**Minimum Investment**
Visiting Angels (Senior care)	$77,985
MaidPro (Cleaning and maintenance)	$74,560
Pinot's Palette (Sports and recreation)	$63,400
Christian Brothers Automotive (Automotive)	$146,693
Home Instead Senior Care (Senior care)	$463,698
Our Town America (Advertising and Sales)	$115,000
FASTSIGNS (Business services)	$63,300
Sandler Training (Business services)	$182,329
Soccer Shots ((Child services)	$88,150
Two Men and a Truck (Services)	$36,000
Franchise Gator Top 10	
Franchise Name	**Minimum Cash Required**
Fast Signs	$100,000
Tropical Smoothie Cafe	$100,000
Marco's Pizza	$100,000
Zoup	$100,000
Mathnasium	$100,000
Christian Brothers Automotive	$80,000
Two Men and a Truck	$150,000

Top 10 Franchises for 2017	
Kiddie Academy	$200,000
Wild Birds Unlimited	$40,000
SportClips	$200,000

Chances are you recognize some of the names listed in Table 3.4.1 and deal with franchise systems in your neighborhood every day. When you have lunch at **Taco Bell** or Jamba Juice, make copies at FedEx Office, change your oil at Jiffy Lube, buy candles at Wicks 'n' Sticks, or mail a package at The UPS Store, you are dealing with a franchised business. These and other familiar name brands mean quality, consistency, and value to consumers. Franchised businesses provided about 8.9 million direct jobs with an $890 billion economic output for the U.S. economy.

Franchising is a form of business organization that involves a **franchisor**, the company supplying the product or service concept, and the **franchisee**, the individual or company selling the goods or services in a certain geographic area. The franchisee buys a package that includes a proven product or service, proven operating methods, and training in managing the business. Offering a way to own a business without starting it from scratch and to expand operations quickly into new geographic areas with limited capital investment, franchising is one of the fastest-growing segments of the economy. If you are interested in franchising, food companies represent the largest number of franchises.

A **franchise agreement** is a contract that allows the franchisee to use the franchisor's business name, trademark, and logo. The agreement also outlines rules for running the franchise, services provided by the franchisor, and financial terms. The franchisee agrees to follow the franchisor's operating rules by keeping inventory at certain levels, buying a standard equipment package, keeping up sales and service levels, taking part in franchisor promotions, and maintaining a relationship with the franchisor. In return, the franchisor provides the use of a proven company name and symbols, help in finding a site, building plans, guidance and training, management assistance, managerial and accounting systems and procedures, employee training, wholesale prices for supplies, and financial assistance.

Advantages of Franchises

Like other forms of business organization, franchising offers some distinct advantages:

- *Increased ability for franchisor to expand.* Because franchisees finance their own units, franchisors can grow without making a major investment.
- *Recognized name, product, and operating concept.* Consumers know they can depend on products from franchises such as Pizza Hut, Hertz, and Holiday Inn. As a result, the franchisee's risk is reduced and the opportunity for success increased. The franchisee gets a widely known and accepted business with a proven track record, as well as operating procedures, standard goods and services, and national advertising.
- *Management training and assistance.* The franchisor provides a structured training program that gives the new franchisee a crash course in how to start and operate their business. Ongoing training programs for managers and employees are another plus. In addition, franchisees have a peer group for support and sharing ideas.
- *Financial assistance.* Being linked to a nationally known company can help a franchisee obtain funds from a lender. Also, the franchisor typically gives the franchisee advice on financial management, referrals to lenders, and help in preparing loan applications. Many franchisors also offer short-term credit for buying supplies, payment plans, and loans to purchase real estate and equipment. Although franchisors give up a share of profits to their franchisees, they receive ongoing revenues in the form of royalty payments.



Figure 3.4.2: Countless franchise opportunities exist for entrepreneurs with access to start-up capital. Despite the broad range of franchise opportunities available, lists of the fastest-growing franchises are heavily weighted with restaurant chains and cleaning services. Start-up costs for a Quiznos franchise can be pricey; expenses associated with opening a Club Pilates franchise or a Visiting Angels adult care service are significantly lower. How do entrepreneurs evaluate which franchising opportunity is right for them? *(Credit: Mr. Blue Mau Mau/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

Disadvantages of Franchises

Franchising also has some disadvantages:

- *Loss of control.* The franchisor has to give up some control over operations and has less control over its franchisees than over company employees.
- *Cost of franchising.* Franchising can be a costly form of business. Costs will vary depending on the type of business and may include expensive facilities and equipment. The franchisee also pays fees and/or royalties, which are usually tied to a percentage of sales. Fees for national and local advertising and management advice may add to a franchisee's ongoing costs.
- *Restricted operating freedom.* The franchisee agrees to conform to the franchisor's operating rules and facilities design, as well as inventory and supply standards. Some franchises require franchisees to purchase from only the franchisor or approved suppliers. The franchisor may also restrict the franchisee's territory or site, which could limit growth. Failure to conform to franchisor policies could mean the loss of the franchise.

Franchise Growth

Many of today's major franchise brands, such as McDonald's and KFC, started in the 1950s. Through the 1960s and 1970s, many more types of businesses—clothing, convenience stores, business services, and many others—used franchising to distribute their goods and services. Growth comes from expansion of established franchises—for example, Subway, Pizza Hut, and OrangeTheory Fitness—as well as new entrants such as those identified by *Entrepreneur* and *Franchise Gator* among other sources. According to *Entrepreneur* magazine, the top three new franchises in 2017 are (1) Mosquito Joe, (2) Blaze Fast-Fire'd Pizza, and (3) uBreakiFix, whereas according to *Franchise Gator,* the top three new franchises in 2017 are (1) Mosquito Joe, (2) Digital Doc, and (3) Nurse

Next Door Home Healthcare Services. On both rankings, Mosquito Joe ranks at the top. Mosquito Joe provides mosquito control treatment services for both residential and commercial clients.

Changing demographics drive franchise industry growth, in terms of who, how, and what experiences the most rapid growth. The continuing growth and popularity of technology and personal computing is responsible for the rapidly multiplying number of eBay drop-off stores, and tech consultants such as Geeks on Call are in greater demand than ever. Other growth franchise industries are the specialty coffee market, children's enrichment and tutoring programs, senior care, weight control, and fitness franchises.

The Next Big Thing in Franchising

All around you, people are talking about the next big thing—Subway is the new miracle weight-loss solution, the workout at OrangeTheory Fitness is the answer to America's fitness needs—and you are ready to take the plunge and buy a trendy franchise. But consumers' desires can change with the tide, so how do you plan an entrance—and exit—strategy when purchasing a franchise that's a big hit today but could be old news by tomorrow? Table 3.4.2 outlines some tips on purchasing a franchise.

International Franchising

Like other forms of business, franchising is part of our global marketplace economy. As international demand for all types of goods and services grows, most franchise systems are already operating internationally or planning to expand overseas. Restaurants, hotels, business services, educational products, car rentals, and nonfood retail stores are popular international franchises.

Franchisors in foreign countries face many of the same problems as other firms doing business abroad. In addition to tracking markets and currency changes, franchisors must understand local culture, language differences, and the political environment. Franchisors in foreign countries also face the challenge of aligning their business operations with the goals of their franchisees, who may be located half a globe away.

Table 3.4.2

Tips for Purchasing a Franchise
1. Take a personality test to determine the traits that will help and hurt you and assess your strengths and weaknesses.
2. Do your research about the franchise company, its services, and your potential location, and study the field.
3. Seek assistance from tax advisors and contract specialists.
4. Focus on financials: count your money, limit liability with appropriate business structure, and look beyond.
5. Beware of franchise consultants.
6. Use the franchise disclosure document to ensure everything is clear.
7. Utilize your instincts, and follow your gut.

Is Franchising in Your Future?

Are you ready to be a franchisee? Before taking the plunge, ask yourself some searching questions: Are you excited about a specific franchise concept? Are you willing to work hard and put in long hours? Do you have the necessary financial resources? Do you have prior business experience? Do your expectations and personal goals match the franchisor's?

Qualities that rank high on franchisors' lists are passion about the franchise concept, desire to be your own boss, willingness to make a substantial time commitment, assertiveness, optimism, patience, and integrity. Prior business experience is also a definite plus, and some franchisors prefer or require experience in their field.

EXPANDING AROUND THE GLOBE

Setting Up (Sandwich) Shop in China

Lured by China's fast-food industry, estimated today at $180 billion, Jim Bryant, 50, was not the only entrepreneur to discover it is hard to do business in China. In ten years, Bryant has opened 19 Subway stores in Beijing—only half the number he was supposed to have by now—while other companies such as Chili's and Dunkin' Donuts have given up their Chinese operations altogether.

Subway, or Sai Bei Wei (Mandarin for “tastes better than others”), is now the third-largest U.S. fast-food chain in China, right behind McDonald’s and KFC, and all its stores are profitable. Although Bryant had never eaten a Subway sandwich before, Jana Brands, the company Bryant worked for in China, sold $20 million in crab to Subway annually, so he knew it was big business. When Subway founder Fred DeLuca visited Beijing in 1994, Bryant took him to a place not on the official tour: McDonald’s. It was Sunday night, and the place was packed. “We could open 20,000 Subways here and not scratch the surface,” Bryant remembers DeLuca saying.

Two weeks later, Bryant called Subway’s headquarters in Milford, Connecticut, and asked to be the company representative in China. He would recruit local entrepreneurs, train them to become franchisees, and act as a liaison between them and the company. He would receive half the initial $10,000 franchise fee and one-third of their 8 percent royalty fees. He could also open his own Subway restaurants. Steve Forman, the founder of Jana Brands, invested $1 million in return for a 75 percent stake.

All foreign businesses in China had to be joint ventures with local partners, so Bryant used the Chinese business practice of relying on local relationships to find a manager for his first restaurant in Beijing. The project ran into problems immediately. Work on the store was delayed, and construction costs soared. It didn’t take Bryant long to realize that he and Forman had been swindled out of $200,000.

When it finally opened, the restaurant was a hit among Americans in Beijing, but the locals weren’t sure what to make of it. They didn’t know how to order and didn’t like the idea of touching their food, so they held the sandwich vertically, peeled off the paper, and ate it like a banana. Most of all, the Chinese didn’t seem to want sandwiches.

But Subway did little to alter its menu—something that still irks some Chinese franchisees. “Subway should have at least one item tailored to Chinese tastes to show they respect local culture,” says Luo Bing Ling, a Beijing franchisee. Bryant thinks that with time, sandwiches will catch on in China. Maybe he’s right: Tuna salad, which he couldn’t give away at first, is now the number one seller. Today there are nearly 600 Subway stores in China, with China’s fast-food industry estimated at over $180 billion.

Critical Thinking Questions

1. What are some of the main problems U.S. franchisors encounter when attempting to expand their business in a country such as China?
2. What steps can franchisors take to ensure a smooth and successful launch of a new franchise business in a foreign country?

So what can you do to prepare when considering the purchase of a franchise? When evaluating franchise opportunities, professional guidance can prevent expensive mistakes, so interview advisers to find those that are right for you. Selecting an attorney with franchise experience will hasten the review of your franchise agreement. Getting to know your banker will speed up the loan process if you plan to finance your purchase with a bank loan, so stop by and introduce yourself. The proper real estate is a critical component for a successful retail franchise, so establish a relationship with a commercial real estate broker to begin scouting locations. Doing your homework can spell the difference between success and failure, and some early preparation can help lay the groundwork for the successful launch of your franchised business.

If the franchise route to business ownership seems right for you, begin educating yourself on the franchise process by investigating various franchise opportunities. You should research a franchise company thoroughly before making any financial commitment. Once you’ve narrowed your choices, ask for the *Uniform Franchise Offering Circular (UFOC)* for that franchisor, and read it thoroughly. The Federal Trade Commission (FTC) requires franchisors to prepare this document, which provides a wealth of information about the franchisor, including its history, operating style, management, past or pending litigation, the franchisee’s financial obligations, and any restrictions on the sale of units. Interviewing current and past franchisees is another essential step. And most franchise systems use computers, so if you are not computer literate, take a class in the basics.

Would-be franchisees should also check recent issues of small-business magazines such as *Entrepreneur*, *Inc.*, *Startups*, and *Success* for industry trends, ideas on promising franchise opportunities, and advice on how to choose and run a franchise. The International Franchise Association website at http://www.franchise.org has links to *Franchising World* and other useful sites. (For other franchise-related sites, see the “Working the Net” questions.)

CONCEPT CHECK

1. Describe franchising and the main parties to the transaction.
2. Summarize the major advantages and disadvantages of franchising.
3. Why has franchising proved so popular?

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CHAPTER OVERVIEW

Chapter 4: Family Business

4.1: Introduction

4.2: Family Business - An Overview

4.3: Family Business Issues

4.4: Conflict

4.5: The Three Threads

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4.1: Introduction

Westbrook Lobster

In 1957, Westbrook Lobster opened in Westbrook, Connecticut, as a specialized lobster and fish market. As time went on, the company expanded to offer a comprehensive range of fish, shrimp, and prepared foods. In 1989, Larry Larivere, who grew up near the docks of New Bedford, Massachusetts, bought the business and had a dream of expanding the business with a seafood restaurant.



Figure 4.1.1: Plates of food at Westbrook Lobster. *Source: Used with permission, Michael Larivere, manager, Westbrook Lobster, Wallingford, CT.*

Fast forward to 2004. Larry and his two sons, Michael (an environmental science major) and Matthew (a business major), opened up their second restaurant in Wallingford, Connecticut. It overlooks the Quinnipiac River in the historic Yale Brother's Mill built in the late 1670s. Originally a grain mill, later converted to a German and Britannia silver spoon factory, and finally converted into a restaurant, the building was rich with history.

Michael speaks easily about the value that Westbrook Lobster offers its customers: high-quality food, great service…and visiting the tables while people are dining. He sees these visits as an important part of the relationships that he has built with his customers over the years. Westbrook customers eagerly await the monthly postcards that are sent out that feature dining specials, discounts, and coupons. He tries to get the postcards out early and actually receives phone calls if they are not received early. Many people have come to depend on them. Michael says that these postcards definitely give the restaurant its greatest return. The restaurant has a presence on Facebook, but that is geared to the bar crowd—a younger crowd.

Technology plays an important but mixed part in the restaurant's operations. Michael says that it is tough to run a restaurant these days without technology tools like POS (point of service) systems. These systems include touch screens for placing orders and paying for food items. Interestingly, however, most food vendors still do their business face to face (or telephone to telephone), choosing to stick with personal relationships. Only a few suppliers, such as liquor vendors, accept orders online.

The current Westbrook Lobster website was created by Michael and Matthew using services from intuit.com. They built the site themselves and are proud to note that restaurant gift cards can now be purchased directly from the site. This is a perfect example of Web 2.0 capabilities.

As far as running the business, currently fifty employees strong, Larry Larivere (Dad) is brought in on the big decisions. Otherwise, Michael and Mathew run the restaurants on their own. There are currently no other family members in the business.

Westbrook Lobster continues to provide the freshest seafood available at competitive prices. The daily selection includes everything from locally harvested shellfish to fresh fish from waters up and down the East Coast. They also offer several "healthy" options that are made without butter or bread crumbs. These menu items are very popular and are especially attractive for people with food allergies or people who just want to eat a bit lighter. All their efforts continue to pay off. Westbrook Lobster was voted "Best Seafood Restaurant Statewide" in *Connecticut Magazine* 2009 and "Best Seafood in New Haven County" in *Connecticut Magazine* 2009 and 2010.

Larry, Michael, and Matthew invite you to Westbrook Lobster when you are in the area. Once you are there, you are family.

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4.2: Family Business - An Overview

Learning Objectives

- Explain what a family business is.
- Understand the role that family businesses play in the US economy.
- Explain the advantages and disadvantages of family businesses.

There is no agreed-on definition of a family business. The percentage of ownership, the strategic control, the involvement of multiple generations, and the intention for the business to remain in the family are among the many criteria that experts use to distinguish family businesses from other types of businesses. For the purposes of this section, however, a **family business** is defined as a business that is actively owned and/or managed by more than one member of the same family. A family business can also be defined as the result of someone's dream:

The story of every successful family business starts with someone who has the passion, confidence, and courage to put his [or her] money where his [or her] mouth is… [These entrepreneurs] work incredibly hard, make things happen, are positive without being unrealistic and possess the resourcefulness to overcome all sorts of hurdles. They are also socially adept, capable of communicating effectively, and good at inspiring others…

Family business owners know that their roles are different from that of shareholders in companies owned by many public investors. In addition, "employees in family businesses know the difference that family control makes in their work lives, the company culture, and their career. Marketers appreciate the advantage that the image of a family business presents to customers. And families know that being in business together is a powerful part of their lives."

Market and Employment Presence

Because of the private nature of most family businesses, it is difficult to obtain accurate information about them. Complicating the situation is that most data sources do not distinguish between small family businesses, such as the local pizza parlor or deli, and large family businesses, such as Walmart, Mars, and Ford. "The reality is that family-based operations are represented across the full spectrum of American companies, from small businesses to large corporations." Within this context, the following has been observed:

- Family businesses account for a staggering 50 percent of the gross domestic product (GDP).
- Although it may seem that this GDP contribution comes from thousands of small operations, 35 percent of the *Fortune 500* companies are family companies.
- Family businesses account for 60 percent of US employment and 78 percent of the new jobs created.
- Family businesses represent one of the fastest-growing sectors of the economy because their new job requirements outpace their current employment rates when compared to other types of businesses.

What this means is that family businesses continue to be a powerful economic force, no matter what their size and no matter how they are defined. "Family firms are the most common form of business structure; they employ many millions of people, and they generate a considerable amount of the world's wealth."

The focus of this section is on the small family business.

Video Clip: Mothers and Daughters Partner in Family Business

A YouTube element has been excluded from this version of the text. You can view it online here.

Advantages and Disadvantages of the Family Business

There are benefits to a family business, but there are disadvantages that must be considered as well. Starting a family business is not for everyone.

Advantages

A family business offers the following advantages:

- One of the popular misconceptions about family businesses is that they are unable to adapt easily to increasing competitiveness and technological progress. The reality is that family businesses frequently have the advantage of entrepreneurial spirit, flexibility, and opportunism.
- It is believed by some that family firms are “too soft” and rarely reach their potential. The reality is that family businesses actually outperform public companies. Oftentimes, the marketplace forces public companies to make short-term decisions, whereas a family business has the advantage of having more freedom to make its decisions. Family businesses can adapt to market fluctuations more easily because they can afford to be patient. They have common goals, shared values, and a commitment to brand building.
- Family-owned businesses are often seen as ideal because family members form a “grounded and loyal foundation” for the company, and family members tend to exhibit more dedication to their common goals. “Having a certain level of intimacy among the owners of a business can help bring about familiarity with the company and having family members around provides a built-in support system that should ensure teamwork and solidarity.”
- The culture of a family business is very different from that of a company you will find on Wall Street. “Family businesses frequently take a very long-term point of view. They’ll make investments that they don’t expect to pay off for 5 or 15 or 25 years… Culture in a family business is more frequently based on very personal and emotional values. It’s stronger because there are deeper roots and closer connections to the history of the company.”
- Family businesses are becoming more and more attractive to undergraduate business students who face a bleak job and salary outlook for new grads. These undergrads are choosing to return to their family businesses directly after graduation instead of trying to find a job in corporate America or on Wall Street.
- There is a common misperception that family businesses are less professional and rigorous in their behavior because of the relational nature of the businesses. However, like all other businesses, family businesses face global competition and rapidly changing markets. This creates more pressure on those who join to make sure that they produce. “This emphasis on professionalism has made family businesses both more daunting and more attractive—and has created new interest in them, from family members, outsiders, and business school students.”
- Many family-owned businesses tend to be stable and optimistic, even when economic times are uncertain. They seem to be better able to weather economic difficulties and stabilize the economy than their non-family counterparts. However, this is a function of the industry and the size of the business.
- In general, family businesses feel that they are stronger because family members are involved in their activities. Family owners believe that their family members can be trusted, will work harder, and care more. This can help create competitive advantage in the marketplace.
- Family businesses may be more open to flexible or part-time schedules or choosing your hours. This presents a very attractive work environment for people who need to tend to children, parents, or other family members in need.
- Family businesses tend to operate more ethically. In fact, many family businesses believe that their ethical standards are more stringent than those of their competitors. In addition, family businesses are often deeply embedded in their communities, and this proximity is seen as an important factor that increases the likelihood of ethical decision-making and moral behavior. As members of the local community, any ethical problems with a family business will be quickly visible.
- Family businesses also exhibit more social responsibility than their competitors. This has been attributed to their concern about image and local reputation as well as their closeness to the community.
- Family businesses may incur lower costs because of the greater willingness of family members to make financial sacrifices for the sake of the business. Accepting lower pay than they would get elsewhere to help the business in the longer-term or deferring wages in a cash-flow crisis are examples of family altruistic behavior.
- Family businesses, in general, have greater independence of action because they have less (or no) pressure from the stock market and less (or no) takeover risk.
- Family businesses tend to be more resilient in hard times because they are willing to plow profits back into the business.
- Family businesses are less bureaucratic and less impersonal, which allows for greater flexibility and quicker decision-making.
- Family businesses offer the possibility of great financial success. This can manifest itself in interesting ways. “As the family of a media conglomerate once mentioned, ‘The name I have has certainly helped me to get access to top executives of companies, persons who under other circumstances would have kept their doors shut.’
- Family members have the chance to learn the business early. This extensive expertise can create an important competitive advantage. “One executive recalled how as a child he would take long walks with his father, during which they would visit

stores to look at competitor's products. Afterward, his father would ask him which products he liked most, and this would lead to lengthy arguments about each product's quality. This man felt that the expertise he gained during those informal outings proved invaluable later in life."

Video Link: The Future of Family Business

A YouTube element has been excluded from this version of the text. You can view it online here.

Why Family Businesses Are So Special

"If family businesses are so common, how can they also be special? When Freud was asked what he considered to be the secret of a full life, he gave a three-word answer: '*Lieben und arbeiten* [to love and to work].' For most people, the two most important things in their lives are their families and their work. It is easy to understand the compelling power of organizations that combine both. Being in a family firm affects all the participants. The role of chairman of the board is different when the company was founded by your father and when your mother and siblings sit around the table at board meetings, just as they sat around the dinner table. The job of a CEO is different when the vice president in the next office is also a younger sister. The role of partner is different when the other partner is a spouse or a child. The role of sales representative is different when you cover the same territory that your parent did twenty-five years earlier, and your grandparent twenty-five years before that. Even walking through the door on your first day of work on an assembly line or in a billing office is different if the name over the door is your own."

Disadvantages

As attractive as family businesses are on many fronts, they have the following disadvantages:

- Family businesses tend to be stable organizations. Although this is a good thing in many instances, stability can also make it difficult to change. A new, younger family member coming into the business will find tradition and structure. Changing that is not simple. The key to changing a family business lies in defining tradition in terms of the company's core values, not in specific ways of doing things.
- Family closeness can lead to sibling rivalry or problems when both the parent and the child want control. By the third or fourth generation, with many cousins possibly sharing ownership, governance can become very complicated.
- There may be times when the interests of a family member conflict with the interests of the business. One family member may want to expand the business, but other family members may not share this person's desire. The needs of the business are not in sync with the needs of the family.
- Family ties have a downside. Family members will frequently be expected to work harder, make more of a commitment, and get paid less than other employees in the business.
- Family business owners may automatically promote someone from the family or give family members a job even if they do not have adequate skills for the job. A non-family employee may be better qualified. This can cause dissension and resentment among other employees.
- Relationships between parents and children or among siblings have a tendency to deteriorate due to communication problems. "This dysfunctional behavior can result in judgments, criticism, and lack of support."
- The family business may be a breeding ground for jealousies, resentment, anger, and sabotage. Family problems may spill over into the workplace.
- The business may be plagued with managerial incompetence, the lack of exposure to other businesses, and the inability to separate family and work.
- Some family businesses may have difficulty attracting and keeping highly qualified managers. "Qualified managers may avoid family firms due to the exclusive **succession**, limited potential for professional growth, lack of perceived professionalism, and limitations on wealth transfer." Succession refers to passing the business to the next generation.
- Family businesses have limited sources of external capital because they tend to avoid sharing equity with non-family members. Having less access to capital markets may curtail growth.
- Not all children of owner-managers may want to join the business. According to one study, 80 percent of those who did not work in the family business did not intend to go into the business. This reluctance comes from several directions, such as the following:
    - My parents would not want me to join.

- I could not work for my parents.
- There are already too many family members in the business.
- I am not interested in this particular business.
- The business is too small for me.
- The business would not allow me to use my talents.
- The business would not allow me to use my training.
- I can earn more elsewhere.
- I am not interested in a business career.

In Their Own Words

I see the pressure my dad is under—this does put me off slightly. I want to enjoy my job as well as enjoying life outside work.

A larger factor when working under a relative is the problem of self-worth. It is hard to feel like you are worth something when your father is an MD.

A business relationship with your father makes your family relationship harder.

I do not look to go into the family business straight away, as I feel this is giving a commitment to work there for the rest of my life.

I would join only because I am genuinely qualified, not because I am the owner's daughter.

The difference in my father's education and mine is a factor affecting why I have decided not to go into the business. I have more choice over what I want to do as a career, and my personal interests would not be met by my father's company. I am sure it would not have been his choice had he had the same educational choices as me.

As much as the route into the family business is seen by outsiders as an "easy route to wealth and inheritance," in my case it was also a liability. At 17, was I to be the fourth generation after 100 years that could not keep the company going?

- The "spoiled kid syndrome" often occurs in a family business. The business owner may feel guilty because his devotion to the business takes away from the attention he should be giving to his children. Out of a sense of guilt, he or she starts to bribe the children, "a kind of pay-off for not being available emotionally or otherwise."
- Financial strain emanating from "family members milking the business and a disequilibrium between contribution and compensation" can have a significant negative impact on the business.
- Nepotism that results in the "tolerance of inept family members as managers, inequitable reward systems, [and] greater difficulties in attracting professional management" can easily lead to low morale among non-family members of the business, and it can ultimately result in business failure.
- Family businesses frequently have a confusing organization, with "messy structure and no clear division of tasks." Authority and responsibility lines are unclear; jobs may overlap; executives may hold a number of different jobs; and the decision-making hierarchy may be completely ignored, existing only to be bypassed. This can create a dysfunctional working environment.
- Family businesses frequently have paternalistic or autocratic rule that is characterized by a resistance to change, secrecy, and the attraction of dependent personalities.

KEY TAKEAWAYS

- Family businesses account for 50 percent of the GDP, 60 percent of US employment, and 78 percent of the new jobs that are created.
- A family business offers both advantages and disadvantages. It is important to understand both.

EXERCISE

Robert Rainsford has returned to his family business, Frank's All-American BarBeQue, and is very enthusiastic about expanding the business. He has identified four options: (a) expanding the restaurant either at its current site or elsewhere in Fairfield; (b) opening several similar-sized restaurants in nearby towns; (c) using the Internet to expand sales; and (d) expanding the sales of Frank's sauces from a local store to a regional supermarket chain. Any one of these ideas would represent a change from his father's business model. Given that he had not expressed any interest in the management of the

> business, how should he go about approaching his father with these ideas? If the company expands, should Robert approach his sister and her husband about taking a more active role in the business? What should their roles be?

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4.3: Family Business Issues

Learning Objectives

- Explain why communication, employing family and non-family members, professional management, employment qualifications, salaries and compensation, succession, and ethics are important issues for all family businesses.

Looking at the vision and hard work of the founders, family businesses "take on their unique character as new members of the family enter the business. At best, the environment can be inspiring and motivating. At worst, it can result in routine business decisions becoming clouded by emotional issues."

The owners and managers of family businesses face many unique challenges. These challenges stem from the overlap of family and business issues and include communication, employing family and non-family members, professional management, employment qualifications, salaries and compensation, and succession.

Communication

Communication is important in any business, but the complexities of communication in a family business are particularly problematic. Experts say that communication is one of the most difficult parts of running a family business. The approach to communication needs to include commitment, the avoidance of secrecy, and an understanding of the risks of bad communication.

Commitment

In a family business, it is critical that there be a commitment to communicate effectively with family and non-family members of the business. "Business leaders should be open about their awareness of the potential for communication issues to evolve and their willingness to accept feedback and input from all employees about opportunities for improvement and areas of concern."

One important issue is whether there should be a line drawn between family and business discussions. Some suggest that setting up strict guidelines from the start that draw a clear line between the different types of discussions is a good approach. By contrast, the Praxity Family Business Survey found that it is considered okay to talk about the business anywhere and at any time, whether at work or at home:

- Nineteen percent of the family businesses in the survey reported talking about business at home.
- Thirty-seven percent talk about it in the workplace.
- Forty-four percent talk about it when and wherever.

Secrecy

In family businesses, it is particularly important not to convey the impression that family members are more in the know than other employees. "…Even when this is not the case, the potential for the perception of exclusivity may exist. Steps should be taken to address any issues that may arise openly, honestly, and without preference for family members."

Risks of Bad Communication

If good communication channels are not in place, the following can occur:

- "Family members assume they know what other family members feel or want."
- "Personal ties inhibit honest opinions being expressed."
- "The head of the family may automatically assume control of the business even if they don't have the best business skills."
- "One family member ends up dominating the business."
- "Family-member shareholders not active in the business fail to understand the objectives of those who are active and vice versa."
- "Personal resentments become business resentments and vice versa."

These difficulties can be overcome if the family business makes a concerted effort to create and maintain an environment of open communication where people feel comfortable voicing opinions and concerns. It is important that family and non-family members have an equal opportunity to express their views.

Employing Family and Non-family Members

It is natural for a family business to employ family members, especially in management positions. Family members tend to be the first people hired when a small business gets started, and as the business grows, so do their roles. There are both pros and cons to hiring family members. Both need to be considered carefully. Who to hire may well be the biggest management challenge that a family business owner faces.

Pros

On the positive side of things, several advantages can be identified for hiring family members:

- Improved customer relations through family contact
- Intergenerational continuity
- Long-term stability
- Shared values
- Loyalty and commitment
- Inherent trust
- Willingness to sacrifice for the business
- Emotional attachment to the business; more willing to contribute to its success
- Share the same culture

“A family whose members work well together can also give the business a welcoming and friendly feel. It can encourage employees who aren’t in the immediate family to work harder to gain acceptance by those employees who are.”

Cons

There are also quite a few disadvantages to hiring family members:

- Families are not perfect, so a dispute among family members can spill from home into the workplace.
  - There is always the possibility of managerial incompetence.
  - It may not be possible to separate family and work.
  - Patterns of conflict will be rooted in early family experiences.
  - Communication may break down.
  - Sibling rivalry may create problems.
- Newly hired family members may feel that they do not have to earn their positions; their success will be seen as linked to their name instead of their abilities.
  - The company may be subject to charges of discriminatory hiring practices if job openings are not published.
  - Non-family members of the business may feel that family members get hiring preference.
  - Non-family members may feel that they will be automatically outvoted in decision making.
  - Hiring primarily family members for management positions may lead to hiring suboptimal people who cannot easily be dismissed. This could lead to greater conflict because of promotion criteria that are not based on merit.

Hiring Non-family Members

There will be times when the better decision may be to hire a non-family person for a particular job. Experience has shown that a family business is less likely to be successful if it employs only family members; bringing in the fresh thinking that comes with external expertise can be valuable at all levels of a business. In addition, non-family members can offer stability to a family business by offering a fair and impartial perspective on business issues. The challenge is in attracting and retaining non-family employees because these employees “may find it difficult to deal with family conflicts on the job, limited opportunities for advancement, and the special treatment sometimes accorded family members. In addition, some family members may resent outsiders being brought into the firm and purposely make things unpleasant for non-family employees.” Because it is likely that a growing family business will need to hire people from the outside, it is important that the business come to terms with that necessity. Policies and procedures can help with the transition, but the most important thing is to prepare the family culture of the business to accept a non-family member. Not surprisingly, this is much easier said than done.

Professional Management

The decision to hire a **professional manager** is likely one of the most important and difficult hiring decisions that a family business owner will have to make. The typical definition of professional managers equates them with external, non-family, non-owner managers, thus declaring professional management and family management as mutually exclusive. “A typical argument…is that professional non-family managers should be brought in to provide ‘objectivity’ and ‘rationality’ to the family firm.”

There are several problems with this way of thinking. First, it perpetuates the outdated notion that family members are not professional, that the smartest thing for a family business to do is to bring in professional management—as quickly as possible.

Second, professional managers are not always prepared to deal with the special nature of family-owned businesses. “The influence of families on businesses they own and manage is often invisible to management theorists and business schools. The core topics of management education—organizational behavior, strategy, finance, marketing, production, and accounting—are taught without differentiating between family and non-family businesses.” This does an injustice to the unique workings of a family-owned business.

Third, a professional manager from the outside is not always prepared, perhaps not even most of the time, to deal with the special nature of family companies. The dominant view on professional management downplays the importance of the social and the cultural context. “This is a problem in family firms where family relations, norms, and values are crucial to the workings and development of the business.” It is argued that the meaning business families attach to their businesses is guided by family values and expectations—so much so that “anything or anyone that interrupts this fragility could send the business into chaos.”

The hiring of an outside manager, therefore, should include an assessment of both **formal competence** and **cultural competence**. Formal competence refers to formal education, training, and experience outside the family business. Although it is certainly helpful and appropriate, formal competence is not sufficient for managerial effectiveness. It needs to be supplemented with cultural competence, an understanding of the culture of a specific firm. Interestingly, most family businesses look only to formal competence when selecting a CEO.

Culture and Non-family CEOs

It is extremely important to understand the culture of the family firm. It means that as a leader you have to be sensitive to the organization’s reactions on the things you say and do. I have a long-term employee on my management team, and she is my guide in these issues. She can tell me how the organization will react and how things are likely to be received. We have to build on the past even though we have to do a lot of things in new and different ways. But because of the culture, this might be very sensitive. (The words of a non-family CEO in a family business.)

As a non-family CEO, you have to have in-depth respect for the invisible forces among the employees in the family firm. You cannot escape the fact that there will always be special bonds between the family firm and the owner. Always. (The words of a non-family CEO in a family business.)

One concern of family businesses may be that the hiring of a non-family manager will result in the loss of their “familiness.” However, one study found that, even with non-family managers bringing non-family management activities, styles, and characteristics, “the special and unique aspects and forces of the system of the family, its individual family members, and the business itself provide a synergistic force that offsets the outside influences of the [non-family managers].” This same study acknowledged, however, that their research did not focus on understanding at what point, or percentage of non-family members, the feeling of “familiness” will begin to erode.

Employment Qualifications

One of the more difficult challenges that a family business must face is determining employment qualifications for employees, both family and non-family. The lack of a clear employment policy and process can lead to major conflicts in the company. Unfortunately, it would appear that, despite their benefit, most family businesses have a family employment policy. As a result, many family businesses may end up with more employees from the family than the company needs, and some of these people may not even be qualified or suitable for the jobs they have been given. “Some family businesses even find themselves acquiring businesses that have no relationship with their original business or keeping some unprofitable business lines just to make sure that everybody in the family gets a job within the company.” This kind of situation benefits no one.

A written family-business employment policy can solve a myriad of problems because it spells out the specific terms for family and non-family members with respect to recruiting, hiring, promoting, compensating, and terminating. One recommendation is that an ideal family employment policy should include the following:

- "Explain the family employment policy's purpose and philosophy."
- "Describe how family members will apply and be considered for positions."
- "Cover the general conditions of employment, including compensation and supervision."
- "Outline the approach to be taken in developing and promoting family business members."
- Make clear that family members will be completing the same applications that other candidates will complete.
- Include an inspiring and upbeat reminder that the policy's purpose is to help the family business succeed and to support, develop, and motivate family members to lead successful and productive lives.
- Have all family business owners sign the policy, indicating they have read and agreed to it.

Others have recommended "that family members meet three qualifications before they are allowed to join the family business on a permanent basis: an appropriate educational background; three to five years' outside work experience; and an open, existing position in the firm that matches their background."

There are no rules that dictate the content of a family business employment policy, so differences from one family business to another can be expected. However, it is very important "to set employment conditions that do not discriminate against or favor family members. This would help establish an atmosphere of fairness and motivation for all employees of the family business."

The benefits of an employment policy notwithstanding, the idea may be met with resistance. There may be the feeling that hiring decisions for family members should be separate from the hiring decisions for non-family members because being a family member provides special qualifications that cannot be matched by someone outside the family. How to proceed will ultimately fall on the shoulders of the family business owner.

Salaries and Compensation

As difficult as hiring decisions may be for the family business, decisions about salaries and compensation are probably even worse. No matter how well-intentioned and well-designed the company's compensation plan may be, there will still be jealousies, hard feelings, severed sibling relationships, and even lawsuits, particularly among those family members who feel they have been treated unfairly. This presents a daunting challenge: how to develop a compensation plan that will be fair to family members and good for the business:

One of the greatest struggles of operating a family business is separating the family from the business. Oh yes, there are many great benefits to having family in the business and to being a family member in a family business, but the most difficult problems result when "family values" and issues take over, leaving business values and needs wanting. There is no greater source for family business problems—nor more fertile ground for their cure—than the family business compensation systems.

Some of the Problems

Family businesses often make several common mistakes when developing their compensation plans.

- They consider fair compensation to be equal compensation for all family members, sometimes even for the owner. This creates a very sticky situation because all family members are not created equal. "It is sometimes difficult to assess and compare the talents of family members who are also employees. Nor do all family members contribute equally to the business. As a result of the stress that this causes, many family business owners ignore the problem and let compensation become a breeding ground for dissension in the family."
- They do not compensate wives for the work they do. The reason often given? It saves on taxes. Not surprisingly, this approach leaves wives isolated from the business, invisible in the decision-making process, and unappreciated. This problem extends to the compensation of sons and daughters as well. A survey by Mass Mutual Insurance Company reported a big discrepancy among the salaries of sons and daughters in family businesses across America. The average salary of the typical son in a family business was $115,000, while his sister earned only $19,000. This may be due to the tendency of sons being groomed for leadership, while daughters are groomed for the supportive roles that command lower salaries.

- The compensation for family members is higher than that for non-family members, but the differential is not tied to the actual job requirements or performance. This situation can lead to anger, reduced motivation, resentment, and eventual departure of the non-family member from the firm.
- The business overpays family members—for a variety of reasons:
  - "Guilt, because mom & pop were so busy working when the kids were young."
  - "Fear of conflict, because someone's wife threatens not to come to the family picnic."
  - "Resistance to change, because 'That's the way we've always done it.'"
  - "Inability to confront family members who feel 'entitled' to inflated salaries."
  - "Determination to minimize estate taxes by transferring wealth through compensation."
- Emotional pressures are allowed to determine compensation policies. What this means is that compensation is not correctly determined by job requirements and performance in those jobs. When this happens, small problems develop centrifugal force:
  - "Fighting between sibling/cousin partners increases."
  - "Hard-working family members and employees lose morale."
  - "Well-motivated competent employees leave the company."
  - "The company loses its competitive edge and growth potential."
  - "Family harmony decreases."
  - "The value of the company declines, or it is sold—for the wrong reasons."

Some of the Solutions

Developing a fair compensation plan for the family business is not easy. It requires good faith, trust, and good business sense. The dollar amounts offered to family members will be critical, but the more pressing issue is fairness. Unfortunately, fairness is often construed as equality. This must be avoided.

There is no template for designing a compensation plan for family businesses, but there are several recommendations:

- Develop accurate job descriptions for each employee that include responsibilities, level of authority, technical skills, level of experience and education required for the job, and goals for an annual performance review. In a performance-based company, the amount of stock owned by a family member will not be related to his or her compensation.
- Develop a clear philosophy of compensation so that everyone understands the standards that are used to pay people. The following is a sample of a written compensation plan philosophy that was developed by one family.

Family members employed in the business will be paid according to the standards in our region, as reported by our trade association, for a specific position, in companies of our size. In order to retain good employees we will pay all employed family members and other managers within the top quartile of our industry's standards. Additional compensation will be based on success in reaching specific company goals, with bonuses shared among all members of the management team. Individual incentives will be determined according to measurable goals for job performance determined each year, and reviewed by the appropriate manager.

- Gather information about the salaries of similar positions in the industry of the family business in the applicable region of the country. Look at companies that are similar in the number of employees, revenue, and product. If possible, obtain salary and benefit information.
- Have the base salary for each position be consistent with the salaries and wages paid for comparable positions at similarly sized businesses. Paying at this market value will have an excellent effect on non-family members because they will feel that they are on an even playing field. There will be a positive effect on business morale.
- The family business owner might consider seeking outside help in determining compensation levels for individual family members. However, this assistance must be seen as truly objective, with no reason to favor one viewpoint over another.

Oh, Those Sleepless Nights!

A recent family business survey reported that the following things keep family business owners awake at night.

Rank	The Nightmare	Percentage Citing as a Significant Concern (%)
1	Family members can never get away from work.	18
2	Business disagreements can put strain on family relationships.	17
3	Emotional aspects can get in the way of important business decisions.	16
4	Transition to the next generation is more difficult than a third-party sale.	10
5	There can often be conflicts regarding the fairness of reward for effort.	9
6	The business rewards are not necessarily based on merit.	8
7	Family members find it difficult to be individuals in their own right.	5
8	Difficulties arise in attracting professional management.	5
9	Children can be spoiled through inequitable rewards.	4
10	Outside shareholders do not contribute but take payouts from the business.	3
11	The family is always put before the business and therefore can be less efficient.	3
12	Past deeds are never forgotten and are brought up at inappropriate times.	2

Other urgent issues identified by a different family business survey included, in order of importance, the following:

- Labor costs
- Health-care costs
- Finding qualified employees
- Foreign competition
- Labor union demands
- Domestic competition
- Oil prices
- Availability of credit from lenders
- Estate taxes

Succession

Another important issue that is particularly difficult for family businesses is **succession**. As mentioned earlier in this chapter, succession is about passing the business to the next generation. Decisions have to be made about who will take over the leadership and/or ownership of the company when the current generation dies or retires. Interestingly, “only a third of all family businesses successfully make the transition to the second generation largely because succeeding generations either aren’t interested in running the business or make drastic changes when they take the helm.” There are family businesses that manage the transition across

generations quite easily because the succession process chooses only the children willing and able to join and work with the prevailing family, business values, and goals. Unfortunately, there are also instances in which children have had to leave school as soon as legally allowed, not equipped to manage either the business, their lives, or their family. These children spend many resentful years in the business until it fails.

Passing the family business to the next generation is a difficult thing to do, but succession is a matter of some urgency because 40 percent of US businesses are facing the issue of succession at any given point in time. This urgency notwithstanding, there are several forces that act against succession planning:

1. Founder
    - Fear of death
    - Reluctance to let go of power and control
    - Personal loss of identity
    - Fear of losing work activity
    - Feelings of jealousy and rivalry toward successor
2. Family
    - Founder's spouse's reluctance to let go of role in firm
    - Norms against discussing family's future beyond lifetime of parents
    - Norms against favoring siblings
    - Fear of parental death
3. Employees
    - Reluctance to let go of personal relationship with founder
    - Fears of differentiating among key managers
    - Reluctance to establish formal controls
    - Fear of change
4. Environmental
    - Founder's colleagues and friends continue to work
    - Dependence of clients on founder
    - Cultural values that discourage succession planning

These are powerful forces working against succession planning, but they need to be overcome for the good of the founder, the family, and the business. It will be tricky to balance the needs of all three and fold them into a good succession plan.

The Succession Plan

Voyageur Transportation, a company in London, calls its successful succession planning program, "If you got hit by a beer truck, what would happen to your department?" As a family business owner, you should pose this question in terms of yourself and your business. Hopefully, this will provide the impetus you need to develop a succession plan.

A good succession plan outlines how the succession will occur and what criteria will be used to judge when the successor is ready to take on the task. It eases the founder's concerns about transferring the firm to someone else and provides time in which to prepare for a major change in lifestyle. It encourages the heirs to work in the business, rather than embarking on alternative careers, because they can see what roles they will be able to play. And it endeavors to provide what is best for the business; in other words, it recognizes that managerial ability is more important than birthright, and that appointing an outside candidate may be wiser than entrusting the company to a relative who has no aptitude for the work.

A good succession plan will recognize and accept people's differences, not assume that the next generation wants the business; determine if heirs even have enough experience to run the business; consider fairness; and think and act like a business. The plan should also include a timetable of the transition stages, from the identification of a successor to the staged and then full transfer of responsibilities, and a contingency plan in case the unforeseen should happen, such as the departure or death of the intended successor or the intended successor declining the role. It would also be helpful to get some good professional advice—from company advisors who have expertise in the industry as well as other family-run businesses.

Although each succession plan will be different, the following components should be seen as necessary for a good succession plan:

1. **Establish goals and objectives.** As the family business owner, you must establish your personal goals and vision for the business and your future role in its operation. You should include your retirement goals, family member goals, goals of other stakeholders (e.g., partners, shareholders, and employees), and goals relating to what should happen in the case of your illness, death, or disability.
2. **Family involvement in the decision-making process.** If the family and stakeholders who are involved in the decision-making process are kept informed of the decisions being made, many of the problems related to inheritance, management, and ownership issues will be alleviated. Communication, the process for handling family change and disputes, the family vision for the business, and the relationship between the family and the business should be addressed. The surest path to family discord is developing the succession plan on your own and then announcing it.
3. **Identify successor(s).** This section of the plan will address the issue of who takes over ownership and management of the business. Identification of the potential successor(s), training of the successor(s), building support for the successor(s), and teaching the successor(s) to build vision for the business are included here. Working with your successor(s) for a year or two before you hand over the business will increase the chances for success.
4. **Estate planning.** Estate planning is important if you are planning to retire or want to take precautionary measures regarding the future of the business in the event you are unable to continue operation of the family business due to illness, disability, or death. You should consult a lawyer, an accountant, a financial/estate planner, and a life insurance representative so that your benefits will be maximized. You will need to consider taxation, retirement income, provisions for other family members, and active/nonactive family members.
5. **Contingency planning.** Contingency planning is about unforeseen circumstances. It is about strategizing for the most likely "what if" scenarios (e.g., your death or disability). By thinking in terms of the unforeseen, you will be taking a proactive rather than reactive approach.
6. **Company structure and transfer methods.** This section of the succession plan involves the review and updating of the organizational and structural plan for the organization taking into account the strengths and weaknesses of the successor. The following needs to be identified: the roles and the responsibilities of the successor, the filling of key positions, structuring of the business to fit the successor, the potential roles for the retiring owner, any legal complications, and financial issues.
7. **Business valuation.** This section is relevant only if the business is being sold. Passing the business to a family member would not involve a business valuation.
8. **Exit strategy.** With any succession, ownership will be transferred, and you will remove yourself from the day-to-day operations of the business. Alternatives will be compared, and a framework for making your final choices will be developed. The transfer method and the timelines are decided. The exit plan should then be published and distributed to everyone who is involved in the succession process.
9. **Implementation and follow-up.** The succession plan should be reviewed regularly and revised as situations change. It should be a dynamic and flexible document.

As difficult as the planning process can be, the goal should be a succession plan that will be in the best interests of all—or most—of the parties involved. Business interests should be put ahead of family interests, and merit should be emphasized over family position.

The Family Business and Technology

In 2008, when R. Michael Johnson—Mikee to everyone who knows him—took over the pressure-treated lumber company his grandfather founded in 1952, he had a great idea: laptops for all managers and sales staff.

"'You would have thought the world was coming apart," says Johnson, CEO and president of Cox Industries in Orangeburg, South Carolina. One salesman—convinced that the computer would be used to track his movements outside the office—up and quit. A buyer who had been with the company for thirty-five years said he would like a fax machine but could not see why he needed a computer when he had managed just fine without one for so long.

And that was just the beginning. In an industry where some businesses still write delivery tickets by hand and tote them up on calculators, Johnson recently led the company through an ERP (enterprise resource planning) software conversion and distributed iPhones to the sales team so they can use the company's new customer relationship management (CRM) system.

"'Let's just say I have spent quite a few Sunday lunches after church explaining technology acronyms to Granddad and Grandmom," Johnson says.

The resistance to new technology quieted, however, after Johnson was able to point to market share growth of 35 percent at the $200 million business in the past year. "The numbers are starting to resonate," he says. "Five years ago, I couldn't even say what our market share was because we didn't have the technology to figure it."

KEY TAKEAWAYS

- Important family issues include communication, employing family and non-family members, professional management, employment qualifications, salaries and compensation, and success. Each issue can create conflict.
- It is very important to understand the culture of the family business, especially by non-family CEOs.
- Succession planning is critical to the success of passing a business to family members.

EXERCISES

1. Select a family business in your area. Make arrangements to speak with three members of the family who work in the business. Develop a list of ten questions that cover a broad range of issues, such as the approach to compensation (but do not ask for specific salary or wage numbers), the process for hiring family and nonfamily members, and the plans for passing the business to the next generation. Ask each member of the business the same questions. Pull the answers together and compare them. Where did you find similarities? Where did you find differences? Did everyone know the answer to each question? Where were people reluctant to answer? Prepare a three- to five-page report on your findings.
2. The family business is looking to expand, and some members of the family, but not all, feel that it might be worth bringing in someone from the outside to fill one of the new management positions because the family talent has been pretty much exhausted. Design a process for hiring an external manager. What things should be considered? How might you get buy-in from all family members?

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4.4: Conflict

Learning Objectives

- Explain what conflict is.
- Explain why positive or constructive conflict can be helpful to a family business.
- Explain why negative or destructive conflict can damage a family business.
- Identify sources of negative conflict in a family business.
- Identify some ways in which negative conflict can be avoided.

All businesses have conflict. It can be a good thing or it can be a bad thing. **Positive or constructive conflict** can be beneficial to a family business when it increases opportunity recognition, produces high-quality decisions, encourages growth, strengthens groups and individuals, increases the learning necessary for entrepreneurial behavior, and increases the levels of commitment to the decisions being made. An example of positive conflict is a disagreement between family members on the strategic direction of the family business, the result being a much-needed rethinking of the business plan and a new agreed-on vision for the company.

By contrast, **negative or destructive conflict** can hurt a business by damaging the harmony and relationships of family members in the family business, discouraging learning, causing ongoing harm to groups and individuals in the business, frustrating adequate planning and rational decision making, and resulting in poor quality decisions. “The absence of good conflict makes it that much harder to accurately evaluate business ideas and make important decisions…But conflict does not mean browbeating.” An example of a negative conflict would be arguments over the successor to the business. Ultimately, the failure to adequately control negative conflict may contribute to the high mortality rate of family-owned businesses.

Because of the clash between business and emotional concerns in a family business, the potential for negative conflict can be greater than for other businesses. The tension that exists among the personal lives and career pursuits of family members creates an **interrole conflict** (occurring when a family member has simultaneous roles with conflicting expectations) in which the role pressures from work and home are incompatible. This conflict is difficult—if not impossible in some instances—to resolve. “Due to the interconnection and frequent contact among family members working in the business with those who are not but may still have an ownership stake, recurring conflict is highly probable in family firms.”

Sources of Conflict

The specific causes of conflict in a family business are many. Because the typical understanding of conflict in family businesses is that conflict refers to negative conflict that is unhealthy and disruptive, negative conflict is the focus of this section.

The PricewaterhouseCoopers Family Business Survey identified a core group of issues that are likely to cause tension.

Issue Causing Tension	Causes Some Tension (%)	Causes a Lot of Tension (%)
Discussion about the future strategy of the business	25	9
Performance of family members actively involved in the business	19	8
Decisions about who can and cannot work in the business	19	7
Failure of family members actively involved in the business to consult the wider family on key issues	16	7
Decisions about the reinvestment of profits in the business versus the payment of dividends	15	7
The setting of remuneration levels for family members actively involved in the business	14	7
The role in-laws should or should not play in the business	14	7
Decisions about who can and cannot hold shares in the business	13	6
Discussions about the basis on which shares in the business should be valued	12	5
Rejection of chosen successor by other family members	10	5

Add to this the fact that “family firms are prone to psychodynamic effects like sibling rivalry, children’s desire to differentiate themselves from their parents, marital discord, identity conflict, and succession and inheritance problems that non-family businesses do not suffer from, and it’s easy to see how the family business is a fertile field for negative conflict.

Several other sources of conflict can occur in a family-owned business. A sampling of those sources is discussed here. All have the potential to adversely impact family relationships, business operations, and business results.

- **Rivalry.** Harry Levinson from the Harvard Business School maintains that, “the fundamental psychological conflict in family businesses is rivalry, compounded by feelings of guilt, when more than one family member is involved.” This rivalry can occur between father and son, siblings, husband and wife, father and daughter, and in-laws with members of the family that own the business.
- **Differing vision.** Family members will often disagree with the founder and with each other about the vision and strategy for the business. These differences “can create fear, anger, and destructive attempts to control decisions that are divisive and counter-productive to making and implementing sound decisions.” Rivalries that spill into the workplace can get nasty, leading to destructive behaviors.
- **Jealousy.** There is always the potential for jealousy in the family business. It can arise from feelings of unfairness in such things as compensation, job responsibilities, promotions, “having the ear” of the business founder, and stock distributions. It can also arise with respect to the planned successor when there is a difference of opinion about who it should be. If it is not resolved, jealousy has the potential to divide the family and destroy the business.
- **Succession.** Succession is always a big obstacle for a family business. In some cases, the founder may feel that his or her children are not capable of running the business. This will cause obvious tension between the parent and the child/children, such

that the child or children may leave the business in frustration. This, in turn, becomes problematic for succession. “Who gets what type of equity, benefit, title, or role can be major sources of explicit conflict or implicit but destructive behaviors.” It is also true that while the founder of the business wants to continue family ownership and leadership of the business, this may not be true of his or her immediate family or later-generation family members. This can create substantive conflict during succession planning.

- **Playing by different rules.** This cause of negative conflict “often presents itself as a form of elitism or entitlement that exists simply by virtue of being in a family that owns a business. Examples show up in allowing one or more family members to exhibit deficient standards of conduct or performance that violate sound business practices or important requirements that all other employees are expected to follow. Such behaviors can be divisive and demoralizing to all employees and customers as well as harmful to the reputation of the business.”
- **Decision making.** If roles and responsibilities are not clearly defined, conflict will arise over who can make decisions and how decisions should be made. This will lead to confusion, uncertainty, and haphazard decisions that will put the company at risk.
- **Compensation and benefits.** “This is one of the most frequent sources of conflict, especially among members of the younger generation.” A person’s compensation is inextricably linked to his or her feelings of importance and self-worth. Compound that with the emotions associated with being a member of the family that owns the business, and you have the potential for explosive negative conflict. Clearly, this is not in the best interests of the business.

Avoiding Conflict

Some measure of family squabbling is expected in a family business. Some of the arguments will be logical and necessary. However, “it’s important that they remain professional and not personal, because squabbling among family members in a work environment can make the employees and customers feel extremely uncomfortable, and can give them grounds for legal claims against the business.” The negative effects of family squabbling are as follows:

- **Unprofessional image.** Family squabbling conjures up images of children—immaturity and pettiness. This sends a signal to customers and other employees that they are not in a professional environment that focuses on the right things.
- **Uncomfortable environment.** It is embarrassing to witness squabbling. No one likes to be in an awkward atmosphere; squabbling can cost you customers and employees, and it may result in expensive and unpleasant lawsuits. This can affect your bottom line very quickly.
- **Discrimination.** Nepotism is one of the biggest dangers of working in a family business. Arguing with relatives will only reinforce to other employees that they are in a family business. This can quickly lead to feelings of disparate treatment which, in turn, can lead to discrimination charges.
- **Legal troubles.** In the worst cases of family squabbling, disagreements over business can lead to lawsuits. If one family member’s role is minimized and his or her authority is restricted, this is violating the person’s rights as a shareholder. This can lead to an oppressed minority shareholder suit against the family business. This would be expensive, it would be ugly, and it could lead to the demise of the company.

Avoiding conflict is no easy feat. However, there are several things that a family business should consider. First, there are consultants who engage in conflict resolution for a living. The possibilities should be checked out. If the budget can handle the costs of a consultant, it could be the best choice. A consultant, having no reason to take one side or the other, will bring the necessary objectivity to resolution of the conflict.

Second, emotional reactions should be differentiated from problem-solving reactions. Family members need to take a professional perspective rather than that of an irritated sibling, parent, son, or daughter. It will probably be difficult to do this, but it is important that it be done.

Third, focus on the professional role instead of the family role. “Make sure it’s clear what the expectations and attitudes of all your employees are…Because you’re a small business, you might not have as strict a policy as a large corporation, but it would still be helpful to put it in writing, such as in an employee handbook, which carries legal responsibilities to both family and outside employees.”

Fourth, encourage honesty from the beginning. When first starting to work together, it is important that family members sit down together to talk about potential conflicts that might arise. Acknowledging that it will be more difficult to work together because of

being family is a good beginning. Treating family members and the professional environment with respect and expecting honesty when someone steps over the line should make for a smoother process.

Last, the founder should try to keep the conflict constructive. This means stimulating task-oriented disagreement and debate while trying to minimize interpersonal conflicts. This will require a fair decision-making process. For people to believe that a process is fair, it means that they must:

- "Have ample opportunity to express their views and to discuss how and why they disagree with other [family] members";
- "Feel that the decision-making process has been transparent, i.e., deliberations have been relatively free of secretive, behind-the-scenes maneuvering";
- "Believe that the leader listened carefully to them and considered their views thoughtfully and seriously before making a decision";
- "Perceive that they had a genuine opportunity to influence the leader's final decision"; and
- "Have a clear understanding of the rationale for the final decision."

KEY TAKEAWAYS

- Conflict can be either positive or negative. Negative conflict can potentially harm the business.
- There are many sources of negative conflict in a family business. The fundamental psychological conflict in family businesses is rivalry.
- It is important to avoid negative conflict. In particular, family squabbling that is witnessed by others can cause damage to the firm. Employees and customers will feel uncomfortable, and there may ultimately be grounds for a lawsuit.

EXERCISE

The founder of XYZ company has decided to retire. He wants one of three children to take over leadership of the business—and he knows exactly who it should be. Other members of the family have their ideas as well. One segment of the family wants the oldest son, Michael, to take over, but the founder thinks Michael is a melon head. The second son, Christopher, is a well-meaning and hard-working part of the business, but he just does not have what it takes to be a leader. Nonetheless, he is favored by another group of family members. Samantha, the youngest child, is as sharp as a tack, with solid experience and accomplishments under her belt. On an objective basis, Samantha would be the best choice for the business. She is the founder's choice to take over the company and has other family supporters as well, although not as many as for Michael or Christopher. This is a situation tailor-made for conflict. How does the founder finesse the selection of Samantha and minimize the conflict that is bound to occur? Can he win?

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4.5: The Three Threads

Learning Objectives

- Explain how a family business adds to customer value.
- Explain how being a family business can positively and negatively impact cash flow.
- Explain how technology and the e-environment are impacting family businesses.

Customer Value Implications

When people think about family businesses, they usually think friendly, "quality, wholesome, and continuity." Customers feel that they have a connection to the business because they also have a family. It is something customers feel they can trust. Customers are reminded that there is a family behind the business, not a faceless corporate entity. These are important sources of customer value.

The high priority that family businesses place on community involvement and the "reputational capital attributed to the family name" also translate into a perception of greater value by the customer. "Family business's identification with the family name motivates a greater emphasis on serving customers and consumers effectively, such as through providing quality products and customer services." The emphasis of the family business on its family identity may, in fact, contribute to its competitive advantage. "It is conceivable that family businesses who promote their familiness build a reputation in the marketplace related to customers' positive perception of the family." The long-term source of value for the customers of family businesses may rest with the belief that the businesses are customer-focused.

Cash-Flow Implications

A family business can help or hurt its cash flow depending on whether it compensates family members at market value. If a family member's compensation is based on "family values," such that the parents' compensation is excessive and the children's compensation is much less than their fair market value, this would give an inflated picture of the company's profitability. However, it will help the company's cash flow because they will have more money to spend on the business. If, however, the children's compensation is excessive, often based on housing and family needs of the family members as opposed to their worth to the business, this would give an unrealistically low portrayal of the profitability of the business. This will hurt the company's cash flow because the amount of money available to spend on the business will be reduced.

Digital Technology and E-Environment Implications

It is estimated that about 40 percent of US family-owned businesses survive into second-generation businesses, but only about 13 percent are passed down successfully to a third generation. One of the main reasons for this is that technological change moves so swiftly that it bypasses the older generation. "Unless the next generation is poised to update, and can get buy-in from longtime employees wedded to 'the way we always did it,' a business can quickly become obsolete." It is understood that family businesses will have different technology needs depending on their size, industry, and growth objectives. For many family businesses, however, the move to greater technology integration should be seen as a natural part of business evolution.

With respect to e-business and e-commerce, the commitment of a family business to digital technology will be a necessary precursor to the integration of e-business solutions. The commitment to e-commerce should also be seen as a natural part of business evolution and a necessary response to the ubiquitous nature of the Internet.

KEY TAKEAWAYS

- Family businesses offer increased customer value because they are associated with families instead of impersonal corporate entities.
- Not all family businesses may choose to integrate digital technology, e-business, and e-commerce into their planning and operations. The level of integration will occur on a continuum. Given the extent to which digital technology pervades business, however, it will be difficult to ignore it. The same is true for e-business and e-commerce.
- Overpaying or underpaying family members has an effect on cash flow.

EXERCISES

1. Select two family businesses in your area. Interview each business owner about how he or she currently uses technology in the business and what the plans are for future technology integration. Prepare a three- to five-page report on your findings.
2. Select three family businesses that you patronize. Think about what you see as the source(s) of customer value for each business. Interview the owner(s) of each business and ask them to describe the customer value that they offer. Compare your thoughts with what the owners said. Are they different? How? If they are different, what might account for the differences?

Disaster Watch: What Happens Now?

"From the day he opened his jewelry store in 1980, Michael Genovese, 57, expected his son Joseph, now 32, to come into and eventually take over the business. Joe started working there part-time while still in junior high, engraving and polishing. 'Dad offered me a job, and I jumped at it,' he recalls. He did repairs, made jewelry, and worked in sales. 'He worked hard and did the dirtiest jobs' as he learned the business from the bottom up, says Mike."

"After graduating from college, Joe returned to the store, although Mike had urged him to first 'get some different experience working in another job.'"

"Back in the store, Joe was soon out-selling the other salespeople. Mike also began gradually training him in management duties—i.e., buying, working with vendors, personnel duties (like hiring and firing), financial matters, and managing sales staff—as he groomed him to lead the business. 'I never had a written [transition] plan, says Mike, 'but in my mind, I planned this from the time he was a kid working here.'"

Then disaster struck. Mike had a serious heart attack. He was incapacitated by bypass surgery and months of recovery. Everything started going haywire. Joe's older brother, who never before had any interest, has now expressed an interest in the business. He has had several years of experience in another job and feels that it would be appropriate to come into the business at a high salary. In the meantime, the other salespeople are beginning to express dissatisfaction with their compensation and benefit plans, feeling that Joe has always received special treatment. There is a lot of dissension at the jewelry store. Joe is ready to tear his hair out. What should he do?

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5.1.1: Prelude to Business Model and Plan

Michael Kirban and Ira Liran had no experience in their industry when they launched their business. After a chance encounter with Brazilian women in a bar who mentioned how much they missed having coconut water, Kirban and Liran decided to launch Vita Coco.



Figure 5.1.1.1: The initial plan for Vita Coco did not work for its founders, Michael Kirban and Ira Liran, but the coconut water found later success, ultimately becoming the market leader, by using customer-focused design throughout the entrepreneurial process. (credit: modification of “Vita Coco at Vitality Show” by Zeyus Media/Flickr, CC BY 2.0)

The Vita Coco founders promised to deliver a product they had not even created yet, and further, they had no experience in manufacturing, but they launched the business nonetheless in the early 2000s. The initial plan for the business did not work after the US Food and Drug Administration blocked shipments to the United States because they failed to register the business properly. The partners developed the business into a social movement with a specific mission: to make an impact on both their consumers and the people they work with and the communities in which they live. Things ultimately worked out for Kirban and Liran. Vita Coco became the market leader in this niche segment, as they turned their attention to putting customers first. Although customer-focused design is integral to the entrepreneurial planning process, you should avoid launching a venture with the attitude that if you build it, customers will automatically come, because it does not always work that way. There are tools available to entrepreneurs to use to plan their journey to make goals a reality rather than just a wish or a dream.

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5.1.2: Avoiding the "Field of Dreams" Approach

Learning Objectives

By the end of this section, you will be able to:

- Understand the importance of planning
- Understand the concepts of product and service innovation, and define and understand key business models
- Describe and be able to construct a value proposition for a new business idea (product or service)

In the 1989 film *Field of Dreams*, Kevin Costner plays an Iowa farmer who hears a voice that tells him, "If you build it, he will come." Inspired by this vision, Costner's character turns his cornfield into a baseball field (of dreams), and eventually, the ghosts of deceased baseball players such as Shoeless Joe Jackson appear on the field as younger versions of themselves. The movie coined the popular axiom that "if you build it, they will come," just as the players appeared after the field of dreams was built. Although it's a fun saying for film buffs and sports fans, this approach is one you will want to avoid in entrepreneurship. In fact, the entrepreneurial graveyard is littered with ghosts of startups that never gained traction with customers, never to be heard from again. (Seventy-five percent of venture-backed startups fail, according to one recent study.) Thus, you don't want to blindly build a product and hope that customers will come. Juicero is one recent example of product that conducted little-to-no customer discovery before launch. A cold press juicer made by this San Francisco startup cost $699 at launch. The juicer squeezed packs of cut-up fruits and vegetables, but customers found they could just as easily squeeze the juice out of the packs by hand and avoid the hefty price of the juicer.

Customer acquisition and customer retention are not easy processes by any means. You have to work to gain a customer and work even harder to get her to return. One study by the data analysis firm CBInsights of why 101 startups failed found that 42 percent of them joined the "entrepreneurial afterlife" because there was "no market need," which suggests a customer (or lack thereof) problem. Current trends in entrepreneurial thinking reflect a customer-centric approach: From the start, entrepreneurs infuse their insights into the planning process through a process called "customer discovery." The entrepreneurial journey should begin with finding what the serial entrepreneur, author, and educator Steve Blank, one of the founders of modern entrepreneurship, calls the problem/solution fit. In a complementary approach, the Mosaic/Netscape founder Marc Andreesen discussed the need to achieve product-market fit. In other words, don't just build a baseball field and expect players to show up. This is an oversimplification, but if we extend the *Field of Dreams* analogy before blindly believing in the magic, you would want to talk to prospective players and fans to see if a field is needed, what type of field (corn-to-baseball?), why that field is needed, how that field would be used, and what features of the field would be most useful—*before* you go to bat (Figure 5.1.2.1).



Figure \(\PageIndex{1}\): This field in Dyersville, Iowa, was used in the filming of *Field of Dreams*. (credit: "FieldofDreamsMay06" by "JoeyBLS"/Wikimedia Commons, CC BY 2.5)

Business Model

Although there are countless varieties of business models, the *Scaling Lean* author Ash Maurya offers three common types: direct, multisided, and marketplace. Direct businesses are the most common and involve one-sided actors—that is, users—becoming your customers. A coffee shop is a classic example; other examples include retail stores, software as a service (SaaS), many mobile apps, hardware stores, and stores that sell physical goods. In multisided models, users and customers—multi-actors—are usually

different people. Ad-based models, big data, and enterprise are common examples where the products are free to users, and their value is monetized by a different customer base. Marketplace models are a more complex variant of multisided models made up of two different customer segments of buyers and sellers. eBay and Airbnb are well-known examples of marketplace models.

Although planning is important, adaptability within the planning process is equally important. That's what the business model approach is all about: outlining an approach but changing that approach throughout if or when you discover that your assumptions and educated guesses were wrong. For each new iteration, or version, the entrepreneur makes a minor change to the current business model to better capitalize on market opportunities.

Successful entrepreneurs are often multidimensional: part dreamer, part pragmatist. Adam Grant, Wharton School of Business professor and author of the best-selling book *Origins: How Non-Conformists Move the World*, explores how entrepreneurs are "capable of recognizing a good idea, speaking up without getting silenced, building a coalition of allies, choosing the right time to act, and managing fear and doubt." *Entrepreneur* magazine tells the story of FedEx founder Fred Smith, who, while attending Yale University in the mid-1960s, wrote an economics term paper on the need for a new approach to overnight delivery in the computer age. His professor, unimpressed with Smith's idea, graded his paper a C because the idea was not feasible. After graduation, using innovative thinking, dogged determination, and hard work, Smith would turn his "unfeasible" concept into the world's first overnight delivery company, and in so doing, change the transportation industry forever. Smith embodied the entrepreneurial concept of being part dreamer, part pragmatist.

LINK TO LEARNING

Read about the popular corporate narratives related to relatively new companies. Consider whether these stories involve inventor-founders. If so, what is the invention, and how does that tie in with the current and future narrative of the company?

Listen to the NPR podcast "How I Built This" with Guy Raz to hear stories about more than 100 startup companies and their founders.

Several more brief narratives on how to tell your company's story are also available.

Sports metaphors offer important entrepreneurial lessons beyond insights on customer discovery and planning. In baseball and softball, you must field a team to enter the game. In boxing, you enter the ring alone to go toe to toe with your competitor (where some of the best-laid plans get thrown out after you get hit). The tides of entrepreneurial thinking have shifted from the twentieth-century economist Joseph Schumpeter's early belief that it is "lone individuals who carry novelty" for wider market exploitation and benefit to society to the notion that it takes a team to innovate and back to the idea that individuals can enact entrepreneurial change. "Solopreneurs," for instance, are hard-working entrepreneurs who are comfortable working alone on all the requisite tasks of starting a venture. At the same time, many successful investors preach the merits of teams in entrepreneurship. Venture capitalist Aileen Lee says that people are the second-most important factor behind addressable market when evaluating startups. The cohesion, diversity, and makeup of the team all contribute to investable worthiness and potential entrepreneurial success (Figure 5.1.2.2). Many successful accelerator programs have typically required teams in order to be considered for entry into their programs. The accelerator Techstars has said that what they look for in a startup is "team, team, and team," and the accelerator Boomtown requires at least two present founders for the duration of its accelerator program.



Figure \(\PageIndex{2}\): While solopreneurs can certainly find success, many ventures find value in a team approach. (credit: "achievement agreement arms business" by rawpixel/Pixabay, CC0)

Multiple shifts in sources of innovations and rapid business model exploration may reflect high startup failure rates. Lack of planning is also a major reason for failure. Most small businesses fail within the first few years because of cash-flow issues. With more people today willing to field a startup team or enter the entrepreneurial ring, failure is more often than not a part of the entrepreneurial journey. Serial entrepreneurs launch numerous ventures, many of which fail, before moving on to other efforts. Entrepreneurs are the modern-day equivalent of *Hamilton: An American Musical*'s Hercules Mulligan to the world: They get back up again after getting knocked down.

Innovation

One of the fundamental theories of entrepreneurship is that it brings **innovation**, which can be a new addition to the market or a novel change to an existing product or service. The famed management guru Peter Drucker put it simply: "Entrepreneurs innovate." Of course, we should note that not all entrepreneurial ventures involve innovation. Even for those that do, however, the term *innovation* can be ambiguous. Further complicating the issue, a plethora of different extensions (or "types") has arisen surrounding the concept of innovations—such as radical, incremental, and disruptive—that have been used to describe and emphasize different innovations in different situations. *Innovation* can also refer to products or processes because there are differences between product innovation and process innovation. In other words, not all innovations are created equal.

As it pertains to entrepreneurship, the creative destruction of old markets with inferior technology and the creation of new markets, as defined by Schumpeter back in the 1930s, occurs through **disruptive innovation**.

The adjective *disruptive* also became a bit of a catchphrase in the 1990s during the first Internet era, largely due to the popularity of Clayton Christensen's Figure 5.1.2.3 theory of incumbent failure in the face of what he first termed "disruptive technology" and later renamed "disruptive innovation."



Figure \(\PageIndex{3}\): Clayton M. Christensen has contributed many ideas about innovation to the field of entrepreneurship. (credit: "Follow Business of Software - Clayton Christensen" by Betsy Weber/Flickr, CC BY 2.0)

As Christensen defines them, disruptive innovations are often more advantageous to new entrants than to incumbent firms. This is because once market uncertainty occurs as a consequence of the disruption around the disruptive product, established firms consider it irrational to abandon their existing paying customers for the smaller customer base of the new, initially small market for what they believe is inferior technology. New entrants challenge incumbent firms by either creating markets where no markets exist, turning nonconsumers into consumers, or by targeting overlooked segments of the market and later moving up market as the product improves. Leading firms' decision criteria for developing new products and commercializing innovations are all biased toward supporting incremental innovations that build on their existing technology base and help maintain or grow revenue and profitability in established markets. This opens the door for startups to develop and introduce disruptive innovations and profit from them. Table 5.1.2.1 lists some disruptive innovations.

Table 5.1.2.1: Disruptive Innovations

Area	Timeframe	Established Market	Disruptive Innovation
Medical imaging	1960s	X-rays	Ultrasound offered a new type of imaging; X-ray companies lost out to the market and could not match the innovation, although eventually they purchased many ultrasound companies
Screens	1990s–2000s	CRT (cathode ray tube)	LED/LCDs innovated to overcome their display limitations, replacing heavy and bulky CRTs. More recent innovations like foldable screens and retinal scans have added more functionality and "intelligence" to link to Internet of Things devices
Entertainment	2000s	Video rental	Streaming services ousted much of the video rental market and companies like Blockbuster found themselves irrelevant in the market. More recently, multiple streaming services along with proprietary content (and "Over the Top" menu options) have disrupted cable TV companies

ARE YOU READY?

Netflix's Disruption

Netflix, founded in 1997 in California, disrupted video rental stores such as Blockbuster with its subscription service, which mailed DVDs directly to customers' homes. The rental stores, whose business model was predicated on revenue from late fees, could not compete with the ease and convenience of home delivery coupled with lower costs than the per-tape rental fees. But as streaming video content directly to televisions or over-the-top devices disrupted Netflix's original DVD-by-mail model, Netflix moved to offer a streaming service in addition to the DVD by mail model. In both instances, Netflix's prevailing model was predicated on serving as a distribution outlet for content created by other businesses. Netflix in recent years has begun not only distributing others' content but creating its own TV and movie content as well. (*Orange Is the New Black* and *The Unbreakable Kimmy Schmidt* are both original Netflix series; *The Irishman* is an original Netflix film.) Now content creators

such as Disney and Marvel are creating their own streaming distribution platforms to exclusively deliver their own content, eventually pulling those shows from Netflix.

- What should Netflix do to counter this threat to the third iteration of its business model?
- What threats does the end of net neutrality pose to Netflix's business model?
- If you were in charge at Netflix, would you pay more to Internet providers to gain faster delivery of your content on the Internet? Why or why not?

In separate but related work, Christensen also developed the jobs-to-be-done theory, which aids companies in determining how to create products and services that customers want to buy by getting at the causal driver behind a purchase. Christensen uses the term *job* as shorthand for what an individual wants to accomplish in a given circumstance, often with social, emotional, and functional dimensions. For example, two jobs that a newspaper does for its readers are to inform and entertain, whereas the jobs to be done of a newspaper are completely different for another customer segment—advertisers. A newspaper's jobs to be done for advertisers, for instance, may include promotions, attracting customers, or selling products. The jobs-to-be-done approach has also been incorporated into the development of business models in the form of customer empathy maps and value proposition canvases covered.

LINK TO LEARNING

Watch this video illustrating Christensen's jobs-to-be-done theory through a milkshake to learn more.

After you watch this video, think about how Christensen's definition of jobs relates to innovation. What are some jobs to be done for your entrepreneurial idea?

Disruptive innovations are contrasted with sustaining technologies, which improve the performance of established products through characteristics that mainstream customers adopt. Disruptive technologies allow for new entrants in the market, often with simpler, more affordable, more convenient products. Entrepreneurs and marketers have difficulty predicting or projecting how the emergence of an innovation will occur, and anticipating how customers will react to the new offerings. Predicting who the early adopters will be can also be difficult during the early stage of an innovation's emergence. The mainstream customer base initially fails to find value in the new product. New customer segments, however, see value in the new features and lower prices. Eventually, developments improve the new product's features to a level that will satisfy mainstream customers and thus attract more of the mainstream market.

WORK IT OUT

Ride Sharing



Figure \(\PageIndex{4}\): Uber and Lyft are popular ride-sharing services. (credit: "navigation car drive road gps" by "DariuszSankowski"/Pixabay, CC0)

Ride-sharing services disrupted the traditional taxicab business by providing a mobile platform that connected ride-seeking consumers with drivers willing to provide transportation. In rapidly becoming the market leader of ride-sharing services, Uber

became the poster child for disruptive innovation. A customer using a ride-sharing service like Uber or Lyft no longer had to wave down a cab on the street, nor did she need cash in hand anymore through its mobile payment system within the app. An Uber ride usually costs less than a regular cab ride. Ride-sharing services also offer more versatility in choices and greater overall convenience. Now Uber continues to evolve its model, adding options like Uber Eats and Uber Copter.

- What are the jobs to be done that Uber addresses?
- What areas of a taxi cab's business model does Uber disrupt?

Christensen prefers the term *disruptive innovation* to *disruptive technology* because even in his original theoretical framework, technology was not the driving force disrupting existing markets, products, and models—rather, business models were. The root of the tension in disruptive innovation is the conflict between the previously established business model for the incumbent technology and the new business model that may be necessary for exploiting the disruptive technology or process.

The efforts of incumbents to capitalize on a disruptive technology will fail in most instances because commercializing the new technology will require a different business model from the one that the incumbents currently use. When disruption occurs, incumbents struggle to commercialize, whereas new entrants take control through their mastery of the requisite new business models. Thus, a disruptive business model can fundamentally reshape profits within an industry because managers are faced with a technological disruption/innovation that alters their businesses, specifically their business models. This phenomenon is known as business model innovation.

Business model innovation, as defined by Professor Constantinos Markides of the London Business School, occurs when an existing business fundamentally changes their business model. In order to be an innovation, the "new business model must enlarge the existing economic pie, either by attracting new customers or by encouraging existing consumers to consume more." Disruptive innovations tend to require a business model that is not only different from but even in conflict with the traditional way of competing. In contrast, radical innovations (see the preceding text) are new-to-the-world products that are disruptive to both consumers and producers.

In the context of disruptive innovation, business model innovation is distinct from open business model innovation, which leverages external ideas together with internal ones. We also can define a business model innovation as a reformulation of an existing product or service, including a shift in how it is provided to the end user. A business model innovation "leads to a new way of playing the game" and can consist of new performance attributes on price or distribution outlets. Stitch Fix uses data to offer personal styling at scale and ships customized clothing boxes from its own in-house label and from 1,000 brands in its collection directly to customers who want to avoid the hassles of in-store shopping. Despite volatility from investors, which dropped its initial $5.1 billion valuation at offering by two-thirds over three months, the company continues to reinvent the $334 billion US apparel industry.

Value Proposition

Entrepreneurs play a key role in determining the value of their products. Of course, there are financial measures of value such as economic performance, job creation, wealth, and growth measures. But more often than not, value creation at the outset of a new startup venture lies outside these financial realms and addresses instead individual value to customers. The **value proposition** in a business model, for example, is a summary describing the benefits (value) customers can expect from a particular product or service. Your value proposition describes the benefits customers can expect from your products and services. The value proposition is an integral part of the business model canvas.

ENTREPRENEUR IN ACTION

From Odeo to Twitter

Evan Williams and Biz Stone, both ex-Google employees, began a podcasting platform startup called Odeo around 2005. According to an early engineer in the company, Blaine Cooke, they built and tested Odeo but never used it. Shortly after co-founder Noah Glass created Odeo's podcasting platform, Apple announced plans to include a podcasting platform in all of its iPods. Faced with the reality that many of Odeo's fourteen employees weren't using the product they had built and the emergence of a giant competitor with a tremendous unfair advantage in Apple, Williams decided Odeo's future wouldn't be in podcasting.

The company held hackathons among employees and began searching for a pivot. One of those fourteen Odeo employees, Jack Dorsey, focused his efforts on the problem of status, the position of affairs at a particular time. In February 2006, Dorsey, Glass, and Florian Weber, a German contract developer, presented what they called Twttr, a system whereby a user could send a text message to a phone number, and it would be broadcast to the user's friends. A month later, Odeo had a working Twttr prototype, while obsessed employees were racking up hundreds of dollars in text messaging bills using the product. By the fall, Twitter (as it was now called) had thousands of users. Many began to see the product's utility after a San Francisco earthquake when it was heavily used to broadcast messages throughout the Bay Area.

- What type of innovation would you consider the original Odeo platform? Why?
- Why did Apple have an "unfair advantage" with its podcasting platform over competitors like Odeo?
- What value proposition did the early version of Twttr offer its users?

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5.1.3: Designing the Business Model

Learning Objectives

By the end of this section, you will be able to:

- Define a business model and its purpose
- Describe a business model canvas
- Describe a lean model canvas
- Describe a social business model canvas

According to Alexander Osterwalder and Yves Pigneur, the authors of *Business Model Generation*, a business model "describes the rationale of how an organization creates, delivers and captures value." Nevertheless, there is no single definition of this term, and usage varies widely.

In standard business usage, a **business model** is a plan for how venture will be funded; how the venture creates value for its stakeholders, including customers; how the venture's offerings are made and distributed to the end users; and the how income will be generated through this process. The business model refers more to the design of the business, whereas a business plan is a planning document used for operations.

Each business model is unique to the company it describes. A typical business model addresses the desirability, feasibility, and viability of a company, product, or service. At a bare minimum, a business model needs to address revenue streams (e.g., a revenue model), a value proposition, and customer segments. In non-jargon English, this means you want to address what your idea is, who will use it, why they will use it, and how you will make money off it.

A canvas is a display that would-be entrepreneurs commonly use to map out and plan different components of their business models. There are several different types of canvases, with the business model canvas and the lean canvas being the most commonly used. There are hard-copy canvases modeled after an art canvas as well as digital versions. The original physical canvases are meant to serve as visual tools, used with sticky notes and sketches.

As developed by Osterwalder and Pigneur, the **business model canvas** has nine components, as shown in Figure 5.1.3.1.

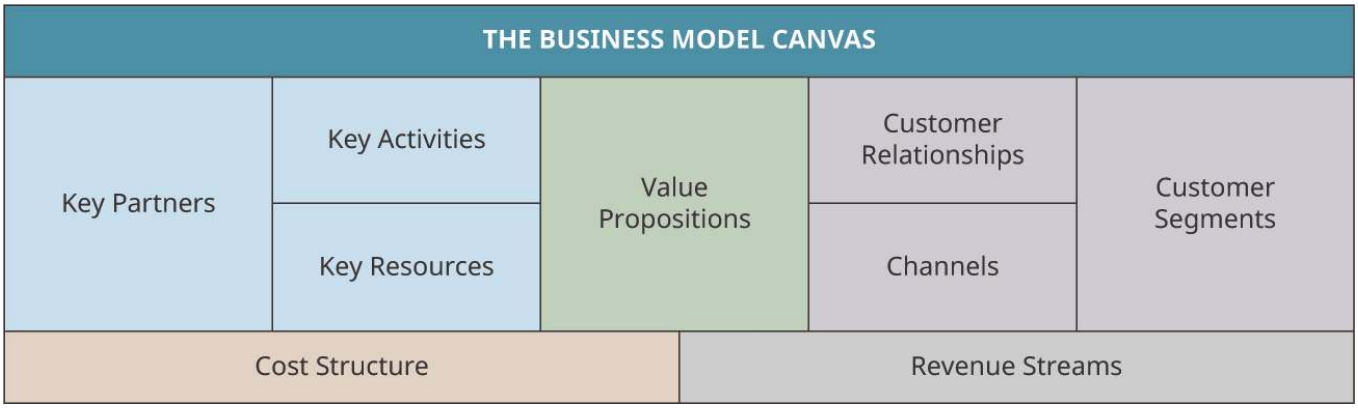


Figure 5.1.3.1: The business model canvas can be used to map or lay out the initial concept of your business. (CC BY 4.0; Rice University & OpenStax)

LINK TO LEARNING

Visit this site to see examples of completed Business Model Canvases for a variety of industries for a deeper understanding of how the different categories are filled in.

Osterwalder and Pigneur wrote *Value Proposition Design* as a sequel to *Business Model Generation*. Their value proposition canvas is a plug-in that complements the business model canvas, going in-depth on activities such as encouraging entrepreneurs to address and tackle customer pains, gains, and jobs-to-be-done trigger questions, and designing pain relievers and gains. The complementary and accompanying activities and resources can be useful for a deeper dive into and understanding of customer

value creation in the form of value proposition, although there are other approaches to conceptualizing your value proposition. For Christensen, the originator of the disruptive innovation and jobs-to-be-done theories, a value proposition is a product that helps customers do a job they've been trying to do more effectively, conveniently, and affordably.

Finding the intersection of your customers' problems and your solutions is how you create a unique value proposition, according to the entrepreneur Ash Maurya, the author of *Scaling Lean* and *Running Lean*. In *Running Lean*, Maurya offers the following formula for creating an initial value proposition in the canvas, as shown in Figure 5.1.3.2.



Figure 5.1.3.2: Maurya's formula to determine value proposition considers customer needs and potential objections within a specific period of time. (CC BY 4.0; Rice University & OpenStax)

Maurya deviated from the standard business model canvas to create the lean canvas. It overlaps the business model canvas in five of the nine components: customer segments, value proposition, revenue streams, channels, and cost structure (Figure 5.1.3.3). Rather than addressing key partners, key activities, and key resources, the lean canvas helps you tackle problems, solutions, and key metrics instead.

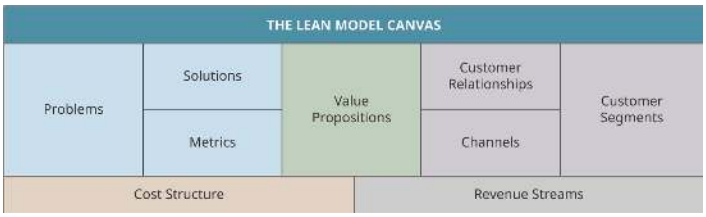


Figure 5.1.3.3: The lean model canvas is a modification of the Business Model Canvas. (CC BY 4.0; Rice University & OpenStax)

LINK TO LEARNING

Visit this site to see examples of completed Lean Model Canvases from some major companies for a deeper understanding of how the canvas can be applied.

While the business model canvas and the lean canvas are similar in format, there are differences in how they are used. It is generally accepted that the lean canvas model is a better fit for startups, whereas the business model canvas works well for already established businesses. The lean canvas is simpler; the business model canvas provides a more complete picture of a mature business.

LINK TO LEARNING

Watch this Railsware video that demonstrates how the lean canvas model might be applied to startups to learn more. In the case example in the video, the lean canvas model is applied to the successful P2P ride-sharing app Uber, as if it were a startup.

Both the business model canvas and the lean canvas are designed for constant iterations, allowing for multiple versions and changes throughout the entrepreneurial process. Part of that process involves customer discovery; thus, the canvases invoke customer-focused design. The target customer is integrated into the canvas from the start through the use of a customer empathy map and a number of design-thinking ideation activities. The **customer empathy map** is a portrayal of a target customer—the most promising candidate from a business's customer segments—that explores the understanding of that person's condition from their perspective to understand his or her problems and needs (Figure 5.1.3.4). Osterwalder and Pigneur used a customer empathy map as part of the design ideation phase of developing a business model canvas. There are differing versions of customer empathy maps, but most seek to answer common questions pertaining to the customer, such as:

- With whom are we empathizing?
- What do they need to do?
- What do they see?
- What do they say?

- What do they do?
- What do they hear?
- What do they think?

Phillips, Proctor & Gamble, Microsoft, and Yeti are examples of well-known companies that make use of customer empathy mapping because, according to the journal *Entrepreneur*, every transaction can be turned into a meaningful and valuable customer interaction. Once a company analyzes the results of customer mapping exercises, it may very well lead to new products that serve customer needs and/or wants.

For example, Philips used empathy mapping to detect a high level of fear in young patients immediately before an MRI medical procedure, so it invented a miniature version of the CAT scan equipment used in the procedure called the "kitten scanner" along with toy animal characters that were used to dispel the fear of MRIs among children. Proctor & Gamble created a new advertisement that was released for the 2012 Olympics visualizing the trials and tribulations of mothers raising young athletes, demonstrating Proctor and Gamble's awareness that some of its customers wanted or needed empathy for the sacrifices they had made to help their children succeed. Likewise, Microsoft has attempted to demonstrate empathy with customers' privacy concerns by developing an interactive website that explains not only how data is stolen but also how we can better protect our own data.

On their company website, the now-famous Yeti cooler company publicly extols the value of empathy mapping, explaining that it leads to better products. Yeti doesn't just create one on its own, it actually asks its clients to work with the company to create an empathy map. Thus, empathy mapping for Yeti is part of its product development process.

Customer empathy maps also strive to address customer pains (in this case, fears, frustrations, and anxieties) and gains (wants, needs, hopes, and dreams).



Figure 5.1.3.4: An empathy map portrays the target customer in order to understand the market needs. (CC BY 4.0; Rice University & OpenStax)

LINK TO LEARNING

Strategyzer offers six videos outlining the business model canvas that total about 12 minutes; specifically, they cover the prototyping journey from ideation to visualization of conceptualization.

Business Model Canvas

As Osterwalder and Pigneur describe it, according to *Media Innovation and Entrepreneurship*, their business model canvas blocks include revenue streams, customer segments, value propositions, cost structures, channels, key activities, key partners, key resources, and customer relationships.

Early on, your greatest focus should be on the right side of the canvas because:

- These are, in many ways, the most critical aspects of starting a new venture (customer segments, value propositions, channels, and revenue streams).
- The most fluid (revenue streams, channels, and value propositions will likely differ for the differing customer segments and, as you iterate and adapt throughout the customer discovery process, could likely change).

- These follow a logical temporal order (there's no need to focus on the costs of building a company if you won't have customers).

In a follow-up to business model generation, the Strategyzer team created a second canvas, the value proposition canvas: https://www.strategyzer.com/canvas/v...osition-canvas. The value proposition canvas is a new tool that pulls out the customer segment and value proposition blocks of the business model canvas, and encourages more in-depth exploration of those blocks to achieve a good fit between the two. The value proposition canvas tool looks at customer pains, gains and jobs to be done on the customer side and painkillers, gain creators, and products and services on the value proposition side.

LINK TO LEARNING

Read this blog that provides a walk-through of how to fill in a value proposition canvas to learn more.

When you peel away the language used to describe business models, the early startup planning stages come down to a series of questions. When it comes to formulating a business model for a startup concept, another popular framework used in entrepreneurial circles is that of desirability-feasibility-viability (Figure 5.1.3.5). This framework forces the entrepreneur to address broad questions about the startup concept:

- Desirability: How desirable is the product? Who will use it and why?
- Feasibility: How feasible is this idea? What are the costs of making it? How practical is the concept?
- Viability: Will this idea remain viable? How will it make money? How will it be sustained over time?

These questions then begin to connect to form a narrative about where the startup concept came from, whom it serves, why it's needed, how it will make money, and how it will be sustained in the future.

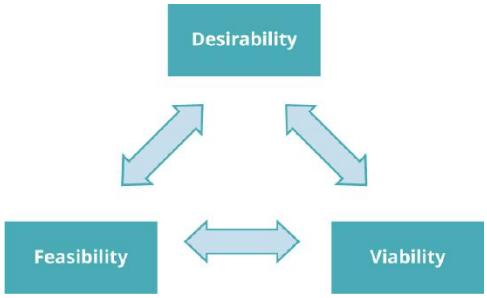


Figure 5.1.3.5: The framework of desirability, feasibility, and viability form a story about a company's startup. (CC BY 4.0; Rice University & OpenStax)

The value propositions, customer relationships, customer segments, and channels address the assumptions that will create customer value (desirability). The cost structure and revenue stream blocks are aimed at viability, or overcoming flawed business models. The key partners, key activities, and key resources are about execution and address feasibility. The risk of poor execution can undermine your assumptions that you chose the right infrastructure to execute your business model (feasibility). The risk of solving an irrelevant customer job (sometimes derisively labeled "a solution in search of a problem") undercuts desirability in your business. The risk of a flawed business model would hamper the financial assumption that your business will earn more money than you spend (viability). Adaptability is about the assumption that you chose the right business model within the context of external factors such as technology change, competition, and regulation.

The business model canvas is not an exhaustive planning tool by any means. The risk of such external threats is not specifically addressed on the canvas blocks. The external threats not specifically covered by the canvas blocks can be designed for adaptability, that is, the business model canvas is a necessary but insufficient component of determining the viability of the business idea/concept. There are many elements not included in the canvas that entrepreneurs must address. Industry analysis, including a competitive analysis, for example, falls "off canvas" but is important nonetheless.

The Lean Model Canvas

The **lean model canvas** is Ash Maurya's adaptation of the original business model canvas. As we noted earlier, gone are the customer relationships, key activities, key partners, and key resources blocks. Instead, a problem block is added, because as Maurya explains, "Most startups fail, not because they fail to build what they set out to build, but because they waste time, money

and effort building the wrong product. I attribute a significant contributor to this failure to a lack of proper 'problem understanding' from the start." Maurya next added a solution block to the lean model canvas, which corresponds well with features on a minimum viable product (MVP). The lean model canvas also adds an "Unfair Advantage" block, similar to the block for competitive advantages or barriers to entry found in a business plan.

Social Business Model Canvas

As you've noticed by now, the core canvas components are common throughout the various versions. Many of the blocks of the **social business model canvas** are similar to those used in the business model canvas and the lean model canvas. A few differences, as developed by Tandemic, focus on areas unique to social entrepreneurship ventures. For example, the new areas added include measures of what kind of social impact you are creating or developing, measures of surplus to address what happens with profits and where you intend to reinvest them, and measures of beneficiary segments, and social and customer value propositions. These could be measures such as the number of trees planted, number of refugees housed and fed, jobs created, or investments made—depending on the venture. Social impact looks at an organization's social mission beyond the bottom line. Measurement can differ among social entrepreneurs, but in terms of the canvas, impact measures are an effort to establish quantifiable metrics.

Social impact can be hard to measure, but nonetheless, many social entrepreneurs aim for long-lasting impact. A 2014 report by the think tank, consultancy, and member network SustainAbility lists cooperative ownership, inclusive sourcing, and the "buy one, give one" model as three forms of social impact. In addition to the Tandemic social business model canvas, there are other versions of similar canvases used for social entrepreneurship. For instance, Osterwalder adapted the business model canvas for mission-driven organizations into a mission model canvas. There's also a social lean canvas that adds purpose (explaining your reason for creating the venture in terms of social or environmental problems) and impact sections (describing the intended social or environmental impact).

LINK TO LEARNING

This completed social business model canvas for the popular peer-to-peer lending platform Kiva illustrates how the business model canvas can and perhaps should be adapted for social entrepreneurship ventures.

WHAT CAN YOU DO?

TOMS Shoes

Toms Shoes is perhaps one of the best-known companies for adopting a social entrepreneurship purpose into its business model. Part of its early success hinged on the fact that for every pair of shoes a customer bought, the company donated a pair of shoes to someone in need. The company won a prize in 2006 for its innovative solution to poverty. This "1-for-1 business model," sometimes commonly called the "Toms model" after the shoe company that popularized it, gained traction among other companies that followed suit in similar fashion, seeing both the social and the financial successes in the Toms model. Warby Parker is another example of a company that does essentially the same: A customer purchases a pair of eyeglasses, and the company donates a pair (although Warby Parker pays a third party to procure the glasses, as eyeglasses require an individual prescription, whereas shoes do not).

- Can you think of an innovative social entrepreneurship business model?

WHAT CAN YOU DO?

The Birthday Party Project



Figure 5.1.3.6: The Birthday Party Project helps provide celebrations to honor the birthdays of homeless children. (credit: modification of "children's birthday table" by "Efraimstochter"/Pixabay, CC0)

Paige Chenault wanted homeless children in Dallas to feel special on their birthdays. Many have never experienced a birthday party. So this professional event planner sprang into action in January 2012. She launched the Birthday Party Project (https://www.thebirthdaypartyproject.org/), a nonprofit group whose mission is to celebrate the lives of homeless children (ages one to twenty-two). The group organizes monthly birthday parties with partner shelters. Since its inception, the concept has spread beyond Texas to cities across the United States, including Atlanta, Chicago, Los Angeles, New York, and San Francisco. In six years, the Birthday Party Project has celebrated 4,800 birthdays with 30,000 kids in attendance, eaten 40,000 cupcakes, cracked 30,000 glow sticks, and performed 1,100 renditions of “Happy Birthday.”

- Identify a need in your community that could become a social entrepreneurship business, as Paige discovered with an initial passion project.

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5.1.4: Conducting a Feasibility Analysis

Learning Objectives

By the end of this section, you will be able to:

- Describe the purpose of a feasibility analysis
- Describe and develop the parts of a feasibility analysis
- Understand how to apply feasibility outcomes to a new venture

As the name suggests, a **feasibility analysis** is designed to assess whether your entrepreneurial endeavor is, in fact, feasible or possible. By evaluating your management team, assessing the market for your concept, estimating financial viability, and identifying potential pitfalls, you can make an informed choice about the achievability of your entrepreneurial endeavor. A feasibility analysis is largely numbers-driven and can be far more in-depth than a business plan. It ultimately tests the viability of an idea, a project, or a new business. A feasibility study may become the basis for the business plan, which outlines the action steps necessary to take a proposal from ideation to realization. A feasibility study allows a business to address where and how it will operate, its competition, possible hurdles, and the funding needed to begin. The business plan then provides a framework that sets out a map for following through and executing the entrepreneurial vision.

Organizational Feasibility Analysis

Organizational feasibility aims to assess the prowess of management and sufficiency of resources to bring a product or idea to market Figure 5.1.4.1. The company should evaluate the ability of its management team on areas of interest and execution. Typical measures of management prowess include assessing the founders' passion for the business idea along with industry expertise, educational background, and professional experience. Founders should be honest in their self-assessment of ranking these areas.

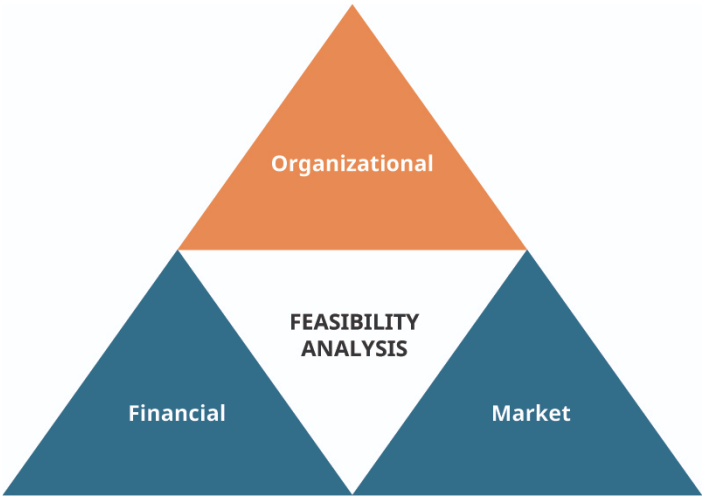


Figure 5.1.4.1: An analysis of organizational feasibility focuses on resource needs and management capabilities. (CC BY 4.0; Rice University & OpenStax)

Resource sufficiency pertains to nonfinancial resources that the venture will need to move forward successfully and aims to assess whether an entrepreneur has a sufficient amount of such resources. The organization should critically rank its abilities in six to twelve types of such critical nonfinancial resources, such as availability of office space, quality of the labor pool, possibility of obtaining intellectual property protections (if applicable), willingness of high-quality employees to join the company, and likelihood of forming favorable strategic partnerships. If the analysis reveals that critical resources are lacking, the venture may not be possible as currently planned.

Financial Feasibility Analysis

A **financial analysis** seeks to project revenue and expenses (forecasts come later in the full business plan); project a financial narrative; and estimate project costs, valuations, and cash flow projections Figure 5.1.4.2.



Figure 5.1.4.2: An analysis of financial feasibility focuses on expenses, cash flow, and projected revenue. (CC BY 4.0; Rice University & OpenStax)

The financial analysis may typically include these items:

- A twelve-month profit and loss projection
- A three- or four-year profit-and-loss projection
- A cash-flow projection
- A projected balance sheet
- A breakeven calculation

The financial analysis should estimate the sales or revenue that you expect the business to generate. A number of different formulas and methods are available for calculating sales estimates. You can use industry or association data to estimate the sales of your potential new business. You can search for similar businesses in similar locations to gauge how your business might perform compared with similar performances by competitors. One commonly used equation for a sales model multiplies the number of target customers by the average revenue per customer to establish a sales projection:

$$T \times A = ST \times A = S$$

Target(ed) Customers/Users × Average Revenue per Customer = Sales Projection

Another critical part of planning for new business owners is to understand the **breakeven point**, which is the level of operations that results in exactly enough revenue to cover costs. It yields neither a profit nor a loss. To calculate the breakeven point, you must first understand the two types of costs: fixed and variable. **Fixed costs** are expenses that do not vary based on the amount of sales. Rent is one example, but most of a business's other costs operate in this manner as well. While some costs vary from month to month, costs are described as variable only if they will increase if the company sells even one more item. Costs such as insurance, wages, and office supplies are typically considered fixed costs. **Variable costs** fluctuate with the level of sales revenue and include items such as raw materials, purchases to be sold, and direct labor. With this information, you can calculate your breakeven point—the sales level at which your business has neither a profit nor a loss. Projections should be more than just numbers: include an explanation of the underlying assumptions used to estimate the venture's income and expenses.

Projected cash flow outlines preliminary expenses, operating expenses, and reserves—in essence, how much you need before starting your company. You want to determine when you expect to receive cash and when you have to write a check for expenses. Your cash flow is designed to show if your working capital is adequate. A **balance sheet** shows assets and liabilities, necessary for reporting and financial management. When liabilities are subtracted from assets, the remainder is owners' equity.

Market Feasibility Analysis

A **market analysis** enables you to define competitors and quantify target customers and/or users in the market within your chosen industry by analyzing the overall interest in the product or service within the industry by its target market Figure 5.1.4.3. You can define a market in terms of size, structure, growth prospects, trends, and sales potential. This information allows you to better position your company in competing for market share. After you've determined the overall size of the market, you can define your

target market, which leads to a **total available market (TAM)**, that is, the number of potential users within your business's sphere of influence. This market can be segmented by geography, customer attributes, or product-oriented segments. From the TAM, you can further distill the portion of that target market that will be attracted to your business. This market segment is known as a **serviceable available market (SAM)**.

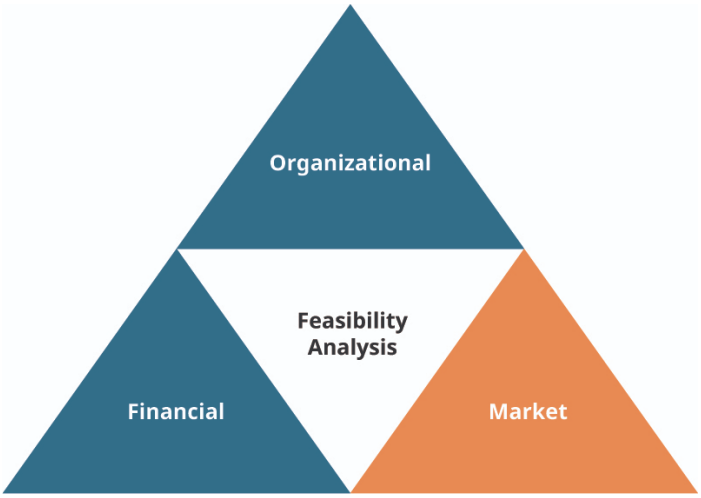


Figure 5.1.4.3: An analysis of market feasibility examines the overall market and focuses on the anticipated share of the target market. (CC BY 4.0; Rice University & OpenStax)

Projecting market share can be a subjective estimate, based not only on an analysis of the market but also on pricing, promotional, and distribution strategies. As is the case for revenue, you will have a number of different forecasts and tools available at your disposal. Other items you may include in a market analysis are a complete competitive review, historical market performance, changes to supply and demand, and projected growth in demand over time.

ARE YOU READY?

Market Feasibility Analysis

You've been hired by a leading hotel chain to determine the market and financial potential for the development of a mixed-use property that will include a full-service hotel in downtown Orlando, located at 425 East Central Boulevard, in Orlando, Florida. The specific address is important so you can pinpoint existing competitors and overall suitability of the site. Using the information given, conduct a market analysis that can be part of a larger feasibility study.

WORK IT OUT

Location Feasibility



Figure 5.1.4.4: If you wanted to open a business in downtown Atlanta, you would need to research the feasibility of operating a location there. (credit: “Atlanta,Georgia,downtown skyline,dusk” by “tableatny”/Flickr, CC BY 2.0)

You’re considering opening a boutique clothing store in downtown Atlanta. You’ve read news reports about how downtown Atlanta and the city itself are growing and undergoing changes from previous decades. With new development taking place there, you’re not sure whether such a venture is viable. Outline what steps you would need to take to conduct a feasibility study to determine whether downtown Atlanta is the right location for your planned clothing store.

Applying Feasibility Outcomes

After conducting a feasibility analysis, you must determine whether to proceed with the venture. One technique that is commonly used in project management is known as a **go-or-no-go decision**. This tool allows a team to decide if criteria have been met to move forward on a project. Criteria on which to base a decision are established and tracked over time. You can develop criteria for each section of the feasibility analysis to determine whether to proceed and evaluate those criteria as either “go” or “no go,” using that assessment to make a final determination of the overall concept feasibility. Determine whether you are comfortable proceeding with the present management team, whether you can “go” forward with existing nonfinancial resources, whether the projected financial outlook is worth proceeding, and make a determination on the market and industry. If satisfied that enough “go” criteria are met, you would likely then proceed to developing your strategy in the form of a business plan.

WHAT CAN YOU DO?

Love Beyond Walls

When Terence Lester saw a homeless man living behind an abandoned, dilapidated building, he asked the man if he could take him to a shelter. The man scoffed, replying that Lester should sleep in a shelter. So he did—and he saw the problem through the homeless man’s perspective. The shelter was crowded and smelly. You couldn’t get much sleep, because others would try to steal your meager belongings. The dilapidated building provided isolation away from others, but quiet and security in its own way that the shelter could not. This experience led Lester to voluntarily live as a homeless person for a few weeks. His journey led him to create Love Beyond Walls (www.lovebeyondwalls.org), an organization that aids the homeless, among other causes. Lester didn’t conduct a formal feasibility study, but he did so informally by walking in his intended customers’ shoes—literally. A feasibility study of homelessness in a particular area could yield surprising findings that might lead to social entrepreneurial pursuits.

- What is a social cause you think could benefit from a formal feasibility study around a potential entrepreneurial solution?

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5.1.5: The Business Plan

Learning Objectives

By the end of this section, you will be able to:

- Describe the different purposes of a business plan
- Describe and develop the components of a brief business plan
- Describe and develop the components of a full business plan

Unlike the brief or lean formats introduced so far, the **business plan** is a formal document used for the long-range planning of a company's operation. It typically includes background information, financial information, and a summary of the business. Investors nearly always request a formal business plan because it is an integral part of their evaluation of whether to invest in a company. Although nothing in business is permanent, a business plan typically has components that are more "set in stone" than a business model canvas, which is more commonly used as a first step in the planning process and throughout the early stages of a nascent business. A business plan is likely to describe the business and industry, market strategies, sales potential, and competitive analysis, as well as the company's long-term goals and objectives. An in-depth formal business plan would follow at later stages after various iterations to business model canvases. The business plan usually projects financial data over a three-year period and is typically required by banks or other investors to secure funding. The business plan is a roadmap for the company to follow over multiple years.

Some entrepreneurs prefer to use the canvas process instead of the business plan, whereas others use a shorter version of the business plan, submitting it to investors after several iterations. There are also entrepreneurs who use the business plan earlier in the entrepreneurial process, either preceding or concurrently with a canvas. For instance, Chris Guillebeau has a one-page business plan template in his book *The $100 Startup*. His version is basically an extension of a napkin sketch, without the detail of a full business plan. As you progress, you can also consider a brief business plan (about two pages)—if you want to support a rapid business launch—and/or a standard business plan.

As with many aspects of entrepreneurship, there are no clear hard and fast rules to achieving entrepreneurial success. You may encounter different people who want different things (canvas, summary, full business plan), and you also have flexibility in following whatever tool works best for you. Like the canvas, the various versions of the business plan are tools that will aid you in your entrepreneurial endeavor.

Business Plan Overview

Most business plans have several distinct sections (Figure 5.1.5.1). The business plan can range from a few pages to twenty-five pages or more, depending on the purpose and the intended audience. For our discussion, we'll describe a brief business plan and a standard business plan. If you are able to successfully design a business model canvas, then you will have the structure for developing a clear business plan that you can submit for financial consideration.

BUSINESS PLAN	
√	Executive Summary
√	Business Description
√	Market Strategies
√	Marketing Plan
√	Competitive Analysis
√	Operations and Management Plan
√	Financial Analysis
√	Design and Development Plan

Figure 5.1.5.1: Most business plans include the same important sections. (CC BY 4.0; Rice University & OpenStax)

Both types of business plans aim at providing a picture and roadmap to follow from conception to creation. If you opt for the brief business plan, you will focus primarily on articulating a big-picture overview of your business concept.

The full business plan is aimed at executing the vision concept, dealing with the proverbial devil in the details. Developing a full business plan will assist those of you who need a more detailed and structured roadmap, or those of you with little to no background in business. The business planning process includes the business model, a feasibility analysis, and a full business plan, which we will discuss later in this section. Next, we explore how a business plan can meet several different needs.

Purposes of a Business Plan

A business plan can serve many different purposes—some internal, others external. As we discussed previously, you can use a business plan as an internal early planning device, an extension of a napkin sketch, and as a follow-up to one of the canvas tools. A business plan can be an organizational roadmap, that is, an internal planning tool and working plan that you can apply to your business in order to reach your desired goals over the course of several years. The business plan should be written by the owners of the venture, since it forces a firsthand examination of the business operations and allows them to focus on areas that need improvement.

Refer to the business venture throughout the document. Generally speaking, a business plan should not be written in the first person.

A major external purpose for the business plan is as an investment tool that outlines financial projections, becoming a document designed to attract investors. In many instances, a business plan can complement a formal investor's pitch. In this context, the business plan is a presentation plan, intended for an outside audience that may or may not be familiar with your industry, your business, and your competitors.

You can also use your business plan as a contingency plan by outlining some "what-if" scenarios and exploring how you might respond if these scenarios unfold. Pretty Young Professional launched in November 2010 as an online resource to guide an emerging generation of female leaders. The site focused on recent female college graduates and current students searching for professional roles and those in their first professional roles. It was founded by four friends who were coworkers at the global consultancy firm McKinsey. But after positions and equity were decided among them, fundamental differences of opinion about the direction of the business emerged between two factions, according to the co-founder and former CEO Kathryn Minshew. "I think, naively, we assumed that if we kicked the can down the road on some of those things, we'd be able to sort them out," Minshew said. Minshew went on to found a different professional site, The Muse, and took much of the editorial team of Pretty Young Professional with her. Whereas greater planning potentially could have prevented the early demise of Pretty Young Professional, a change in planning led to overnight success for Joshua Esnard and The Cut Buddy team. Esnard invented and patented the plastic hair template that he was selling online out of his Fort Lauderdale garage while working a full-time job at Broward College and running a side business. Esnard had hundreds of boxes of Cut Buddies sitting in his home when he changed his marketing plan to enlist companies specializing in making videos go viral. It worked so well that a promotional video for the product garnered 8 million views in hours. The Cut Buddy sold over 4,000 products in a few hours when Esnard only had hundreds remaining. Demand greatly exceeded his supply, so Esnard had to scramble to increase manufacturing and offered customers two-for-one deals to make up for delays. This led to selling 55,000 units, generating $700,000 in sales in 2017. After appearing on *Shark Tank* and landing a deal with Daymond John that gave the "shark" a 20-percent equity stake in return for $300,000, The Cut Buddy has added new distribution channels to include retail sales along with online commerce. Changing one aspect of a business plan—the marketing plan—yielded success for The Cut Buddy.

LINK TO LEARNING

Watch this video of Cut Buddy's founder, Joshua Esnard, telling his company's story to learn more.

If you opt for the brief business plan, you will focus primarily on articulating a big-picture overview of your business concept. This version is used to interest potential investors, employees, and other stakeholders, and will include a financial summary "box," but it must have a disclaimer, and the founder/entrepreneur may need to have the people who receive it sign a nondisclosure agreement (NDA). The full business plan is aimed at executing the vision concept, providing supporting details, and would be required by financial institutions and others as they formally become stakeholders in the venture. Both are aimed at providing a picture and roadmap to go from conception to creation.

Types of Business Plans

The brief business plan is similar to an extended executive summary from the full business plan. This concise document provides a broad overview of your entrepreneurial concept, your team members, how and why you will execute on your plans, and why you are the ones to do so. You can think of a brief business plan as a scene setter or—since we began this chapter with a film reference—as a trailer to the full movie. The brief business plan is the commercial equivalent to a trailer for *Field of Dreams*, whereas the full plan is the full-length movie equivalent.

Brief Business Plan

As the name implies, the **executive summary** summarizes key elements of the entire business plan, such as the business concept, financial features, and current business position. The executive summary version of the business plan is your opportunity to broadly articulate the overall concept and vision of the company for yourself, for prospective investors, and for current and future employees.

A typical executive summary is generally no longer than a page, but because the brief business plan is essentially an extended executive summary, the executive summary section is vital. This is the "ask" to an investor. You should begin by clearly stating what you are asking for in the summary.

In the business concept phase, you'll describe the business, its product, and its markets. Describe the customer segment it serves and why your company will hold a competitive advantage. This section may align roughly with the customer segments and value-proposition segments of a canvas.

Next, highlight the important financial features, including sales, profits, cash flows, and return on investment. Like the financial portion of a feasibility analysis, the financial analysis component of a business plan may typically include items like a twelve-month profit and loss projection, a three- or four-year profit and loss projection, a cash-flow projection, a projected balance sheet, and a breakeven calculation. You can explore a feasibility study and financial projections in more depth in the formal business plan. Here, you want to focus on the big picture of your numbers and what they mean.

The current business position section can furnish relevant information about you and your team members and the company at large. This is your opportunity to tell the story of how you formed the company, to describe its legal status (form of operation), and to list the principal players. In one part of the extended executive summary, you can cover your reasons for starting the business: Here is an opportunity to clearly define the needs you think you can meet and perhaps get into the pains and gains of customers. You also can provide a summary of the overall strategic direction in which you intend to take the company. Describe the company's mission, vision, goals and objectives, overall business model, and value proposition.

Rice University's Student Business Plan Competition, one of the largest and overall best-regarded graduate school business-plan competitions, requires an executive summary of up to five pages to apply. Its suggested sections are shown in Table 5.1.5.1.

Table 5.1.5.1: Suggested Executive Summary Components for Rice University Business Plan Competition

Section	Description
Company summary	Brief overview (one to two paragraphs) of the problem, solution, and potential customers
Customer analysis	Description of potential customers and evidence they would purchase product
Market analysis	Size of market, target market, and share of market
Product or service	Current state of product in development and evidence it is feasible
Intellectual property	If applicable, information on patents, licenses, or other IP items
Competitive differentiation	Describe the competition and your competitive advantage
Company founders, management team, and/or advisor	Bios of key people showcasing their expertise and relevant experience
Financials	Projections of revenue, profit, and cash flow for three to five years
Amount of investment	Funding request and how funds will be used

ARE YOU READY?

Create a Brief Business Plan

Fill out a canvas of your choosing for a well-known startup: Uber, Netflix, Dropbox, Etsy, Airbnb, Bird/Lime, Warby Parker, or any of the companies featured throughout this chapter or one of your choice. Then create a brief business plan for that business. See if you can find a version of the company's actual executive summary, business plan, or canvas. Compare and contrast your vision with what the company has articulated.

- These companies are well established but is there a component of what you charted that you would advise the company to change to ensure future viability?
- Map out a contingency plan for a "what-if" scenario if one key aspect of the company or the environment it operates in were drastically is altered?

Full Business Plan

Even full business plans can vary in length, scale, and scope. Rice University sets a ten-page cap on business plans submitted for the full competition. The IndUS Entrepreneurs, one of the largest global networks of entrepreneurs, also holds business plan competitions for students through its Tie Young Entrepreneurs program. In contrast, business plans submitted for that competition can usually be up to twenty-five pages. These are just two examples. Some components may differ slightly; common elements are typically found in a formal business plan outline. The next section will provide sample components of a full business plan for a fictional business.

Executive Summary

The executive summary should provide an overview of your business with key points and issues. Because the summary is intended to summarize the entire document, it is most helpful to write this section last, even though it comes first in sequence. The writing in this section should be especially concise. Readers should be able to understand your needs and capabilities at first glance. The section should tell the reader what you want and your "ask" should be explicitly stated in the summary.

Describe your business, its product or service, and the intended customers. Explain what will be sold, who it will be sold to, and what competitive advantages the business has. Table 5.1.5.2 shows a sample executive summary for the fictional company La Vida Lola.

Table 5.1.5.2: Executive Summary for La Vida Lola

Executive Summary Component	Content
The Concept	La Vida Lola is a food truck serving the best Latin American and Caribbean cuisine in the Atlanta region, particularly Puerto Rican and Cuban dishes, with a festive flair. La Vida Lola offers freshly prepared dishes from the mobile kitchen of the founding chef and namesake Lola González, a Duluth, Georgia, native who has returned home to launch her first venture after working under some of the world's top chefs. La Vida Lola will cater to festivals, parks, offices, community and sporting events, and breweries throughout the region.
Market Advantage	Latin food packed with flavor and flair is the main attraction of La Vida Lola. Flavors steeped in Latin American and Caribbean culture can be enjoyed from a menu featuring street foods, sandwiches, and authentic dishes from the González family's Puerto Rican and Cuban roots. *Millennial foodies* craving ethnic food experiences and *Latin food lovers* are the primary customers, but anyone with a taste for delicious homemade meals in Atlanta can order. Having a native Atlanta-area resident returning to her hometown after working in restaurants around the world to share food with area communities offers a competitive advantage for La Vida Lola in the form of founding chef Lola González.
Marketing	The venture will adopt a concentrated marketing strategy. The company's promotion mix will comprise a mix of advertising, sales promotion, public relations, and personal selling. Much of the promotion mix will center around dual-language social media.
Venture Team	The two founding members of the management team have almost four decades of combined experience in the restaurant and hospitality industries. Their background includes experience in food and beverage, hospitality and tourism, accounting, finance, and business creation.
Capital Requirements	La Vida Lola is seeking startup capital of $50,000 to establish its food truck in the Atlanta area. An additional $20,000 will be raised through a donations-driven crowdfunding campaign. The venture can be up and running within six months to a year.

Business Description

This section describes the industry, your product, and the business and success factors. It should provide a current outlook as well as future trends and developments. You also should address your company's mission, vision, goals, and objectives. Summarize your overall strategic direction, your reasons for starting the business, a description of your products and services, your business model, and your company's value proposition. Consider including the Standard Industrial Classification/North American Industry Classification System (SIC/NAICS) code to specify the industry and ensure correct identification. The industry extends beyond where the business is located and operates, and should include national and global dynamics. Table 5.1.5.3 shows a sample business description for La Vida Lola.

Table 5.1.5.3: Business Description for La Vida Lola

Business Description	La Vida Lola will operate in the mobile food services industry, which is identified by SIC code 5812 Eating Places and NAICS code 722330 Mobile Food Services, which consist of establishments primarily engaged in preparing and serving meals and snacks for immediate consumption from motorized vehicles or nonmotorized carts. Ethnically inspired to serve a consumer base that craves more spiced Latin foods, La Vida Lola is an Atlanta-area food truck specializing in Latin cuisine, particularly Puerto Rican and Cuban dishes native to the roots of the founding chef and namesake, Lola González. La Vida Lola aims to spread a passion for Latin cuisine within local communities through flavorful food freshly prepared in a region that has embraced international eats. Through its mobile food kitchen, La Vida Lola plans to roll into parks, festivals, office buildings, breweries, and sporting and community events throughout the greater Atlanta metropolitan region. Future growth possibilities lie in expanding the number of food trucks, integrating food delivery on demand, and adding a food stall at an area food market. After working in noted restaurants for a decade, most recently under the famed chef José Andrés, chef Lola González returned to her hometown of Duluth, Georgia, to start her own venture. Although classically trained by top world chefs, it was González's grandparents' cooking of authentic Puerto Rican and Cuban dishes in their kitchen that influenced her profoundly. The freshest ingredients from the local market, the island spices, and her attention to detail were the spark that ignited Lola's passion for cooking. To that end, she brings flavors steeped in Latin American and Caribbean culture to a flavorful menu packed full of street foods, sandwiches, and authentic dishes. Through reasonably priced menu items, La Vida Lola offers food that appeals to a wide range of customers, from millennial foodies to Latin natives and other locals with Latin roots.

Industry Analysis and Market Strategies

Here you should define your market in terms of size, structure, growth prospects, trends, and sales potential. You'll want to include your TAM and forecast the SAM. This is a place to address market segmentation strategies by geography, customer attributes, or product orientation. Describe your positioning relative to your competitors' in terms of pricing, distribution, promotion plan, and sales potential. Table 5.1.5.4 shows an example industry analysis and market strategy for La Vida Lola.

Table 5.1.5.4: Industry Analysis and Market Strategy for La Vida Lola

According to *Mobile Food Trends and Insights*' first annual report from the San Francisco-based Off The Grid, a company that facilitates food markets nationwide, the US food truck industry alone is projected to grow by nearly 20 percent from $800 million in 2017 to $985 million in 2019. Meanwhile, an *IBISWorld* report shows the street vendors' industry with a 4.2 percent annual growth rate to reach $3.2 billion in 2018. Food truck and street food vendors are increasingly investing in specialty, authentic ethnic, and fusion food, according to the *IBISWorld* report.

Although the *IBISWorld* report projects demand to slow down over the next five years, it notes there are still opportunities for sustained growth in major metropolitan areas. The street vendors industry has been a particular bright spot within the larger food service sector.

The industry is in a growth phase of its life cycle. The low overhead cost to set up a new establishment has enabled many individuals, especially specialty chefs looking to start their own businesses, to own a food truck in lieu of opening an entire restaurant. Off the Grid's annual report indicates the average typical initial investment ranges from $55,000 to $75,000 to open a mobile food truck.

The restaurant industry accounts for $800 billion in sales nationwide, according to data from the National Restaurant Association. Georgia restaurants brought in a total of $19.6 billion in 2017, according to figures from the Georgia Restaurant Association.

There are approximately 12,000 restaurants in the metro Atlanta region. The Atlanta region accounts for almost 60 percent of the Georgia restaurant industry. The SAM is estimated to be approximately $360 million.

The mobile food/street vendor industry can be segmented by types of customers, types of cuisine (American, desserts, Central and South American, Asian, mixed ethnicity, Greek Mediterranean, seafood), geographic location and types (mobile food stands, mobile refreshment stands, mobile snack stands, street vendors of food, mobile food concession stands).

Secondary competing industries include chain restaurants, single location full-service restaurants, food service contractors, caterers, fast food restaurants, and coffee and snack shops.

The top food truck competitors according to the *Atlanta Journal-Constitution*, the daily newspaper in La Vida Lola's market, are Bento Bus, Mix'd Up Burgers, Mac the Cheese, The Fry Guy, and The Blaxican. Bento Bus positions itself as a Japanese-inspired food truck using organic ingredients and dispensing in eco-friendly ware. The Blaxican positions itself as serving what it dubs "Mexican soul food," a fusion mashup of Mexican food with Southern comfort food. After years of operating a food truck, The Blaxican also recently opened its first brick-and-mortar restaurant. The Fry Guy specializes in Belgian-style street fries with a variety of homemade dipping sauces. These three food trucks would be the primary competition to La Vida Lola, since they are in the "ethnic food" space, while the other two offer traditional American

food. All five have established brand identities and loyal followers/customers since they are among the industry leaders as established by "best of" lists from area publications like the *Atlanta Journal-Constitution*. Most dishes from competitors are in the $10–$13 price range for entrees. La Vida Lola dishes will range from $6 to $13.

One key finding from Off the Grid's *Mobile Food Trends and Insights* report is that mobile food has "proven to be a powerful vehicle for catalyzing diverse entrepreneurship" as 30 percent of mobile food businesses are immigrant owned, 30 percent are women owned, and 8 percent are LGBTQ owned. In many instances, the owner-operator plays a vital role to the brand identity of the business as is the case with La Vida Lola.

Atlanta has also tapped into the nationwide trend of food hall-style dining. These food halls are increasingly popular in urban centers like Atlanta. On one hand, these community-driven areas where food vendors and retailers sell products side by side are secondary competitors to food trucks. But they also offer growth opportunities for future expansion as brands solidify customer support in the region. The most popular food halls in Atlanta are Ponce City Market in Midtown, Krog Street Market along the BeltLine trail in the Inman Park area, and Sweet Auburn Municipal Market downtown Atlanta. In addition to these trends, Atlanta has long been supportive of international cuisine as Buford Highway (nicknamed "BuHi") has a reputation for being an eclectic food corridor with an abundance of renowned Asian and Hispanic restaurants in particular.

The Atlanta region is home to a thriving Hispanic and Latinx population, with nearly half of the region's foreign-born population hailing from Latin America. There are over half a million Hispanic and Latin residents living in metro Atlanta, with a 150 percent population increase predicted through 2040. The median age of metro Atlanta Latinos is twenty-six. La Vida Lola will offer authentic cuisine that will appeal to this primary customer segment.

La Vida Lola must contend with regulations from towns concerning operations of mobile food ventures and health regulations, but the Atlanta region is generally supportive of such operations. There are many parks and festivals that include food truck vendors on a weekly basis.

Competitive Analysis

The competitive analysis is a statement of the business strategy as it relates to the competition. You want to be able to identify who are your major competitors and assess what are their market shares, markets served, strategies employed, and expected response to entry? You likely want to conduct a classic **SWOT analysis** (Strengths Weaknesses Opportunities Threats) and complete a competitive-strength grid or competitive matrix. Outline your company's competitive strengths relative to those of the competition in regard to product, distribution, pricing, promotion, and advertising. What are your company's competitive advantages and their likely impacts on its success? The key is to construct it properly for the relevant features/benefits (by weight, according to customers) and how the startup compares to incumbents. The **competitive matrix** should show clearly how and why the startup has a clear (if not currently measurable) competitive advantage. Some common features in the example include price, benefits, quality, type of features, locations, and distribution/sales. Sample templates are shown in Figure 5.1.5.2 and Figure 5.1.5.3. A competitive

analysis helps you create a marketing strategy that will identify assets or skills that your competitors are lacking so you can plan to fill those gaps, giving you a distinct competitive advantage. When creating a competitor analysis, it is important to focus on the key features and elements that matter to customers, rather than focusing too heavily on the entrepreneur's idea and desires.

	La Vida Lola	Mix'D Up Burgers	Mac the Cheese	The Fry Guy	The Blaxican
Price	$6-$13	$10	$10-13	$13+	High end
Location	Varies	Rotate/Smyrna	Rotates	Buckhead	Midtown
Quality	Mid to high	Low	Mid	High	High
Food type	Latin	American/ Burgers	American/ Comfort	American	Soul/ Mexican fusion

Figure 5.1.5.2: This chart shows one sample format for a competitor analysis. (CC BY 4.0; Rice University & OpenStax)

COMPETITIVE ANALYSIS TEMPLATE							
	Price	**Benefits**	**Quality**	**Features**	**Locations**	**Distribution/ Sales**	**Customer satisfaction**
Competitor 1							
Competitor 2							
Competitor 3							
Competitor 4							

Figure 5.1.5.3: This chart provides a more complex template for creating a competitive analysis. (CC BY 4.0; Rice University & OpenStax)

Operations and Management Plan

In this section, outline how you will manage your company. Describe its organizational structure. Here you can address the form of ownership and, if warranted, include an organizational chart/structure. Highlight the backgrounds, experiences, qualifications, areas of expertise, and roles of members of the management team. This is also the place to mention any other stakeholders, such as a board of directors or advisory board(s), and their relevant relationship to the founder, experience and value to help make the venture successful, and professional service firms providing management support, such as accounting services and legal counsel.

Table 5.1.5.5 shows a sample operations and management plan for La Vida Lola.

Table 5.1.5.5: Operations and Management Plan for La Vida Lola

Operations and Management Plan Category	Content
Key Management Personnel	The key management personnel consist of Lola González and Cameron Hamilton, who are longtime acquaintances since college. The management team will be responsible for funding the venture as well as securing loans to start the venture. The following is a summary of the key personnel backgrounds. *Lola González:* Chef Lola González has worked directly in the food service industry for fifteen years. While food has been a lifelong passion learned in her grandparents' kitchen, chef González has trained under some of the top chefs in the world, most recently having worked under the James Beard Award-winning chef José Andrés. A native of Duluth, Georgia, chef González also has an undergraduate degree in food and beverage management. Her value to the firm is serving as "the face" and company namesake, preparing the meals, creating cuisine concepts, and running the day-to-day operations of La Vida Lola. *Cameron Hamilton:* Cameron Hamilton has worked in the hospitality industry for over twenty years and is experienced in accounting and finance. He has a master of business administration degree and an undergraduate degree in hospitality and tourism management. He has opened and managed several successful business ventures in the hospitality industry. His value to the firm is in business operations, accounting, and finance.
Advisory Board	During the first year of operation, the company intends to keep a lean operation and does not plan to implement an advisory board. At the end of the first year of operation, the management team will conduct a thorough review and discuss the need for an advisory board.
Supporting Professionals	Stephen Ngo, Certified Professional Accountant (CPA), of Valdosta, Georgia, will provide accounting consulting services. Joanna Johnson, an attorney and friend of chef González, will provide recommendations regarding legal services and business formation.

Marketing Plan

Here you should outline and describe an effective overall marketing strategy for your venture, providing details regarding pricing, promotion, advertising, distribution, media usage, public relations, and a digital presence. Fully describe your sales management plan and the composition of your sales force, along with a comprehensive and detailed budget for the marketing plan. Table 5.1.5.6 shows a sample marketing plan for La Vida Lola.

Table 5.1.5.6: Marketing Plan for La Vida Lola

Marketing Plan Category	Content
Overview	La Vida Lola will adopt a concentrated marketing strategy. The company's promotion mix will include a mix of advertising, sales promotion, public relations, and personal selling. Given the target millennial foodie audience, the majority of the promotion mix will be centered around social media platforms. Various social media content will be created in both Spanish and English. The company will also launch a crowdfunding campaign on two crowdfunding platforms for the dual purpose of promotion/publicity and fundraising.
Advertising and Sales Promotion	As with any crowdfunding social media marketing plan, the first place to begin is with the owners' friends and family. Utilizing primarily Facebook/Instagram and Twitter, La Vida Lola will announce the crowdfunding initiative to their personal networks and prevail upon these friends and family to share the information. Meanwhile, La Vida Lola needs to focus on building a community of backers and cultivating the emotional draw of becoming part of the La Vida Lola family. To build a crowdfunding community via social media, La Vida Lola will routinely share its location, daily if possible, on both Facebook, Instagram, and Twitter. Inviting and encouraging people to visit and sample their food can rouse interest in the cause. As the campaign is nearing its goal, it would be beneficial to offer a free food item to backers of a specific level, say $50, on one specific day. Sharing this via social media in the day or two preceding the giveaway and on the day of can encourage more backers to commit. Weekly updates of the campaign and the project as a whole are a must. Facebook and Twitter updates of the project coupled with educational information sharing helps backers feel part of the La Vida Lola community. Finally, at every location where La Vida Lola is serving its food, signage will notify the public of their social media presence and the current crowdfunding campaign. Each meal will be accompanied by an invitation from the server for the patron to visit the crowdfunding site and consider donating. Business cards listing the social media and crowdfunding information will be available in the most visible location, likely the counter. Before moving forward with launching a crowdfunding campaign, La Vida Lola will create its website. The website is a great place to establish and share the La Vida Lola brand, vision, videos, menus, staff, and events. It is also a great source of information for potential backers who are unsure about donating to the crowdfunding campaigns. The website will include these elements: • *About Us*. Address the following questions: Who are you? What are the guiding principles of La Vida Lola? How did the business get started? How long has La Vida Lola been in business? Include pictures of chef González. • *Menu*. List of current offerings with prices. • *Calendar of Events*. Will include promotional events and locations where customers can find the truck for different

Marketing Plan Category	Content
	events. • *Social Media.* Steps will be taken to increase social media followers prior to launching the crowdfunding campaign. Unless a large social media following is already established, a business should aggressively push social media campaigns a minimum of three months prior to the crowdfunding campaign launch. Increasing social media following prior to the campaign kickoff will also allow potential donors to learn more about La Vida Lola and foster relationship building before attempting to raise funds.
Facebook Content and Advertising	The key piece of content will be the campaign pitch video, reshared as a native Facebook upload. A link to the crowdfunding campaigns can be included in the caption. Sharing the same high-quality video published on the campaign page will entice fans to visit Kickstarter to learn more about the project and rewards available to backers. • Promoted Post(s): Boosting/promoting a Facebook post for only $5 can go a long way for a business page the size of La Vida Lola's. Reach and engagement will be exponentially higher than it would have been organically. Promoting two or three posts during the first few weeks of the campaign would be highly effective. • Video Views Ad: Video ads are a little more ambitious than promoted posts and cost a little more. But the objective is the same: increase the number of people who watch the pitch video and drive them to the campaign page.
Crowdfunding Campaigns	Foodstart was created just for restaurants, breweries, cafés, food trucks, and other food businesses, and allows owners to raise money in small increments. It is similar to Indiegogo in that it offers both flexible and fixed funding models and charges a percentage for successful campaigns, which it claims to be the lowest of any crowdfunding platform. It uses a reward-based system rather than equity, where backers are offered rewards or perks resulting in "low-cost capital and a network of people who now have an incentive to see you succeed." Foodstart will host La Vida Lola's crowdfunding campaigns for the following reasons: (1) It caters to their niche market; (2) it has less competition from other projects which means that La Vida Lola will stand out more and not get lost in the shuffle; and (3) it has/is making a name/brand for itself which means that more potential backers are aware of it. La Vida Lola will run a simultaneous crowdfunding campaign on Indiegogo, which has broader mass appeal.
Publicity	Social media can be a valuable marketing tool to draw people to the Foodstarter and Indiegogo crowdfunding pages. It provides a means to engage followers and keep funders/backers updated on current fundraising milestones. The first order of business is to increase La Vida Lola's social media presence on Facebook, Instagram, and Twitter. Establishing and using a common hashtag such as #FundLola across all platforms will promote familiarity

Marketing Plan Category	Content
	and searchability, especially within Instagram and Twitter. Hashtags are slowly becoming a presence on Facebook. The hashtag will be used in all print collateral. La Vida Lola will need to identify social influencers—others on social media who can assist with recruiting followers and sharing information. Existing followers, family, friends, local food providers, and noncompetitive surrounding establishments should be called upon to assist with sharing La Vida Lola's brand, mission, and so on. Cross-promotion will further extend La Vida Lola's social reach and engagement. Influencers can be called upon to cross promote upcoming events and specials. The crowdfunding strategy will utilize a progressive reward-based model and establish a reward schedule such as the following: • $5 or more (unlimited): Exclusive updates on fundraising progress • $10 or more (500): $1 OFF; a coupon for $1 off purchase • $20 or more (200): BOGO! Buy one entree, get one FREE • $50 or more (100): FREE entrée coupon • $250 or more (2): One-on-one with chef González! In addition to the publicity generated through social media channels and the crowdfunding campaign, La Vida Lola will reach out to area online and print publications (both English- and Spanish-language outlets) for feature articles. Articles are usually teased and/or shared via social media. Reaching out to local broadcast stations (radio and television) may provide opportunities as well. La Vida Lola will recruit a social media intern to assist with developing and implementing a social media content plan. Engaging with the audience and responding to all comments and feedback is important for the success of the campaign. Some user personas from segmentation to target in the campaign: • Influencer Isabel: Social media-savvy, college-age Latina influencer • Food truck Freddie: An avid food truck follower, this thirty-three-year-old white urban hipster professional seeks out the best food trucks around town on a regular basis looking for "noms" to satisfy his cravings. • Taco townies: In-town residents who religiously eat tacos on "taco Tuesday," as a family rite of passage for the wives, husbands, and kids. The entire neighborhood turns out for the occasion as a community event of sorts.

Financial Plan

A **financial plan** seeks to forecast revenue and expenses; project a financial narrative; and estimate project costs, valuations, and cash flow projections. This section should present an accurate, realistic, and achievable financial plan for your venture. Include sales forecasts and income projections, pro forma financial statements, a breakeven analysis, and a capital budget. Identify your possible sources of financing. Figure 5.1.5.4 shows a template of cash-flow needs for La Vida Lola.

INCOME		EXPENSES	
Daily Income		**Fixed Monthly Expenses**	
Monday	$	Facility rental	$
Tuesday	$	Personal loans	$
Wednesday	$	Insurance	$
Thursday	$	Credit cards	$
Friday	$	Farmer's Market overheads	$
Saturday AM	$	Planned savings	$
Saturday PM	$	Other	$
Sunday	$	*Total fixed monthly expenses*	$
		Variable Monthly Expenses	
		Food/Beverages	$
		Utilities (electricity, gas)	$
		Uniforms	$
		Wages	$
		Fuel (vehicle)	$
		Medical expenses	$
		Other	$
		Total variable monthly expenses	$
		Fixed Infrequent Expenses	
		Insurance	$
		Annual subscriptions	$
		Property rates/taxes	$
		Union fees	$
		Education	$
		Other	$
		Total fixed infrequent expenses	$
		Variable Infrequent Expenses	
		Gifts	$
		Holidays	$
		Vehicle repairs and registration	$
		Durable goods purchase	$
		Donations	$
		Other	$
		Total variable infrequent expenses	$
TOTAL Income	$	**TOTAL Expenses**	$
		DIFFERENCE = Income available	$

Figure 5.1.5.4: La Vida Lola can use a template like this to project cash flow. (CC BY 4.0; Rice University & OpenStax)

ENTREPRENEUR IN ACTION

Laughing Man Coffee

Hugh Jackman (Figure 5.1.5.5) may best be known for portraying a comic-book superhero who used his mutant abilities to protect the world from villains. But the *Wolverine* actor is also working to make the planet a better place for real, not through adamantium claws but through social entrepreneurship.



Figure 5.1.5.5: Hugh Jackman launched a social entrepreneurship venture called Laughing Man Coffee. (credit: "Hugh Jackman navy" by "U.S. Navy photo by Photographer's Mate Airman Dennard Vinson"/Wikimedia Commons, Public Domain)

A love of java jolted Jackman into action in 2009, when he traveled to Ethiopia with a Christian humanitarian group to shoot a documentary about the impact of fair-trade certification on coffee growers there. He decided to launch a business and follow in the footsteps of the late Paul Newman, another famous actor turned philanthropist via food ventures.

Jackman launched Laughing Man Coffee two years later; he sold the line to Keurig in 2015. One Laughing Man Coffee café in New York continues to operate independently, investing its proceeds into charitable programs that support better housing, health, and educational initiatives within fair-trade farming communities. Although the New York location is the only café, the coffee brand is still distributed, with Keurig donating an undisclosed portion of Laughing Man proceeds to those causes (whereas Jackman donates all his profits). The company initially donated its profits to World Vision, the Christian humanitarian group Jackman accompanied in 2009. In 2017, it created the Laughing Man Foundation to be more active with its money management and distribution.

- You be the entrepreneur. If you were Jackman, would you have sold the company to Keurig? Why or why not?
- Would you have started the Laughing Man Foundation?
- What else can Jackman do to aid fair-trade practices for coffee growers?

WHAT CAN YOU DO?

Textbooks for Change

Founded in 2014, Textbooks for Change uses a cross-compensation model, in which one customer segment pays for a product or service, and the profit from that revenue is used to provide the same product or service to another, underserved segment. Textbooks for Change partners with student organizations to collect used college textbooks, some of which are re-sold while others are donated to students in need at underserved universities across the globe. The organization has reused or recycled 250,000 textbooks, providing 220,000 students with access through seven campus partners in East Africa. This B-corp social enterprise tackles a problem and offers a solution that is directly relevant to college students like yourself. Have you observed a problem on your college campus or other campuses that is not being served properly? Could it result in a social enterprise?

WORK IT OUT

Franchisee Set Out

A franchisee of East Coast Wings, a chain with dozens of restaurants in the United States, has decided to part ways with the chain. The new store will feature the same basic sports-bar-and-restaurant concept and serve the same basic foods: chicken wings, burgers, sandwiches, and the like. The new restaurant can’t rely on the same distributors and suppliers. A new business plan is needed.

- What steps should the new restaurant take to create a new business plan?
- Should it attempt to serve the same customers? Why or why not?

LINK TO LEARNING

This *New York Times* video, “An Unlikely Business Plan,” describes entrepreneurial resurgence in Detroit, Michigan.

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5.1.6: Key Terms

balance sheet
financial statement that summarizes a company's financial condition according to the accounting equation

breakeven point
level of operations that results in exactly enough revenue to cover costs

business model
plan for how venture will be funded; how the venture creates value for its stakeholders, including customers; how the venture's offerings are made and distributed to the end users; and the how income will be generated through this process

business model canvas
developed by Osterwalder and Pigneur, used to develop a business model for a venture, including nine blocks that are mapped out to address customer segments, customer relationships, channels, revenue streams, value propositions, key partners, key activities, key resources, and cost structure

business model innovation
occurs when an existing business fundamentally changes their business model

business plan
formal document that typically describes the business and industry, market strategies, sales potential, and competitive analysis, as well as the company's long-term goals and objectives

competitive matrix
shows how and why a startup has a clear if not measurable competitive advantage for relevant features/benefits by weight according to customers, such as price and quality in relation to competitors

customer empathy map
portrayal of a target customer, the most promising candidate from a business' customer segments, which explores the understanding of that person's condition from their perspective to understand his or her problems and needs

disruptive innovation
process that significantly impacts the market by making a product or service more affordable and/or accessible often by smaller companies in an industry

executive summary
initial section of a business plan document that summarizes the key elements of the entire plan

feasibility analysis
feasibility analysis is the process of determining if a business idea is viable; it includes testing the viability of your product or service, evaluating your management team, assessing the market for your concept, and estimating financial viability

financial analysis
forecasts revenue and expenses; projects a financial narrative; and estimates project costs, valuations, and cash flow projections

fixed costs
costs that do not change, regardless of the amount of sales

go-or-no-go decision
determination to proceed with or abandon a plan or project

innovation

new idea, process, or product, or a change to an existing product or process

lean model canvas

developed by Ash Maurya as a derivation of the original business model canvas; this canvas differs by addressing unfair advantages, problems, solutions, and key metrics rather than customer relationships, key partners, key activities, and key resources

market analysis

analysis of the overall interest in the product or service within the industry by its target market

projected cash flow

outline of preliminary expenses, operating expenses, and reserves

serviceable available market (SAM)

portion of the market that a business can serve based on its products, services, and location

social business model canvas

modification of the business model canvas, designed for social entrepreneurship venues; new areas address impact measures around social impacts and its measurement, surplus, beneficiary segments and social and customer value propositions

SWOT analysis

strategic analytical tool used to help a potential venture or existing company identify its strengths, weaknesses, opportunities, and threats related to business competition

total available market (TAM)

total perceived demand for a product or service within the marketplace

value proposition

summary describing the benefits (value) customers can expect from a particular product or service

value proposition canvas

one of the nine blocks on the business model canvas, this additional tool developed by Osterwalder and Pigneur is designed to illustrate a deeper dive into customer understanding and value creation of a business

variable costs

costs that fluctuate with the level of revenue

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5.1.7: Summary

5.1.2 Avoiding the “Field of Dreams” Approach

Business models and business plans are tools involved in the strategic process of charting a path for your entrepreneurial venture. When starting a company, it’s best to avoid the *Field of Dreams* approach of building a business and hoping that customers will just show up. Innovation has been linked to entrepreneurship for at least nine decades. More recent theories suggest that disruptive innovations are disruptive because they disturb the underlying business model of the companies being disrupted.

5.1.3 Designing the Business Model

A business model, which is unique to a company, describes the rationale of how an organization creates, delivers, and captures values. A business model canvas is a popular tool used by entrepreneurs and intrapraneurs to map out and plan different components of a business model. The business model canvas addresses customer segments, customer relationships, channels (of distribution), revenue streams, value propositions, key partners, key activities, key resources, and cost structure. The lean model canvas and social business model canvas are derivations of the original business model canvas. They are designed more for tech/software/app endeavors and social entrepreneurial ventures, respectively.

5.1.4 Conducting a Feasibility Analysis

A feasibility study is a tool in the entrepreneurs’ toolkit that can help determine whether to proceed on a venture early on. A feasibility study is usually more in-depth than a business plan and focuses on analysis of real-world numbers and projections. The most common elements of a feasibility study include a market analysis, a financial analysis, and management analysis. Feasibility studies can be used to make a “go-or-no-go” decision for a new product or business, as well as help narrow the focus of what that venture should be (what the market would potentially support).

5.1.5 The Business Plan

The business plan is a formal document used for long-range planning of a company’s operation that typically includes financial information, background information, and a summary of the business. Business plans can be used as internal guiding documents early in the entrepreneurial process. They also can be presentation documents for raising funds from prospective investors later in the process, complementing an investor pitch and iterative canvases. A brief business plan functions somewhat like an extended executive summary that summarizes key elements of the entire business plan, such as the business concept, financial features, and current business position. A full business plan can range from ten to twenty-five pages. It includes a business description, industry and marketing analyses, and descriptions of management, marketing, and operational and financial plans.

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5.1.8: Review Quetions

1. According to Ash Maurya's typology, Airbnb is an example of what type of business model?
    a. Direct
    b. Multisided
    c. Open
    d. Marketplace
2. Which startup grew from a failed podcasting company called Odeo?
    a. Instagram
    b. Twitter
    c. StubHub
    d. Groupon
3. What is the job to be done of a milkshake according to Christensen's team's customer observation research in the 'Link to Learning' video?
    a. Employ Chick-Fil-A cows
    b. Accompany on a long morning commute
    c. Placate children
    d. Satisfy hunger
4. What is a change, typically minor, of the current business model in an attempt to capitalize on a closely related market opportunity?
    a. Innovation
    b. Disruption
    c. Iteration
    d. Increment
5. A tool to identify your idealized target customer and develop a better understanding of his or her environment, behavior, concerns, and aspirations.
    a. Jobs to be done
    b. Business plan
    c. Business model canvas
    d. Empathy map
6. A _____ is a formal document that typically describes the business and industry, market strategies, sales potential, and competitive analysis, as well as the company's long-term goals and objectives.
    a. Business plan
    b. Business model
    c. Customer empathy map
    d. Revenue model
7. Select the item that does not belong to the business model canvas.
    a. Market size
    b. Revenue streams
    c. Value proposition
    d. Customer segments
8. The finished story benefit formula of [end customer wants] + [specific period of time] + [address objections] is designed for what component of the lean model canvas?
    a. Unfair advantage
    b. Unique value proposition
    c. Early adopters
    d. High concept pitch

9. How does the social business model canvas differ from the business model canvas and lean model canvas?
    a. Is only used by nonprofit company
    b. Doesn't have customer block and investment block
    c. Has profit block to talk about ways the company can makes more money
    d. Has impact measure, surplus, beneficiary segments, and social and customer value propositions
10. Which of the following has the purpose of evaluating the team, the market for the concept, the financial viability, and possible pitfalls?
    a. Feasibility analysis
    b. Market analysis
    c. Financial analysis
    d. Management analysis
11. Which of the following has the purpose of forecasting revenue and expenses, projecting a financial narrative, estimating project cost, and projecting cash flow?
    a. Feasibility analysis
    b. Market analysis
    c. Financial analysis
    d. Management analysis
12. Which of the following identifies competitors and quantifies target customers and/or users in a specific industry?
    a. Feasibility analysis
    b. Market analysis
    c. Financial analysis
    d. Management analysis
13. What assesses the prowess of the management and sufficiency of resources to bring the product or idea to market?
    a. Management analysis
    b. Operational feasibility analysis
    c. Financial analysis
    d. Cash flow
14. What are expenses that do not vary with the level of sales, such as rent, salaries, utilities, insurance, and other operating expenses?
    a. Fixed costs
    b. Variable costs
    c. Balance sheet
    d. Cash flow statements
15. Which of the following is a formal document that typically describes the business and industry, market strategies, sales potential, and competitive analysis, as well as the company's long-term goals and objectives?
    a. Business plan
    b. Business model
    c. Customer empathy map
    d. Revenue model
16. Which of these is not the purpose of a business plan?
    a. Thoroughly explain a business idea and how it will be carried out
    b. Planning tool and working plan over the course of several years
    c. Requirement to start a business
    d. Planning for "what-if" scenarios and explore new options
17. Which of these components are not in a business plan?
    a. Business description
    b. Industry and market analysis
    c. Financial analysis

d. None of these options is correct

18. Estimated profits and expenses of the business is included in which of the following?
    a. Financial analysis
    b. Industry and market analysis
    c. Operation plan
    d. Marketing plan
19. Who is best suited to write a business plan?
    a. Investor
    b. Founder(s)
    c. Consultant
    d. Chief financial officer

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5.1.9: Discussion Questions

1. What role do customers play in innovation? Is innovation possible without customer support?
2. Do you believe that teamwork is important to entrepreneurship? Or do you prefer solopreneurship? Is one approach “better” than the other? Why or why not?
3. What are the advantages of using a canvas to plan your business?
4. What types of businesses fit best with each respective canvas type?
5. Why would impact measures be important in social entrepreneurship ventures?
6. How do the arts relate to the business model creation process?
7. What are the advantages of using a lean model canvas compared to the traditional business model canvas?
8. What components are in the breakeven analysis? How would you calculate your breakeven point?
9. Why is feasibility analysis important?
10. What are the different components of a feasibility analysis?
11. Explain the purpose and importance of a business plan.
12. Describe the components of a business plan.
13. Should you write a business plan even if you do not need outside financing? Why or why not?

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5.1.10: Case Questions

1. The National Association of Broadcasters launched its PILOT Innovation Challenge in 2016. The challenge is centered around a specific challenge question aimed at helping the association's primary customers, broadcasters. The most recent challenge question was, "What is an unconventional way broadcasters and other local media could serve communities?" The PILOT organizers have contracted you to help them design their next challenge. Using your knowledge of innovation and customer-centric entrepreneurship processes, what would you advise? How would you go about determining the challenge question? What questions about innovation would you have regarding the Innovation Challenge?
2. The Guidewell Innovation Center at Lake Nona Medical Center on the outskirts of Orlando, Florida, is a 92,000-square-foot facility aimed at accelerating innovation within the healthcare industries. Guidewell, the parent company of Florida Blue, brings in outside companies to help with that innovation process. One of the features of the Innovation Center is its Collaborative Resource Ecosystem. Some of the center's strategic areas of focus are next-generation consumer engagement, computational health, well-being and human performance, digital health, and remote management, among other areas. How could Christensen's theory of disruptive innovation and jobs-to-be-done theory help guide Guidewell's mission? What are the prevalent business models in the strategic areas for incumbent businesses? What are opportunities for innovation for new companies?
3. As youth programs face severe budget cuts, many youth sports organizations respond by raising their fees, which shifts the costs to families. Good Sports was founded in 2003, to tackle this problem by providing new equipment, footwear, and apparel to those most in need. The organization's addressable markets include children ages five to eighteen living in low-income households, as defined by poverty data, and participating in youth sports in top fifty metropolitan service areas. This Boston-based organization has plans to expand from its three existing markets in Dallas, Chicago, and Boston to seven total markets by 2023 with a goal to serve 600,000 kids by that target date.
    - What would a customer empathy map look like for Good Sports' target user? What about its target customer segment? Would it or should it differ in differing markets? Is the Boston area user any different from say, an Atlanta, user?
    - Given its social mission, what are some impact measures Good Sports could use to gauge success and impact?
4. DoSomething.Org is a "global movement for good" among 6 million young people, transforming their communities across the United States and in 131 countries worldwide. This nonprofit organization constantly holds cause-based campaigns, ranging from receiving over 1 million pairs of donated jeans from teens to clothe homeless youth to cleaning up 3.7 million cigarette butts through its Get the Filter Out initiative. A past campaign, "Don't Be a Sucker," addressed the problem of Americans losing $5.8 billion annually and producing 8.7 billion pounds of carbon pollution by leaving unused devices plugged in. The campaign sought to slay those "energy vampires" not in use by having users unplug equipment and post a sticky note next to the outlet to remind others not to let them suck the energy dry. Further research the problem, solution and this campaign and answer the following:
    - Identify what social impact(s) the campaign addressed.
    - What impact measures could the campaign assess?
    - Could a viable business be created around this problem?
5. In recent years, the entrepreneurial educator and author Steve Blank began applying lean startup principles to various US governmental agencies. Through a Hacking for Diplomacy course, students at Stanford University began tackling problems for the Department of State. A former US ambassador to the United Nations, a State Department representative to Silicon Valley and senior advisor for technology and innovation, a retired US Army colonel, and other entrepreneurial educators joined Blank in applying lean startup methods to State Department issues. Then-Secretary of State John Kerry even visited the Stanford students and said he was looking forward to the solutions students develop during the ten weeks. One project that emerged was from a group calling themselves Team Space Evaders. The team was tasked with working on the problem of satellite collision. Members charted satellite positioning data and explored how information about potential collision was shared by commercial operators and governmental entities ranging from the Federal Aviation Administration to the Department of Defense.
    - Apply the lean startup methodology to identify potential customer segments and problems and solutions that students such as yourself could identify for the State Department on the issue of satellite collision.
    - What would a unique value proposition for a State Department solution to this issue be? How could a high-level concept pitch work when selling the concept within the State Department?

6. Incorporated in 2003, Tesla declared in its mission statement that its goal is "to accelerate the world's transition to sustainable transport," and it has proven itself a leader in green technology in the automotive sector. In its initial business plan, by co-founder Martin Eberhard, the electric sports car company promised to provide the value of a high-end sports car at a lower cost to the customer and a lower environmental cost to the planet. Electric vehicles were seen as inferior to standard vehicles prior to Tesla's innovations in creating powerful cars that piqued consumer desire. The generic automotive manufacturing business model relies on collaborative manufacturing with industry partners and a distribution model dependent on third parties. Standard cars are aimed at people and businesses with individual transportation needs. This model is commercially viable because of custom-equipped add-on features to the per-vehicle prices.
    - Tesla's business model is different. Identify at least three ways in which the Tesla model differs from the traditional automotive business model.
7. In the mid-1990s, at least one newspaper company, the now-defunct Knight-Ridder chain, created the prototype for a tablet newspaper that very much resembles the present-day iPad. A 1994 video titled "The Tablet Newspaper: A Vision for the Future" shows off the design of a futuristic newspaper designed at the Knight-Ridder Information Design Lab in Boulder, Colorado. The video went viral in 2011 after it was posted on YouTube and numerous websites and blogs. The person behind the tablet vision, Roger Fidler, had even published an essay describing a tablet future as far back as 1981. The Knight-Ridder lab shared a wall with its neighbor Apple, with executives swapping ideas and visitors. The newspaper company, focused on content creation and not the hardware side, decided to not patent its tablet design and scrapped the project because screens took too much energy, and it was too expensive.
    - Using the components of a feasibility study, consider how the newspaper company would stack up on go-or-no-go decisions for each component of the feasibility study.
    - How did the newspaper company in the 1990s fare in terms of management prowess, resource capabilities, financial viability, and market analysis?
    - Do you think the newspaper made a wise decision to abandon the project when it did? Why or why not?
8. Founded in 2013 primarily as a coding boot camp, Tech Talent South offers both part-time and full-time courses on topics like Ruby on Rails and Big Data Analytics. Most of the camp's programs are run out of cooperative working spaces and temporary locations throughout the cities it has a presence in. The primary focus of the Atlanta-founded and now North Carolina-based company as branded in the name was on coding in the South, but the company to date has expanded to eleven markets with plans to expand even more. The founder, Betsy Idilbi, jokes that she wouldn't have named the company Tech Talent South if she had known its full potential and growth, including being plugged into the entrepreneurial ecosystem in places such as Columbus, Ohio. The company even has offices in the northeastern city of Hartford, Connecticut.
    - Could a feasibility analysis have helped Betsy from the start?
    - The company has expanded its business to offer corporate trainings at existing companies, rather than teaching classes directly to student enrollees. How would you identify a new potential market for Tech Talent South to enter?
    - What could be done with its existing business?
    - How would you advise the company on making go-or-no-go decisions for entering new markets?
9. Earlier, you were introduced to The Cut Buddy, a plastic hair and beard grooming tool that began selling on Amazon in 2016. Following funding from the *Shark Tank* investor Daymond John, the company plans to expand into retail and extend its product line.
    - How would a business plan for the company's e-commerce business differ from a retail distribution outlet?
    - Discuss how changes to aspects of the original business plan affected the outcome of the success of The Cut Buddy.
    - What do you think should be the key markets and strategies moving forward for the company?
10. Pretty Young Professional, discussed earlier, failed because of disagreements among its four founders that emerged shortly after launch.
    - If you were to launch the venture today, outline what steps you would need to take in formulating a business plan.
    - What do you think the total addressable market would be, which industry classification would it fall under, and who would be the primary competition?

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5.1.11: Suggested Resources

5.1.3 Designing the Business Model

Business model canvas and resources: Strategyzer.com

Lean canvas and associated resources: Leanstack.com

Social business model canvas and related resources: Socialbusinessmodelcanvas.com

Christopher Steiner and Brett Nelson. “The 20 Most Important Questions in Business.” *Forbes*. June 17, 2010: https://www.forbes.com/2010/06/17/mo...l#7975585a3e93

5.1.4 Conducting a Feasibility Analysis

Bruce Barringer, *Preparing Effective Business Plans: An Entrepreneurial Approach*, 2nd ed. (Upper Saddle River, NJ: Pearson, 2015).

https://bizfluent.com/how-8048004-pr...ity-study.html

https://thebusinessprofessor.com/kno...idea-overview/

5.1.5 The Business Plan

SBA Business Plan resources: https://www.sba.gov/business-guide/p...-business-plan

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SECTION OVERVIEW

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5.2.1: The Business Plan

5.2.2: Developing Your Strategy

5.2.3: The Necessity for a Business Plan

5.2.4: Building a Plan

5.2.5: The Three Threads

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5.2.1: The Business Plan

Consolidated Industries' Hammer Forge

Consolidated Industries represents one of the thousands of small manufacturers that exist throughout the United States. It has been in business for more than sixty years, specializing in the forging of ferrous, nonferrous, and exotic materials. Its prime customer base has been the aerospace industry, but it has also expanded into other industrial customers.



Figure 5.2.1.1: *Source: Used with permission from Consolidated Industries.*

Originally a family business, Consolidated Industries was sold to new owners in 1999. Once the owner reached retirement age, his children, a brother and sister, found it difficult to agree on the future direction of the company. This period of confusion was made more difficult when the head of sales died. Competitors exploited this situation. The new CEO—John Wilbur—immediately recognized that there had been some complacency about generating new customers, and the firm would not be able to survive in the long run merely on its backlog of orders. Wilbur began to aggressively deal with the firm's problems and build its customer base. In ten years, he was able to take Consolidated Industries' sales from $8 million a year to $30 million a year. He attributes much of this success to the firm's commitment to business planning.

Soon after taking over the business, he started a comprehensive planning process. Given the pressing issues the firm was facing, the first plan had a one-year horizon. It was instrumental in gaining the support of Consolidated Industries' bankers, which carried it through those difficult years. In the intervening years, the plan's horizon was expanded to five years. Although Wilbur admitted that the projections may be "pipe dreams" after the first two years, he said it was important to maintain the five-year horizon to force the business to think about the future. The main goals of the plan had been to examine ways to lower costs and expand the customer base, particularly outside the aerospace industry.

The plan would be constantly evolving; detailed metrics would provide guidance to the various units throughout the firm. These metrics were broken down on a quarterly basis and were color-coded to allow the various units to see how well they were progressing toward the achievement of the goals and the objectives. It had a detailed sales plan that emphasized developing new customers in new industries. To this end, it significantly focused on developing new products. In the past few years, the number of new products increased from six per year to seventy-seven per year. This meant an enlargement of the engineering staff, but it is also meant a much closer relationship with customers. Wilbur estimated that 50 percent of the new products were a co-design with customers. The planning process also enabled the business to incorporate technology in new ways. The firm used videoconferencing to communicate with both customers and sister units. Another important element of the plan was the concept of succession planning. As vital as the planning process was, Wilbur said that "it is all about people. Any plan to improve the firm has to bring people into the process and bring them together."

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5.2.2: Developing Your Strategy

Learning Objectives

- Understand the term *strategy* and why it is important for small business.
- Define the four generic strategies identified by Porter.
- Evaluate the ramifications of each generic strategy for the operations of a small business.

It is critically important for any business organization to be able to accurately understand and identify what constitutes customer value. To do this, one must have a clear idea of who your customers are or will be. However, simply identifying customer value is insufficient. An organization must be able to provide customer value within several important constraints. One of these constraints deals with the competition—what offerings are available and at what price. Also, what additional services might a company provide? A second critically important constraint is the availability of resources to the business organization. Resources consist of factors such as money, facilities, equipment, operational capability, and personnel.

Here is an example: a restaurant identified its prime customer base as being upscale clientele in the business section of a major city. The restaurant recognized that it has numerous competitors that are interested in providing the same clientele with an upscale dining experience. Our example restaurant might provide a five-course, five-star gourmet meal to its customers. It also provides superlative service. If a comparable restaurant failed to provide a comparable meal to the example restaurant, the example restaurant would have a competitive advantage. If the example restaurant offered these sumptuous meals for a relatively low price in comparison to its competitors, it would initially seem to have even more of an advantage. However, if the price charged is significantly less than the cost of providing the meal, the service in this situation could not be maintained. In fact, the restaurant inevitably would have to go out of business. Providing excellent customer service may be a necessary condition for business survival but, in and of itself, it is not a sufficient condition.

So how does one go about balancing the need to provide customer value within the resources available while always maintaining a watchful eye on competitors' actions? We are going to argue that what is required for that firm is to have a **strategy**.

The word *strategy* is derived from the Greek word *strategos*, which roughly translates into the art of the general, namely a military leader. Generals are responsible for marshaling required resources and organizing the troops and the basic plan of attack. Much in the same way, executives as owners of businesses are expected to have a general idea of the desired outcomes, acquire resources, hire and train personnel, and generate plans to achieve those outcomes. In this sense, all businesses, large and small, have strategies, whether they are clearly written out in formal business plans or reside in the mind of the owner of the business.

There are many different formal definitions of strategy with respect to business. The following is a partial listing of some of the definitions given by key experts in the field:

- "A strategy is a pattern of objectives, purposes or goals and the major policies and plans for achieving these goals, stated in such a way as to define what business the company is in or is to be in and the kind of company it is or to be," - Kenneth Arrow
- "The determination of the long-run goals and objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals," - Alfred Chandler
- "What business strategy is all about, in a word, is competitive advantage," - Kenichi Ohmae

We define the strategy of a business as follows: *A firm's strategy is the path by which it seeks to provide its customers with value, given the competitive environment and within the constraints of the resources available to the firm.*

Whatever definition of strategy is used, it is often difficult to separate it from two other terms: strategic planning and strategic management. Both terms are often perceived as being in the domain of large corporations, not necessarily small to midsize businesses. This is somewhat understandable. The origin of strategic planning as a separate discipline occurred over fifty years ago. It was mainly concerned with assisting huge multidivisional or global businesses in coordinating their activities. In the intervening half-century, strategic planning has produced a vast quantity of literature. Mintzberg, Lampel, Ahlstrand, in a highly critical review of the field, identified ten separate schools associated with strategic planning. With that number of different schools, it is clear that the discipline has not arrived at a common consensus. Strategic planning has been seen as a series of techniques and tools that would enable organizations to achieve their specified goals and objectives. Strategic management was seen as the organizational

mechanisms by which you would implement the strategic plan. Some of the models and approaches associated with strategic planning and strategic management became quite complex and would prove to be fairly cumbersome to implement in all but the largest businesses. Further, strategic planning often became a bureaucratic exercise where people filled out forms, attended meetings, and went through the motions to produce a document known as the strategic plan. Sometimes what is missed in this discussion was a key element—strategic thinking. Strategic thinking is the creative analysis of the competitive landscape and a deep understanding of customer value. It should be the driver of the entire process. This concept is often forgotten in large bureaucratic organizations.

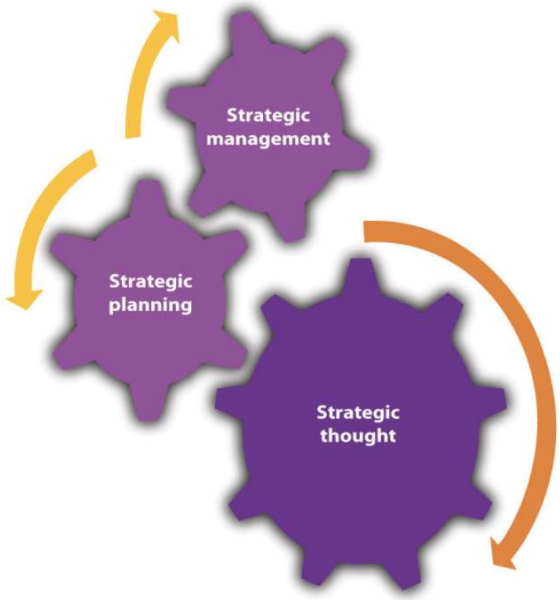


Figure 5.2.2.1: Strategy Troika (CC BY-SA-NC; anonymous)

Strategic thinkers often break commonly understood principles to reach their goals. This is most clearly seen among military leaders, such as Alexander the Great or Hannibal. Robert E. Lee often violated basic military principles, such as dividing his forces. General Douglas MacArthur shocked the North Koreans with his bold landings behind enemy lines at Inchon. This mental flexibility also exists in great business leaders.

Solomon and Friedman recounted a prime example of true strategic thinking. Wilson Harrell took a small, closely-held, cleaning spray company known as Formula 409 to the point of having national distribution. In 1967, the position that Formula 409 held was threatened by the possible entry of Procter & Gamble into the same spray cleaning market. Procter & Gamble was a huge consumer products producer, noted for its marketing savvy. Procter & Gamble began a program of extensive market research to promote its comparable product they called Cinch. Clearly, the larger firm had a much greater advantage. Harrell knew that Procter & Gamble would perform test market research. He decided to do the unexpected. Rather than directly confront this much larger competitor, he began a program where he reduced advertising expenditures in Denver and stopped promoting his Formula 409. The outcome was that Procter & Gamble had spectacular results, and the company was extremely excited with the potential for Cinch. Procter & Gamble immediately begin a national sales campaign. However, before the company could begin, Harrell introduced a promotion of his own. He took the Formula 409 sixteen-ounce bottle and attached it to a half-gallon size bottle. He then sold both at a significant discount. This quantity of spray cleaner would last the average consumer six to nine months. The market for Procter & Gamble's Cinch was significantly reduced. Procter & Gamble was confused and confounded by its poor showing after the phenomenal showing in Denver. Confused and uncertain, the company chose to withdraw Cinch from the market. Wilson Harrell's display of brilliant strategic thinking had bested them. He leveraged his small company's creative thinking and flexibility against the tremendous resources of an international giant. Through superior strategic thinking, Harrell was able to best Procter & Gamble.

Video Clip: What is Strategy?

Michael Porter of Harvard Business School provides a brief discussion of what strategy is.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Strategic Thinking and the Definition of Strategy

A Center for Management Organization and Effectiveness (CMOE) discussion of strategy; leads to other similar videos.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Strategic Thinking—Develop Strategic Thinking Skills to Give Yourself a Competitive Edge

Follow-up CMOE video on strategic thinking.

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Video Clip: Strategic Thinking and Management for Competitive Advantage

Two Wharton professors discuss how strategic thinking is critical to the acquisition of competitive advantage.

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Video Clip: Mastering Strategic Thinking Workshop

A professor discusses the importance of strategic thinking for leadership.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: From Strategic Thinking to Planning

A speaker illustrates that successful plans are tied to strategic thinking.

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Do You Have a Strategy and What is it?

We have argued that all businesses have strategies, whether they are explicitly articulated or not. Perry stated that "small business leaders seem to recognize that the ability to formulate and implement an effective strategy has a major influence on the survival and success of small business."

The extent to which a strategy should be articulated in a formal manner, such as part of a business plan, is highly dependent on the type of business. One might not expect a formally drafted strategy statement for a nonemployee business funded singularly by the owner. One researcher found that formal plans are rare in businesses with fewer than five employees. However, you should clearly have that expectation for any other type of small or midsize business.

Any business with employees should have an articulated strategy that can be conveyed to them so that they might better assist in implementing it. Curtis pointed out that in the absence of such communication, "employees make pragmatic short-term decisions that cumulatively form an ad-hoc strategy." These ad hoc (realized) strategies may be at odds with the planned (intended) strategies to guide a firm. However, any business that seeks external funding from bankers, venture capitalists, or "angels" must be able to specify its strategy in a formal business plan.

Clearly specifying your strategy should be seen as an end in itself. Requiring a company to specify its strategy forces that company to think about its core issues, such as the following:

- Who are your customers?
- How are you going to provide value to those customers?
- Who are your current and future competitors?
- What are your resources?
- How are you going to use these resources?

One commentator in a blog put it fairly well, "It never ceases to amaze me how many people will use GPS or Google maps for a trip somewhere but when it comes to starting a business they think that they can do it without any strategy, or without any guiding road-map."

Types of Strategies

In 1980, Michael Porter a professor at Harvard Business School published a major work in the field of strategic analysis—*Competitive Strategy*. To simplify Porter's thesis, while competition is beneficial to customers, it is not always beneficial to those

who are competing. Competition may involve lowering prices, increasing research and development (R&D), and increasing advertising and other expenses and activities—all of which can lower profit margins. Porter suggested that firms should carefully examine the industry in which they are operating and apply what he calls the five forces model. These five forces are as follows: the power of suppliers, the power of buyers, the threat of substitution, the threat of new entrants, and rivalry within the industry. We do not need to cover these five forces in any great detail, other than to say that once the analysis has been conducted, a firm should look for ways to minimize the dysfunctional consequences of competition. Porter identified four generic strategies that firms may choose to implement to achieve that end. Actually, he initially identified three generic strategies, but one of them can be bifurcated. These four strategies are as follows: cost leadership, differentiation, cost focus, and differentiation focus. These four generic strategies can be applied to small businesses. We will examine each strategy and then discuss what is required to successfully implement them.

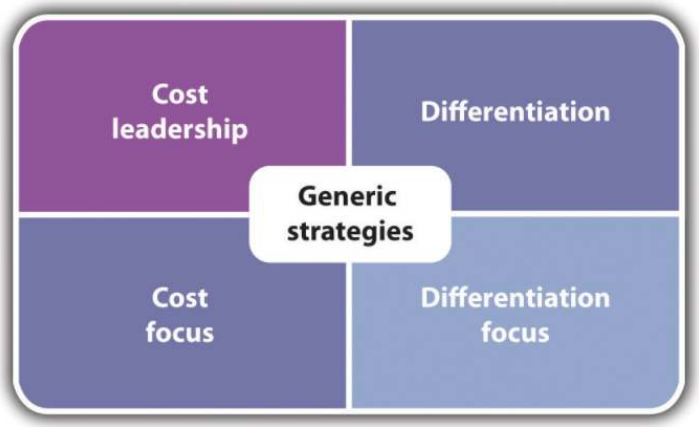


Figure 5.2.2.2: Generic Strategies

Low-Cost Advantage

A **cost leadership** strategy requires that a firm be in the position of being the lowest cost producer in its competitive environment. By being the lowest cost producer, a firm has several strategic options open to it. It can sell its product or service at a lower price than its competitors. If price is a major driver of customer value, then the firm with the lowest price should sell more. The low-cost producer also has the option of selling its products or services at prices that are comparable to its competitors. However, this would mean that the firm would have a much higher margin than its competitors.

Obviously, following a cost leadership strategy dictates that the business be good at curtailing costs. Perhaps the clearest example of a firm that employs a cost leadership strategy is Walmart. Walmart's investment in customer relations and inventory control systems plus its huge size enables it to secure the "best" deals from suppliers and drastically reduce costs. It might appear that cost leadership strategies are most suitable for large firms that can exploit economies of scale. This is not necessarily true. Smaller firms can compete on the basis of cost leadership. They can position themselves in low-cost areas, and they can exploit their lower overhead costs. Family businesses can use family members as employees, or they can use a web presence to market and sell their goods and services. A small family-run luncheonette that purchases used equipment and offers a limited menu of standard breakfast and lunch items while not offering dinner might be a good example of a small business that has opted for a cost leadership strategy.

Differentiation

A **differentiation** strategy involves providing products or services that meet customer value in some unique way. This uniqueness may be derived in several ways. A firm may try to build a particular brand image that differentiates itself from its competitors. Many clothing lines, such as Tommy Hilfiger, opt for this approach. Other firms will try to differentiate themselves on the basis of the services that they provide. Dominoes began to distinguish itself from other pizza firms by emphasizing the speed of its delivery. Differentiation also can be achieved by offering a unique design or features in the product or the service. Apple products are known for their user-friendly design features. A firm may wish to differentiate itself on the basis of the quality of its product or service. Kogi barbecue trucks operating in Los Angeles represent such an approach. They offer high-quality food from mobile food trucks. They further facilitate their differentiation by having their truck routes available on their website and on their Twitter account.

Adopting a differentiation strategy requires significantly different capabilities than those that were outlined for cost leadership. Firms that employ a differentiation strategy must have a complete understanding of what constitutes customer value. Further, they must be able to rapidly respond to changing customer needs. Often, a differentiation strategy involves offering these products and services at a premium price. A differentiation strategy may accept lower sales volumes because a firm is charging higher prices and obtaining higher profit margins. A danger in this approach is that customers may no longer place a premium value on the unique features or quality of the product or the service. This leaves the firm that offers a differentiation strategy open to competition from those that adopt a cost leadership strategy.

Focus—Low Cost or Differentiation

Porter identifies the third strategy—focus. He said that focus strategies can be segmented into a **cost focus** and a **differentiation focus**.

In a focus strategy, a firm concentrates on one or more segments of the overall market. Focus can also be described as a niche strategy. Focus strategy entails deciding to some extent that we do not want to have everyone as a customer. There are several ways that a firm can adopt a focus perspective:

- **Product line.** A firm limits its product line to specific items of only one or more product types. California Cart Builder produces only catering trucks and mobile kitchens.
- **Customer.** A firm concentrates on serving the needs of a particular type of customer. Weight Watchers concentrates on customers who wish to control their weight or lose weight.
- **Geographic area.** Many small firms, out of necessity, will limit themselves to a particular geographic region. Microbrewers generally serve a limited geographic region.
- **Particular distribution channel.** Firms may wish to limit themselves with respect to the means by which they sell their products and services. Amazon began and remains a firm that sells only through the Internet.

Firms adopting focus strategies look for distinct groups that may have been overlooked by their competitors. This group needs to be of a sufficiently sustainable size to make it an economically defensible option. One might open a specialty restaurant in a particular geographic location—a small town. However, if the demand is not sufficiently large for this particular type of food, then the restaurant will probably fail. Companies that lack the resources to compete on either a national level or an industry-wide level may adopt focus strategies. Focus strategies enable firms to marshal their limited resources to best serve their customers.

As previously stated, focus strategies can be bifurcated into two directions—cost focus or differentiation focus. IKEA sells low-priced furniture to those customers who are willing to assemble the furniture. It cuts its costs by using a warehouse rather than showroom format and not providing home delivery. Michael Dell began his business out of his college dormitory. He took orders from fellow students and custom-built computers to their specifications. This was a cost focus strategy. By building to order, it almost totally eliminated the need for any incoming, work-in-process, or finished goods inventories.

A focus differentiation strategy concentrates on providing a unique product or service to a segment of the market. This strategy may be best represented by many specialty retail outlets. The Body Shop focuses on customers who want natural ingredients in their makeup. Max and Mina is a kosher specialty ice cream store in New York City. It provides a constantly rotating menu of more than 300 exotic flavors, such as Cajun, beer, lox, corn, and pizza. The store has been written up in the *New York Times* and *People* magazine. Given its odd flavors, Max and Mina's was voted the number one ice cream parlor in America in 2004.

Evaluating Strategies

The selection of a generic strategy by a firm should not be seen as something to be done on a whim. Once a strategy is selected, all aspects of the business must be tied to implementing that strategy. As Porter stated, "Effectively implementing any of these generic strategies usually requires total commitment and supporting organizational arrangements." The successful implementation of any generic strategy requires that a firm possess particular skills and resources. Further, it must impose particular requirements on its organization.

Even successful generic strategies must recognize that market and economic conditions change along with the needs of consumers. Henry Ford used a cost leadership strategy and was wildly successful until General Motors began to provide different types of automobiles to different customer segments. Likewise, those who follow a differentiation strategy must be cautious that customers

may forgo “extras” in a downturn economy in favor of lower costs. This requires businesses to be vigilant, particularly with respect to customer value.

Table 5.2.2.1: Summary of Generic Strategies

Generic Strategy	Required Activities	Issues
Cost leadership	• Economies of scale • Reduce overhead costs • Lower cost of supplies • Capital investment in technology to reduce cost • Labor cost reduction through supervision, outsourcing, and work design • Low-cost distribution • Reduce cost of manufacturing or providing service • Tight financial control • Operate in lower-cost environments • Production-based incentives	• Product or service becomes a commodity with no brand loyalty • Changing technology cuts your cost advantage • New entrants can produce at even lower costs (e.g., China) • Focus on cost reduction means that you miss changing customer tastes
Differentiation	• Unique or highly improved products or services • Brand image • Creative approach to marketing • Reputation for quality and product or service innovation • Ability to attract creative personnel • Effective coordination among R&D, marketing, and operations	• Qualitative difference between you and low-cost producer may not be enough to sustain sales • Differentiating factor may no longer be attractive to customers • Imitation narrows perceived differences
Focus—low cost	• Reduce overhead costs • Lower cost of supplies • Labor cost reduction through supervision, outsourcing, and work design • Low-cost distribution • Tight financial control • Operate in lower-cost environments • Production-based incentives	• Cost advantage of focused firms is lost with respect to broader competitors • Differentiation advantage with a focused market is lost • Competitors find even smaller markets to focus on
Focus—differentiation	• Unique or highly improved products or services • Creative approach to marketing • Reputation for quality and product/service innovation • Ability to attract creative personnel • Effective coordination among R&D, marketing, and operations	• Cost advantage of focused firms is lost with respect to broader competitors • Differentiation advantage with a focused market is lost • Competitors find even smaller markets to focus on

Video Clip: Porter’s Strategies—Generic Strategies

Examples of generic strategies.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: The Five Competitive Forces That Shape Strategy

A long interview with Michael Porter discussing the five forces model.

A YouTube element has been excluded from this version of the text. You can view it online here.

KEY TAKEAWAYS

- Any firm, regardless of size, needs to know how it will compete; this is the firm's strategy.
- Strategy identifies how a firm will provide value to its customers within its operational constraints.
- Strategy can be reduced to four major approaches—cost leadership, differentiation, cost focus, and differentiation focus.
- Once a given strategy is selected, all of a firm's operations should be geared to implementing that strategy.
- No strategy will be successful forever and therefore needs to be constantly evaluated.

EXERCISES

1. As previously noted, Walmart competes on the basis of cost leadership. Show how a variety of local firms could successfully compete with Walmart by the correct selection of one of the generic strategies.
2. Identify five local businesses and talk to their owners. Ask them if they have a formal strategy. If they say no, ask how they compete. Try to determine if they have a strategy in place even if they cannot articulate one.

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5.2.3: The Necessity for a Business Plan

Learning Objectives

- Understand that the probability of running a successful business is significantly increased with a formal business plan.
- Understand that although many small business owners express reasons for not planning, they do themselves a great disservice by not having a formal plan.
- Understand that businesses that seek to secure external funding must produce a formal plan.

Earlier, we discussed the issue of failure and small businesses. Although research on small business failure has identified many factors, one reason that always appears at the top of any list is the failure to plan. Interestingly, some people argue that planning is not essential for a start-up business, but they are in a distinct minority. The overwhelming consensus is that a well-developed plan is essential for the survival of any small (or large) business. Stephen C. Perry found that firms with more than five people benefit from having a well-developed business plan.

A recent study found that there was a near doubling of successful growth for those businesses that completed business plans compared to those that did not create one. It must be pointed out that this study might be viewed as being biased because the founder of the software company whose main product is a program that builds business plans conducted the study. However, the results were examined by academics from the University of Oregon who validated the overall results. They found that “except in a small number of cases, business planning appeared to be positively correlated with business success as measured by our variables. While our analysis cannot say the completing of a business plan will lead to success, it does indicate that the type of entrepreneur who completes a business plan is also more likely to produce a successful business.”

Basically, there are two main reasons for developing a comprehensive business plan: (1) a plan will be extraordinarily useful in ensuring the successful operation of your business; and (2) if one is seeking to secure external funds from banks, venture capitalists, or other investors, it is essential that you be able to demonstrate to them that they will be recovering their money and making a profit. Let us examine each reason in detail.

Many small business owners operate under a mistaken belief that the only time that they need to create a business plan is at the birth of the company or when they are attempting to raise additional capital from external sources. They fail to realize that a business plan can be an important element in ensuring day-to-day success.

The initial planning process aids the operational success of a small business by allowing the owner a chance to review, in detail, the viability of the business idea. It forces one to rigorously consider some key questions:

- Is the business strategy feasible?
- What are the chances it will make money?
- Do I have the operational requirements for starting and running a successful business?
- Have I considered a well-thought-out marketing plan that clearly identifies who my customers will be?
- Do I clearly understand what value I will provide to these customers?
- What will be the means of distribution to provide the product or the service to my customers?
- Have I clarified to myself the financial issues associated with starting and operating the business?
- Do I have to reexamine these notions to ensure success?

Possessing an actual written plan enables you to have people outside the organization evaluate your business plan. Using friends, colleagues, partners, or even consultants may provide you with an unbiased evaluation of the assumptions.

It is not enough to create an initial business plan; you should anticipate making the planning process an annual activity. The Prussian military theorist von Moltke once argued that no military plan survives the first engagement with the enemy. Likewise, no company evolves in the same way as outlined in its initial business plan.

Overcoming the Reluctance to Formally Plan

Unfortunately, it appears that many small businesses do not make any effort to build even an initial business plan, let alone maintain a planning process as an ongoing operation, even though there is clear evidence that the failure to plan may have serious

consequences for the future success of such firms. This unwillingness to plan may be understandable in nonemployee businesses, but it is inexcusable as a business grows in size. Why, therefore, do some businesses fail to begin the planning process?

- **We do not need to plan.** One of the prime reasons individuals fail to produce a business plan is that they believe that they do not have to plan. This may be attributable to the size of the firm; nonemployee firms that have no intention of seeking outside financing might sincerely believe that they have no need for a formal business plan. Others may believe that they so well understand the business and/or industry that they can survive and prosper without the *burdensome* process of a business plan. The author of *Business Plan for Dummies*, Paul Tiffany, once argued that if one feels lucky enough to operate a business successfully without resorting to a business plan, then he or she should forget about starting a business and head straight to Las Vegas.
- **I am too busy to plan.** Anyone who has ever run a business on his or her own can understand this argument. The day-to-day demands of operating a business may make it seem that there is insufficient time to engage in any ancillary activity or prepare a business plan. Individuals who accept this argument often fail to recognize that the seemingly endless buzz of activities, such as constantly putting out fires, may be the direct result of not having thought about the future and planned for it in the first place.
- **Plans do not produce results.** Small-business owners (entrepreneurs) are action- and results-oriented individuals. They want to see a tangible outcome for their efforts, and preferably they would like to see the results as soon as possible. The idea of sitting down and producing a large document based on assumptions that may not play out exactly as predicted is viewed as a futile exercise. However, those with broader experience understand that there will be no external funding for growth or the initial creation of the business without the existence of a well-thought-out plan. Although plans may not yield the specified results contained within them, the process of thinking about the plan and building it often yield results that the owner might not initially appreciate.
- **We are not familiar with the process of formal planning.** This argument might initially appear to have more validity than the others. Developing a comprehensive business plan is a daunting task. It might seem difficult if not impossible for someone with no experience with the concept. Several studies have indicated that small business owners are more likely to engage in the planning process if they have had prior experience with planning models in their prior work experience. Fortunately, this situation has changed rather significantly in the last decade. As we will illustrate later, there are numerous tools that provide significant support for the development of business plans. We will see that software packages greatly facilitate the building of any business plan, including marketing plans and financial plans for small businesses. We also show that the Internet can provide an unbelievably rich source of data and information to assist in the building of these plans.

Although one could understand the reticence of someone new to small business (or in some cases even seasoned entrepreneurs), their arguments fall short with respect to the benefits that will be derived from conducting a structured and comprehensive business planning process.

Plans for Raising Capital

Every business plan should be written with a particular audience in mind. The annual business plan should be written with a management team and for the employees who have to implement the plan. However, one of the prime reasons for writing a business plan is to secure investment funds for the firm. Of course, funding the business could be done by an individual using his or her own personal wealth, personal loans, or extending credit cards. Individuals also can seek investments from family and friends. The focus here will be on three other possible sources of capital—banks, venture capitalists, and angel investors. It is important to understand what they look for in a business plan. Remember that these three groups are investors, so they will be anticipating, at the very least, the ability to recover their initial investment if not earn a significant return.

Bankers

Bankers, like all businesspeople, are interested in earning a profit; they want to see a return on their investment. However, unlike other investors, bankers are under a legal obligation to ensure that the borrower pledge some form of collateral to secure the loan. This often means that banks are unwilling to fund a start-up business unless the owner is willing to pledge some form of collateral, such as a second mortgage on his or her home. Many first-time business owners are not in a position to do that; securing money from a bank occurs most frequently for an existing business that is looking to expand or for covering a short-term cash-flow need. Banks may lend to small business owners who are opening a second business provided that they can prove a record of success and profitability.

Banks will require a business plan. It should be understood that bank loan officers will initially focus on the financial components of that client, namely, the income statement, balance sheet, and the cash-flow statement. The bank will examine your projections with respect to known industry standards. Therefore, the business plan should not project a 75 percent profit margin when the industry standard is 15 percent, unless the author of the plan can clearly document why he or she will be earning such a high return.

Some businesses may raise funds with the assistance of a Small Business Administration (SBA) loan. These loans are always arranged through a commercial bank. With these loans, the SBA will pledge up to 70 percent of the total value of the loan. This means that the owner still must provide, at the very least, 30 percent of the total collateral. The ability to secure one of these loans is clearly tied to the adequacy of the business plan.

Venture Capitalists

Another possible source of funding is **venture capitalists**. The first thing that one should realize about venture capitalists is that they are not in it just to make a profit; they want to make returns that are substantially above those to be found in the market. For some, this translates into the ability to secure five to ten times their initial investment and recapture their investment in a relatively short period of time—often less than five years. It has been reported that some venture capitalists are looking for returns in the order of twenty-five times their original investment.

The financial statement, particularly the profit margin, is obviously important to venture capitalists, but they will also be looking at other factors. The quality of the management team identified in the business plan will be examined. They will be looking at the team's experience and track record. Other factors needed by venture capitalists may include the projected growth rate of the market, the extent to which the product or the service being offered is unique, the overall size of the market, and the probability of producing a highly successful product or service.

Businesses that are seeking financing from banks know that they must go to loan officers who will review the plan, even though a computerized loan assessment program may make the final decision. With venture capitalists, on the other hand, you often need to have a personal introduction to have your plan considered. You should also anticipate that you will have to make a presentation to venture capitalists. This means that you have to understand your plan and be able to present it in a dynamic fashion.

Angel Investors

The third type of investors are referred to as **angel investors**, a term that originally came from those individuals who invested in Broadway shows and films. Many angel investors are themselves successful entrepreneurs. As with venture capitalists, they are looking for returns higher than they can normally find in the market; however, they often expect returns lower than those anticipated by venture capitalists. They may be attracted to business plans because of an innovative concept or the excitement of entering a new type of business. Being successful small business owners, many angel investors will not only provide capital to fund the business but also bring their own expertise and experience to help the business grow. It has been estimated that these angel investors provide between three and ten times as much money as venture capitalists for the development of small businesses.

Angel investors will pay careful attention to all aspects of the proposed business plan. They expect a comprehensive business plan —one that clearly specifies the future direction of the firm. They also will look at the management team not only for its track record and experience but also their (the angel investor's) ability to work with this team. Angel investors may take a much more active role in the management of the business, asking for positions on the board of directors, taking an equity position in the firm, demanding quarterly reports, or demanding that the business not take certain actions unless it has the approval of these angel investors. These investors will take a much more hands-on approach to the operations of a firm.

KEY TAKEAWAYS

- Planning is a critical and important component of ensuring the success of a small business.
- Some form of formal planning should not only accompany the start-up of a business but also be a regular (annual) activity that guides the future direction of the business.
- Many small business owners are reluctant to formally plan. They can produce many excuses for not planning.
- Businesses may have to raise capital from external sources—bankers, venture capitalists, or angel investors. Each type of investor will expect a business plan. Each type of investor will be more or less interested in different parts of the plan. Business owners should be aware of what parts of the plan each type of investor will focus on.

EXERCISE

In an earlier exercise, you were asked to interview five local business owners. In addition to asking them questions about strategy, ask them the following questions about planning: (a) When you began the business, did you have a formal plan? (b) If not, why not? (c) Do you conduct some form of planning regularly?

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5.2.4: Building a Plan

Learning Objectives

- Understand that before starting a business and before writing a formal plan, individuals should ask themselves some specific questions to see if they are ready for the challenges of small business ownership.
- Understand that any solidly written plan will require information about the competitive environment. There are many publicly available sources of such information.
- Understand that plans are future-oriented documents that require forecasts. Forecasting can be done through a variety of methods. Planners should be familiar with a variety of forecasting methods.
- Understand that formal business plans should contain specific sections.
- Know that scenario planning should help businesses prepare for low-probability events that might have a significant impact on the firm.
- Know that there are many computer software packages that can assist in building a formal business plan.

Before talking about writing a formal business plan, someone interested in starting a business might want to think about doing some personal planning before drafting the business plan. Some of the questions that he or she might want to answer before drafting a full business plan are as follows:

- Why am I going into this business?
- What skills and resources do I possess that will help make the business a success?
- What passion do I bring to this business?
- What is my risk tolerance?
- Exactly how hard do I intend to work? How many hours per week?
- What impact will the business have on my family life?
- What do I really wish from this business?
  - Am I interested in financial independence?
  - What level of profits will be required to maintain my personal and/or family's lifestyle?
  - Am I interested in independence of action (no boss but myself)?
  - Am I interested in personal satisfaction?
- Will my family be working in this business?
- What other employees might I need?

Having addressed these questions, one will be in a much better position to craft a formal business plan.

Video Clip: How to Write a Business Plan

Cartoon introduction to building a business plan.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: How to Write a Business Plan in 6 Minutes—Template

Voiceover PowerPoint video.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: How to Start a Business—How to Write a Business Plan

A video from Startupdaddy.com that emphasizes the need for a business plan.

A YouTube element has been excluded from this version of the text. You can view it online here.

Gathering Information

Building a solid business plan requires knowing the economic, market, and competitive environments. Such knowledge transcends "gut feelings" and is based on data and evidence. Fortunately, much of the required information is available through library

resources, Internet sources, and government agencies and, for a fee, from commercial sources. Comprehensive business plans may draw from all these sources.

Public libraries and those at educational institutions provide a rich resource base that can be used at no cost. Some basic research sources that can be found at libraries are given in this section—*be aware that the reference numbers provided may differ from library to library*.

Library Sources

Background Sources

- Berinstein, Paula. *Business Statistics on the Web: Find Them Fast—At Little or No Cost* (Ref HF1016 .B47 2003).
- *The Core Business Web: A Guide to Information Resources* (Ref HD30.37 .C67 2003).
- Frumkin, Norman. *Guide to Economic Indicators*, 4th ed. (Ref HC103 .F9 2006). This book explains the meanings and uses of the economic indicators.
- Solie-Johnson, Kris. *How to Set Up Your Own Small Business*, 2 volumes (Ref HD62.7 .S85 2005). Published by the American Institute of Small Business.

Company and Industry Sources

- *North American Industry Classification System, United States* (NAICS), 2007 (Ref HF1042 .N6 2007). The NAICS is a numeric industry classification system that replaced the Standard Industrial Classification (SIC) system. An electronic version is available from the US Census Bureau.
- *Standard Industrial Classification Manual* (Ref HA40 .I6U63 1987). The industry classification system that preceded the NAICS.
- *Value Line Investment Survey* (Ref HG4751 .V18). Concise company and industry profiles are updated every thirteen weeks.

Statistical Sources

- *Almanac of Business and Industrial Financial Ratios* (Ref HF5681 .R25A45 2010).
- *Business Statistics of the United States* (Ref HC101 .A13123 2009). This publication provides recent and historical information about the US economy.
- *Economic Indicators* (1971–present). The Council of Economic Advisers for the Joint Economic Committee of Congress publishes this monthly periodical; recent years are in electronic format only. Ten years of data are presented. Electronic versions are available in ABI/INFORM and ProQuest from September 1994 to present and Academic OneFile from October 1, 1991.
- *Industry Norms and Key Business Ratios* (Dun & Bradstreet; Ref HF5681 .R25I532 through Ref HF5681 .I572 [2000–2001 through 2008–2009]).
- *Rma Annual Statement Studies* (Ref HF5681 .B2R6 2009–2010). This publication provides annual financial data and ratios by industry.
- *Statistical Abstract of the United States* (Ref HA202 .S72 2010). This is the basic annual source for statistics collected by the government. Electronic version is available at www.census.gov/compendia/statab.
- *Survey of Current Business* (1956–present). The Bureau of Economic Analysis publishes this monthly periodical; recent years are in electronic format only.

At some libraries, you may find access to the following resources online:

- Mergent Webreports. Mergent (formerly Moody's) corporate manuals are in digitized format. Beginning with the early 1900s, the reports include corporate history, business descriptions, and in-depth financial statements. The collection is searchable by company name, year, or manual type.
- ProQuest Direct is a database of general, trade, and scholarly periodicals, with many articles in full text. Many business journals and other resources are available.
- Standard and Poor's Netadvantage is a database that includes company and industry information.

Internet Resources

In addition to government databases and other free sources, the Internet provides an unbelievably rich storehouse of information that can be incorporated into any business plan. It is not feasible to provide a truly comprehensive list of useful websites; this section provides a highly selective list of government sites and other sites that provide free information.

Government Sites

- **US Small Business Administration (SBA)**. This is an excellent site to begin researching a business plan. It covers writing a plan, financing a start-up, selecting a location, managing employees, and insurance and legal issues. A follow-up page at http://www.sba.gov provides access to publications, statistics, video tutorials, podcasts, business forms, and chat rooms. Another page—http://www.sba.gov/about-offices-list/2—provides access to localized resources.
- **SCORE Program**. The SCORE program is a partner of the SBA. It provides a variety of services to small business owners, ranging from online (and in-person) mentoring, workshops, free computer templates, and advice on a wide range of small business issues.

In developing a business plan, it is necessary to anticipate the future economic environment. The government provides extensive statistics online.

- **Consumer Price Index**. This index provides information on the direction of prices for industries and geographic areas.
- **Producer Price Index**. Businesses that provide services or are focused on business-to-business (B2B) operations may find these data more appropriate for estimating future prices.
- **National Wage Data**. This site provides information on prevailing wages and can be broken down by occupation and location down to the metropolitan area.
- **Consumer Expenditures Survey**. This database provides information on expenditures and income. It allows for a remarkable level of refinement by occupation, age, or race.
- **State and Local Personal Income and Employment**. These databases provide a breakdown of personal income by state and metropolitan area.
- **GDP by State and Metropolitan Region**. This will provide an accurate guide to the overall economic health of a region or a city.
- **US Census**. This is a huge site with databases on population, income, foreign trade, economic indicators, and business ownership.

There are nongovernment websites, either free or charging a fee, that can provide assistance in building a business plan. A simple Google search for the phrase *small business plan* yields more than 67 million results. Various sites will either help with writing the plan, offer to write the plan for a fee, produce reports on industries, or assist small businesses by providing a variety of support services. The Internet offers a veritable cornucopia of information and support for those working on their business plans.

Forecasting for the Plan

Any business plan is a future-oriented document. Business plans are required to look between three and five years into the future. To produce them and accurately forecast sales, you will need estimates of expenses and other items, such as the required number of employees, interest rates, and general economic conditions. There are many different techniques and tools that can be used to forecast these items. The type of techniques used will be influenced by many factors, such as the following:

- **The size of the business.** Smaller businesses may have fewer resources to apply a wide variety of forecasting techniques.
- **The analytical sophistication of people who will be conducting the forecast.** The owner of a home business may have no prior experience with forecasting techniques.
- **The type of the organization.** A manufacturing concern that sells to a stable and relatively predictable environment that has been in existence for years might be able to employ a variety of standard statistical forecasting techniques; however, a small firm operating in a new or a chaotic environment might have to rely on significantly different techniques.
- **Historical records.** Does the firm have historical records for sales that can be used to project into the future?

There is no universal set of forecasting techniques that can be used for all types of small and midsize businesses. Forecasting can fall into a fairly comprehensive range of techniques with respect to level of sophistication. Some forecasting can be done on an

intuitive basis (e.g., back-of-the-envelope calculations); others can be done with standard computer programs (e.g., Excel) or programs that are specifically dedicated to forecasting in a variety of environments.

A brief review of basic forecasting techniques shows that they can be divided into two broad classes: **qualitative forecasting methods** and **quantitative forecasting methods**. Actually, these terms can be somewhat misleading because qualitative forecasting methods do not imply that no numbers will be involved. The two techniques are separated by the following concept: qualitative forecasting methods assume that one either does not have historical data or that one cannot rely on past historical data. A start-up business has no past sales that can be used to project future sales. Likewise, if there is a significant change in the environment, one may feel uncomfortable using past data to project into the future. A restaurant operates in a small town that contains a large automobile factory. After the factory closes, the restaurant owner should anticipate that past sales will no longer be a useful guideline for projecting what sales might be in the next year or two because the owner has lost a number of customers who worked at the factory. Quantitative forecasting, on the other hand, consists of techniques and methods that assume you can use past data to make projections into the future.

Table 5.2.4.1 provides examples of both qualitative forecasting methods and quantitative forecasting methods for sales forecasting. Each method is described, and its strengths and weaknesses are given.

Table 5.2.4.1: Overview of Forecasting Methods

Technique	Description	Strength	Weakness
Qualitative Sales Forecasting Methods			
Simple extrapolation	This approach uses some data and simply makes a projection based on these data. The data might indicate that a particular section of town has many people walk through the section each day. Knowing that number, a store might make a simple estimate of what sales might be.	An extremely simple technique that requires only the most basic analytical capabilities.	Its success depends on the "correctness" of the assumptions and the ability to carry them over to reality. You might have the correct number of people passing your store, but that does not mean that they will buy anything.
Sales force	In firms with dedicated sales forces, you would ask them to estimate what future sales might be. These values would be pieced together with a forecast for next year.	The sales force should have the pulse of your customers and a solid idea of their intentions to buy. Its greatest strength is in the B2B environment.	Difficult to use in some business-to-customer (B2C) environments. Sales force members are compensated when they meet their quotas, but this might be an incentive to "low-ball" their estimates.
Expert opinion	Similar to sales force approach, this technique ask experts within the company to produce estimates of future sales. These experts may come from marketing, R&D, or top-level management.	Coalescing sales forecasts of experts should lead to better forecasts.	Teams can produce biased estimates and can be influenced by particular members of the team (i.e., the CEO).
Delphi	A panel of outside experts would be asked to estimate sales for a particular product or service. The results would be summarized in a report and given to the same panel of experts. They would then be asked to read their forecast. This might go through several iterations.	Best used for entirely new product service categories.	One has to be able to identify and recruit "experts" from outside the organization.
Historical analogy	With this technique, one finds a similar product's or service's past sales (life cycle) and extrapolates to your product or service. A new start-up has developed an innovative home entertainment product, but nothing like it has been seen in the market. You might examine past sales of CD players to get a sense of what future sales of the new product might be like.	One can acquire a sense of what factors might affect future sales. It is relatively easy and quick to develop.	One can select the wrong past industry to compare, and the future may not unfold in a similar manner.

Technique	Description	Strength	Weakness
Market research	The use of questionnaires and surveys to evaluate customer attitudes toward a product or a service.	One gains very useful insights into the stated desires and interests of consumers. Can be highly accurate in the short term.	Experienced individuals should do these. They can take time to conduct and are relatively expensive.
Quantitative Sales Forecasting Methods			
Trend analysis	This forecasting technique assumes that sales will follow some form of pattern. For example, sales are projected to increase at 15 percent a year for the next five years.	Extremely simple to calculate.	Sales seldom follow the same growth rate over any length of time.
Moving average	This technique takes recent class data for *N* number of periods, adds them together, and divides by the number *N* to produce a forecast.	Easy to calculate.	The basic use of this type of model fails to consider the existence of trends or seasonality in the data.
Seasonality analysis	Many products and services do not have uniform sales throughout the year. They exhibit seasonality. This technique attempts to identify the proportion of annual sales sold for any given time. The sales of swimming pool supplies in the Northeast, for example, would be much higher in the spring and summer than in the fall and winter.	Many products and services have seasonal demand patterns. By considering such patterns, forecasts can be improved.	Requires several years of past data and careful analysis. Useful for quarterly or monthly forecasts.
Exponential smoothing	This analytical technique attempts to correct forecasts by some proportion of the past forecast error.	Incorporates and weighs most recent data. Attempts to factor in recent fluctuations.	Several types of this model exist, and users must be familiar with their strengths and weaknesses. Requires extensive data, computer software, and a degree of expertise to use and interpret results.
Causal models—regression analysis	Causal models, of which there are many, attempt to identify why sales are increasing or decreasing. Regression is a specific statistical technique that relates the value of the dependent variable to one or more independent variables. The dependent variable sales might be affected by price and	Can be used to forecast and examine the possible validity of relationships, such as the impact on sales by advertising or price.	Requires extensive data, computer software, and a high degree of expertise to use and interpret results.

Technique	Description	Strength	Weakness
	advertising expenditures, which are independent variables.		

Forecasting key items such as sales is crucial in developing a good business plan. However, forecasting is a very challenging activity. The further out the forecast, the less likely it will be accurate. Everyone recognizes this fact. Therefore, it is useful to draw on a variety of forecasting techniques to develop your final forecast for the business plan. To do that, you should have a fairly solid understanding of the strengths and weaknesses of the various approaches. There are many books, websites, and articles that could assist you in understanding these techniques and when they should or should not be used. In addition, one should be open to gathering additional information to assist in building a forecast. Some possible sources of such information would be associations, trade publications, and business groups. Regardless of what technique is used or the data source employed in building a forecast for business plan, one should be prepared to justify why you are employing these forecasting models.

Video Clip: Ask Tim Berry—How Do I Start a Sales Forecast?

Provides useful insights on how to start forecasting in the small business environment.

A YouTube element has been excluded from this version of the text. You can view it online here.

Web Resources for Forecasting

- **Three methods of sales forecasting** (sbinfocanada.about.com/od/cashflowmgt/a/salesforecast.htm). This site provides three simplified approaches to sales forecasting.
- **Forecasting in business** (www.enotes.com/business-finance-encyclopedia/forecasting-business). This is a relatively comprehensive overview of forecasting techniques in nontechnical terms.
- **Sales forecasting techniques** (www.statisticalforecasting.com/sales-forecasting-techniques.php). This page provides insights into how to begin a sales forecast. It has excellent links to more advanced topics.
- **Time-critical decision-making for business administration** (home.ubalt.edu/ntsbarsh/stat-data/forecast.htm). This site has an e-book format with several chapters devoted to analytical forecasting techniques.

Building a Plan

Building your first business plan may seem extremely formidable. This may explain why there are so many software packages available to assist in this task. After building your first business plan, that steep learning curve should make subsequent plans for the business or other businesses significantly easier.

In preparing to build a business plan, there are some problem areas or mistakes that you should be on guard to avoid. Some may be technical in nature, while others relate to content issues. For the technical side, first and foremost, one should make sure that there are no misspellings or punctuation errors. The business plan should follow a logical structure. No ideal business plan clearly specifies the exact sections that need to be included nor is there an ideal length. Literature concerning business plans indicates that the appropriate length of the body of a business plan line should be between twenty and forty pages. This does not include appendixes that might provide critical data for the reader.

In developing a lengthy report, sometimes it is easy to fall into clichés or overused expressions. These should be avoided. Consider the visuals in the report. Data should be placed in either clearly mapped-out tables or well-designed graphs. The report should be as professional-looking as possible. Anticipate the audience that will be reading the report and write in a way that easily reaches them; avoid using too much jargon or technical terms.

The content in any business plan centers on two areas: realism and accuracy.

Components of the Plan

There is no idealized structure for a business plan or a definitive number of sections that it must contain. The following subsections discuss the outline of a plan for a business start-up and identify some of the major sections that should be part of the plan.

Cover Page

The cover page provides the reader with information about either the author of the plan or the person to contact concerning the business plan. It should contain all the pertinent information to enable the reader to contact the author, such as the name of the business, the business logo, and the contact person's address, telephone number, and e-mail address.

The table of contents enables the reader to find the major sections and components of the plan. It should identify the key sections and subsections and on which pages those sections begin. This enables the reader to turn to sections that might be of particular importance.

Executive Summary

The **executive summary** is a section of critical importance and is perhaps the single most important section of the entire business plan. Quite often, it is the first section that a reader will turn to, and sometimes it may be the only section of the business plan that he or she will read. Chronologically, it should probably be the last section written. The executive summary should provide an accurate overview of the entire document, which cannot be done until the whole document is prepared.

If the executive summary fails to adequately describe the idea behind the business or if it fails to do so in a captivating way, some readers may discard the entire business plan. As one author put it, the purpose of the executive summary is to convince the reader to "read on." The executive summary should contain the following pieces of information:

- What is the company's business?
- Who are its intended customers?
- What will be its legal structure?
- What has been its history (where one exists)?
- What type of funding will be requested?
- What is the amount of that funding?
- What are the capabilities of the key executives?

All this must be done in an interesting and captivating way. The great challenge is that executive summaries should be relatively short—between one and three pages. For many business people, this is the great challenge—being able to compress the required information in an engaging format that has significant size limitations.

Business Section

Goals. These are broad statements about what you would like to achieve at some point in the near future. Your goals might focus on your human resource policies ("We wish to have productive, happy employees"), on what you see as the source of your competitive advantage ("We will be best in service"), or on financial outcomes ("We will produce above-average return to our investors.") Goals are useful, but they can mean anything to anyone. It is, therefore, necessary to translate the goals into objectives to bring about real meaning so that they can guide the organization. Ideally, objectives should be **SMART**—specific, measurable, achievable, realistic, and have a specific timeline for completion. Here is an example: one organizational goal may be a significant rise in sales and profits. When translating that goal into an objective, you might word the objectives as follows: a 15 percent increase in sales for the next three years followed by a 10 percent increase in sales for the following two years and a 12.5 percent increase in profits in each of the next five years. These objectives are quite specific and measurable. It is up to the decision-maker to determine if they are achievable and realistic. These objectives—sales and profits—clearly specify the time horizon. In developing the plan, owners are often very happy to develop goals because they are open to interpretation, but they will avoid objectives. Goals are sufficiently ambiguous, whereas objectives tie you to particular values that you will have to hit in the future. People may be concerned that they will be weighed on a scale and found wanting for failing to achieve their objectives. However, it is critical that your plan contains both goals and objectives. Objectives allow investors and your employees to clearly see where the firm intends to go. They produce targeted values to aim for and, therefore, are critical for the control of the firm's operations.

Vision and Mission Statements. To many, there is some degree of confusion concerning the difference between a vision statement and a mission statement. **Vision statements** articulate the long-term purpose and idealized notion of what a business wishes to become. In the earliest days of Microsoft, when it was a small business, its version of a vision statement was as follows: "A computer on every desk and in every home." In the early 1980s, this was truly a revolutionary concept. Yet it gave Microsoft's

employees a clear idea (vision) that to bring that vision into being, the software being developed would have to be very "user-friendly" in comparison to the software of that day. **Mission statements**, which are much more common in small business plans, articulate the fundamental nature of the business. This means identifying the type of business, how it will leverage its competencies, and possibly the values that drive the business. Put simply, a mission statement should address the following questions:

- Who are we? What business are we in?
- Who do we see as our customers?
- How do we provide value for those customers?

Sometimes vision and mission statements are singularly written for external audiences, such as investors or shareholders. They are not written for the audience for whom it would have the greatest meaning—the management team and the employees of the business. Unfortunately, many recognize that both statements can become exercises of stringing together a series of essentially meaningless phrases into something that appears to sound *right* or *professional*. You can find software on the web to automatically generate such vacuous and meaningless statements.

Sometimes a firm will write a mission statement that provides customers, investors, and employees with a clear sense of purpose of that company. Zappos has the following as its mission statement: "Our goal is to position Zappos as an online service leader. If we can get customers to associate Zappos as the absolute best in service, then we can expand beyond shoes." The mission statement of Ben & Jerry's Ice Cream focuses both on defining their product and their values: "To make, distribute and sell the finest quality all-natural ice cream and euphoric concoctions with a continued commitment to incorporating wholesome, natural ingredients and promoting business practices that respect the Earth and the Environment."

Keys to Success. This section identifies those specific elements of your firm that you believe will ensure success. It is important for you to be able to define the competencies that you intend to leverage to ensure success. What makes your product or service unique? What specific set of capabilities do you bring to the competitive scene? These might include the makeup of and the experience of your management team; your operational capabilities (e.g., unique skills in design, manufacturing, or delivery); your marketing skillsets: your financial capabilities (e.g., the ability to control costs); or the personnel that make up the company.

Industry Review

In this section, you want to provide a fairly comprehensive overview of the industry. A thorough understanding of the industry that you will be operating in is essential to understand the possible returns that your company will earn within that industry. Investors want to know if they will recover their initial investment. When will they see a profit? Remember, investors often carefully track industries and are well aware of the strengths and limitations within a particular industry. Investors are looking for industries that can demonstrate growth. They also want to see if the industry is structurally attractive. This might entail conducting Porter's five forces analysis; however, this is not required in all cases. If there appear to be some issues or problems with industry-level growth, then you might want to be able to identify some segments of the industry where growth is viable.

Products or Services

This section should be an in-depth discussion of what you are offering to customers. It should provide a complete and clear statement of the products or the services that you are offering. It should also discuss the core competencies of your business. You should highlight what is unique, such as a novel product or service concept or the possession of patents. You need to show how your product or service specifically meets particular market needs. You must identify how the product or the service will satisfy specific customers' needs. If you are dealing with a new product or service, you need to demonstrate what previously unidentified needs it will meet and how it will do so. At its birth, Amazon had to demonstrate that an online bookstore would be preferable to the standard bookstore by offering the customer a much wider selection of books than would be available at an on-site location.

This section could include a discussion of technical issues. If the business is based on a technological innovation—such as a new type of software or an invention—then it is necessary to provide an adequate discussion of the specific nature of the technology. One should take care to always remember the audience for whom you are writing the plan. Do not make this portion too technical in nature. This section also might discuss the future direction of the product or service—namely, where will you be taking (changing) the product or the service after the end of the current planning horizon? This may require a discussion of future investment requirements or the required time to develop new products and services. This section may also include a discussion of

pricing the product or the service, although a more detailed discussion of the issue of pricing might be found in the marketing plan section. If you plan to include the issue of pricing here, you should discuss how the pricing of the product or the service was determined. The more detailed you are in this description, the more realistic it will appear to the readers of the business plan. You may wish to discuss relationships that you have with vendors that might have an impact on reducing cost and therefore an impact on price. It is important to discuss how your pricing scheme will compare with competitors. Will it be higher than average or below the average price? How does the pricing fit in with the overall strategy of the firm?

This section must have a high degree of honesty. Investors will know much about the industry and its limitations. You need to identify any areas that might be possible sources of problems, such as government regulations, issues with new product development, securing distribution channels, and informing the market of your existence. Further, it is important to identify the current competitors in the industry and possible future competitors.

Marketing Plan

An introductory marketing course always introduces the four Ps: product, price, place, and promotion. The marketing section of the business plan might provide more in-depth coverage of how the product or the service better meets customer value than that of competitors. It should identify your target customers and include coverage of who your competitors are and what they provide. The comparison between your firm and its competitors should highlight differences and point to why you are providing superior value. Pricing issues, if not covered in the previous section, could be discussed or discussed in more detail.

The issue of location, particularly in retail, should be covered in detail. Perhaps one of the most important elements of the marketing plan section is to specify how you intend to attract customers, inform them of the benefits of using your product or service, and retain customers. Initially, customers are attracted through advertising. This section should delineate the advertising plan. What media will be used—flyers, newspapers, magazines, radio, television, web presence, direct marketing, and/or social media campaigns? This section should cover any promotional campaigns that might be used.

The Management Team

Physical resources are not the only determinant of business success. The human resources available to a firm will play a critical role in determining its success. Readers of your business plan and potential investors should have a clear sense of the management team that will be running a business. They should know the team with respect to the team's knowledge of the business, their experience and capabilities, and their drive to succeed. Arthur Rock, a venture capitalist, was once quoted as saying, "I invest in people, not the idea."

This section of the business plan has several elements. It should contain an organizational chart that will delineate the responsibilities and the chain of command for the business. It should specify who will occupy each major position of the business. You might want to explain who is doing what job and why. For every member of the management team, you should have a complete résumé. This should include educational background (both formal and informal) and past work experience, including the jobs they have held, responsibilities, and accomplishments. You might want to include some other biographical data such as age, although that is not required.

If you plan to use specific advisers or consultants, you should mention the names and backgrounds of these people in this section of the plan. You should also specify why these people are being used.

An additional element of your discussion of the management team will be the intended compensation schemes. You should specify the intended salaries for the management team while also including issues of their benefits and bonuses or any stock position that they may take in the company. This section should also identify any gaps in the management team and how you intend to fill these positions.

Depending on the nature of the business, you might wish to include in this section the personnel (employees) that will be required. You should identify the number of people that are currently working for the firm or that will have to be hired; you should also identify the skills that they need to possess. Further discussion should include the pay that will be provided: whether they will be paid a flat salary or paid hourly, if and when you intend to use overtime, and what benefits you intend to provide. In addition, you should discuss any training requirements or training programs that you will have to implement.

Financial Statements

The financial statements section of the business plan should be broken down into three key subsections: the income statement, the balance sheet, and the cash-flow statement. Before proceeding with these sections, we discuss the assumptions used to build these sections. The opening section of the financial statements section should also include, in summary format, projections of sales, the sales growth rate, key expenses and their growth rates, net income across the forecasting horizon, and assets and liabilities.

As previously discussed, bankers—and to lesser extent venture capitalists—will be primarily concerned with this section of the business plan. It is vital that this section—whether you are an existing business seeking more funding or a start-up—have realistic financial projections. The business plan should contain clear statements of the underlying assumptions that were used to make these financial projections. The clearer the statements and the more realistic the assumptions behind these statements, then the greater the confidence the reader will have in these projections. Few businesspeople have a thorough understanding of these financial statements; therefore, it is advisable that someone with an accounting or a financial background review these statements before they are included in the report.

The future planning horizon for financial projections is normally between three and five years. The duration that you will use will depend on the amount of capital that the business is seeking to raise, the type of industry the business is in, and the forecasting issues associated with making projections. Also, the detail required in these financial statements will be directly tied to the type and size of the business.

Income Statement

The **income statement** examines the overall profitability of a firm over a particular period of time. As such, it is also known as a profit-and-loss statement. It identifies all sources of revenues generated and expenses incurred by the business. For the business plan, one should generate annual plans for the first three to five years. Some suggest that the planner develop more “granulated” income statements for the first two years. By granulated, we mean that the first-year income statement should be broken down on a monthly basis, while the second year should be broken down on a quarterly basis.

Some of the key terms found in the income statement are as follows:

- **Income.** All revenues and additional incomes produced by the business during the designated period.
- **Cost of goods sold.** Costs associated with producing products, such as raw materials and costs associated directly with production.
- **Gross profit margin.** Income minus the cost of goods sold.
- **Operating expenses.** Costs in doing business, such as expenses associated with selling the product or the service, plus general administration expenses.
- **Depreciation.** This is a special form of expense that may be included in operating expenses. Long-term assets—those whose useful life is longer than one year—decline in value over time. Depreciation takes this fact into consideration. There are several ways in which this declining value can be determined. It is a noncash expenditure expense.
- **Total expenses.** The cost of goods sold plus operating expenses and depreciation.
- **Net profit before interest and taxes.** This is the gross profit minus operating expenses; another way of stating net profit is income minus total expenses.
- **Interest.** The required payment on all debt for the period.
- **Taxes.** Federal, state, and local tax payments for the firm.
- **Net profit.** This is the net profit after interest and taxes. This is the term that many will look at to determine the potential success of business operations.

Balance Sheet

The **balance sheet** examines the assets and liabilities and owner’s equity of the business at some particular point in time. It is divided into two sections—the credit component (the assets of the business) and the debit component (liabilities and equity). These two components must equal each other. The business plan should have annual balance sheet for the three- or five-year planning horizon. The elements of the credit component are as follows:

- **Current assets.** These are the assets that will be held for less than one year, including cash, marketable securities, accounts receivable, notes receivable, inventory, and prepaid expenses.
- **Fixed assets.** These assets are not going to be turned into cash within the next year; these include plants, equipment, and land. It may also include intangible assets, such as patents, franchises, copyrights, and goodwill.
- **Total assets.** This is the sum of current assets and fixed assets.

Liabilities consist of the following:

- **Current liabilities.** These are debts that are to be paid within the year, such as lines of credit, accounts payable, other items payable (including taxes, wages, and rents), short-term loans, dividends payable, and current portion of long-term debt.
- **Long-term liabilities.** These are debts payable over a period greater than one year, such as notes payable, long-term debt, pension fund liability, and long-term lease obligations.
- **Total liabilities.** This is the sum of current liabilities and long-term liabilities.
- **Owner's equity.** This represents the value of the shareholders' ownership in the business. It is sometimes referred to as net worth. It may be composed of items such as preferred stock, common stock, and retained earnings.

Cash-Flow Statement

From a practical and survival standpoint, the **cash-flow statement** may be the most important component of the financial statements. The cash-flow statement maps out where cash is flowing into the firm and where it flows out. It recognizes that there may be a significant difference between profits and cash flow. It will indicate if a business can generate enough cash to continue operations, whether it has sufficient cash for new investments, and whether it can pay its obligations. Businesspeople soon realize that profits are nice, but cash is king.

Cash flows can be divided into three areas of analysis: cash flow from operations, cash flow from investing, and cash flow from financing. Cash flow from operations examines the cash inflows from revenues and interest and dividends from investments held by the business. It then identifies the cash outflows for paying suppliers, employees, taxes, and other expenses. Cash flow from investing examines the impact of selling or acquiring current and fixed assets. Cash flow from financing examines the impact on the cash position from the changes in the number of shares and changes in the short- and long-term debt position of the firm.

Additional Information

Depending on the nature of the business and the amount of funding that is being sought, the plan might include more materials. For an existing business, you may wish to include past tax statements and/or personal financial statements. If the business is a franchise, you should include all legal contracts and documents. The same should be done for any leasing, licensing, or rent agreements. This section should be seen as a catchall incorporating any materials that would support the plan. One does not want to be in the position of being asked by readers of the plan—"Where are these documents?"

Appendixes

The financial section of the business plan should include summaries of the three key financial elements. The details behind the financial statements should be included as an appendix along with clear statements concerning the assumptions that were used to build them. The appendixes may also include different scenarios that were considered in building the plan, such as alternative market growth assumptions or alternative competitive environments. Demonstrating that the author(s) considered "what-if" situations tells potential investors that the business is prepared to handle changing conditions. It should include items such as logos, diagrams, ads, and organizational charts.

Developing Scenarios

Business plans are analyses of the future; they can err on the side of either optimistic projections or conservative projections. From the standpoint of the potential investor, it is always better to err on the side of conservatism. Regardless of either bias, business plans are generally built on the basis of expected futures and past experience. Unfortunately, the future does not always emerge in a clearly predicated manner. One can have a dramatic change that can have significant impact on the business. Often such changes occur in the external environment and are beyond the control of the business management team. These external changes can occur within the technical environment; it can be based on changes in customer needs, changes with respect to the suppliers, changes in

the economic environment—at the local, national, or global level. Dramatic change can also occur within the organization itself—the death of the owner or members of the management team.

One way for an organization to deal with significant changes is a process known as **scenario planning**. The real origins of scenario planning can be traced back to the early nineteenth-century activity known as Kreigsspiel—war gaming—a system for training officers developed by the Prussian command. This process of looking at future wars was adopted by many militaries in the later nineteenth century. In the 1950s, a more formal format was used at the RAND Institute for examining possible future changes in the military and geopolitical environments. The early 1980s saw it applied to industrial settings. Royal Dutch Shell examined the question of what would happen if there were a significant drop in the price of oil. This was after two oil crises that pushed the price of oil up significantly. The notion that oil prices would drop was considered to be an extremely unlikely event, but it did occur. Royal Dutch Shell was one of the few oil companies that did not suffer because its scenario analyses enabled them to be ready to deal with that situation.

What could be the possible use of scenario planning for small businesses? There are several areas in which small businesses should apply scenario planning to be better prepared for future disruptions.

Identify Significant Changes That Might Impact the Business

Consider major shifts in the customer's notion of value. The firm should always be examining what constitutes value in the eyes of the consumer and how that might shift. Henry Ford's Model T car was a global success because customers initially valued a reliable vehicle at a low price. Ford Motor Company continued to meet the customer's notion of value by constantly driving down the unit cost. However, by the mid-1920s, customers' notion of value included not only price but also issues such as styling and improved technologies. General Motors was able to recognize that there were changes in the customer's value notion and provided them with a range of vehicles. Ford failed to recognize that change and suffered a significant drop in sales.

Shifts in the economic environment. The recent recession clearly indicates that economies can suffer significant shifts in a short period of time. These shifts can have dramatic impact on all business operations. Small-business owners have seen significant tightening of bank credit and changes with respect to the requirements for using credit cards. One could easily imagine the critical importance for small businesses to consider the impacts that would follow significant changes in interest rates. Southwest Airlines, in anticipation of possible fluctuations in oil prices, used futures contracts to deal with dramatic shifts in the price of oil. When oil prices rose significantly, they were in a much better position than their competitors.

The entrance of new competitors. Small businesses should always be ready to consider the impact of facing new competitors and new types of competition. Consider the case of small local retail outlets when a Walmart superstore opens in the area.

Consideration of Disasters

The best way to deal with any potential disaster is not while it is occurring or after it has happened but before it occurs. Small businesses should anticipate what they will do in the case of physical disasters, such as fire, earthquakes, or floods. Other disasters might involve the bankruptcy or loss of a major supplier or a major customer. A restaurant or a food market should have a contingency plan in the case of a power failure that might lead to food spoilage. Such a business might also want to conduct a scenario planning exercise to see what its responses would be in the case of a customer complaining of food poisoning. Other disaster scenarios that should be considered by small businesses include the impact and ramifications of having the computer system crash; having the service for the website crash; or having the website hacked, with the possible loss of customer information.

New Opportunities

Almost all businesses, large and small, must be prepared to seize new opportunities. This may mean that they have to consider the impact of technological change on the business or how technology can offer them new business opportunities. The technology of stereolithography, a process by which three-dimensional objects are built layer by layer, has been available for more than a decade. Bespoke Innovations saw the potential for using this technology. Bespoke Innovations can develop, in a short period of time, custom artificial legs for a price of $5,000–$6,000 and with features that are not found in $60,000 prostheses.

Scenario planning should be a periodic exercise, but it should be conducted no more than once a year. The actual frequency might be dependent on the perceived rate of change for the industry or the presence of storm clouds on the horizon. Scenario planning has

several distinct activities, which may be as follows:

- **Pick one area that might occur in the future that would have significant impact on the business.** What if the national joblessness rate remains at over 9 percent for the next three to five years? What if a major customer decides to buy from a competitor or that customer is in financial trouble? What if there are changes in the national defense budget? A luncheonette in New London, Connecticut, where Electric Boat builds nuclear submarines, wants to consider the impact of changes in the defense budget. A decrease in the budget for building nuclear submarines would reduce the number of subs made in New London, which might lead to layoffs at Electric Boat and fewer customers for the luncheonette.
- **Identify factors that might impact that issue.** This sometimes is referred to as a PEST analysis, where the P stands for political issues, E stands for economic issues, S stands for sociocultural issues, and T stands for technology issues. Each factor would be analyzed to see how it might impact the scenario. In our previous luncheonette example, the restaurant might want to consider an upcoming election to see how each party would support defense appropriations, and it might look at the overall economy to determine whether a downturn in the economy might lead to a cut in defense appropriations. It is unlikely that sociocultural issues would impact defense appropriations. Technology issues, whether a breakthrough in some design by the United States or by some other country, might determine the number and location of submarines built in the United States.
- **Rank the relative importance of the previous factors.** Not all factors under consideration can be considered equally important. It is critical in a scenario planning exercise to see which factors are most important so that decision-makers can focus on the ramifications of those factors in the analysis.
- **Develop scenarios.** Having identified the relative importance of the factors, the next stage would be to develop a limited number of possible scenarios (no more than two or three). Each scenario would map out possible outcomes for each key factor. Based on these values, the group conducting the scenario planning exercise would develop insights into this possible future world.
- **How do the scenarios impact your business?** For each future scenario, the team should examine how that possible future state would impact the operation of the business. Continuing with the luncheonette example, the owner might see that a particular political party would be elected in the next election and the economy will still be in the doldrums. Together, this might indicate a cut in the naval building budget. This will translate into a reduced number of submarines built in New London and a reduction in employment at Electric Boat. The luncheonette's sales will obviously drop off. Now the owner must consider what it might do in that situation.

Scenario planning offers the opportunity for small business owners to examine the future on a long-term basis. It should force them to look at external environments and conditions that can have a dramatic impact on the survival of their firm. It broadens their thinking and creates an environment of increased flexibility. It enables a business to respond to those sudden shocks that might destroy other firms.

Computer Aids

Business plans can be built using a combination of word-processing and spreadsheet programs by those who are adept at using them. However, the entire process of constructing a comprehensive business plan can be greatly simplified by using a dedicated business plan software package. These packages are designed to produce reports that have all the required sections for a business plan, they greatly facilitate the creation of the financial statements with charts, and they often allow for the inclusion of materials from other programs. Most of them are fairly reasonably priced from $50 to $150.

There are many such packages on the market, and they range from those designed for novices to those that can generate annual plans by easily incorporating data from external sources, such as the accounting programs of a business. When evaluating competing programs, there are some primary and secondary factors that should be considered. The primary factors are as follows:

- **Ease of building the report.** The various sections of the report should be clearly identified, and the authors should be able to work on each section independent of their sequence within the report. Text and data entry should be simple and allow for easy corrections or revisions.
- **Financial statements.** The software should facilitate building the income statement, the balance sheet, and the cash-flow statement. For multiyear projections, the software should support the forecasting process.
- **Import from other programs.** The software should be able to incorporate data from a variety of programs, such as Word and Excel. Ideally, it should be able to import data from a variety of accounting programs.

- **Support services.** The software company should bundle a variety of support services, including clear instructions, tutorials, and access to Internet or call-number support. Many packages provide sample business plans for different industries.

The secondary factors are as follows:

- **Access to research support.** Some software packages include access to business publications and databases to aid with market research.
- **Export options.** These packages allow for the report or parts of the report to be exported to different formats—Word, Excel, PowerPoint, HTML, or PDF.
- **Ancillary analysis tools.** Some packages either directly include or offer additional programs for market planning, budgeting, or valuation.

The following is a partial listing of companies that have business planning software:

- **Small Business Point.** This company offers business planning software and the opportunity for them to build your plan for you.
- **Business Plan Pro.** This company provides business planning software with sample plans for a wide number of industries plus options for acquiring industry data at national, state, or local levels. The company also has programs for marketing planning and legal issues advice.
- **Business Plan Software.** This company offers a number of products, including business planning software, a strategic planning program, financial projection and cash-flow forecasting programs, and marketing planning software.
- **JIAN Biz Plan.** This company's products include business planning programs, software for human resources, marketing planning programs, and contract development software.
- **PlanWrite.** In addition to offering programs for business, strategic, and marketing planning, this company has products that provide advice in the area of sales strategy and pricing.
- **Plan Magic.** This company offers a suite of planning products ranging from particular industries to financial and marketing planning software.

KEY TAKEAWAYS

- The business planning for a start-up business should consider if the owner(s) is/are ready to accept the challenges of operating a business.
- Comprehensive business plans will require information about the industry, competitors, and customers. Owners or the writers of the business plan should be aware of where they can obtain this information.
- Forecasting is critical to the success of any business. There are many different approaches to forecasting: some are simple extrapolations of trends, while others can be computationally complex. The business should use a forecasting system that is not only accurate but also makes the users feel comfortable.
- Although business plans come in different "sizes and shapes," they should have some key sections: executive summary, mission statement, industry analysis, marketing plan, description of the management team, and financial projections.
- Some businesses should make it a practice of conducting scenario analyses. This is a process of examining possible future events and what should be the response of the business.
- The complexity and difficulty of building a comprehensive business plan can be significantly reduced by using one of the available business-planning software packages.

EXERCISES

1. In an earlier exercise, you were asked to interview five local business owners. In addition to asking them questions about strategy, please ask them the following questions: (a) How do they forecast their sales? (b) Inventory? (c) Economic conditions? (d) Have they ever conducted anything like a scenario analysis or formally considered what they would do if an emergency struck—fire, flood, death of a business partner, and so forth?
2. Go to the appendix, which contains Robert Rainsford's business plan. (You will be asked to examine portions of this report throughout the text to evaluate different sections.)
    1. Read his executive summary and critique it. How would you improve it?
    2. Evaluate the document's vision and mission statements. Are there any major problems? How would you improve them?

3. Evaluate the industry analysis section of the report. What additional data could be used in this section of the report? Where would you suggest that Robert go to get the data?

3. Imagine that you are going to start a business and that you want a great-looking plan. Evaluate three of the business plan software packages. Based on your evaluation, write a report that describes their strengths and weaknesses. Which would you select and why?

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5.2.5: The Three Threads

Learning Objectives

- Learn that the planning process can add significantly to the delivery of customer value.
- Understand that the proper management of the cash flow of a business can occur only in an environment of comprehensive planning.
- Understand that although not all businesses will rely on e-business or e-commerce, they should carefully plan their inclusion into a firm's operations.

The business plan is the backbone of both start-up and existing businesses. The initial business plan forces one to consider the core issues in detail. These issues directly relate to the themes that are stressed throughout this text: customer value; cash flow; and digital technologies, e-commerce, and e-business. Building a good initial business plan requires the author(s) to seriously consider these three themes. It must be pointed out that these themes *must* be reviewed regularly as part of a continuous planning process. A great mistake of many small businesses is that they may begin with a formal plan, but they abandon the concept after receiving initial funding. Regardless of the industry or the business size, formally thinking about these themes in the context of planning is essential.

Customer Value

Businesses survive because they provide value to customers. To begin a business, one should have a clear vision as to what constitutes value to the targeted customers. The initial business plan must be able to articulate this vision. However, that notion of value can change over time. Customers' perceptions of value can evolve or change radically. Competitors can change what they offer customers, and the firm itself can acquire or lose capabilities that were used to provide value. This shifting value landscape does not allow any business to adhere to its initial plan as though it were dogma. Evaluations of customer value must be conducted regularly as part of an annual planning process.

Cash-Flow Implications

It cannot be repeated too often nor overemphasized: the survival of a small business often hinges on its ability to successfully manage its cash flow. Balancing cash inflows with outflows is not something that can be done in an ad hoc fashion. It requires a plan. Because one cannot count on accuracy in long-range forecasts, or even short-range forecasts, examining your cash flow must become part of an ongoing planning process. The text has promoted the idea of small businesses having annually updated plans. In the case of cash-flow calculations, it might be advisable for small firms to update their cash-flow analyses monthly.

The Influence of E-Commerce and E-Business

Not all firms will have the same commitment to e-commerce or e-business options. The level of commitment will be determined not so much by size, but by the nature of the business, the knowledge and experience of the owner(s) and the management team, and the firm's growth objectives. However, given the declining costs for website development and hosting, and the increasing ease of using tools such as social media, web store sales management, and **customer relationship management**, it would be odd if these options were not considered in the planning process. This is not to say that all small businesses must include them in their initial business plan, but the integration of e-commerce or e-business can be an evolutionary process that can be made much easier by thoughtful planning.

KEY TAKEAWAYS

- The planning process for a small business must always incorporate the notion of customer value and recognize that this notion can change over time.
- The proper management of a firm's cash flow requires a commitment to planning the management of one's cash flow.
- Although e-business and e-commerce options may not be considered in the original plan for a business, if they are eventually considered, their successful implementation will require a detailed plan.

EXERCISES

1. In an earlier exercise, you were asked to interview five local business owners. Ask them how they manage to identify how customer needs might change over time and how they would plan on responding to such changes.
2. While interviewing them, ask how they go about managing their cash flow. Ask how far ahead they plan their cash-flow management.
3. If they have a website, ask how they planned for its creation and use.

Disaster Watch

When failure is not an option, then planning is a necessity. A well-built plan enables the management team of a business to fully anticipate what problems they may encounter and what will be required of them to make the firm successful. There is an almost innumerable number of factors that can become a disaster for a business, but solid planning can significantly reduce that number. A good plan should also force the owner and the management team to anticipate major areas of concern that can become disasters, such as the following:

- **Are the participants ready?** For the prospective first-time business owner, the task of building a business plan should provide valuable insights into what will be required to make the business function. The plan should indicate the necessary initial funding and the work commitment necessary for success.
- **Unrealistic expectations.** A thoughtful plan should eliminate assumptions or outcomes that cannot be supported after careful consideration or analysis. It may be sound that your sales will grow by 100 percent every year for five years or that you will recoup your investment in six months, but some simple running of numbers might show that those are impossible outcomes. Simply "forcing" someone to articulate such assumptions can help return him or her to a more realistic vision of the world. Better yet, have some outside sets of "eyes"—friends, other businesspeople, your lawyer, or your accountant—review the plan.
- **Determining whether the business will be profitable.** The financial analysis section of your plan should indicate when a start-up will become profitable or how much profit a business will make. This is of great importance to potential investors and to the owner.
- **Not truly understanding the market by failing to know how customers determine value.** The business plan requires that one clearly identifies who the targeted customers are and how the business will provide greater value than its competitors. Plans force owners and managers to specifically articulate how they will serve their customer base. Without clearly stating these key points, any business is headed for disaster because having some sort of "hunch" or "idea" about your customers and their needs is not enough.
- **Failure to adequately capitalize the business.** The overwhelming consensus is that small businesses "fail" for two main reasons: inadequate management (often attributed to a failure to plan) and insufficient capitalization. Start-ups often underestimate the required capital to begin operations and continue operations for the foreseeable horizon. A structured plan requires them to consider what will be needed during the next few years.
- **Not determining the cash flow.** The lifeblood of any business is its cash flow. This is particularly true for small businesses. Anticipating a firm's cash inflows and outflows is not something that can be handled in an intuitive fashion. It requires analysis. Misjudging these two flows is, perhaps, the surest recipe for disaster.
- **Failure to create the appropriate management structure.** Small-business owners are often accused of wanting complete control of all aspects of their firm's operations. For microsized small businesses, this may be feasible, but as the firm's size increases, it is critical that lines of responsibility be clearly drawn. Managers and employees must know what is expected of them and their responsibilities. A failure to do so produces confusion and conflict—another good recipe for disaster. If the formal delineation of the management structure is not part of a plan, then it is highly unlikely that necessary clarity will arise spontaneously.

Managers in businesses both small and large often complain of "firefighting" problems; unfortunately, many of these problems are a result of inadequate or nonexistent planning. In the case of the smaller enterprise, a small blaze can rapidly become an inferno that can lead to disaster. According to a report released by the Epicurus Institute, "when a business starts or operates without a plan, the principles are not prepared to deal with the slightest problem that can affect their business."

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5.3: Developing a Business Plan

Learning Objectives

After completing this section, you will be able to:

- Describe the purposes for business planning
- Describe common business planning principles
- Explain common business plan development guidelines and tools
- List and explain the elements of the business plan development process
- Explain the purposes of each element of the business plan development process
- Explain how applying the business plan development process can aid in developing a business plan that will meet entrepreneurs' goals

Overview

This section describes the purposes, principles, and general concepts and tools for business planning, and the process for developing a business plan.

Purposes for Developing Business Plans

Business plans are developed for both internal and external purposes. Internally, entrepreneurs develop business plans to help put the pieces of their business together. Externally, the most common purpose is to raise capital.

Internal Purposes

As the road map for a business's development, the business plan:

- Defines the vision for the company
- Establishes the company's strategy
- Describes how the strategy will be implemented
- Provides a framework for analysis of key issues
- Provides a plan for the development of the business
- Helps the entrepreneur develop and measure critical success factors
- Helps the entrepreneur to be realistic and test theories

External Purposes

The business plan provides the most complete source of information for the valuation of the business. Thus, it is often the main method of describing a company to external audiences such as potential sources for financing and key personnel being recruited. It should assist outside parties to understand the current status of the company, its opportunities, and its needs for resources such as capital and personnel.

Business Plan Development Principles

Hindle and Mainprize (2006) suggest that business plan writers must strive to effectively communicate their expectations about the nature of an uncertain future and to project credibility. The *liabilities of newness* make communicating the expected future of new ventures much more difficult than for existing businesses. Consequently, business plan writers should adhere to five specific *communication principles*.

First, business plans must be written to meet the *expectations* of targeted readers in terms of what they need to know to support the proposed business. They should also lay out the *milestones* that investors or other targeted readers need to know. Finally, writers must clearly outline the *opportunity*, the *context* within the proposed venture will operate (internal and external environment), and the *business model* (Hindle & Mainprize, 2006).

There are also five *business plan credibility principles* that writers should consider. Business plan writers should build and establish their credibility by highlighting important and relevant information about the venture *team*. Writers need to *elaborate* on the plans

they outline in their document so that targeted readers have the information they need to assess the plan's credibility. To build and establish credibility, they must *integrate scenarios* to show that the entrepreneur has made realistic assumptions and has effectively anticipated what the future holds for their proposed venture. Writers need to provide comprehensive and realistic *financial links* between all relevant components of the plan. Finally, they must outline *the deal*, or the value that targeted readers should expect to derive from their involvement with the venture (Hindle & Mainprize, 2006).

General Guidelines for Developing Business Plans

Many businesses must have a business plan to achieve their goals. Using a standard format helps the reader understand that you have thought everything through and that the returns justify the risk. The following are some basic guidelines for business plan development.

As You Write Your Business Plan

1. If appropriate, include nice, catchy, professional graphics on your title page to make it appealing to targeted readers, but don't go overboard.

2. Bind your document so readers can go through it easily without it falling apart. You might use a three-ring binder, coil binding, or a similar method. Make sure the binding method you use does not obscure the information next to where it is bound.

3. Make certain all of your pages are ordered and numbered correctly.

4. The usual business plan convention is to number all major sections and subsections within your plan using the format as follows:

    1. First main heading

    1.1 First subheading under the first main heading

    1.1.1. First sub-subheading under the first subheading

    2. Second main heading

    2.1 First subheading under the second main heading

Use the *styles* and *references* features in Word to automatically number and format your section titles and to generate your table of contents. *Be sure that the last thing you do before printing your document* is update your automatic numbering and automatically generated tables. If you fail to do this, your numbering may be incorrect.

5. Prior to submitting your plan, *be 100% certain* each of the following requirements are met:

- Everything must be completely integrated. The written part must say exactly the same thing as the financial part.
- All financial statements must be completely linked and valid. Make sure all of your balance sheets balance.
- Everything must be correct. There should be NO spelling, grammar, sentence structure, referencing, or calculation errors.
- Your document must be well organized and formatted. The layout you choose should make the document easy to read and comprehend. All of your diagrams, charts, statements, and other additions should be easy to find and be located in the parts of the plan best suited to them.
- In some cases, it can strengthen your business plan to show some information in both text and table or figure formats. You should avoid *unnecessary repetition*, however, as it is usually unnecessary—and even damaging—to state the same thing more than once.
- You should include all the information necessary for readers to understand everything in your document.
- The terms you use in your plan should be clear and consistent. For example, the following statement in a business plan would leave a reader completely confused:

  "There is a shortage of 100,000 units with competitors currently producing 25,000. We can help fill this huge gap in demand with our capacity to produce 5,000 units."

  This statement might mean there is a total shortage of 100,000 units, but competitors are filling this gap by producing 25,000 per year; in which case, there will only be a shortage for four years. However, it could mean that the annual shortage is 100,000 units and only 25,000 are produced each year, in which case the total shortage is very high and is growing each year.

- You must always provide the complete perspective by indicating the appropriate time frame, currency, size, or other measurement.
- If you use a percentage figure, you must indicate to what it refers—otherwise, the number is meaningless to a reader.
- If your plan includes an international element, you must indicate in which currency or currencies the costs, revenues, prices, or other values are quoted. This can be solved by indicating up-front in the document in which currency all values will be quoted. Another option is to indicate each time which currency is being used, and sometimes you might want to indicate the value in more than one currency. Of course, you will need to assess the exchange rate risk to which you will be exposed and describe this in your document.

6. Ensure credibility is both established and maintained (Hindle & Mainprize, 2006).

- If a statement presents something as a fact when this fact is not generally known, always indicate the source. Unsupported statements damage credibility.
- Be specific. A business plan is simply not of value if it uses vague references to high demand, carefully set prices, and other weak phrasing. It must show hard numbers (properly referenced, of course), actual prices, and real data acquired through proper research. This is the only way to ensure your plan is considered credible.
- Your strategies must be integrated. For example, your pricing strategy must complement and mesh perfectly with your product/service strategy, distribution strategy, and promotions strategy. For example, you probably shouldn't promote your product as a premium product if you plan to charge lower-than-market prices for it.

7. Before finalizing your business plan, re-read each section to evaluate whether it will appeal to your targeted readers.

Useful Resources for Business Planning

Canada Business Network

- http://www.canadabusiness.ca/eng/

Innovation, Science and Economic Development Canada: Financial Performance Data

- http://www.ic.gc.ca/eic/site/pp-pp.nsf/eng/Home

BizPal site for accessing licensing and other needs

- http://www.bizpal.ca/

Canada Revenue Agency site for CRA asset classifications

- http://www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/rprtng/cptl/dprcbl-eng.html

Canadian Company Capabilities database to use to find suppliers and buyers

- http://www.ic.gc.ca/eic/site/ccc-rec.nsf/eng/home

For finding possible Canadian Government contracts

- http://www.merx.com/

The Conference Board of Canada

- http://www.conferenceboard.ca/

Bank of Canada

- http://www.bankofcanada.ca/

Bank Sites

- http://www.td.com/
- http://www.rbc.com/
- http://www.scotiabank.com/
- http://www.bmo.com/
- http://www.cibc.com/

Business Loan Calculator

- http://www.rbcroyalbank.com/cgi-bin/business/loan_calc/loans.cgi

The business area within our library site

- http://library.usask.ca/

Employee compensation calculators

- https://www.payscale.com/research/CA/Country=Canada/Salary
- https://www.glassdoor.ca/Salaries/index.htm

Existing business plans

The Word and Excel templates in this book

- Business Plan Template (Word)
- Business Plan Template (Excel)

Business Plan Development Tools

Credibility and Communication

According to Hindle and Mainprize (2006), strong business plans effectively communicate the necessary information to the targeted readers while also establishing the credibility of the plan and the entrepreneur. The Credibility and Communication Meter icon is used throughout this book to highlight where and how business plan writers can improve the quality of the information and enhance their and their plan's credibility.

[Image "The Credibility and Communication Meter" is missing from this section]

Use the following tools to improve the information in and credibility of your plans:

The Ratchet Effect

A ratchet is a tool that most of us are familiar with. It is useful because it helps its user accomplish something with each effort expended while guarding against losing past advancements.

With each word, sentence, paragraph, heading, chart, figure, and table you include in your final business plan, the ratchet should move ahead a notch because you achieve two important things.

First, only needed and relevant information is included.

Second, your additions build credibility in a relevant way.

Apply the ratchet effect by making sure that each and every sentence and paragraph conveys needed and relevant information that adds to your and your plan's credibility. Use the following principles:

Rarely—and only if it truly needs to be said again—repeat something that you have already said in your plan.

Avoid using killer phrases, like "there is no competition for our product" or "our product will sell itself, so we will not need to advertise it." Any savvy reader will understand that these kinds of statements are naive and demonstrate a lack of understanding about how the market and other real-life factors actually work.

Avoid contradicting yourself. Make sure that what is said in the written part of your plan completely syncs with what is said in the other parts of your plan. Likewise, ensure that what you include in the financial parts of your plan is completely in sync with what is said the written part.

The Magic Formula

Apply the following magic formula throughout your write your plan.

(a)… consideration X affects my business because …

(b)… consideration X is subject to this trend into the future …

(c)… which means that we have decided to do this … (or) will implement this strategy … in response to how the expected trends for consideration X will affect my business

Here is an example of how you can use the magic formula to develop part of the pricing strategy in the marketing plan part of your business plan:

We expect that our expenses to run our business will rise with the rate of inflation, which means that we must plan to increase the prices on our products to establish and maintain our profitability. The Bank of Canada (201x) has projected that the general inflation rate in <the city in which my business will operate> will be 3.0% in 201x, 3.5% in 201y, and 4.0% in 201z. In our projected financial statements, therefore, we have inflated both our expenses and our prices by those rates in those years.

Context and Framing

You must provide the right context when you describe situations, strategies, and other components of your plan. Business plan readers should never be left to guess why you indicate in a business plan that you will do something. Proper context is needed to help you frame the information you present.

When you frame the stories you tell correctly, the ratchet effect will happen and your plan will be stronger. One example of effective framing is when you, as the writer of the plan and the entrepreneur, clearly indicate how your education, expertise, relevant experiences, and network of contacts will make up for any lack of direct experience you have in running this particular kind of business. An example of ineffective framing is when you indicate that you lack experience with this type of business, or when you fail to specify how and why your levels of experience will affect the business's development.

Prioritizing Problems

Don't get hung up on something that doesn't need an immediate solution. Instead, flag it for future consideration and move on. When you return to re-address the issue, it might no longer be a problem or you might have by then figured out a solution.

Process for Developing Business Plans

The business plan development process described next has been extensively tested with entrepreneurship students and has proven to provide the guidance entrepreneurs need to develop a business plan appropriate for their needs: a *high power business plan*.

Developing a high power business plan has six stages, which can be compared to a process for hosting a dinner for a few friends. A host hoping to make a good impression with their anticipated guests might analyze the situation at multiple levels to collect data on new alternatives for healthy ingredients, what ingredients have the best prices and are most readily available at certain times of year, the new trends in party appetizers, what food allergies the expected guests might have, possible party themes, and so on. This analysis is the *Essential Initial Research* stage.

In the *Business Model* stage, the host might construct a menu of items to include with the meal along with a list of decorations to order, music to play, and costume themes to suggest to the guests. The mix of these kinds of elements chosen by the host will aid in the success of the party.

The *Initial Business Plan Draft* stage is where the host rolls up their sleeves and begins to make some of the food items, puts up some of the decorations, and generally gets everything started for the party.

During this stage, the host will begin to realize that some plans are not feasible and that changes are needed. The required changes might be substantial, like the need to postpone the entire party and ultimately start over in a few months, and others might be less drastic, like the need to change the menu when an invited guest indicates that they can't eat food containing gluten. These changes are incorporated into the plan during the *Making the Business Plan Realistic* stage to make it realistic and feasible.

The *Making the Plan Appeal to Stakeholders and Desirable to the Entrepreneur* stage involves further changes to the party plan to make it more appealing to both the invited guests and to make it a fun experience for the host. For example, the host might learn that some of the single guests would like to bring dates and others might need to be able to bring their children to be able to attend. The host might be able to accommodate those desires or needs in ways that will also make the party more fun for them—maybe by accepting some guests' offers to bring food or games, or maybe hiring a babysitter to entertain and look after the children.

The final stage—*Finishing the Business Plan*—involves the host putting all of the final touches in place for the party in preparation for the arrival of the guests.

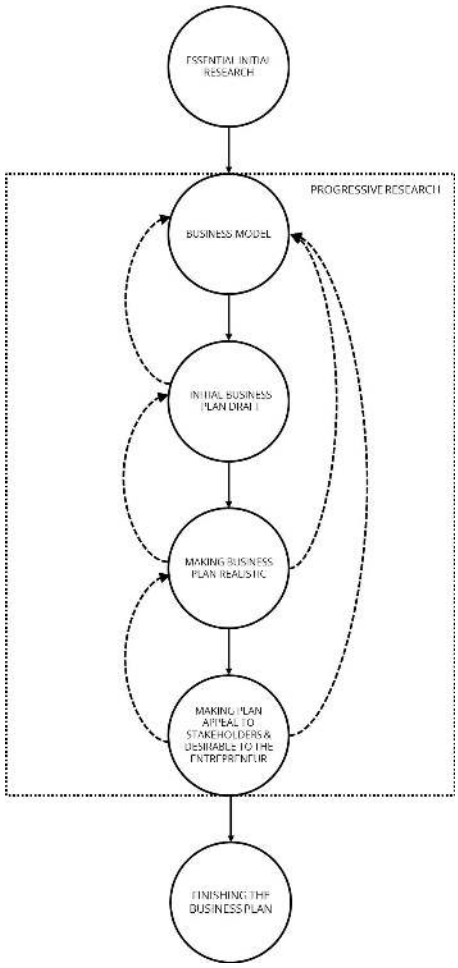


Figure 5.3.1: Business Plan Development Process (Illustration by Lee A. Swanson)

Essential Initial Research

A business plan writer should analyze the environment in which they anticipate operating at each of the levels of analysis: *Societal*, *Industry*, *Market*, and *Firm*. This stage of planning is called the *Essential Initial Research* stage, and it is a necessary first step to better understand the trends that will affect their business and the decisions they must make to lay the groundwork for, which will improve their potential for success.

In some cases, much of this research should be included in the developing business plan as its own separate section to help show readers that there is a market need for the business being considered and that it stands a good chance of being successful.

In other cases, a business plan will be stronger when the components of the research are distributed throughout the business plan to provide support for the outlined plans and strategies outlined. For example, the industry- or market-level research might outline the pricing strategies used by identified competitors, which might be best placed in the *Pricing Strategy* part of the business plan to support the decision made to employ a particular pricing strategy.

Business Model

Inherent in any business plan is a description of the *Business Model* chosen by the entrepreneur as the one that they feel will best ensure success. Based upon their analysis from the Essential Initial Research stage, an entrepreneur should determine how each element of their business model—including their revenue streams, cost structure, customer segments, value propositions, key activities, key partners, and so on—might fit together to improve the potential success of their business venture.

For some types of ventures, at this stage an entrepreneur might launch a lean start-up and grow their business by continually pivoting, or constantly adjusting their business model in response to the real-time signals they get from the markets' reactions to

their business operations. In many cases, however, an entrepreneur will require a business plan. In those cases, their initial business model will provide the basis for that plan.

Of course, throughout this and all of the stages in this process, the entrepreneur should seek to continually gather information and adjust the plans in response to the new knowledge they gather. As shown in Figure 5.3.1 by its enclosure in the *Progressive Research* box, the business plan developer might need to conduct further research before finishing the business model and moving on to the initial business plan draft.

Initial Business Plan Draft

The *Initial Business Plan Draft* stage involves taking the knowledge and ideas developed during the first two stages and organizing them into a business plan format. Many entrepreneurs prefer to create a full draft of the business plan with all of the sections, including the front part with the business description, vision, mission, values, value proposition statement, preliminary set of goals, and possibly even a table of contents and lists of tables and figures all set up using the software features enabling their automatic generation. Writing all of the operations, human resources, marketing, and financial plans as part of the first draft ensures that all of these parts can be appropriately and necessarily integrated. The business plan will tell the story of a planned business startup in two ways: 1) by using primarily words along with some charts and graphs in the operations, human resources, and marketing plans and 2) through the financial plan. Both must tell the same story.

The feedback loop shown in Figure 5.3.1 demonstrates that the business developer may need to review the business model. Additionally, as shown by its enclosure in the *Progressive Research* box, the business plan developer might need to conduct further research before finishing the Initial Business Plan Draft stage and moving on to the Making Business Plan Realistic stage.

Making Business Plan Realistic

The first draft of a business plan will almost never be realistic. As the entrepreneur writes the plan, it will necessarily change as new information is gathered. Another factor that usually renders the first draft unrealistic is the difficulty in making certain that the written part—in the front part of the plan along with the operations, human resources, and marketing plans—tells the exact same story as the financial part does. This stage of work involves making the necessary adjustments to the plan to make it as realistic as possible.

The *Making Business Plan Realistic* stage has two possible feedback loops. The first means going back to the Initial Business Plan Draft stage if the initial business plan needs to be significantly changed before it is possible to adjust it so that it is realistic. The second feedback loop circles back to the Business Model stage if the business developer needs to rethink the business model. As shown in Figure 5.3.1 by its enclosure in the *Progressive Research* box, the business plan developer might need to conduct further research before finishing the Making Business Plan Realistic stage and moving on to the Making Plan Appeal to Stakeholders stage.

Making Plan Appeal to Stakeholders and Desirable to the Entrepreneur

A business plan can be realistic without appealing to potential investors and other external stakeholders, like employees, suppliers, and needed business partners. It might also be realistic (and possibly appealing to stakeholders) without being desirable to the entrepreneur. During this stage, the entrepreneur will keep the business plan realistic as they adjust plans to appeal to potential investors, stakeholders, and themselves.

If, for example, investors will be required to finance the business's start, some adjustments might need to be relatively extensive to appeal to potential investors' needs for an exit strategy from the business, to accommodate the rate of return they expect from their investments, and to convince them that the entrepreneur can accomplish all that is promised in the plan. In this case, and in others, the entrepreneur will also need to get what they want out of the business to make it worthwhile for them to start and run it. So, this stage of adjustments to the developing business plan might be fairly extensive, and they must be informed by a superior knowledge of what targeted investors need from a business proposal before they will invest. They also need to be informed by a clear set of goals that will make the venture worthwhile for the entrepreneur to pursue.

The caution with this stage is to balance the need to make realistic plans with the desire to meet the entrepreneur's goals while *avoiding becoming discouraged enough to drop the idea of pursuing the business idea*. If an entrepreneur is convinced that the proposed venture will satisfy a valid market need, there is often a way to assemble the financing required to start and operate

the business while also meeting the entrepreneur's most important goals. To do so, however, might require significant changes to the business model.

One of the feedback loops shown in Figure 5.3.1 indicates that the business plan writer might need to adjust the draft business plan while ensuring that it is still realistic before it can be made appealing to the targeted stakeholders and desirable to the entrepreneur. The second feedback loop indicates that it might be necessary to go all the way back to the Business Model stage to re-establish the framework and plans needed to develop a realistic, appealing, and desirable business plan. Additionally, this stage's enclosure in the *Progressive Research* box suggests that the business plan developer might need to conduct further research.

Finishing the Business Plan

The final stage involves putting the important finishing touches on the business plan so that it will present well to potential investors and others. This involves making sure that the math and links between the written and financial parts are accurate. It involves ensuring that all the needed corrections are made to the spelling, grammar, and formatting. The final set of goals should be written to appeal to the target readers and to reflect what the business plan says. An executive summary should be written and included as a final step.

Section Summary

This section described the internal and external purposes for business planning. It also explained how business plans must effectively communicate while establishing and building credibility for both the entrepreneur and the venture. The general guidelines for business planning were covered as were some important business planning tools. The section concluded with descriptions of the stages of the business development process for effective business planning.

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5.4: Essential Initial Research

Learning Objectives

After completing this section, you will be able to:

- Apply analytical skills to assess how the nature of the entrepreneurial environment can influence entrepreneurial outcomes
- Apply the right tools to do impactful analyses at each of the societal, industry, market, and firm levels to evaluate entrepreneurial and other business opportunities

Overview

This chapter introduces the distinct levels of analyses that must be considered while stressing the importance of applying the appropriate tools to conduct the analyses at each level.

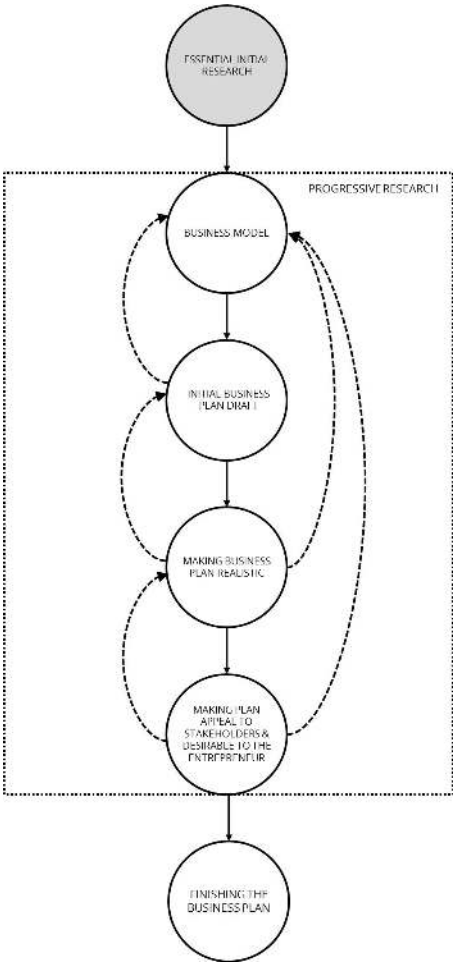


Figure 5.4.1: Essential Initial Research (Illustration by Lee A. Swanson)

Support Information

It is important to conduct the essential initial research. All information and items in the plan should be backed with facts from valid primary or secondary sources. Alternatively, some entrepreneurs can make valid claims based on experience and expertise. As such, their background and experiences should be delineated to support the claims made in their business plan.

Levels of Analyses

When evaluating entrepreneurial opportunities—sometimes called idea screening—an effective process involves assessing the various venture ideas being considered by applying different levels and types of analyses. Entrepreneurs starting ventures and running existing businesses should also regularly analyze their operating environments at the societal, industry, market, and firm levels. The right tools, though, must be applied at each level of analysis (see Figure 5.4.2). It is critical to complete the essential initial research at all four levels (societal, industry, market, and firm). The initial scan should be high-level, designed to assist in making key decisions (i.e. determining if there is a viable market opportunity for the venture). Secondary scans should be continuously conducted to support each part of the business plan (i.e. operations, marketing, and finance). However, information should only be included if it is research-based, relevant, and adds value to the business plan. The results from such research (i.e. the Bank of Canada indicates that interest rates will be increasing in the next two years) should support business strategies within the plan (i.e. debt financing may be less favourable than equity financing). Often, obtaining support data (i.e. construction quotes) is not immediate, so plant a flag and move forward. Valid useful resources may include information from Statistics Canada, Bank of Canada, IBIS World Report, etc.

Societal Level

At a *societal level*, it is important to understand each of the political, economic, social, technological, environmental, and legal (PESTEL) factors—and, more specifically, the trends affecting those factors—that will affect a venture based on a particular idea. Some venture ideas might be screened out and others might be worth pursuing at a particular time because of the trends occurring with those PESTEL factors. When including this research in your business plan, avoid using technical jargon or informal language that may distract readers (i.e. rivalry among firms) and use simpler language (i.e. competitive environment).

Industry Level

Analysis of the *industry level* will focus on the sector of the economy in which you intend to operate. Because the right analysis tool must be used for the assessment to be effective, apply Porter's (1985) Five Forces Model, or a similar tool, to assess industry-level factors. Again, avoid technical jargon (i.e. threat of new entrants) and use simpler wording (i.e. difficulty of entering the market) or flip to an analysis of the threat (i.e. strategies to establish and maintain market share).

Market Level

At the *market level*, you need to use a tool to generate information about the part of the industry in which your business will compete. This tool might be a set of questions designed to uncover information that you need to know to help develop plans to improve your proposed venture's success.

Firm Level

At a *firm level*, both the internal organizational trends and the external market profile trends should be analyzed. There are several tools for conducting an internal organizational analysis, and you should normally apply many of them.

Analyzing the Trends at Each Level

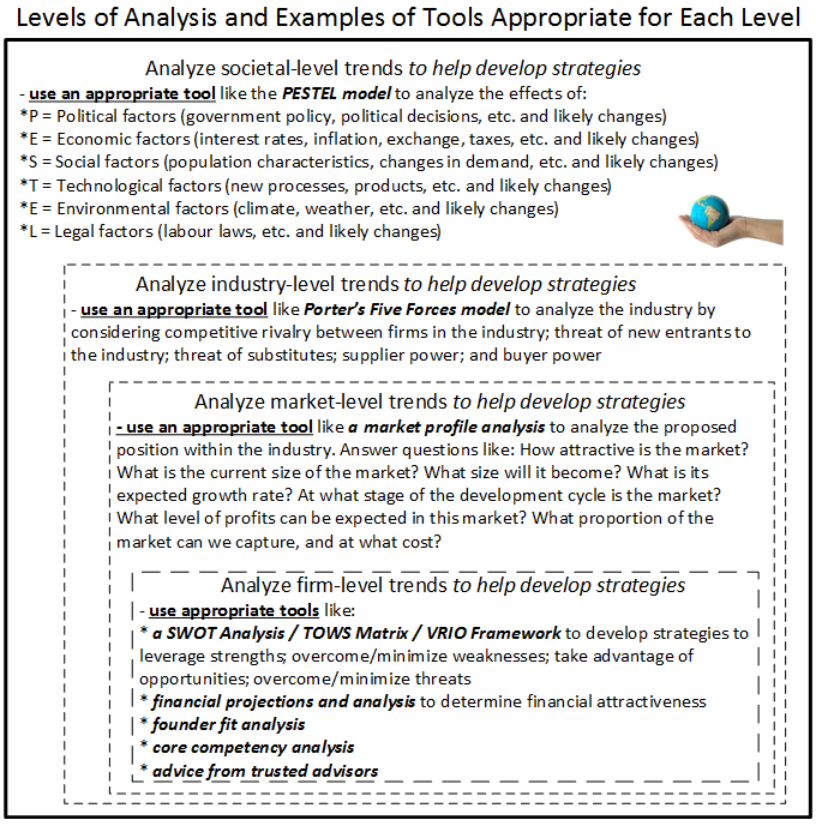


Figure 5.4.2: Different Levels of Analysis (Illustration by Lee A. Swanson)

Analyze Societal-Level Trends

Use an appropriate tool like the PESTEL Model to assess both the current situation and the likely changes that may affect your venture in the future:

- Political factors – federal & provincial & municipal government policy, nature of political decisions, potential political changes, infrastructure plans, etc.
- Economic factors – interest rates, inflation rates, exchange rates, tax rates, GDP growth, health of the economy, etc.
- Social factors – population characteristics like age distribution and education levels, changes in demand for types of products and services, etc.
- Technological factors – new processes, new products, infrastructure, etc.
- Environmental factors – effects of climate/weather, water availability, smog and pollution issues, etc.
- Legal factors – labour laws, minimum wage rates, liability issues, etc.

After assessing these factors, analyze the impact these trends have upon the venture:

- Do the trends uncover opportunities and threats?
- Can opportunities be capitalized on?
- Can problems be mitigated?
- Can the venture be sustained?

Analyze Industry-Level Trends

Use an appropriate tool like the Five Forces Model (Porter, 1985) to analyze the industry in which you expect to operate:

- Horizontal relationships – threat of substitutes, rivalry among existing competitors, threat of new entrants, etc.
- Vertical Relationships – bargaining power of buyers, bargaining power of suppliers, etc.

Analyze Market-Level Trends

Use an appropriate method like a market profile analysis to assess the position within the industry in which you expect to operate. To do so, determine the answers to questions like the following:

- How attractive is the market?
- In what way are competitors expected to respond if you enter the market?
- What is the current size of the market and how large is it expected to become?
- What are the current and projected growth rates?
- At what stage of the development cycle is the market?
- What level of profits can be expected in the market?
- What proportion of the market can be captured? What will be the cost to capture this proportion and what is the cost to capture the proportion required for business sustainability?

Prior to a new business start-up, the customers that the new business wishes to attract either already purchase the product or service from a competitor to the new business—or do not yet purchase the product or service at all. A new venture's customers, therefore, must come from one of two sources. They must be attracted away from existing (direct) competitors or be convinced to make different choices about where they spend their money so they purchase the new venture's product or service instead of spending their money in other ways (with indirect competitors). This means an entrepreneur must decide from which source they will attract their customers, and how they will do so. They must understand the competitive environment.

According to Porter (1996), strategy is about doing different things than competitors or doing similar things but in different ways. In order to develop an effective strategy, an entrepreneur must understand the competition.

To understanding the competitive environment, entrepreneurs must do the following:

- Determine who their current direct and indirect competitors are and who the future competitors may be
- Understand the similarities and differences in quality, price, competitive advantages, and other factors that exist between their proposed business and the existing competitors
- Establish whether they can offer different products or services—or the same products or services in different ways—to attract enough customers to meet their goals
- Anticipate how the competitors will react in response to the new venture's entry into the market

Analyze Firm-Level Trends (Organizational Analysis)

There are several tools available for firm-level analysis, and usually several of them should be applied because they serve different purposes.

Tools like a SWOT Analysis or TOWS Matrix can formulate and evaluate potential strategies to leverage organizational strengths, overcome/minimize weaknesses, take advantage of opportunities, and overcome/minimize threats. You will also need to do a *financial analysis* and consider the *founder fit* and the *competencies* a venture should possess.

- SWOT Analysis – identify organizational strengths and weaknesses and external opportunities and threats
- TOWS Matrix – develop strategies to
    - Leverage strengths to take advantage of opportunities
    - Leverage strengths to overcome threats
    - Mitigate weaknesses by taking advantage of opportunities
    - Mitigate weaknesses while minimizing the potential threats or the potential outcomes from threats

To analyze a firm's strategy, apply a *VRIO Framework* analysis, as Barney (1997) and Barney and Hesterly (2006) outline. While conceptualizing the resource-based view (RBV) of a firm, they identified the following four considerations regarding resources and their ability to help a firm gain a competitive advantage. Together, the following four questions make up the VRIO Framework, which can assess a firm's capacity and determine what competencies a venture should have. To use this tool, you need to determine whether competencies are valuable, rare, inimitable, and organized in a way that they can be exploited:

- Value – Is a particular resource (financial, physical, technological, organizational, human, reputational, innovative) valuable to a firm because it helps it take advantage of opportunities or eliminate threats?

- Rarity – Is a particular resource rare in that it is controlled by or available to relatively few others?
- Imitability – Is a particular resource difficult to imitate so that those who have it can retain cost advantages over those who might try to obtain or duplicate it?
- Organization – Are the resources available to a firm useful to it because it is organized and ready to exploit them?

To assess the financial attractiveness of the venture, analyze

- Similar firms in industry
  - Comparative ratio and financial analysis (Vesper, 1996, p. 145-148) can help determine industry norm returns, turnover ratios, working capital, operating efficiency, and other measures of firm success.
- Projected market share
  - Analyzes the key industry players' relative market share, and make judgments about how the proposed venture would fare within the industry.
  - Uses information from market profile analysis and key industry player analysis.
- Margin analysis
  - Involves projecting expected margins from venture
  - Useful information might come from financial analysis, market profile analysis, and NAICS (North American Industry Classification System) codes (six-digit codes used to identify an industry—first five digits are standardized in Canada, the United States, and Mexico—is gradually replacing the four-digit SIC [Standard Industrial Classification] codes)
- Break-even analysis
  - Involves using information from margin analysis to determine break-even volume and break-even sales in dollars
  - Is there sufficient volume to sustain the venture?
- Pro forma analysis
  - Forecasts income and assets required to generate profits
- Sensitivity analysis
  - What will be the likely impact if some assumed variable values change?
- Return on investment (ROI) projections
  - Projects the ROI from undertaking the venture
  - What is the opportunity cost of undertaking the venture?

Founder fit is an important consideration for entrepreneurs screening venture opportunities. While there are plenty of examples of entrepreneurs successfully starting all types of businesses, "technical capability can be an important if not all-important factor in pursuing ventures success" (Vesper, 1996, p. 149). Factors such as the experience, training, credentials, reputation, and social capital an entrepreneur has can play an important role in their success or failure in starting a new venture. Even when an entrepreneur can recruit expert help through business partners or employees, it might be important that he or she also possess technical skills required in that particular kind of business.

- A common and useful way to help screen venture options is to seek input from experts, peers, mentors, business associates, and perhaps other stakeholders like potential customers and direct family members.

Lean Start-up

Ries (2011) defines a lean start-up as "a human institution designed to create a new product or service under conditions of extreme uncertainty" (p. 27). The lean-start-up approach involves releasing a *minimal viable product* to customers with the expectation that this early prototype will change and evolve frequently and quickly in response to customer feedback. This is meant to be a relatively easy and inexpensive way to develop a product or service by relying on customer feedback to guide the *pivots* in new directions that will ultimately—and relatively quickly—lead to a product or service with the appeal required for business success. It is only then that the actual business will truly emerge. As such, entrepreneurs that apply the lean-start-up approach—because their business idea allows for it—actually forgo developing a business plan, at least until they might need one later to get financing, because introducing a *minimum viable product* helps "entrepreneurs start the process of learning as quickly as possible" (Ries, 2011, p. 93). This is followed by ever improving versions of their products or services. However, all entrepreneurs must directly

consult with their potential target purchasers and end users to assess if and how the market might respond to their proposed venture. The Essential Initial Research and Progressive Research stages should include purposeful and meaningful interactions between the entrepreneur and the target purchasers and end users.

Ries's (2011) five lean-start-up principles start with the idea that entrepreneurs are everywhere and that anyone working in an environment where they seek to create new products or services "under conditions of extreme uncertainty" (p. 27) can use the lean-start-up approach. Second, a start-up is more than the product or service: it is an institution that must be managed in a new way that promotes growth through innovation. Third, start-ups are about learning "how to build a sustainable business" (p. 8-9) by validating product or service design through frequent prototyping that allows entrepreneurs to test the concepts. Fourth, start-ups must follow this process or feedback loop: create products and services; measure how the market reacts to them; and learn from that to determine whether to pivot or to persevere with an outcome the market accepts. Finally, Ries (2011) suggested that entrepreneurial outcomes and innovation initiatives need to be measured through innovative accounting.

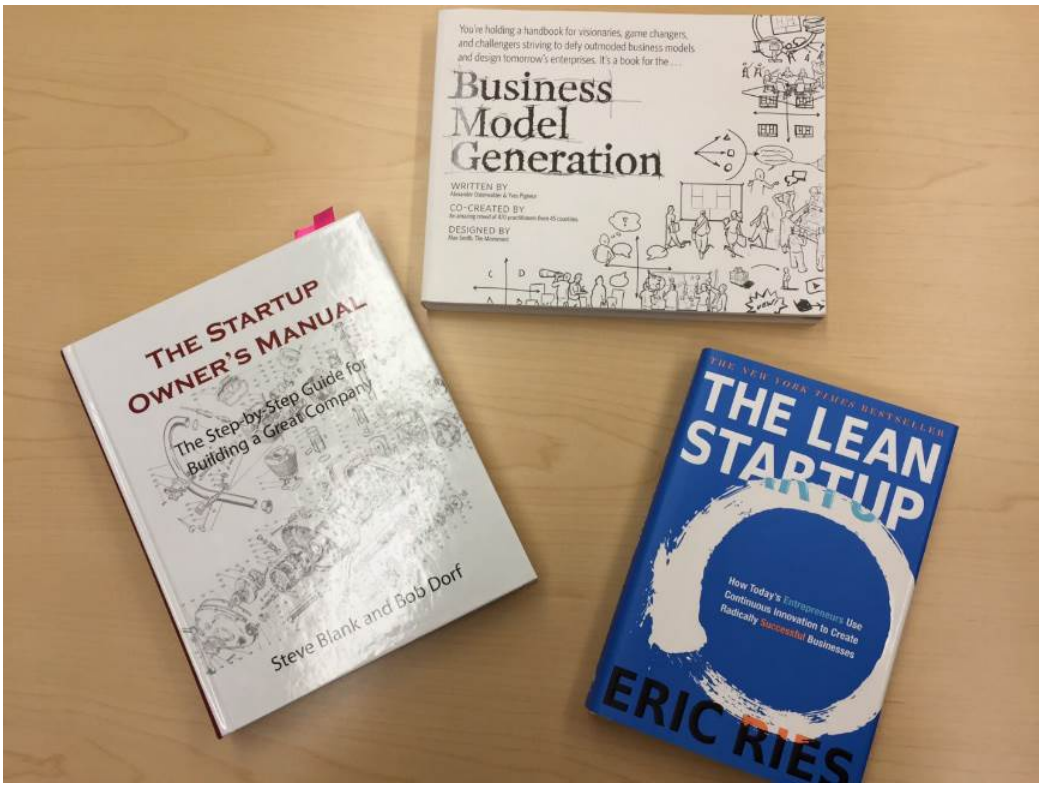


Figure 5.4.3: Business Model and Lean Start-Up Books (Picture by Lee A. Swanson)

Section Summary

By applying the right tools to analyze the operating environment at each of the societal, industry, market, and firm levels, entrepreneurs screen venture ideas, plan new venture development, and potentially detect factors that might affect their business operations. The lean start-up is an alternative that can be used to circumvent the usual planning steps in favour of continuous innovation. See Figure 5.4.3 for other resources on business models and lean start-ups.

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5.5: Business Models

Learning Objectives

After completing this section, you will be able to:

- Describe what a business model is
- Analyze existing and proposed businesses to determine what business models they are applying and what business models they plan to apply
- Develop and analyze alternative business models for new entrepreneurial ventures

Overview

In this section, the concept of the business model is introduced. One concept of the business model, in particular, the Business Model Canvas, is explored as a way to conceptualize and categorize elements of a business model.

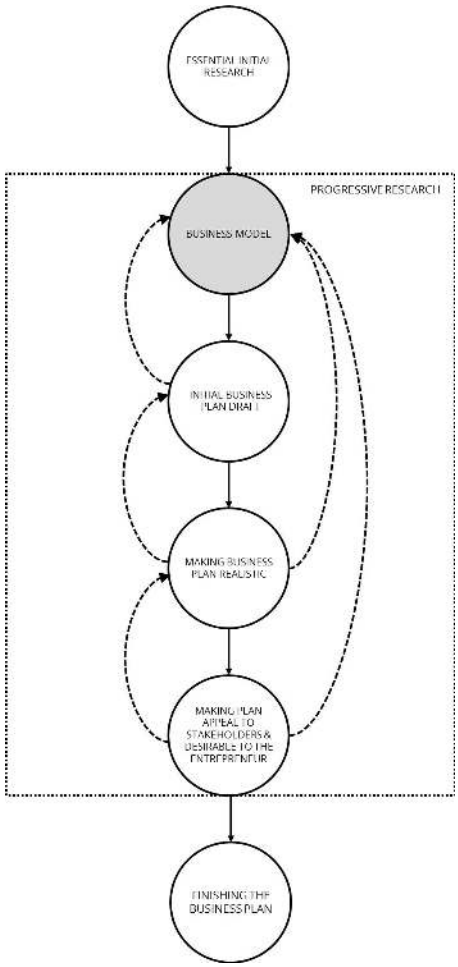


Figure 5.5.1: Business Model (Illustration by Lee A. Swanson)

What are Business Models?

Magretta (2002) described business models as “stories that explain how enterprises work” (p. 87) and Osterwalder, Pigneur, and Clark (2010) noted that they reveal “the rationale of how an organization creates, delivers, and captures value” (p. 14). Chatterjee (2013) said that “A business is about selling what you make for a profit. A business model is a configuration (activity systems) of what the business does (activities) and what it invests in (resources) based on the logic that drives the profits for a specific business” (p. 97).

Osterwalder et al. (2010) said that a start-up is something quite different than an ongoing venture. A start-up should not be viewed as a smaller version of a company because it requires very different skills to start up a company than it does to operate one. A start-up that is still a start-up after some time has passed—maybe after a couple of years for some kinds of start-ups—is actually a failed enterprise since it hasn't converted into an ongoing venture. Entrepreneurs who develop a business model for their ventures that deliver value to the targeted customers and to the entrepreneur stand a better chance of converting their start-up into an ongoing venture.

The Business Model Canvas

The business model canvas is made up of nine parts that, together, describe the business model (see Figure 5.5.2).

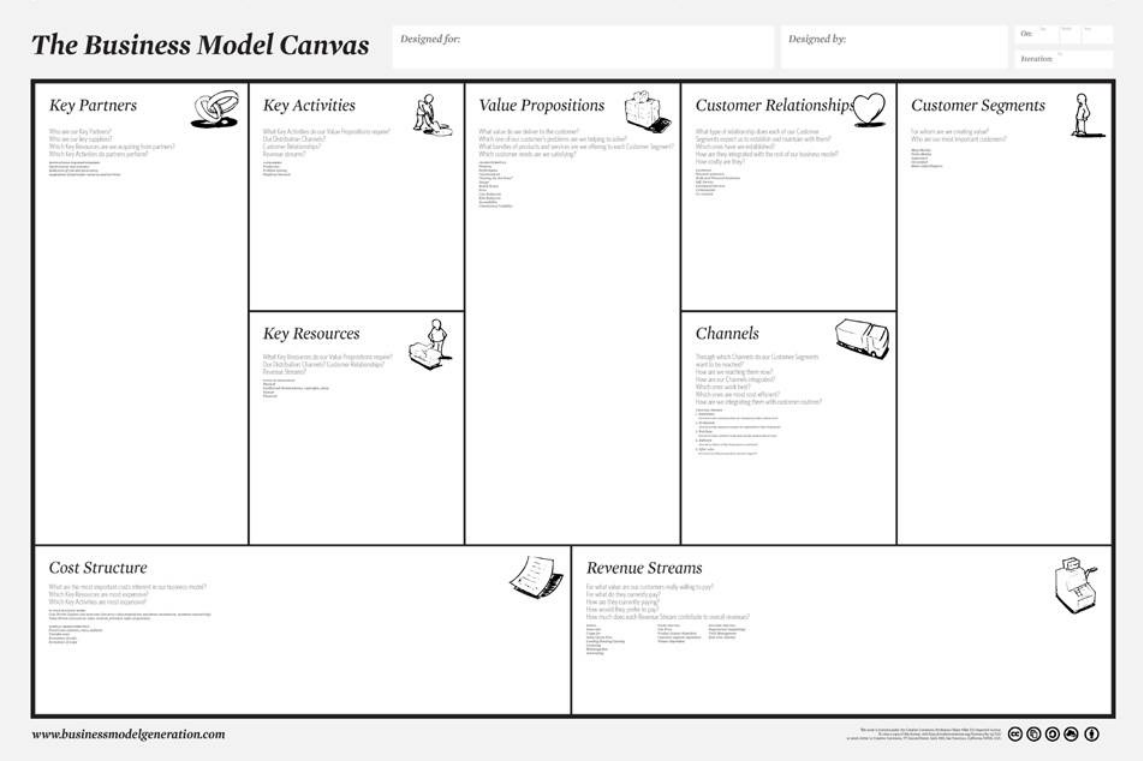


Figure 5.5.2: Business Model Canvas from https://strategyzer.com/ (Designed by: Strategyzer AG, strategyzer.com, Creative Commons Attribution-Share Alike 3.0 Unported License)

The following elements of the Business Model Canvas were taken, with permission, from http://www.businessmodelgeneration.com.

- Key partners
  - Who are our key partners?
  - Who are our key suppliers?
  - Which key resources are we acquiring from partners?
  - Which key activities do partners perform?
  - Motivations for partnerships: optimization and economy; reduction of risk and uncertainty; acquisition of particular resources and activities
- Key activities
  - What key activities do our value propositions require?
  - Our distribution channels?
  - Customer relationships?
  - Revenue streams?
  - Categories: production; problem-solving; platform/network
- Key resources

    - What key resources do our value propositions require?
    - Our distribution channels?
    - Customer relationships?
    - Revenue streams?
    - Types of resources: physical; intellectual (brand patents, copyrights, data); human; financial
- Value propositions
    - What value do we deliver to the customer?
    - Which one of our customer's problems are we helping to solve?
    - What bundles of products and services are we offering to each customer segment?
    - Which customer needs are we satisfying?
    - Characteristics: newness; performance; customization; "getting the job done"; design; brand/status; price; cost reduction; risk reduction; accessibility; convenience/usability
- Customer relationships
    - What type of relationship does each of our customer segments expect us to establish and maintain with them?
    - Which ones have we established?
    - How are they integrated with the rest of our business model?
    - How costly are they?
    - Examples: personal assistance; dedicated personal assistance; self-service; automated services; communities; co-creation
- Customer segments
    - For whom are we creating value?
    - Who are our most important customers?
    - Mass market; niche market; segmented; diversified; multi-sided platform
- Channels
    - Through which channels do our customer segments want to be reached?
    - How are we reaching them now?
    - How are our channels integrated?
    - Which ones work best?
    - Which ones are most cost-efficient?
    - How are we integrating them with customer routines?
    - Channel phases:
        - awareness – How do we raise awareness about our company's products and services?
        - evaluation – How do we help customers evaluate our organization's value proposition?
        - purchase – How do we allow customers to purchase specific products and services?
        - delivery – How do we deliver a value proposition to customers?
        - after sales – How do we provide post-purchase customer support?
- Revenue streams
    - For what value are our customers really willing to pay?
    - For what do they currently pay?
    - How are they currently paying?
    - How would they prefer to pay?
    - How much does each revenue stream contribute to overall revenues?
    - Types: asset sale; usage fee; subscription fees; lending/renting/leasing; licensing; brokerage fees; advertising
    - Fixed pricing: list price; product feature dependent; customer segment dependent; volume dependent
    - Dynamic pricing: negotiation (bargaining); yield management; real-time-market
- Cost structure
    - What are the most important costs inherent in our business model?
    - Which key resources are most expensive?
    - Which key activities are most expensive?

- Is our business more cost-driven (leanest cost structure, low price value proposition, maximum automation, extensive outsourcing) or value-driven (focused on value creation, premium value proposition)?
- Sample characteristics: fixed costs (salaries, rents, utilities); variable costs; economies of scale; economies of scope

The idea is to keep adding descriptions or plans to the nine components to create the initial business model and then to actually do the start-up activities and replace the initial assumptions in each of the nine parts with newer and better information or plans and let the business model evolve. This model is partly based on the idea that the owner should be the one interacting with potential customers so they fully understands what these potential customers want. These interactions should not only be done by hired salespeople, at least until the business model has evolved into one that works, because this evolution can only happen when the venture owner is completely engaged with the potential customers and the other business operations (Osterwalder et al., 2010).

A business plan shouldn't be created until the above has been done because you need to know what your business model is before you can really create a business plan (Osterwalder et al., 2010). Thus, the Business Model Canvas is best suited to technology-based and other types of companies that can be started and operated in some way and later converted into an ongoing venture. By starting operations and making adjustments as you go along, you are actually doing a form of market research that can be compiled into a full business plan when one is needed.

According to Osterwalder et al. (2010), the things we typically teach people in business school are geared to helping people survive in larger, ongoing businesses. What is taught—including organizational structures, reporting lines, managing sales teams, advertising, and similar topics—is not designed to help students understand how a start-up works and how to deal with the volatile nature of new ventures. The Business Model Canvas tool is meant to help us understand start-ups better.

The Business Model Canvas tool is intended to be applied when business operations can be started on a small scale and adjustments can be made continually until the evolving business model works in real life. This contrasts the more traditional approach of pre-planning everything, going through the set-up and start-up processes, and ending up with a business venture that opens for business one day without having proven at all that the business model it is founded upon will even work. These traditional start-ups sometimes flounder along as the owners find that their plans are not quite working out and they try to make adjustments on the fly. It can be difficult to adjust, though, because the processes are already set up. For example, sales teams might be in the field trying to make sales and blaming the product developers for the difficulty they are having, and the product developers might be blaming the sales teams for not being able to sell the product properly. The real issue might be that the company simply isn't meeting customers' needs and they don't have any good mechanism for detecting, understanding, and fixing this problem.

Section Summary

This section described business models and presented the Business Model Canvas as a tool that entrepreneurs can use to develop and define their own business models.

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5.6: Initial Business Plan Draft

Learning Objectives

After completing this section, you will be able to:

- Develop a comprehensive business plan draft

Overview

This section describes an approach to writing your draft business plan. It also outlines the elements of a comprehensive business plan that can be used as a template for starting your business plan.

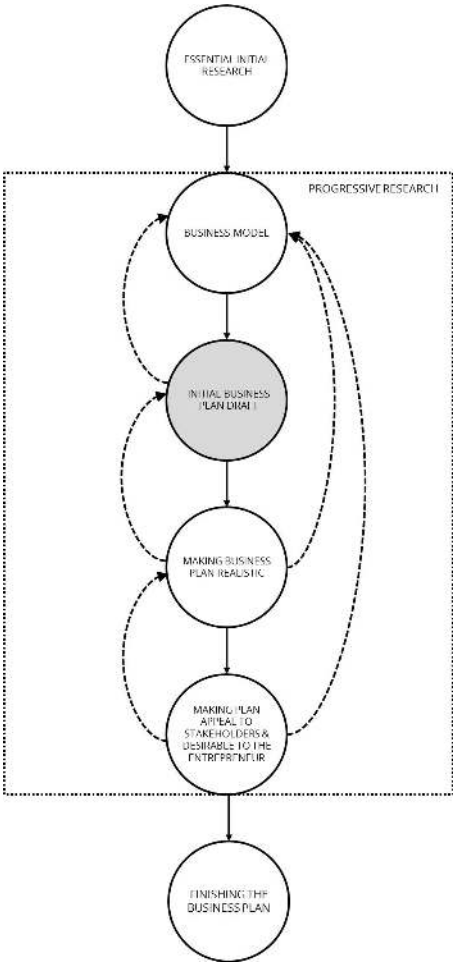


Figure 5.6.1: Initial Business Plan Draft (Illustration by Lee A. Swanson)

Effective Business Plans

Effective business plans:

- Provide statements that are backed by evidence or data
- Include context and references with every table, figure, or illustration
- Include relevant, clear, concise tables and financial information, and exclude unnecessary material
- Present timelines for distinct purposes
- Use clear sections customized to the particular business or its environment rather than generic sections

Writing the Draft Business Plan

Although there are various ways to approach the task of writing a draft business plan, one effective approach is to do the following:

- Use the following sections of this chapter to prepare an outline for your business plan. You should use the *headings* feature in Word so that you can later automatically generate a table of contents
  - This will provide you with a template for the information needed for your plan.
- Insert the relevant parts of the written work produced during essential initial research into your new business plan template. You can do this in one of two ways:
  - You can copy and paste the results of your essential initial research into the sections of your business plan template where you believe that they can be used to support or justify the strategies and other decisions you will later describe in those sections. Of course, you can later move those parts of your environmental scan as needed as you develop your plan. *In general, this strategy results in a stronger business plan.*
  - Or you can insert the results from your societal-level and industry-level analyses in an Operating Environment section as listed in the outline below. As described below, the market-level analysis will probably always fit best within the Marketing Plan and the firm-level analysis might fit across all of the plans within the business plan.
    - Completing this step will give you the satisfaction of seeing some of your work so far taking shape in the form of a business plan.
    - Also, inserting the results from your environmental scan into the relevant sections of your plan should later provide you with the stimulus and support you will need to develop solid, realistic, evidence-based strategies and decisions for those sections.
- Incorporate your business model into your new business plan template. As there is no section in a business plan in which you specifically describe your business model, you will need to incorporate your business model elements into appropriate sections of your plan.
- Fill in as much relevant information as you can under as many of the headings on your business plan template as possible.
  - You will normally include both information that you got from particular sources and information based on an assumption you made (and that you might intend to replace later with more accurate information from valid sources).

Follow these practices as you develop your plan:

- Every time that you insert something into your business plan template that you got from a supplier's catalogue, clearly indicate from where you got that information. For example, if you list the office equipment and furniture that you need along with their exact costs as taken from suppliers' catalogue, clearly indicate from which catalogue(s) you got the information. Similarly, if you spoke to an industry expert who recommended that you manufacture your product in a particular way, clearly indicate who you spoke to and what their credentials are, if you got the person's permission to do so.
  - When you do this, you help establish your credibility as a business plan writer, and your business plan's credibility. It also might save you time later when you discover that you need to add a similar item along with its cost to your list.
  - Note: Do not reinvent the wheel by "inventing" your own method to reference your sources and do not use multiple methods. Use one (and only one) proper and well-established referencing method, like APA. This will improve the degree of professionalism of your plan.
- Every time that you insert something into your plan that did not come from a source, a best practice is to highlight that part of your plan, possibly by using a distinct font color. The objective will be to ultimately *replace all of those assumptions* with source-backed information. When you do so, change the font to its regular color so you can quickly and easily see what still needs to be sourced.
  - Note: if you are an expert source on something—maybe you are a construction expert that business plan readers will trust to do estimates on building costs—you should establish your credentials and clearly indicate when some of the information in your plan is based on your own expert knowledge.
  - When you flag your assumptions in this way, you can quickly and easily see what information needs to be replaced with sourced information before you finalize your business plan.

- Use the appropriate schedule in the spreadsheet templates to record estimated sales revenue for each month. You must base these sales projections on well-reasoned criteria and set them up in your spreadsheets using formulas so that if you need to change a criterion later, you can change a number in one cell or a limited number of cells rather than having to change all of them.
    - Projecting realistic sales can be difficult, but setting up a method for doing so early gives business plan writers a significant start toward completing their business plan. A well-developed sales model that takes advantage of the powers of electronic spreadsheets gives business plan writers the opportunity to relatively quickly and easily make necessary changes to their assumptions and overall estimates when needed.
- Use the spreadsheet templates by filling in all of the numbers you have in the various schedules. As you are doing in the written part of your plan, use a distinct font to flag numbers that are based on assumptions. When you have actual numbers, be certain that it is clear to a reader what sources you used to get those numbers.
    - When you use the schedules provided on the spreadsheet templates, and any others that you add, you will be well on your way to developing the financial component of your business plan.

General Business Plan Format

Letter of Transmittal

A letter of transmittal is similar to the cover letter of a resume. The letter of transmittal should be tailored to the reader, clearly identifying the customized ask of the potential investor or lender. It should be short and succinct, delineating the ask (i.e. funding, specialized recruiting, purchasing a product or service, obtaining advice, etc.) within a few paragraphs. It should not summarize the business plan, as that is the job of the executive summary.

Title Page

- Includes nice, catchy, professional, appropriate graphics to make it appealing for targeted readers

Executive Summary

- Can be longer than normal executive summaries—up to three pages
- Written after remainder of plan is complete
- Includes information relevant to targeted readers as this is the place where they are most likely to form their first impressions of the business idea and decide whether they wish to read the rest of the plan

Table of Contents

List of Tables

- References every table, figure, and appendix within the text of the plan so the relevance of each of these elements is clear.

List of Figures

Introduction

- Indicates the purpose for the plan
- Appeals to targeted readers

Business Idea

- May include description of history behind the idea and the evolution of the business concept if relevant

Value Proposition

- Explains how your business idea solves a problem for your expected customers or otherwise should make them want to purchase your product or service instead of a competitor’s

Vision

- Outlines what you intend for the venture to be
- Inspires all members of the organization

- Helps stakeholders aspire to achieve greater things through the venture because of the general direction provided through the vision statement

After articulating a good vision, the business plan writer should consider what achieving the vision looks like. Many business plan writers write their vision and leave it at that. The problem with this approach is that they often then do not take the necessary steps to illustrate how the strategies they outline in their plan will move them toward achieving their vision. If they make this mistake, their strategies might indicate that they are fulfilling their current mission, but are not taking steps to move beyond that.

Vision statements should be clear with context throughout the business plan. For example, if the goal is to be the premier business operating in that industry in Saskatchewan, does that mean you have one location and are considered the best at what you do it even though you only have a small corner of the market, or does it mean that you have many locations across the province and enjoy a large market share?

Mission

- Should be very brief—a few sentences or a short paragraph
- Indicates what your organization does and why it exists—may describe the business strategy and philosophy

Values

- Consists of five to ten short statements indicating the important values that will guide everything the business will do
- Outlines the personal commitments members of the organization must make, and what they should consider to be important
- Defines how people behave and interact with each other
- Should be reflected in all of the decisions outlined in the business plan, from hiring to promotions to location choices
- Helps the reader understand the type of culture and operating environment this business intends to develop

Major Goals

- Describes the major organizational goals
- Ensures each goal is:
  - Specific, Measurable, Action-oriented, Realistic, and Timely [SMART]
  - Realistic, Understandable, Measureable, Believable, and Achievable [RUMBA]
- Aligns with everything in plan
- Written, or re-written as the second last thing you do before finalizing your business plan by proofreading, polishing, and printing it (writing the Executive Summary is the final thing you should write)

Operating Environment

Trend Analysis

- Usually includes an analysis of how the current and expected trends in the political, economic, social, technological, environmental, and legal (PESTEL) factors will impact the development of this business
  - However, consider whether this is the right place for this analysis: it may be better positioned, for example, in the Financial Plan section to provide context to the analysis of the critical success factors, or in the Marketing Plan to help the reader understand the basis for the sales projections.

Industry Analysis

- Includes an analysis of the industry in which this business will operate
- Typically applies the Five Forces Model (Porter, 1985)
  - As above, consider whether this is the right place for this analysis: it may be better placed, for example, in the Marketing Plan to enhance the competitor analysis, or in the Financial plan to provide context to the industry standard ratios in the Investment Analysis section.

Of course, your trend analysis will also include a market-level analysis (using a set of questions, like those listed in Chapter 2) and a firm-level analysis (using tools like a SWOT Analysis / TOWS Matrix, various forms of financial analyses, a founder fit analysis, and so on), but those analyses are usually best placed in other sections of your plan to support the strategies and decisions you

present there. The market-level analysis will inevitably fit in the Marketing Plan section, but the firm-level analysis might be spread across some or all of the Operating Plan, Human Resources Plan, Marketing Plan, and Financial Plan sections.

Operations Plan

- Answers the following key questions:
  - What constraints are you operating under that will restrict your capacity to produce and sell your product?
    - Given these constraints, what is your operating capacity (in terms of production, sales, etc.)?
  - What is the workflow plan for your operation?
  - What work will your company do and what work will you outsource?

Operations Timeline

- Answers the following questions:
  - When will you make the preparations, such as registering the business name and purchasing equipment, to start the venture?
  - When will you begin operations and make your first sales?
  - When will other milestone events occur such as moving operations to a larger facility, offering a new product line, hiring new key employees, and beginning to sell products internationally?
  - Sometimes it is useful to include a graphical timeline showing when these milestone events have occurred and are expected to occur.

Business Structure and other Set-up Elements

- Indicates the legal structure your venture will take:
  - Sole Proprietorship
  - Partnership
  - Limited Partnership
  - Corporation
  - Cooperative

Note: Your financial statements, risk management strategy, and other elements of your plan are affected by the type of legal structure you choose for your business. For example, all partnerships should have a clear agreement outlining the duties, expectations, and compensation of all partners as well as the process of dissolution. *Spreadsheet templates are formatted for corporations and will need to be formatted for other forms of businesses.*

- Describes your decisions related to the following:
  - Naming
  - Zoning, equipment prices, suppliers, etc.
  - Location
  - Leasing terms, leasehold improvements, signage, pay deposits, etc.
  - Getting business license, permits, etc.
  - Setting up banking arrangements
  - Setting up legal and accounting systems (or professionals)
  - Ordering equipment, locks and keys, furniture, etc.
  - Recruiting employees, setting up the payroll system and benefit programs, etc.
  - Training employees
  - Testing the products/services that will be offered
  - Testing the systems for supply, sales, delivery, and other functions
  - Creating graphics, logos, promotional methods, etc.
  - Ordering business cards, letter head, etc.
  - Setting up supplier agreements and outlining why those sellers are preferred
  - Buying inventory, insurance, etc.
  - Revising business plan

- And many more things, including, when possible, attracting purchased orders in advance of start-up through personal selling (by the owner, a paid sales force, independent representatives, or by selling through brokers wholesalers, catalogue houses, retailers), a promotional campaign, or other means

Note: As part of your business set-up, you need to determine what kinds of control systems you should have in place, establish necessary relationships with suppliers prior to your start-up, and generally deal with a list of issues like those mentioned above.

Start-up

- Answers the following questions:
  - What is required to start-up your business including the purchases and activities that must occur before you make your first sale?
  - When identifying capital requirements for start-up, a distinction should be made between fixed capital requirements and working capital requirements.

Fixed Capital Requirements

- Answers the following question:
  - What fixed assets, including equipment and machinery, must be purchased so your venture can conduct its business?
- May include a start-up budget showing the machinery, equipment, furnishings, renovations, and other capital expenditures required prior to operations commencing
  - May also show the financing required, often in the form of longer-term loans

Working Capital Requirements

- Answers the following question:
  - What money is needed to operate the business (separately from the money needed to purchase fixed assets) including the money needed to purchase inventory and pay initial expenses?
- May include a start-up budget showing the cash required to purchase starting inventories, recruit employees, conduct market research, acquire licenses, hire lawyers, and other operating expenditures required prior to starting operations
  - May also show the financing required. Working capital is usually financed with operating loans, trade credit, credit card debt, or other forms of shorter-term loans

Risk Management Strategies

- Includes descriptions of the organization's risk exposure
  - Enterprise – liability exposure for things like when someone accuses your employees or products you sell of injuring them
  - Financial – securing loans when needed and otherwise having the right amount of money when you need it
  - Operational – securing needed inventories, recruiting needed employees in tight labour markets, operating when customers you counted on not purchasing product as you had anticipated, managing theft, arson, and natural disasters like fires and floods, etc.
- Always includes descriptions of the planned strategies for managing each of the risks identified. Identifies potential risk exposures, their consequences, risk potential, and mitigation strategies (Figure 8).
  - Avoid – choose to avoid doing something, outsource, etc.
  - Reduce – through training, assuming specific operational strategies, etc.
  - Transfer – insure against, outsource, etc.
  - Assume – self-insure, accept, etc.

RISK EXPOSURE	RISK CONSEQUENCE	RISK POTENTIAL	MITIGATION
Fire, flood, or theft	Possibly devastating	Moderate	Purchase insurance and alarm system
Bad debt	Lost income and profit	Moderate	Credit checks, registered security, and legal contracts

Figure 5.6.2: Risk Management Strategies (Illustration by Lee A. Swanson)

Operating Processes

- Answers the following key questions:
  - What operating processes will you apply?
  - Depending upon the type of business, describes things like
    - Retail and wholesale operations
      - How will you ensure your cash is managed effectively?
      - How will you schedule your employees?
      - How will you manage your inventories?
      - If you will have a workforce, how will you manage them?
      - etc.
    - Service operation
      - How will you bill out your employee time?
      - How will you schedule work on your contracts?
      - etc.
    - Manufacturing operation
      - How you will manufacture your product (process flow, job shop, etc.?)
      - How will you maintain quality?
      - How will you institute and manage effective financial monitoring and control systems that provide needed information in a timely manner?
      - How will you manage expansion?
      - etc.

Facilities

- May include planned layouts for facilities
- Answers the following questions:
  - What are your facility plans?
  - Where will your facility be located?
    - Expressed as a set physical location
    - Expressed as a set of requirements and characteristics
  - How large will your facility be and why must it be this size?
  - How much will it cost to buy or lease your facility?
  - What utility, parking, and other costs must you pay for this facility?
  - What expansion plans must be factored into the facility requirements?
  - What transportation and storage issues must be addressed by facility decisions?
  - What zoning and other legal issues must you deal with?
  - What will be the layout for your facility and how will this best accommodate customer and employee requirements?

Organizational Structure

- May include information on Advisory Boards or Board of Directors from which the company will seek advice or guidance or direction
- May include an organizational chart
- Can be a nice lead-in to the Human Resources Plan

Human Resources Plan

- Key questions answered by human resources plans:
  - How do you describe your desired corporate culture?
  - What are the key positions within your organization?
  - How many employees will you have?
  - What characteristics define your desired employees?

- What is your recruitment strategy? What processes will you apply to hire the employees you require?
- What is your leadership strategy and why have you chosen this approach?
- What performance appraisal and employee development methods will you use?
- What is your organizational structure and why is this the best way for your company to be organized?
- How will you pay each employee (wage, salary, commission, etc.)? How much will you pay each employee?
- What are your payroll costs, including benefits?
- What work will be outsourced and what work will be completed in-house?
- Have you shown and described an organizational chart?

Recruitment and Retention Strategies

- Includes how many employees are required at what times
- Estimates time required to recruit needed employees
- Estimates all recruitment costs including:
  - Employment advertisements
  - Contracts with employment agency or search firms
  - Travel and accommodations for potential employees to come for interviews
  - Travel and accommodations for interviewers
  - Facility, food, lost time, and other interviewing costs
  - Relocation allowances for those hired including flights, moving companies, housing allowances, spousal employment assistance, etc.
- May include a schedule showing the costs of initial recruitment that then flows into your start-up expense schedules

Leadership and Management Strategies

- Outlines your leadership philosophy
- Explains why it is the most appropriate leadership approach for this venture

Training

- Answers the following key questions:
  - What training is required because of existing rules and regulations?
  - How will you ensure your employees are as capable as required?
  - In which of the following areas will you provide training for your employees?
    - Health and safety (legislation, WHMIS, first aid, defibulators, etc.)
    - Initial workplace orientation
    - Management
    - Financial systems
    - Sales
    - Contracts
    - Product features
    - Other

Performance Appraisals

- Identifies how you will manage your performance appraisal systems

Health and Safety

- Notes any legal requirements (and also legal requirements for other issues that may be included in other parts of the plan)
- Identifies accreditation you might pursue, such as ISO 9000, and if so, evaluates the costs, benefits, and time frame
- Outlines training for employees, such as WHMIS training or machinery handling training

Compensation

- Always justifies your planned employee compensation methods and amounts
- Always includes all components of the compensation (CPP, EI, holiday pay, etc.)

- Identifies how you will ensure both internal and external equity in your pay systems
- Describes any incentive-based pay or profit-sharing systems planned
- May include a schedule that shows the financial implications of your compensation strategy and supports the cash flow and income statements shown later

Key Personnel

- May include brief biographies of the key organizational people

Marketing Plan

- Identifies the primary and secondary research you have done
  - You must show evidence of having done proper research, both primary and secondary. If you make a statement of fact, you must back it up with properly referenced supporting evidence. If you indicate a claim is based on your own assumptions, you must back this up with a description as to how you came to the conclusion.
- Shows an effective analysis of the economic environment relevant to your business
  - It is a given that you must provide some assessment of the economic situation as it relates to your business. For example, you might conclude that the current economic crisis will reduce the potential to export your product and it may make it more difficult to acquire credit with which to operate your business. Of course, conclusions such as these should be matched with your assessment as to how your business will make the necessary adjustments to ensure it will thrive despite these challenges, or how it will take advantage of any opportunities your assessment uncovers.
- Shows an effective assessment of the industry within which your venture will operate
  - You must provide an assessment of the industry coupled with descriptions of how your venture will prosper in those circumstances. A common approach used to assess the industry is to apply Porter's (1985) Five Forces Model.
    - If you apply the Five Forces Model, do so in the way in which it was meant to be used to avoid significantly reducing its usefulness while also harming the viability of your industry analysis. This model is meant to be used to consider the entire industry, not a subcomponent of it (and it usually cannot be used to analyze a single organization).
  - Your competitor analysis might fit within your assessment of the industry, or it might be best as a section within your marketing plan. Usually, a fairly detailed description of your competitors is required, including an analysis of their strengths and weaknesses. In some cases, your business may have direct and indirect competitors to consider. Maintain credibility by demonstrating that you fully understand the competitive environment.
  - Assessments of the economic conditions and the state of the industry appear incomplete without accompanying appraisals outlining the strategies the organization can/should employ to take advantage of these economic and industry situations. So, depending upon how you have organized your work, it is usually important to couple your appraisal of the economic and industry conditions with accompanying strategies for your venture. This shows the reader that you not only understand the operating environment, but that you have figured out how best to operate your business within that situation.
- Outlines an effective analysis of your venture (see the Organizational Analysis section below)

Market Analysis

- Usually contains customer profiles, constructed through primary and secondary research, for each market targeted
- Contains detailed information on the major product benefits you will deliver to the markets targeted
- Describes the methodology used and the relevant results from the primary market research completed
- If there was little primary research completed, justifies why it is acceptable to have done little of this kind of research and/or indicate what will be done and by when
- Includes a complete description of the secondary research conducted and the conclusions reached
- Describes the potential customers
  - Define your target market in terms of identifiable entities sharing common characteristics. For example, it is not meaningful to indicate you are targeting Canadian universities. It is, however, useful to define your target market as Canadian university students between the ages of 18 and 25, or as information technology managers at Canadian universities, or as student leaders at Canadian universities. Your targeted customer should generally be able to make or significantly influence the buying decision.

- You must usually define your target market prior to describing your marketing mix, including your proposed product line. Sometimes the product descriptions in business plans seem to be at odds with the described target market characteristics. Ensure your defined target market aligns completely with your marketing mix (including product/service description, distribution channels, promotional methods, and pricing). For example, if the target market is defined as Canadian university students between the ages of 18 and 25, the product component of the marketing mix should clearly be something that appeals to this target market.
- Carefully choose how you will target potential customers. Should you target them based on their demographic characteristics, psychographic characteristics, or geographic location?

- Identify how your targeted customers make their buying decisions
  - You will need to access research to answer this question. Based on what you discover, you will need to figure out the optimum mix of pricing, distribution, promotions, and product decisions to best appeal to how your targeted customers make their buying decisions.

Competition

- Fully describes the nature of your competitors
  - However, this information might fit instead under the market analysis section.
- Describes all your direct competitors
- Describes all your indirect competitors
- If you can, includes a competitor positioning map to show where your product will be positioned relative to competitors' products
  - If you include a competitor positioning map, insure that the x-axis and y-axis are meaningful. Often, competitor maps include quality and price as axes. Unless you can clearly articulate the distinction between high quality and low quality, it may be more valuable to have more meaningful axes or describe your value proposition relative to your competitors in the absence of a positioning map.

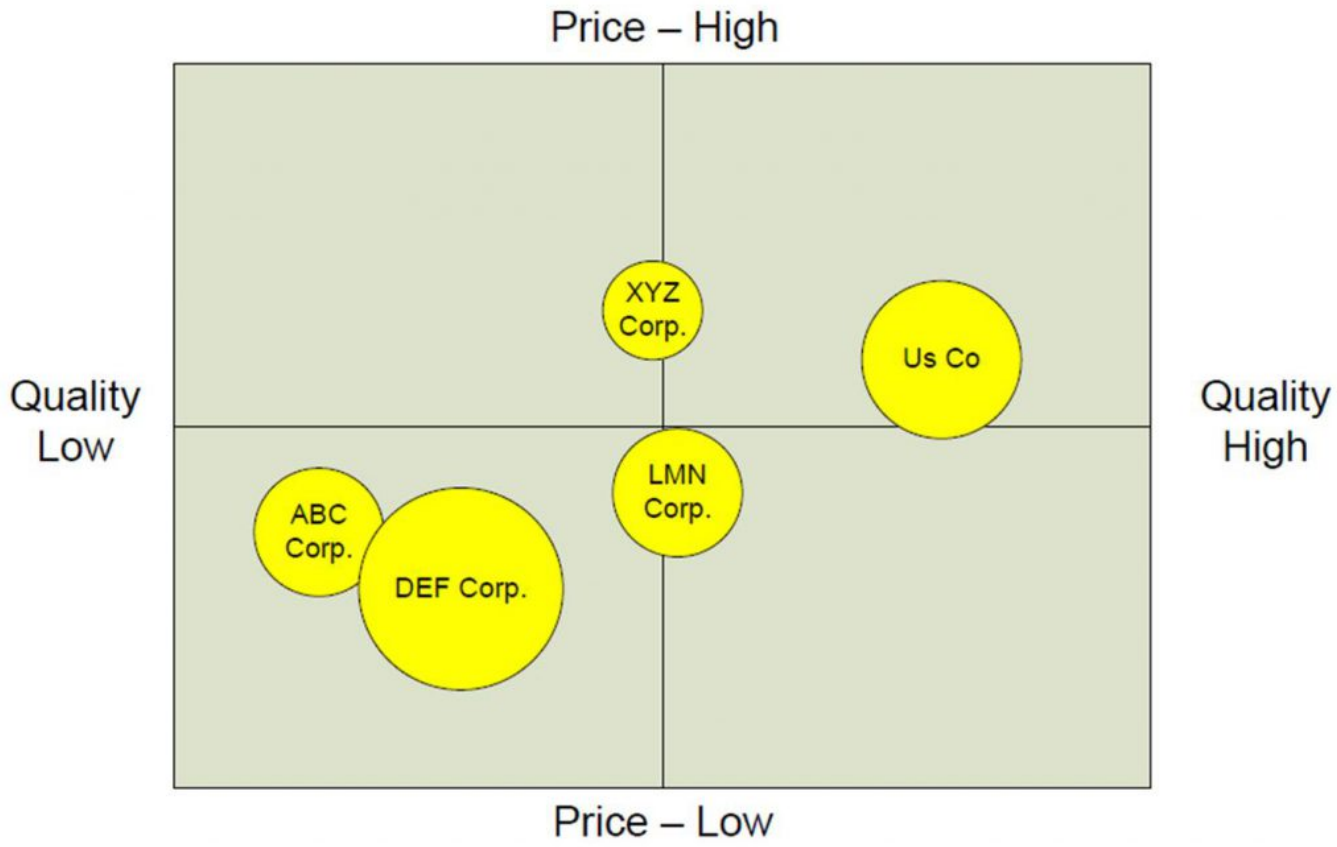


Figure 5.6.3: Competitor Positioning Map (Illustration by Lee A. Swanson)

- Identifies your competitive advantage, your venture`s value proposition, and what distinguishes your business from that of your competitors in a way that will ensure your sales forecasts will be met
  - You must clearly communicate the answers to these questions in your business plan in order to attract the needed support for your business. One caution is that it may sound appealing to claim you will provide a superior service to the existing competitors, but the only meaningful judge of your success in this regard will be customers. Although it is possible some of your competitors might be complacent in their current way of doing things, it is very unlikely that all your competitors provide an inferior service to that which you will be able to provide.

Marketing Strategy

- Covers all aspects of the marketing mix: your promotional decisions, product decisions, distribution decisions, and pricing decisions
- Outlines how you plan to influence your targeted customers to buy from you (your optimum marketing mix, and why is this one better than the alternatives)

Organizational Analysis

- Leads in to your marketing strategy or is positioned elsewhere depending upon how your business plan is best structured
- Often applies a SWOT Analysis to analyze the organization
  - If doing so, ALWAYS ensure this analysis results in more than a simple list of internal strengths and weaknesses and external opportunities and threats. A SWOT analysis should always prove to the reader that there are organizational strategies in place to address each of the weaknesses and threats identified and to leverage each of the strengths and opportunities identified.
  - An effective way to ensure an effective outcome to your SWOT Analysis is to apply a TOWS Matrix approach to develop strategies to take advantage of the identified strengths and opportunities while mitigating the weaknesses and threats. A

TOWS Matrix evaluates each of the identified threats along with each of the weaknesses and then each of the strengths. It does the same with each of the identified opportunities. In this way, strategies are developed by considering pairs of factors.

- The TOWS Matrix is a framework with which to help you organize your thoughts into strategies. Most often you would not label a section of your business plan as a TOWS Matrix because this would not add value for the reader. Instead, you should describe the resultant strategies—perhaps while indicating how they were derived from your assessment of the strengths, weaknesses, opportunities, and threats. For example, you could indicate that certain strategies were developed by considering how internal strengths could be employed toward mitigating external threats faced by the business.

Product Strategy

- Identifies your product/service and why this particular product/service will appeal to your targeted customers more than the alternatives
  - If your product or service is standardized, you will need to compete on the basis of something else—like a more appealing price, having a superior location, better branding, or improved service. If you can differentiate your product or service, you might be able to compete on the basis of better quality, more features, appealing style, or something else. When describing your product, you should demonstrate that you understand this.

Pricing Strategy

- Outlines your pricing strategies and explains what makes these strategies better than the alternatives
  - If you intend to accept payment by credit card (which is probably a necessity for most companies), you should be aware of the fee you are charged as a percentage of the value of each transaction. If you don't account for this you risk overstating your actual revenues by perhaps one percent or more.
- Identifies your sales forecasts and explains why these are realistic
  - Sales forecasts must be done on at least a monthly basis if you are using a projected cash flow statement. These must be accompanied by explanations designed to establish their credibility for readers of your business plan. Remember that many readers will initially assume your planned time frames are too long, your revenues are overstated, and you have underestimated your expenses. Well-crafted explanations for all of these numbers will help establish credibility.

Distribution Strategy

- Explains your distribution strategies and what makes these strategies better than the alternatives
  - If you plan to use e-commerce, you should include all the costs associated with maintaining a website and accepting payments over the Internet.

Promotions Strategy

- Answers the following key questions:
  - As a new entrant into the market, must you attract your customers away from your competitors they currently buy from or will you be creating new customers for your product or service (i.e. not attracting customers away from your competitors)?
  - If you are attracting customers away from competitors, how will these rivals respond to the threat you pose to them?
  - If you intend to create new customers, how will you convince them to reallocate their dollars toward your product or service (and away from other things they want to purchase)?
  - In what ways will you communicate with your targeted customers? When will you communicate with them? What specific messages do you plan to convey to them? How much will this promotions plan cost?
- Outlines the anticipated responses competitors will have to your entrance into the market, especially if your success depends upon these businesses losing customers to you
  - If your entry into the market will not be a threat to direct competitors, it is likely you must convince potential customers to spend their money with you rather than on what they had previously earmarked those dollars toward. In your business plan, you must demonstrate an awareness of these issues.
- Often maps out your promotional expenditures according to method used and time frame
  - Consider listing the promotional methods in rows on a spreadsheet with the columns representing weeks or months over probably about 18 months from the time of your first promotional expenditure. This can end up being a schedule that feeds the costs into your projected cash flow statement and from there into your projected income statements.

- If you phone or visit newspapers, radio stations, or television stations seeking advertising costs, you must go only after you have figured out details like on which days you would like to advertise, at what times on those days, whether you want your print advertisements in color, and what size of print advertisements you want.
- Carefully consider which promotional methods you will use. While using a medium like television may initially sound appealing, it is very expensive unless your ad runs during the non-prime times. If you think this type of medium might work for you, do a serious cost-benefit analysis to be sure.
- Some promotional plans are developed around newspaper ads, promotional pamphlets, printing business cards, and other more obvious mediums of promotion. Be certain to, include the costs of advertising in telephone directories, sponsoring a little league soccer team, producing personalized pens and other promotional client give-always, donating items to charity auctions, printing and mailing client Christmas cards, and doing the many things businesses find they do on-the-fly. Many businesses find it to be useful to join the local chamber of commerce and relevant trade organizations with which to network. Some find that setting a booth up at a trade fair helps launch their business.
- If you are concerned you might have missed some of these promotional expenses, or if you want to have a buffer in place in case you feel some of these opportunities are worthwhile when they arise, you should add some discretionary money to your promotional budget. A problem some companies get into is planning out their promotions in advance only to reallocate some of their newspaper advertisement money, for example, toward some of these other surprise purposes resulting in less newspaper advertising than had been intended.

Financial Plan

- Contains financial statements
- Also includes
  - Various funding options and exit strategies for potential investors
  - Business valuation (be cautious not to overvalue your business)
  - Break-even analysis

Business Valuation

There are a multitude of sophisticated business valuation methodologies. A rule of thumb for business valuations is a multiple of its earnings. For example, if the chosen multiple is five and the business' earnings before taxes are $55M, the business' valuation would be approximately $275M.

Break-Even Analysis

Break-Even Point = FC/(P-VC)

- FC = Fixed Costs
- P = Unit Price
- VC = Variable Cost

Example: If the business' total fixed costs are $1,000,000.00, it costs $5.00 to produce the widget, and the business sells the widget for $7.00, the break-even point is 500,000 widgets.

- You will most certainly need to make monthly cash flow projections from business inception to possibly three years out. Your projections will show the months in which the activities shown on your fixed capital and working capital schedules will occur. This is nearly the only way to clearly estimate your working capital needs and, specifically, important things like the times when you will need to draw on or can pay down your operating loans and the months when you will need to take out longer-term loans with which to purchase your fixed assets. Without a tool like this, you will be severely handicapped when talking with bankers about your expected needs. They will want to know how large of a line of credit you will need and when you anticipate needing to borrow longer-term money. It is only through doing cash flow projections that you will be able to answer these questions. This information is also needed to determine things like the changes to your required loan payments and when you can take owner draws or pay dividends.
- Your projected cash flows are also used to develop your projected income statements and balance sheets.

List of Items a Business May Need to Purchase

Set-up

- Business license
- Registration for name, etc.
- Domain name registration
- Initial product inventory
- Signage
- All the little things like curtains/blinds, decorations, microwave for staff room, etc.
- All the things needed to run the business from day #1 (like cutlery, plates, cooking pots, table settings etc. for restaurants; like towels, soap, etc. for gyms; like equipment and so on for manufacturing and service places)
- Set-up and testing of new facilities—new factories and offices do not operate at peak efficiency for some time after start-up because it takes time for the new systems to kick into high gear
- Professional services needed
- Lawyer's fees to make sure agreements are solid
- Graphic designer or design company needed to develop visuals
- Accounting firm needed to set up initial systems
- Insurance—maybe not a direct cost to this one to account for

Office

- Accounting system software
- Computer, printer, other things needed like scanner
- Office furniture
- Initial office supplies—paper, pens, etc.
- Telephones
- Internet/wifi
- Microwave and coffee maker and similar supplies for staff room or coffee room
- Bank fees—business banking is normally not free—might also need to have business cheques

Customer Interaction

- Cash register
- Loyalty cards/system

Production/Operations

- Safety equipment (fire extinguishers, AED)
- First aid
- Security systems
- Equipment maintenance
- Janitorial services and cleaning supplies
- Bathroom supplies—toilet paper, soap, towels
- Membership costs for various associations, including the local chamber of commerce, any professional associations for the relevant industry, etc.
- Subscriptions for things like important trade publications, etc.
- Shelving and storage systems
- Even when not full restaurant, operations like coffee shops still require equipment like dishwasher

Training

- Safety—prior to start-up and ongoing and for new employees

Hiring

- Ads, travel expenses—flights, hotels, taxi rides, meal allowances, etc.—to recruit people through interviews, meeting meals, set up with real estate agents, etc.

Promotions

- Website development
- Costs for setting up and managing social media (can take a lot of an employee's time)
- Grand opening costs

Property

- If buying, include property taxes and all utilities in cash flows and income statement and include building maintenance and maybe build up a reserve fund to pay for things like future roof repairs and needed renovations and upgrades
- If renting/leasing, include rental/least cost and whatever utilities are not included in rental/lease payment

Renovations

- Construction
- Plumbing
- Electrical
- Utility hookups
- Inspections
- Shelving
- Interior signage
- Fencing, parking lot, exterior lighting, other exterior things

Risk Management

- Insurance (need to choose the types needed)
- Training costs
- Things like snow removal, de-icing sidewalks, etc.

Section Summary

This section described the basic elements of a comprehensive business plan.

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CHAPTER OVERVIEW

Chapter 6: Marketing Plan

6.1: Marketing Basics

6.1.1: Chapter Introduction

6.1.2: What Marketing Is All About

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6.1.4: Marketing Research

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6.2: Marketing Strategy

6.2.1: Chapter Introduction

6.2.2: The Importance of a Marketing Strategy

6.2.3: The Marketing Strategy Process

6.2.4: Segmentation and the Target Market

6.2.5: Differentiation and Positioning

6.2.6: Marketing Strategy and Product

6.2.7: Marketing Strategy and Price

6.2.8: Marketing Strategy and Place

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6.3.2: The Need for a Marketing Plan

6.3.3: The Marketing Plan

6.3.4: The Three Threads

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SECTION OVERVIEW

6.1: Marketing Basics

6.1.1: Chapter Introduction

6.1.2: What Marketing Is All About

6.1.3: The Customer

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6.1.1: Chapter Introduction

Max and Mina's Homemade Ice Cream and Ices

Growing up in the 1970s, Bruce and Mark Becker loved ice cream. Their Grandpa Max used to create all different kinds of ice cream for Grandma Mina and the boys to try. Grandpa was an organic chemist and loved to create some interesting flavors. Years later, after Grandpa Max passed away, Bruce was cleaning out his grandpa's house and discovered his secret book of recipes.

And so it began.

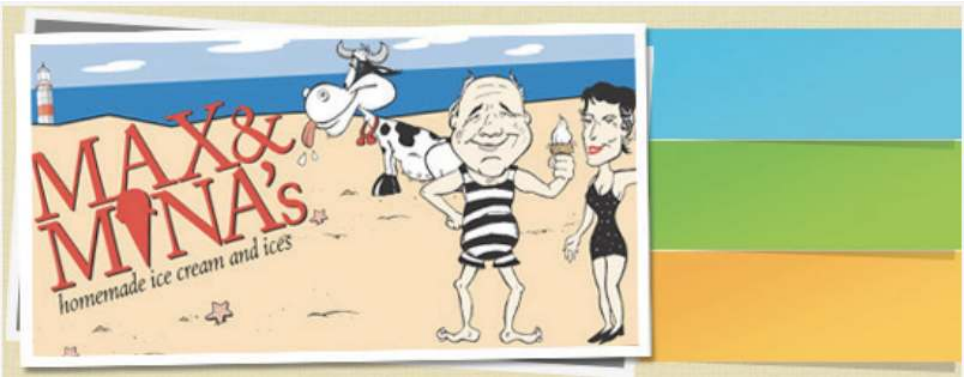


Figure 6.1.1.1: *Source: Used with permission from Max and Mina's Ice Cream.*

In the 1980s, Bruce started on his journey and traveled throughout Europe and the United States doing gourmet ice cream research. With all the new information gathered and the treasure trove of Grandpa Max's secret recipes, Bruce and Mark opened Max and Mina's Ice Cream in 1997 in a shopping center next to Shimon's Pizza Falafel Dairy Restaurant in Flushing, Queens, New York. They test marketed their recipes directly to the public. The public loved it—and so did the local restaurants and party planners.

Max and Mina's Ice Cream revolutionized America's favorite dessert with daring ingredients and bold innovation. Their unique ability to intrigue and challenge old notions of mundane flavors draws unbelievable attention at home in New York and around the globe. The most distant customer of note was from Australia, someone who insisted on going to Max and Mina's right off the plane at Kennedy Airport.

The Beckers make their ice cream products with at least 16 percent butterfat, putting them into the gourmet category. All their ice creams are kosher, but some products adhere to even stricter dairy guidelines. The shop itself features an array of posters, a display of Wacky Packages bubblegum stickers, candy wrappers, a Jerry Garcia etching, and old-fashioned signs.

A visit to Max and Mina's will be an unusual ice cream experience. If you dare to take the plunge, why not try unforgettable flavors like beer, lox, babka, corn-on-the-cob, ketchup, garlic, or merlot—just to mention a few? There are also many of the more traditional flavors that you know and love. There is a rotating menu of one thousand flavors, but only about forty ice cream flavors and eight to ten sorbets are available at any one time. Bruce and Mark constantly encourage their patrons to be vocal in brainstorming new flavors, especially flavors that complement events. Turkey ice cream, anyone? Have an idea? Stop by and give Max and Mina's a try.

Video Clip: Max and Mina's Ice Cream

An ice cream revolution.

A YouTube element has been excluded from this version of the text. You can view it online here.

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6.1.2: What Marketing Is All About

Learning Objectives

- Define marketing.
- Explain why marketing is so important to small business.
- Explain the marketing concept, the societal marketing concept, and the holistic marketing concept.
- Define customer value and discuss the role of marketing and delivering it.
- Explain market segmentation, target market, marketing mix, differentiation, positioning, marketing environment, marketing management, and marketing strategy.

Because the purpose of business is to create a customer, the business enterprise has two—and only two—basic functions: marketing and innovation. Marketing and innovation produce results; all the rest are costs. Marketing is the distinguishing, unique function of the business.

Marketing is defined by the American Marketing Association as "the activity, set of institutions, and processes for creating, communicating, and exchanging offerings that have value for customers, clients, partners, and society at large." Putting this formality aside, marketing is about delivering value and benefits: creating products and services that will meet the needs and wants of customers (perhaps even delighting them) at a price they are willing to pay and in places where they are willing to buy them. Marketing is also about promotional activities such as advertising and sales that let customers know about the goods and services that are available for purchase. Successful marketing generates revenue that pays for all other company operations. Without marketing, no business can last very long. It is that important and that simple—and it applies to small business.

Marketing is applicable to goods, services, events, experiences, people, places, properties, organizations, businesses, ideas, and information.

There are several concepts that are basic to an understanding of marketing: the marketing concept, customer value, the marketing mix, segmentation, target market, the marketing environment, marketing management, and marketing strategy.

The Marketing Concept… and Beyond

The **marketing concept** has guided marketing practice since the mid-1950s. The concept holds that the focus of all company operations should be meeting the customer's needs and wants in ways that distinguish a company from its competition. However, company efforts should be integrated and coordinated in such a way to meet organizational objectives and achieve profitability. Perhaps not surprisingly, successful implementation of the marketing concept has been shown to lead to superior company performance. "The marketing concept recognizes that there is no reason why customers should buy one organization's offerings unless it is in some way better at serving the customers' wants and needs than those offered by competing organizations. Customers have higher expectations and more choices than ever before. This means that marketers have to listen more closely than ever before."

Sam Walton, the founder of Walmart, put it best when he said, "There is only one boss: the customer. And he can fire everybody in the company, from the chairman on down, simply by spending his money somewhere else." Small businesses are particularly suited to abiding by the marketing concept because they are more nimble and closer to the customer than are large companies. Changes can be made more quickly in response to customer wants and needs.

The **societal marketing concept** emerged in the 1980s and 1990s, adding to the traditional marketing concept. It assumes that a "company will have an advantage over competitors if it applies the marketing concept in a manner that maximizes society's well-being" and requires companies to balance customer satisfaction, company profits, and the long-term welfare of society. Although the expectation of ethical and responsible behavior is implicit in the marketing concept, the societal marketing concept makes these expectations explicit.

Small business is in a very strong position in keeping with the societal marketing concept. Although small businesses do not have the financial resources to create or support large philanthropic causes, they do have the ability to help protect the environment through **green business practices** such as reducing consumption and waste, reusing what they have, and recycling everything they

can. Small businesses also have a strong record of supporting local causes. They sponsor local sports teams, donate to fund-raising events with food and goods or services, and post flyers for promoting local events. The ways of contributing are virtually limitless.

Video Clip: Do Well While Doing Good

Small business sustainability practices.

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The **holistic marketing concept** is a further iteration of the marketing concept and is thought to be more in keeping with the trends and forces that are defining the twenty-first century. Today's marketers recognize that they must have a complete, comprehensive, and cohesive approach that goes beyond the traditional applications of the marketing concept. A company's "sales and revenues are inextricably tied to the quality of each of its products, services, and modes of delivery and to its image and reputation among its constituencies. [The company] markets itself through everything it does, its substance as well as its style. It is that all-encompassing package that the organization then sells." What we see in the holistic marketing concept is the traditional marketing concept on steroids. Small businesses are natural for the holistic marketing concept because the bureaucracy of large corporations does not burden them. The size of small businesses makes it possible, perhaps imperative, to have fluid and well-integrated operations.

Customer Value

The definition of **marketing** specifically includes the notion that offerings must have value to customers, clients, partners, and society at large. This necessarily implies an understanding of what customer value is. **Customer value** can be defined simply as the difference between perceived benefits and perceived costs. Such a simple definition can be misleading, however, because the creation of customer value will always be a challenge—most notably because a company must know its customers extremely well to offer them what they need and want. This is complicated because customers could be seeking **functional value** (a product or a service performs a utilitarian purpose), **social value** (a sense of relationship with other groups through images or symbols), **emotional value** (the ability to evoke an emotional or an affective response), **epistemic value** (offering novelty or fun), or **conditional value** (derived from a particular context or a sociocultural setting, such as shared holidays)—or some combination of these types of value.

Marketing plays a key role in creating and delivering value to a customer. Customer value can be offered in a myriad of ways. In addition to superlative ice cream, for example, the local ice cream shop can offer a frequent purchase card that allows for a free ice cream cone after the purchase of fifteen ice cream products at the regular price. Your favorite website can offer free shipping for Christmas purchases and/or pay for returns. Zappos.com offers free shipping both ways for its shoes. The key is for a company to know its consumers so well that it can provide the value that will be of interest to them.

Market Segmentation

The purpose of segmenting a market is to focus the marketing and sales efforts of a business on those prospects who are most likely to purchase the company's product(s) or service(s), thereby helping the company (if done properly) earn the greatest return on those marketing and sales expenditures. **Market segmentation** maintains two very important things: (1) there are *relatively* homogeneous subgroups (no subgroup will ever be exactly alike) of the total population that will behave the same way in the marketplace, and (2) these subgroups will behave differently from each other. Market segmentation is particularly important for small businesses because they do not have the resources to serve large aggregate markets or maintain a wide range of different products for varied markets.

The marketplace can be segmented along a multitude of dimensions, and there are distinct differences between consumer and business markets. Some examples of those dimensions are presented in Table 6.1.2.1:

LifeLock, a small business that offers identity theft protection services, practices customer type segmentation by separating its market into business and individual consumer segments.

Table 6.1.2.1: Market Segmentation

Consumer Segmentation Examples	Business Segmentation Examples
Geographic Segmentation • Region (e.g., Northeast or Southwest) • City or metro size (small, medium, or large) • Density (urban, suburban, or rural) • Climate (northern or southern)	**Demographic Segmentation** • The industry or industries to be served • The company sizes to be served (revenue, number of employees, and number of locations)
Demographic Segmentation • Age • Family size • Family life cycle (e.g., single or married without kids) • Gender • Income • Occupation • Education • Religion • Race/ethnicity • Generation • Nationality • Social class	**Operating Variables** • The customer technologies to be focused on • The users that should be served (heavy, light, medium, or nonusers) • Whether customers needing many or few services should be served
Psychographic Segmentation • Personality • Lifestyle • Behavioral occasions (regular or special occasion) • Values	**Purchasing Approaches: Which to Choose?** • Highly centralized versus decentralized purchasing • Engineering dominated, financially dominated, and so forth • Companies with whom a strong relationship exists or the most desirable companies • Companies that prefer leasing, service contracts, systems purchases, or sealed bidding • Companies seeking quality, service, and price
Behavioral Segmentation • Benefits of the product (e.g., toothpaste with tartar control) • User status (nonuser, regular user, or first-time user) • Usage rate (light user, medium user, or heavy user) • Loyalty status (none, medium, or absolute) • Attitude toward the product (e.g., enthusiastic or hostile)	**Situational Factors: Which to Choose?** • Companies that need quick and sudden delivery or service • Certain application of the product instead of all applications • Large or small orders or something in-between
Personal Characteristics: Which to Choose? • Companies with similar people and values • Risk-taking or risk-aversive customers • Companies that show high loyalty to their suppliers	**Other Characteristics** • Status in industry (technology or revenue leader) • Need for customization (specialized computer systems)

Source: Adapted from "Market Segmentation," *Business Resource Software, Inc.*, accessed December 2, 2011, www.businessplans.org/segment.html; adapted from Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 214, 227.

Market segmentation requires some marketing research.

Target Market

Market segmentation should always precede the selection of a **target market**. A target market is one or more segments (e.g., income or income + gender + occupation) that have been chosen as the focus for business operations. The selection of a target market is important to any small business because it enables the business to be more precise with its marketing efforts, thereby being more cost-effective. This will increase the chances for success. The idea behind a target market is that it will be the best

match for a company's products and services. This, in turn, will help maximize the efficiency and effectiveness of a company's marketing efforts:

It is not feasible to go after all customers, because customers have different wants, needs, and tastes. Some customers want to be style leaders. They will always buy certain styles and usually pay a high price for them. Other customers are bargain hunters. They try to find the lowest price. Obviously, a company would have difficulty targeting both of these market segments simultaneously with one type of product. For example, a company with premium products would not appeal to bargain shoppers…

Hypothetically, a certain new radio station may discover that their music appeals more to 34–54-year-old women who earn over $50,000 per year. The station would then target these women in their marketing efforts.

Target markets can be further divided into niche markets. A **niche market** is a small, more narrowly defined market that is not being served well or at all by mainstream product or service marketers. People are looking for something specific, so target markets can present special opportunities for small businesses. They fill needs and wants that would not be of interest to larger companies. Niche products would include such things as wigs for dogs, clubs for left-handed golfers, losing weight with apple cider vinegar, paint that transforms any smooth surface into a high performance dry-erase writing surface, and 3D printers. These niche products are provided by small businesses. Niche ideas can come from anywhere.

Marketing Mix

Marketing mix is easily one of the most well-known marketing terms. More commonly known as "the four Ps," the traditional marketing mix refers to the combination of product, price, promotion, and place (distribution). Each component is controlled by the company, but they are all affected by factors both internal and external to the company. Additionally, each element of the marketing mix is impacted by decisions made for the other elements. What this means is that an alteration of one element in the marketing mix will likely alter the other elements as well. They are inextricably interrelated. No matter the size of the business or organization, there will always be a marketing mix. A brief overview is presented here.



Figure 6.1.2.1: The Marketing Mix

Product

Product refers to tangible, physical products as well as to intangible services. Examples of product decisions include design and styling, sizes, variety, packaging, warranties and guarantees, ingredients, quality, safety, brand name and image, brand logo, and support services. In the case of a services business, product decisions also include the design and delivery of the service, with

delivery including such things as congeniality, promptness, and efficiency. Without the product, nothing else happens. Product also includes a company's website.

Price

Price is what it will cost for someone to buy the product. Although the exchange of money is what we traditionally consider as price, time and convenience should also be considered. Examples of pricing decisions include pricing strategy selection (e.g., **channel pricing** and **customer segment pricing**), retail versus wholesale pricing, credit terms, discounts, and the means of making online payments. Channel pricing occurs when different prices are charged depending on where the customer purchases the product. A paper manufacturer may charge different prices for paper purchased by businesses, school bookstores, and local stationery stores. Customer segment pricing refers to charging different prices for different groups. A local museum may charge students and senior citizens less for admission.

Promotion

Having the best product in the world is not worth much if people do not know about it. This is the role of *promotion*—getting the word out. Examples of promotional activities include advertising (including on the Internet), sales promotion (e.g., coupons, sweepstakes, and 2-for-1 sales), personal sales, public relations, trade shows, webinars, videos on company websites and YouTube, publicity, social media such as Facebook and Twitter, and the company website itself. **Word-of-mouth communication**, where people talk to each other about their experiences with goods and services, is the most powerful promotion of all because the people who talk about products and services do not have any commercial interest.

Place

Place is another word for distribution. The objective is to have products and services available where customers want them when they want them. Examples of decisions made for place include inventory, transportation arrangements, channel decisions (e.g., making the product available to customers in retail stores only), order processing, warehousing, and whether the product will be available on a very limited (few retailers or wholesalers) or extensive (many retailers or wholesalers) basis. A company's website is also part of the distribution domain.

Two Marketing Mixes

No matter what the business or organization, there will be a marketing mix. The business owner may not think about it in these specific terms, but it is there nonetheless. Here is an example of how the marketing mix can be configured for a local Italian restaurant (consumer market).

- **Product.** Extensive selection of pizza, hot and cold sub sandwiches, pasta and meat dinners, salads, soft drinks and wine, homemade ice cream and bakery products; the best service in town; and free delivery.
- **Price.** Moderate; the same price is charged to all customer segments.
- **Promotion.** Ads on local radio stations, websites, and local newspaper; flyers posted around town; coupons in ValPak booklets that are mailed to the local area; a sponsor of the local little league teams; ads and coupons in the high school newspaper; and a Facebook presence.
- **Place.** One restaurant is located conveniently near the center of town with plenty of off-street parking. It is open until 10:00 p.m. on weekdays and 11:30 p.m. on Fridays and Saturdays. There is a drive-through for takeout orders, and they have a special arrangement with a local parochial school to provide pizza for lunch one day per week.

Here is an example of how the marketing mix could be configured for a green cleaning services business (business market).

- **Product.** Wide range of cleaning services for businesses and organizations. Services can be weekly or biweekly, and they can be scheduled during the day, evening, weekends, or some combination thereof. Only green cleaning products and processes are used.
- **Price.** Moderate to high depending on the services requested. Some price discounting is offered for long-term contracts.
- **Promotion.** Ads on local radio stations, website with video presentation, business cards that are left in the offices of local businesses and medical offices, local newspaper advertising, Facebook and Twitter presence, trade show attendance (under consideration but very expensive), and direct mail marketing (when an offer, announcement, reminder, or other item is sent to an existing or prospective customer).

- **Place.** Services are provided at the client's business site. The cleaning staff is radio dispatched.

The Marketing Environment

The **marketing environment** includes all the factors that affect a small business. The **internal marketing environment** refers to the company: its existing products and strategies; culture; strengths and weaknesses; internal resources; capabilities with respect to marketing, manufacturing, and distribution; and relationships with stakeholders (e.g., owners, employees, intermediaries, and suppliers). This environment is controllable by management, and it will present both threats and opportunities.

The **external marketing environment** must be understood by the business if it hopes to plan intelligently for the future. This environment, not controllable by management, consists of the following components:

- **Social factors.** For example, cultural and subcultural values, attitudes, beliefs, norms, customs, and lifestyles.
- **Demographics.** For example, population growth, age, gender, ethnicity, race, education, and marital status.
- **Economic environment.** For example, income distribution, buying power and willingness to spend, economic conditions, trading blocs, and the availability of natural resources.
- **Political and legal factors.** For example, regulatory environment, regulatory agencies, and self-regulation.
- **Technology.** For example, the nature and rate of technological change.
- **Competition.** For example, existing firms, potential competitors, bargaining power of buyers and suppliers, and substitutes.
- **Ethics.** For example, appropriate corporate and employee behavior.



Figure 6.1.2.2: The Marketing Environment

Small businesses are particularly vulnerable to changes in the external marketing environment because they do not have multiple product and service offerings and/or financial resources to insulate them. However, this vulnerability is offset to some degree by small businesses being in a strong position to make quick adjustments to their strategies if the need arises. Small businesses are also ideally suited to take advantage of opportunities in a changing external environment because they are more nimble than large corporations that can get bogged down in the lethargy and inertia of their bureaucracies.

Marketing Strategy versus Marketing Management

The difference between marketing strategy and marketing management is an important one. **Marketing strategy** involves selecting one or more target markets, deciding how to differentiate and position the product or the service, and creating and maintaining a marketing mix that will hopefully prove successful with the selected target market(s)—all within the context of marketing objectives. **Differentiation** involves a company's efforts to set its product or service apart from the competition. **Positioning** "entails placing the brand [whether store, product, or service] in the consumer's mind in relation to other competing products, based on product traits and benefits that are relevant to the consumer."

Video Clip: Small Business Makeover Successes

A YouTube element has been excluded from this version of the text. You can view it online here.

Marketing management, by contrast, involves the day-to-day tactical decisions, resource allocations (funds and people), and carrying out of tasks that implement the marketing strategy. It is the responsibility of marketing management to focus on quality and develop the marketing plan.

Video Clip: Marketing Concepts in Two Minutes

A humorous definition of key marketing concepts.

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KEY TAKEAWAYS

- Marketing is a distinguishing, unique function of a business.
- Marketing is about delivering value and benefits, creating products and services that will meet the needs and wants of customers (perhaps even delighting them) at a price they are willing to pay and in places where they are willing to buy them. It is also about promotion, getting the word out that the product or the service exists.
- The marketing concept has guided business practice since the 1950s.
- Customer value is the difference between perceived benefits and perceived costs. There are different types of customer value: functional, social, epistemic, emotional, and conditional.
- Marketing plays a key role is delivering value to the customer.
- Market segmentation, target market, niche market, marketing mix, marketing environment, marketing management, and marketing strategy are key marketing concepts.
- The marketing mix, also known as the four Ps, consists of product, price, promotion, and place.

EXERCISE

Select two different kinds of local small businesses. Ask the owners how they segment the market, who they target, and how they define their marketing mix. Compare the answers that you get. Do you notice any similarities?

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6.1.3: The Customer

Learning Objectives

- Explain the difference between a customer and a consumer.
- Understand the relationship between the customer/consumer and the marketing mix.
- Define the two types of customer markets.
- Understand the factors that contribute to consumer behavior.
- Describe the B2C and B2B buying processes.
- Understand the differences between B2C and B2B buying behavior.
- Define customer experience and explain its role in small business marketing.
- Explain the importance of customer loyalty to small business.

It is very important in marketing to distinguish between the customer and the consumer. The **customer**, the person or the business that actually buys a product or a service, will determine whether a business succeeds or fails. It is that simple. It does not matter one iota if a business thinks its product or service is the greatest thing since sliced bread if no one wants to buy it. This is why customers play such a central role in marketing, with everything revolving around their needs, wants, and desires. We see the customer focus in the marketing concept, and we see it in the marketing mix.

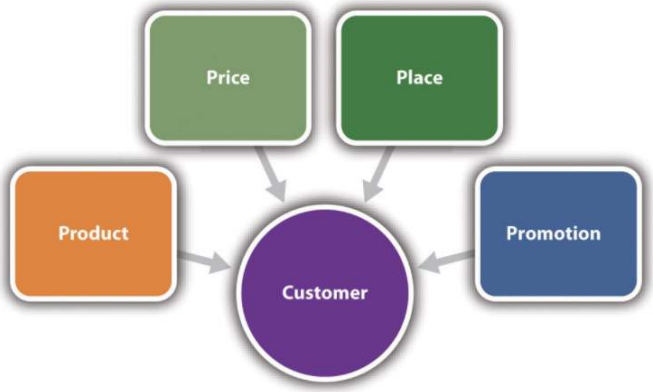


Figure 6.1.3.1: The Customer and the Marketing Mix

The marketing mix should follow the determination of customer needs, wants, and desires. However, there are instances in which a product is created before the target market is selected and before the rest of the marketing mix is designed. One well-known example is Ivory Soap. This product was created by accident. Air was allowed to work its way into the white soap mixture that was being cooked. The result was Ivory Soap, a new and extraordinarily successful product for Procter & Gamble. Most companies do not have this kind of luck, though, so a more deliberate approach to understanding the customer is critical to designing the right marketing mix.

The **consumer** is the person or the company that uses or consumes a product. For example, the customer of a dry cleaning service is the person who drops off clothes, picks them up, and pays for the service. The consumer is the person who wears the clothes. Another example is a food service that caters business events. The person who orders lunch on behalf of the company is the customer. The people who eat the lunch are the consumers. The person who selects the catering service could be either or both. It is common for the customer and the consumer to be the same person, but this should not be assumed for all instances. The challenge is deciding whether to market to the customer or the consumer—or perhaps both.

Customer Markets

There are two major types of customer markets: **business-to-business (B2B)** customers and **individual consumers or end users (business-to-consumer [B2C])**. B2B customers are organizations such as corporations; small businesses; government agencies; wholesalers; retailers; and nonprofit organizations, such as hospitals, universities, and museums. In terms of dollar volume, the

B2B market is where the action is. More dollars and products change hands in sales to business buyers than to individual consumers or end users. The B2B market offers many opportunities for the small business. Examples of B2B products include office supplies and furniture, machinery, ingredients for food preparation, telephone and cell phone service, and delivery services such as FedEx or UPS.

The B2C market consists of people who buy for themselves, their households, friends, coworkers, or other non-business-related purposes. Examples of B2C products include cars, houses, clothing, food, telephone and cell phone service, cable television service, and medical services. Opportunities in this market are plentiful for small businesses. A walk down Main Street and a visit to the Internet are testaments to this fact.

Understanding the Customer

The better a small business understands its customers, the better off it will be. It is not easy, and it takes time, but knowing who the customers are, where they come from, what they like and dislike, and what makes them tick will be of immeasurable value in designing a successful marketing mix. Being intuitive can and does work…but not for everyone and not all the time. A more systematic and thorough approach to understanding the customer makes much more sense. The problem is that many if not most small businesses probably do not take the time to do what it takes to understand their customers. This is an important part of the reason why so many small businesses fail.

Video Clip: Consumer Behavior Matters

Understanding a customer's behavior will increase sales.

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Consumer Behavior

Consumer behavior—"how individuals, groups, and organizations select, buy, use, and dispose of goods, services, ideas, or experiences to satisfy their needs and wants"—is the result of a complex interplay of factors, none of which a small business can control. These factors can be grouped into four categories: **personal factors**, **social factors**, **psychological or individual factors**, and **situational factors**. It is important that small-business owners and managers learn what these factors are.

- **Personal factors.** Age, gender, race, ethnicity, occupation, income, and **life-cycle stage** (where an individual is with respect to passage through the different phases of life, e.g., single, married without children, empty nester, and widow or widower). For example, a 14-year-old girl will have different purchasing habits compared to a 40-year-old married career woman.
- **Social factors.** Culture, subculture, social class, family, and **reference groups** (any and all groups that have a direct [face-to-face] or indirect influence on a person's attitudes and behavior, e.g., family, friends, neighbors, professional groups [including online groups such as LinkedIn], coworkers, and social media such as Facebook and Twitter). For example, it is common for us to use the same brands of products that we grew up with, and friends (especially when we are younger) have a strong influence on what and where we buy. This reflects the powerful influence that family has on consumer behavior.
- **Psychological or individual factors.** Motivation, **perception** (how each person sees, hears, touches, and smells and then interprets the world around him or her), learning, attitudes, personality, and **self-concept** (how we see ourselves and how we would like others to see us). When shopping for a car, the "thud" sound of a door is perceived as high quality whereas a "tinny" sound is not.
- **Situational factors.** The reason for purchase, the time we have available to shop and buy, our mood (a person in a good mood will shop and buy differently compared to a person in a bad mood), and the **shopping environment** (e.g., loud or soft music, cluttered or neat merchandise displays, lighting quality, and friendly or rude help). A shopper might buy a higher quality box of candy as a gift for her best friend than she would buy for herself. A rude sales clerk might result in a shopper walking away without making a purchase.

These factors all work together to influence a five-stage buying-decision process (Table 6.1.3.1), the specific workings of which are unique to each individual. This is a generalized process. Not all consumers will go through each stage for every purchase, and some stages may take more time and effort than others depending on the type of purchase decision that is involved. Knowing and understanding the consumer decision process provides a small business with better tools for designing and implementing its marketing mix.

Table 6.1.3.1: Five Stages of the Consumer Buying Process

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Stage		Description	Example
1.	**Problem recognition**	Buyer recognizes a problem or need.	Joanne's laptop just crashed, but she thinks it can be fixed. She needs it quickly.
2.	**Information search**	Buyer searches for extensive or limited information depending on the requirements of the situation. The sources may be personal (e.g., family or friends), commercial (e.g., advertising or websites), public (e.g., mass media or consumer rating organizations), or experiential (e.g., handling or examining the product).	Joanne is very knowledgeable about computers, but she cannot fix them. She needs to find out about the computer repair options in her area. She asks friends for recommendations, checks out the yellow pages, does a Google search, draws on her own experience, and asks her husband.
3.	**Evaluation of alternatives**	Buyer compares different brands, services, and retailers. There is no universal process that everyone uses.	Joanne knows that computer repair services are available at the nearby Circuit Place and Computer City stores. Unfortunately, she has had bad experiences at both. Her husband, David, recently took his laptop to a small computer repair shop in town that has been in business for less than a year. He was very pleased. Joanne checks out their website and is impressed by the very positive reviews. None of her friends could recommend anyone.
4.	**Purchase decision**	Buyer makes a choice.	Joanne decides to take her computer to the small repair shop in town.
5.	**Postpurchase behavior**	How the buyer feels about the purchase and what he or she does or does not do after the purchase.	Joanne's laptop was fixed quickly, and the cost was very reasonable. She feels very good about the experience, so she posts a glowing review on the company's website, recommends the shop to everyone she knows, and plans to go back should the need arise. Had she been unhappy with her experience, she would have posted a negative review on the company's website, told everyone she knows not to go there, and refuse to go there again. It is this latter scenario

Stage		Description	Example
			that should be every small business's nightmare.

Business Buying Behavior

Understanding how businesses make their purchasing decisions is critical to small businesses that market to the business sector. Purchases by a business are more complicated than purchases by someone making a personal purchase (B2C). B2B purchases vary according to dollar amount, the people involved in the decision process, and the amount of time needed to make the decision, and they involve "a much more complex web of interactions between prospects and vendors in which the actual transaction represents only a small part of the entire purchase process."

The individual or the group that makes the B2B buying decisions is referred to as the **buying center**. The buying center consists of "all those individuals and groups who participate in the purchasing decision-making process, who share some common goals and the risks arising from the decision." The buying center in a small business could be as small as one person versus the twenty or more people in the buying center of a large corporation. Regardless of the size of the buying center, however, there are seven distinct roles: initiator, gatekeeper, user, purchaser or buyer, decider, approver, and influencer. One person could play multiple roles, there could be multiple people in a single role, and the roles could change over time and across different purchase situations.

1. **Initiator**. The person who requests that something be purchased.
2. **Gatekeeper**. The person responsible for the flow of information to the buying center. This could be the secretary or the receptionist that screens calls and prevents salespeople from accessing users or deciders. By having control over information, the gatekeeper has a major impact on the purchasing process.
3. **User**. The person in a company who uses a product or takes advantage of a service.
4. **Purchaser or buyer**. The person who makes the actual purchase.
5. **Decider**. The person who decides on product requirements, suppliers, or both.
6. **Approver**. The person who authorizes the proposed actions of the decider or the buyer.
7. **Influencer**. The person who influences the buying decision but does not necessarily use the product or the service. The influencer may assist in the preparation of product or service specifications, provide vendor ideas, and suggest criteria for evaluating vendors.

Identification of Needs, Establishment of Specifications, Identification of Solutions, Identification of Vendors, Evaluation of Vendors, Vendor selection, Negotiation of Terms

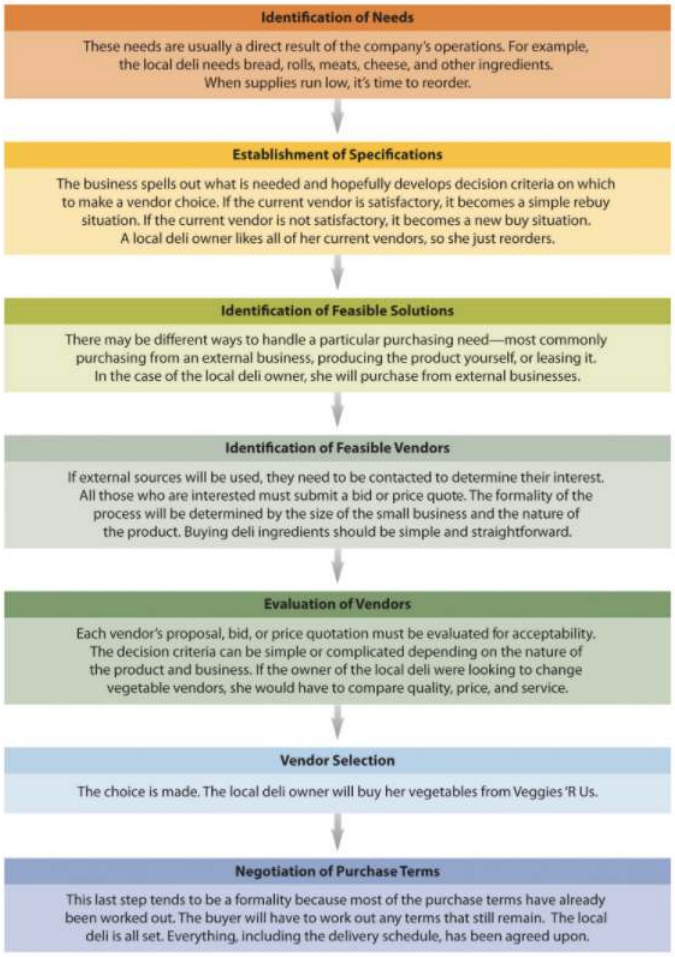


Figure 6.1.3.2: The *B2B Buying Process Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 148–55.*

The B2B purchasing process for any small business will be some variation of the process described in 6.1.3.2. The specifics of the process will depend on the nature of product, the simplicity of the decision to be made, and the number of people involved. Clearly, the purchasing process for a single-person business will be much simpler than for a multiproduct business of 400 employee.

The Customer Experience

Customer experience refers to a customer's entire interaction with a company or an organization. The experience will range from positive to negative, and it begins when any potential customer has contact with any aspect of a business's persona—the company's marketing, all representations of the total brand, and what others say about the experience of working with the business.

Customer Experience in the B2C Market

Customers will experience multiple **touchpoints** (i.e., all the communication, human, and physical interactions that customers experience during their relationship life cycle with a small business) during their visit. In a retail situation, a customer will experience the store design and layout; the merchandise that is carried and how it is displayed; the colors, sounds, and scents in the store; the cleanliness of the store; the lighting; the music; the helpfulness of the staff; and the prices. In a business situation, a customer will experience the design and layout of the reception and office areas, the colors chosen for carpeting and furniture, the friendliness and helpfulness of the reception staff, and the demeanor of the person or people to be seen. The experience also occurs when a customer communicates with a company via telephone; e-mail; the company website; and Facebook, Twitter, or other social media.

The Role of Store Design in Customer Experience

Store design plays a very important role in a customer's experience. Check out the following three examples of small business store redesigns that have contributed to increased profitability:

1. Fine Wine & Good Spirits, Philadelphia
2. The Diamond Cellar, Dublin, Ohio
3. Roche Bros. Supermarkets

Good customer experiences "*from the perspective of the customer*… are useful (deliver value), usable (make it easy to find and engage with the value), and enjoyable (emotionally engaging so that people want to use them)." A customer experience can be a one-time occurrence with a particular company, but experiences are more likely to happen across many time frames. The experience begins at the point of need awareness and ends at need extinction.

Exploring Consumer Behavior Online and Offline

Consumers are willing to pay more for products they can touch. "Touching" is an important part of the customer experience.

B2C customer experiences also involve emotional connections. When small businesses make emotional connections with customers and prospects, there is a much greater chance to forge bonds that will lead to repeat and referral business. When a business does not make those emotional connections, a customer may go elsewhere or may work with the business for the moment —but never come back and not refer other customers or clients to the business.

Many businesses may not appreciate that 50 percent of a customer's experience is about how a customer feels. Emotions can drive or destroy value. "Customers will gladly pay more for an experience that is not only functional but emotionally rewarding. Companies skilled at unlocking emotional issues and building products and services around them can widen their profit margins… Great customer experiences are full of surprising 'wow' moments."

Small businesses should learn and think about how to market a great B2C customer experience, not just a product or a service. Design an experience that is emotionally engaging by mapping the customer's journey—and then think of ways to please, perhaps even delight, the customer along that journey. A history of sustained positive customer experiences will increase the chances that a business will be chosen over its competition.

Meaningful, memorable, fun, unusual, and unexpected experiences influence the way customers perceive you in general and feel about you in particular. These little details are so easy to overlook, so tempting to brush off as unimportant. But add a number of seemingly minor details together, and you end up with something of far more value than you would without them.

It's the little details that keep a customer coming back over and over, it's the little details that cause a customer to rationalize paying more because she feels she is getting more, it's the little details that keep people talking about you and recommending everyone they know to you.

Anyone can do the big things right; it's the little things that differentiate one business from another and that influence customers to choose one over the other. Often, small-business owners cut out the little details when times get tough, and this is a big mistake.

There is, however, no one-size-fits-all design for customer experience in the B2C market. Small businesses vary in terms of the size, industry, and nature of the business, so customer experience planning and design will necessarily differ in accordance with these factors. The customer experience for a 1-person business will be very different from an experience with a 400-employee company.

Video Clip: How to Hire the Right Customer Service Person For Your Small Business

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Customer Experience in the B2B Market

Talk to customer experience executives in a B2B environment about emotional engagement and you will see their eyes roll. Ask them if they would consider designing retail stores with customized smell and music to reinforce the customer experience and you will most likely be ushered out of their offices. Mention the iPod or MySpace experience and you will likely face a torrent of sighs and frowns.

Creating customer relationships in the B2B environment is radically different from the B2C environment because customers face different challenges, resources, and suppliers. In the B2B world, there will almost always be "multiple people across multiple functions who play major roles in evaluating, selecting, managing, paying for and using the products and services their company buys… So, unlike the B2C company, if you are a B2B supplier there will be a host of individual 'customers' in engineering, purchasing, quality, manufacturing, etc. with different needs and expectations whose individual experiences you must address to make any given sale." This is offset, however, by the fact that a B2B company probably has a substantially smaller number of potential customers in a given target market, so it is often possible to actually get to know them personally. Smart B2B firms can tailor their products or services specifically to deliver the experiences wanted by people they know directly.

Video Clip: How Customer Experience Applies in the B2B Sector

Customer experience concerns are relevant in the B2B environment.

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Despite the challenges, customer experience is relevant in the B2B environment. However, because "the buy decision-making processes in most companies are typically fully structured and quantitative criteria-based…the explicitly emotional experience laden sales pitch that drives consumer buying is not a fit in the B2B world." The products that often represent B2B business's sole value proposition are rarely emotionally engaging or visually appealing. Think bolts, wires, copy paper, shredding machines, bread for a restaurant, and machinery. How engaging can these items be?

There are touchpoints in B2B processes before and after the sale (e.g., information gathering, website visits and inquiries, delivery of spare parts, service calls on machinery and office equipment, and telephone interactions) that can be identified and improved. However, the inherent differences between B2B and B2C environments must be clearly understood so that the B2C customer experience models do not become the paradigm for B2B customer experience designs. As is the case in the B2C market, there is no universal approach to customer experience in the B2B market. Small B2B companies also vary in terms of the products and the services offered and the size, industry, and nature of the business, so customer experience planning and design will necessarily differ in accordance with these factors.

The greatest challenge in delighting B2B customers is adding unique and differentiating value that solves customer problems. When defining the customer experience, recognize that this value should extend to the entire customer and business life cycle—presale engagement, the sales process, and post-sale interactions. Experiences at every stage of the customer life cycle should be customized to each individual customer.

Video Clip: Customer Experience Differentiation

Customer experience in the B2C and B2B environments.

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Customer Loyalty

Customer loyalty is "all about attracting the right customers, getting them to buy, buy often, buy in higher quantities and bring [the business] even more customers." It involves an emotional commitment to a brand or a business ("We love doing business with your company,") an attitude component ("I feel better about this brand or this business,") and a behavior component ("I'll keep buying this brand or patronizing that business, regardless.") Attitudes are important because repeat purchases alone do not always mean that a customer is emotionally invested. Think about the thrill of buying car insurance. We may keep buying from the same company, but we rarely have an emotional commitment to that company. Emotional commitment is key to customer loyalty.

The benefits of loyal customers are numerous:

- They buy more and are often willing to pay more. This creates a steadier cash flow for a business.
- Loyal customers will refer other customers to a company, saving the marketing and advertising costs of acquiring customers.
- They are more forgiving when you make mistakes—even serious ones—especially if you have a system in place that empowers employees to correct errors on the spot. Then loyal customers become even more loyal.
- A loyal customer's endorsement can outstrip the most extravagant marketing efforts. The word on the street is usually more powerful.
- Thriving companies with high customer loyalty usually have loyal employees who are genuinely engaged.

- Thriving companies with high customer and employee loyalty are generally known to outpace their competition in innovation.
- Loyal customers understand a company's processes and can offer suggestions for improvement.
- An increase in customer retention can boost a company's bottom-line profit by 25–100 percent, depending on **fixed costs**—costs that remain the same regardless of the amount of sales (e.g., rent).

Customer loyalty begins with the customer experience and is built over time through the collection of positive experiences. This will be true no matter the size, industry, and nature of the small business. Customers' experiences will influence how much they will buy, whether they switch to a competitor, and whether they will recommend the brand or the business to someone else. Small businesses cannot rely on the loyalty that comes from convenience (e.g., using the car dealer close to home for repairs instead of the one farther away that provides better service). Loyalty is about making a customer feel special. This is the dream of all small businesses—which is something that small businesses are particularly well suited to create. Because of their size, it is easier for small businesses to have closer relationships with their customers, create a more personal shopping environment, and, in general, create great customer experiences. Think back to Bob Brown of the Cheshire Package Store. He prides himself on the kind of shopping environment and customer relationships that lead to loyalty.

Grounds for Loyalty

How do people make choices about which pharmacy to go to? Paul Gauvreau decided to find out by asking customers why they were shopping in one particular store.

- "I shop here because it's close to where I live." (The convenience shopper.)
- "I like the pharmacist, I trust him/her." (This customer has a good relationship with their pharmacist.)
- "The staff makes me feel like part of the family."
- "I feel like they care about my health."
- "The entire atmosphere in this store reminds me of home, where I felt welcome."
- "I don't feel like another number here or just another patient. They really care about me."

Paul concluded that this pharmacy succeeded in differentiating itself from the competition in a unique way: by how they made their customers feel—and this is what will generate the most intimate loyalty in a customer.

Video Clip: Listening to Customers Leads to Loyalty

All customers really want is for the companies they do business with to listen to them.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Is There a Right Kind of Customer Loyalty?

Behavioral, emotional, and profitable customer loyalty. What they are, and what companies can do to create and improve them.

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Small businesses that are operating in the B2B sector might wonder whether there are major differences between B2B and B2C models of customer loyalty. Michael Lowenstein, vice president and senior consultant in customer loyalty management at Harris Interactive says that "except for the specific supplier decision criteria, which varies from situation to situation, there is [sic] more similarities than differences between B2C and B2B in what drives customer loyalty behavior." What can be concluded in either case is that achieving and retaining loyal customers should be an important goal for any company—small or large.

KEY TAKEAWAYS

- The customer and the consumer are not necessarily the same person… but they can be.
- The customer and the consumer should be the focus of the marketing mix.
- B2C and B2B are the two types of customer markets. The B2B market dwarfs the B2C market in terms of sales.
- It is critical for a small business to understand its customers.
- Customer experience is a person's entire interaction with a small business. It involves emotional connections to the business.
- There is no one-size-fits-all customer experience for a B2C or a B2B small business. The customer's journey should be mapped and changes made to improve the experience.

- There are big differences between the customer experiences for B2C and B2B businesses.
- There are multiple benefits to customer loyalty. It is important to small business success. A positive customer experience drives loyalty.

EXERCISES

1. Visit a small business that you patronize often. Plan to make a purchase. Describe your experience from the time you enter the store to the time you leave (the touchpoints) as specifically as possible. What surprised you the most? Were you disappointed at all? Please explain. What recommendations would you make to the owner? Do you plan on going back to this store?
2. Identify a small business to which you are loyal. Why are you loyal to that business? What in particular does the business do that you like? Have you told them?

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6.1.4: Marketing Research

Learning Objectives

- Understand and be able to explain what marketing research is all about.
- Explain why a small business should conduct marketing research and why many small businesses do not do it.
- Define and give examples of the two types of marketing research.
- Understand the marketing research process.
- Understand the costs of marketing research.

Not everyone can be like Steve Jobs of Apple. Jobs was famous for saying that he did not pay too much attention to customer research, particularly with respect to what customers say they want. Instead, he was very "adept at seeing under the surface of what customers want now; they just don't realize it until they see it. This ability is best expressed by the German word 'zeitgeist'—the emerging spirit of the age or mood of the moment. It probably best translates as market readiness or customer readiness. People like Jobs can see what the market is ready for before the market knows itself." Most small businesses will not find themselves in this enviable position. However, this does not mean that all small businesses take a methodical approach to studying the marketplace and their prospective as well as current consumers. Marketing research among small businesses ranges along a continuum from no research at all to the hiring of a professional research firm. Along the way, there will be both formal and informal approaches, the differences again being attributable to the size, industry, and nature of the business along with the personal predispositions of the small-business owners or managers. Nonetheless, it is important for small-business owners and managers to understand what marketing research is all about and how it can be helpful to their businesses. It is also important to understand that marketing research must take the cultures of different communities into consideration because the target market might not be the same—even in relatively close localities.

What Is Marketing Research?

Marketing research is about gathering the information that is needed to make decisions about a business. As an important precursor to the development of a marketing strategy, marketing research "involves the systematic design, collection, recording, analysis, interpretation, and reporting of information pertinent to a particular marketing decision facing a company." Marketing research is not a perfect science because much of it deals with people and their constantly changing feelings and behaviors—which are all influenced by countless subjective factors. What this means is that facts and opinions must be gathered in an orderly and objective way to find out what people want to buy, not just what the business wants to sell them." It also means that information relevant to the market, the competition, and the marketing environment should be gathered and analyzed in an orderly and objective way.

Why Do It?

The simple truth is that a small business cannot sell products or services—at least not for long—if customers do not want to buy them. Consider the following true scenario: A local small business that specialized in underground sprinkling systems and hot tubs for years decided to start selling go-carts. Not long after they introduced them, they had a fleet of go-carts lined up outside their business with a huge "Must go; prices slashed" banner over them. This was not a surprise to anyone else. Go-carts had nothing to do with their usual products, so why would their regular customers be interested in them? Also, a quick look at the demographics of the area would have revealed that the majority of the consumers in the retirement town were elderly. There would likely be little interest in go-carts. It is clear that the business owner would have benefitted from some marketing research.

Marketing research for small business offers many benefits. For example, companies can find hidden niches, design customer experiences, build customer loyalty, identify new business opportunities, design promotional materials, select channels of distribution, find out which customers are profitable and which are not, determine what areas of the company's website are generating the most revenue, and identify market trends that are likely to have the greatest impact on the business. Answers can be found for the important questions that all small businesses face, such as the following:

- How are market trends impacting my business?
- How does our target market make buying decisions?

- What is our market share and how can we increase it?
- How does customer satisfaction with our products or services measure up to that of the competition?
- How will our existing customers respond to a new product or service?

In many ways, small businesses have a marketing research advantage over large businesses. The small business is close to its customers and is able to learn much more quickly about their buying habits, what they like, and what they do not like. However, even though "small business owners have a sense [of] their customers' needs from years of experience…this informal information may not be timely or relevant to the current market."

It, therefore, behooves a small business to think seriously in terms of a marketing research effort—even a very small one—that is more focused and structured. This will increase the chances that the results will be timely and will enable the small-business owner or manager "to reduce business risks, spot current and upcoming problems in the current market, identify sales opportunities, and develop plans of actions." The specific nature and extent of any marketing research effort will, however, be a function of the product, the size and nature of the business, the industry, and the small-business owner or manager. There is no approach that is right for all situations and all small businesses.

Types of Marketing Research

Small businesses can conduct primary or secondary marketing research or a combination of the two. **Primary marketing research** involves the collection of data for a specific purpose or project. For example, asking existing customers why they purchase from the business and how they heard about it would be considered primary research. Another example would be conducting a study of specific competitors with respect to products and services offered and their price levels. These would be simple marketing research projects for a small business, either business-to-consumer (B2C) or business-to-business (B2B), and would not require the services of a professional research company. Such companies would be able to provide more sophisticated marketing research, but the cost might be too high for the many small businesses that are operating on a shoestring budget.

Data gathering techniques in primary marketing research can include observation, surveys, interviews, questionnaires, and **focus groups**. A focus group is six to ten people carefully selected by a researcher and brought together to discuss various aspects of interest at length. Focus groups are not likely to be chosen by small businesses because they are costly. However, the other techniques would be well within the means of most small businesses—and each can be conducted online (except for observation), by mail, in person, or by telephone. SurveyMonkey is a popular and very inexpensive online survey provider. Its available plans run from free to less than $20 per month for unlimited questions and unlimited responses. They also provide excellent tutorials. SurveyMonkey, used by many large companies, would be an excellent choice for any small business.

Secondary marketing research is based on information that has already been gathered and published. Some of the information may be free—as in the case of the US Census, public library databases and collections, certain websites, company information, and some trade associations to which the company belongs—or it can be bought. Purchased sources of information (not an exhaustive list) include newspapers, magazines, trade association reports, and **proprietary research reports** (i.e., reports from organizations that conduct original research and then sell it). eMarketer is a company that provides excellent marketing articles for free but also sells its more comprehensive reports. The reports are excellent, providing analysis and in-depth data that cannot be found elsewhere, but they are pricey.

If a small business was looking to introduce a new product to an entirely different market, secondary research could be conducted to find out where customer prospects live and whether the potential market is big enough to make the investment in the new product worthwhile. Secondary research would also be appropriate when looking for things such as economic trends, online consumer purchasing habits, and competitor identification.

Table 6.1.4.1: Types of Marketing Research

Primary Marketing Research	Secondary Marketing Research
Data for a specific purpose or for a specific project	Information that has already been gathered and published
Tends to be more expensive	Tends to be lower cost
Customized to meet a company's needs	May not meet a company's needs
Fresh, new data	Data are frequently outdated (e.g., using US 2000 census data in 2011)
Proprietary—no one else has it	Available to competitors
Examples: in-person surveys, customer comments, observation, and SurveyMonkey online survey	**Examples:** *Wall Street Journal*, *Bloomberg BusinessWeek*, US Census 2010, Bureau of Labor Statistics, FedStats, MarketingSherpa, ResearchInfo, and eMarketer

Source: Adapted from Marcella Kelly and Jim McGowen, *BUSN* (Mason, OH: South-Western, 2008), 147.

The Marketing Research Process

Most small-business owners do marketing research every day—without being aware of it. They analyze returned items, ask former customers why they switched to another company, and look at a competitor's prices. Formal marketing research simply makes this familiar process orderly by providing the appropriate framework. Effective marketing research follows the following six steps:

1. **Define the problem and the research objectives.** Care must be taken not to define the problem too broadly or too narrowly—and not to identify a symptom as the problem. The research objectives should flow from the problem definition.
2. **Develop the research plan.** This is a plan for gathering the needed information, part of which will include cost. Also to be determined is the following: whether primary research, secondary research, or some combination of the two will be used. The specific techniques will be identified, and a timetable will be established.
3. **Collect the information.** This phase is typically the most expensive and the most error-prone.
4. **Analyze the information.** Analysis involves extracting meaning from the raw data. It can involve simple tabulations or very sophisticated statistical techniques. The objective is to convert the raw data into actionable information.
5. **Present the findings.** The findings are presented to the decision-maker(s). In many small businesses, the owner or the manager may conduct the research, so the findings are presented in a format that will make sense for the owner and other members of the decision-making team.
6. **Make the decision.** The owner or manager must consider the information and decide how to act on it. One possible result is that the information gathered is not sufficient for making a decision. The problem may be a flawed marketing research process or problems obtaining access to appropriate data. The question becomes whether the situation is important enough to warrant additional research.

What Does It Cost?

A popular approach with small-business owners is to allocate a small percentage of gross sales for the most recent year for marketing research. This usually amounts to about 2 percent for an existing business. It has been suggested, however, that as much as 10 percent of gross sales should be allocated to marketing research if the business is planning to launch a new product.

There are several things that small businesses can do to keep the costs down. They can do the research on their own; work with local colleges and universities to engage business students in research projects; conduct online surveys using companies such as SurveyMonkey and Zoomerang; and create an online community with forums, blogs, and chat sessions that reveal customers' experiences with a company's product or the perception of a company's brand. The latter two options, of course, presume the existence of an e-commerce operation. Even given the inexpensive options that are available, however, hiring a professional research firm can be worth the price. The specific marketing research choice(s) made will depend, as always, on the size and the nature of the business, the industry, and the individual B2C or B2B small-business owner or manager.

When Should Marketing Research Be Done?

There is no precise answer to this question. As a general rule, marketing research should be done when important marketing decisions must be made. It should be done at times when customers may be easily accessible (e.g., a gift shop may want to conduct research before the holiday season when customers are more likely to be thinking about buying gifts for friends and loved ones), when you are thinking about adding a new product or service to the business, or when a competitor seems to be taking away market share. The trick, though, "is not to wait very long, because your competitors can start getting the answers before you do."

Common Marketing Research Mistakes

Before deciding on a marketing research path, it is important for a small-business owner or manager to be aware of the following common pitfalls that small businesses encounter:

- **Thinking the research will cost too much.** Small businesses definitely face a challenge to afford the costs of marketing research. However, marketing research costs range from free to several thousands of dollars.
- **Using only secondary research.** The published work of others is a great place to start, but it is often outdated and provides only broad knowledge. More specific knowledge can be obtained from purchasing proprietary reports, but this can be pricey, and the focus may not be quite right. Primary research should also be considered.
- **Using only web resources.** Data available on the Internet are available to everyone who can find it. It may not be fully accurate, and its accuracy may be difficult to evaluate. Deeper searches can be conducted at the local library, college campus, or small business center.
- **Surveying only the people you know.** This will not get you the most useful, accurate, and objective information. You must talk to actual customers to find out about their needs, wants, and expectations.
- **Hitting a wall.** Any research project has its ups and downs. It is easy to lose motivation and shorten the project. Persistence must be maintained because it will all come together in the end. It is important to talk to actual or potential customers early.

KEY TAKEAWAYS

- Many small businesses do not conduct any marketing research.
- Marketing research is about gathering the information that is needed to make decisions about the business.
- Marketing research is important because businesses cannot sell products or services that people do not want to buy.
- Small businesses can conduct primary or secondary research or a combination of the two. They can also buy proprietary reports that have been prepared by other companies.
- It is common for small businesses to allocate 2 percent of their gross sales to marketing research. Several things can be done to keep marketing research costs down.
- Marketing research should be done when key decisions must be made.
- Small-business owners should be aware of several common marketing research pitfalls that small businesses encounter.

EXERCISE

A small-business owner has an idea for a new product that may be a big hit with current customers and bring in new customers as well. The owner has not done much marketing research in the past, but with the lagging economy, the owner wants to be sure that the right steps are being taken. What would you advise the owner concerning the importance of marketing research and how to proceed? Be specific.

FRANK'S BARBEQUE: A MARKETING QUESTION

One night after the restaurant had closed, Frank Rainsford sat down with his son, Robert. Frank had finished reading his son's business plan for a third time. Robert sensed that his father had some sort of reservations. "What's the matter, Dad? Didn't you like the plan?" Frank paused and said, "Bobby, from a technical standpoint I think you have done a very, very credible job, but you are right. I do have some concerns." Disappointed, Robert asked his father to lay out his concerns.

Frank told him that opening another restaurant was a huge and expensive undertaking. He knew that Robert understood the financial risks, but he was not sure that his son understood the problems associated with getting people to come to a new restaurant. Frank was straightforward and told his son, "I have been at this for thirty-plus years. It took me years to build up my

client base. I really know my customers and what they like. Up until this year, the only marketing I did was flyers and a few ads in the local paper and the church bulletin. How are we going to understand our customers at the new location? We are going to have to fill it up quickly if we are to pay the bills. I know I've had some good success with selling the sauces during the last few years, but remember that I'm selling them from Harry's grocery store. His customers already know me and my product. Your plans for ramping up sauce sales are great, but again, how are we going to get people to know who we are and interested enough to buy a six-dollar bottle of barbecue sauce?" Frank went on to tell his son that he knew that Robert was extremely knowledgeable about marketing and the use of the Internet. He reminded Robert that he had given him a greatly enlarged marketing budget in 2010.

If you were Robert, how would you go about alleviating your father's concerns? Answer the question from a marketing perspective.

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6.1.5: The Three Threads

Learning Objectives

- Understand how marketing contributes to customer value.
- Explain how marketing can positively and negatively impact cash flow.
- Explain how digital technology and the e-environment impact marketing.

Customer Value Implications

It is the customer who decides whether to buy a small business's products or services. The customer decides whether the appropriate value is present, and that value will always be as he or she perceives it. "The decision to buy and the price that customers are willing to pay is dependent on their assessment of the value they will receive from one product relative to the known alternatives." Marketing plays a key role in creating and delivering value to the customer, but it is the establishment of a strong link between customer value requirements and the major value-producing activities of the firm that is the foundation on which the delivery of superior customer value is based.

The creation of customer value begins with a company commitment to the customer. Marketing has the responsibility for researching the current or prospective customer base, selecting a target market, and then developing a marketing mix that will hopefully meet the value expectations of customers. Product comes first, followed by price, promotion, and place. Delivering customer value should be the key consideration in all marketing mix decisions, with all four Ps working together. A small business needs to be aware, however, that customer value can and does change. What is considered as providing appropriate value one day may change the next day. It is marketing's responsibility to keep on top of such value migrations so that the marketing mix can be changed accordingly. Fortunately, small businesses are in a stronger position to make marketing mix changes because they are generally more nimble and are closer to the customer.

Cash-Flow Implications

Because sales are the only generator of revenue in most small businesses, marketing decisions play a major role in the health of a company's cash flow. A product or a service that does not sell will have a negative impact on cash flow, whereas a winner can result in a cash-flow bonanza. However, a product or a service that generates major cash can actually send the business into failure if the appropriate cash-flow mechanisms are not in place. The timely collection of money owed and being able to pay for the products and the services needed to run the business are critical to a positive cash flow. Providing extended terms for vendor accounts to be paid, delayed payments from credit cards used by customers for their purchases (something that is expected by most customers as part of the value they receive), the costs associated with an over-ambitious expansion, money-losing customer promotions, a product or a service that is priced too low (unable to cover costs), and a distribution approach that does not work well will all have a negative impact on cash flow.

Video Clip: Cash Flow and the Marketing Budget

Why cash flow is relevant to marketing.

A YouTube element has been excluded from this version of the text. You can view it online here.

Digital Technology and E-Environment Implications

The integration, acceptance, and popularity of technology in the current marketplace and workplace are widespread, particularly with respect to marketing. Marketing opportunities have exploded with the rise of digital technology and the Internet, and with those opportunities have come new ways to make marketing decisions and interact with customers.

As do all businesses, small businesses should be concerned about the customer experience. Emerging mobile technologies make it possible "to elevate the classic brick-and-mortar shopper experience." But there is a cautionary note. A **mobile shopping solution** (i.e., a way for shoppers to engage with their favorite retail brand or store using their mobile phones) can be cost-prohibitive for many retailers or B2B businesses, especially small ones. Nonetheless, it is a technology that small retail businesses should keep their eye on. One retail shopping solution is being developed by ARS Interactive and CellPoint Mobile. It will be "the only fully integrated mobile retail shopping solution in the United States that combines product information, coupons, customer loyalty, and

mobile payment into one experience. This will give customers complete shopping control directly from their mobile phones, while providing retailers with a constant customer touch-point inside and outside the store."

Video Clip: Mobile Marketing Solutions for Retail

A YouTube element has been excluded from this version of the text. You can view it online here.

An example of a mobile-assisted shopping solution offered by 2ergo.

Technology is also available to help in customer value analysis. New in 2010, the Value-Strategy Tool Kit helps a company:

- understand the true strengths and weaknesses of a product offer and identify opportunities that can make a product more competitive,
- look at a product head-to-head against each competitor to think through the selling strategy,
- set prices based on what a product is truly worth,
- hone the marketing message, and
- align the management team around a plan to serve customers better.

The target for this software is the larger business, but the principles remain the same. Because the price is based on the number of users, a small business with only one or two users may find it affordable.

Social media also needs to be seriously considered in small business marketing efforts. Social media "generally refers to websites featuring user-generated content or material created by visitors rather than the website publishers. In turn, these sites encourage visitors to read and respond to that material." Popular social media sites include Facebook and Twitter. These channels are being used by a wide range of small businesses to market their businesses via interaction with their customers.

As has been said in the past, small businesses will have different technology needs and desires. However, given the pervasiveness of technology in marketing, it is in the best interests of any small business to consider how technology could improve marketing effectiveness.

KEY TAKEAWAYS

- Marketing plays a key role in delivering customer value.
- Marketing decisions play a major role in the health of a company's cash flow.
- Small businesses of any size should consider how technology could improve marketing effectiveness.

EXERCISE

Assume that you have a friend who owns a small office supply business. Your friend is doing fairly well, but you are convinced that integrating more technology into his marketing efforts would increase sales. What would you recommend to your friend? How might technology add to customer value and a positive cash flow?

Disaster Watch

Customer Experience

You are the owner of the local BMW dealer. A customer has just taken delivery of a new BMW 1 Series. Within a couple of weeks, the customer was in an accident with the car. Another driver had driven into her shiny new car—her pride and joy. It was a disaster for the customer. Her dream of owning a BMW had been shattered by the accident happening when the car was only a few days old. It is now your responsibility to manage the repairs and deal with a customer whose car ownership experience is now in disaster territory. The customer knows that when she gets the car back, it will no longer be new. What could you do to turn this disaster into a great customer experience?

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6.2.1: Chapter Introduction

Elegant Touch

Anita Bruscino, the sole proprietor of Elegant Touch, began her career as a mechanical engineer. She worked in her family's manufacturing business until she and her father left because of too many factions in the company. This provided her with the opportunity to start her own business, something she had always known in her heart that she wanted to do.



Figure 6.2.1.1: Used with permission from Anita Bruscino.

Anita was inspired to open a gift shop by a family friend who had owned her own gift shop. She gave Anita advice on starting her own business, and Elegant Touch opened in 1994. Anita has since expanded the business and is celebrating the shop's eighteenth anniversary, with the last six years in its larger location. The shop is warm, lovely, and comfortable, featuring unique gifts for all occasions and specializing in American handcrafted gift items and gift baskets. Shoppers will also find maternity gifts, items for the sweet tooth, specialty foods, special seasonal sections—and a friendly smile from Anita. One thing that you will not find at Elegant Touch is what you find in other gift shops in her market area. When selecting products for her shop, Anita asks vendors whether other stores in the area carry the gift line she is considering. She will not carry duplicates. She likes to see new things and follows the trade magazines to help her do that. When asked how she chooses the products to carry, she described the process as instinctive—"from the gut."

Anita describes her customer demographics as mostly women, between thirty and seventy years old, married, and established with a home. Because many of her customers are repeat customers, the reason for fresh products is clear. A stale product line is not something that she can afford. Her pricing strategy is consistent with common practice in the industry, but many of her customers have commented that she delivers very high value for the prices she charges. She is not interested in selling online because she does not want to expand any further. She is at a nice comfort level and does not want to deal with additional inventory implications or the need to hire additional employees. As a result, the Elegant Touch website is for basic information only. In promoting Elegant Touch, Anita says that word of mouth works the best. She advertises in the local paper occasionally, supports local events, and is preparing for her first e-mail blast. She is exploring a Facebook presence but is not yet convinced that it will be of much value to her business.

Like all small businesses, Elegant Touch has been impacted by the ups and downs in the economy, with some times being tougher than others. Because Anita has only two part-time employees, however, she has not been faced with the employee layoffs that have hit other small companies. When asked what keeps her going in the rough times, she answered, "You have to love it." Just walk into her gift shop, and you will see clearly that she does. Except for the content from CheshirePatch.com, all information herein is based on an interview with Anita Bruscino, owner of Elegant Touch, March 2, 2012.

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6.2.2: The Importance of a Marketing Strategy

Learning Objectives

- Understand how marketing for small businesses differs from marketing for big businesses.
- Understand the most significant risk factor facing small businesses.
- Explain marketing strategy and why it is so important for small businesses.

Small-business marketing and big business marketing are not the same. The basic marketing principles that guide both are the same, but there are important differences with respect to scope, budget, risk factors, and areas of opportunity. Small businesses cannot compete with the marketing budgets of big companies. As a result, small businesses do not have the luxury of large staffs and the staying power that comes with high profits. There is little room for error. Failed strategies can lead to ruin.

The scope of small business marketing does not extend across the same level of multiple products and services that characterize most big businesses. Combined with having few if any products in the pipeline, this significantly reduces the insulation that small businesses have against ups and downs in the marketplace or strategic failures. “Small business marketing strategies have to be more targeted, cost-effective and more elaborately planned [s]o as to minimize the losses in case the strategy fails.”

Competition is the most significant risk factor facing small businesses. Trying to eliminate an established brand takes a lot of work, but it is an overnight job to wipe out a small business. Competition is a huge threat for small businesses. This means that small businesses should be very knowledgeable about their competition to deal effectively with them.

Opportunity areas for small businesses are also very different from those of big businesses. The small business can take advantage of niche markets and local needs and wants. They are much better able to emphasize personal, one-to-one interactions and can market real time in ways that cannot be matched by big businesses. Smaller can actually end up being more powerful.

Given the special marketing vulnerabilities of small businesses, the importance of understanding the components of a **marketing strategy** should be clear. A marketing strategy involves selecting one or more target markets, deciding how to differentiate and position the product or the service, and creating and maintaining a marketing mix that will hopefully prove successful with the selected target market(s)—all within the context of **marketing objectives**. Marketing objectives are what a company wants to accomplish with its marketing strategy: “Strategy is not a wish list, set of goals, mission statement, or litany of objectives…A marketing strategy is a clear explanation of how you’re going to get there, not where or what there is. An effective marketing strategy is a concise explanation of your stated plan of execution to reach your objectives…Marketing without strategy is the noise before failure.”

KEY TAKEAWAYS

- Small-business marketing and big business marketing are not the same.
- The most significant risk factor facing small businesses is competition.
- It is important for a small business to have a marketing strategy so that it is better positioned to choose among options.
- An effective marketing strategy is a concise explanation of a business’s stated plan of execution to reach its objectives.
- Marketing without strategy is the noise before the failure.

EXERCISE

You just started a new job with a twenty-five-employee small business. By accident, you found out that the company does not have a clear marketing strategy. So far, the company has been lucky with its product sales, but you have a feeling that things will not continue at the same pace for much longer because a competitor has entered the marketplace. Assuming that you had the opportunity, how would you go about convincing the owner that the smart thing to do right now is to create a marketing strategy? Make the case to the owner.

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6.2.3: The Marketing Strategy Process

Learning Objectives

- Describe the marketing strategy process.
- Explain why segmentation, target market, differentiation, positioning, and website decisions are so important for the small business.
- Describe the marketing strategy decision areas for each element of the marketing mix.

The focus of this text is on the management of the small business that is up and running as opposed to a start-up operation. As a result, the considerations of marketing strategy are twofold: (1) to modify or tweak marketing efforts already in place and (2) to add products or services as the business evolves. In some instances, it may be appropriate and desirable for a small business to backfit its marketing activities into a complete marketing strategy framework.

The marketing strategy process consists of several components. Each component should be considered and designed carefully: company vision, company mission, marketing objectives, and the marketing strategy itself.



Figure 6.2.3.1: Marketing Strategy Process (*Source: Susan I. Reid, "How to Write a Great Business Vision Statement," Alkamae, February 23, 2009, accessed December 2, 2011, http://alkamae.com/content.php?id=285; "Marketing Plan: Marketing Objectives and Strategies," Small Business Notes, accessed December 2, 2011, http://www.smallbusinessnotes.com/st...trategies.html.*)

Vision and Mission

It is awfully important to know what is and what is not your business.

The **vision statement** tries to articulate the long-term purpose and idealized notion of what a business hopes to become. (Where do we see the business going?) It should coincide with the founder's goals for the business, stating what the founder ultimately envisions the business to be. The **mission statement** looks to articulate the more fundamental nature of a business (i.e., why the business exists). It should be developed from the customer's perspective, be consistent with the vision, and answer three questions: What do we do? How do we do it? And for whom do we do it?

Both the vision statement and the mission statement must be developed carefully because they "provide direction for a new or small firm, without which it is difficult to develop a cohesive plan. In turn, this allows the firm to pursue activities that lead the organization forward and avoid devoting resources to activities that do not." Although input may be sought from others, the ultimate responsibility for the company vision and mission statements rests with the small business owner. The following are examples of both statements:

- **Vision statement.** "Within the next five years, Metromanage.com will become a leading provider of management software to North American small businesses by providing customizable, user-friendly software scaled to small business needs."
- **Mission statement.** "Studio67 is a great place to eat, combining an intriguing atmosphere with excellent, interesting food that is also very good for the people who eat there. We want fair profit for the owners and a rewarding place to work for the employees."

Marketing Objectives

Marketing objectives are what a company wants to accomplish with its marketing. They lay the groundwork for formulating the marketing strategy. Although formulated in a variety of ways, their achievement should lead to sales. The creation of marketing objectives is one of the most critical steps a business will take. The company needs to know, as precisely as possible, what it wants to achieve before allocating any resources to the marketing effort.

Marketing objectives should be SMART: specific, measurable, achievable, realistic, and time-based (i.e., have a stated time frame for achievement). It has been recommended that small businesses limit the number of objectives to a maximum of three or four. If you have fewer than two objectives, you aren't growing your business like you should be in order to keep up with the market. Having more than four objectives will divide your attention, and this may result in a lackluster showing on each objective and no big successes. If a small business has multiple marketing objectives, they will have to be evaluated to ensure that they do not conflict with each other. The company should also determine if it has the resources necessary to accomplish all its objectives.

For small businesses that already have, or are looking to have, a web presence and sell their products or services online, **e-marketing** objectives must be included with all other marketing objectives. E-marketing is defined as "the result of information technology applied to traditional marketing." The issues of concern and focus will be the same as for traditional marketing objectives. The difference is in the venue (i.e., online versus on-ground). Examples of e-marketing objectives are as follows: to establish a direct source of revenue from orders or advertising space; improve sales by building an image for the company's product, brand, and/or company; lower operating costs; provide a strong positive customer experience; and contribute to brand loyalty. The ultimate objective, however, will be "the comprehensive integration of e-marketing and traditional marketing to create seamless strategies and tactics."

The Marketing Strategy

With its focus being on achieving the marketing objectives, marketing strategy involves segmenting the market and selecting a target or targets, making differentiation and positioning decisions, and designing the marketing mix. The design of the product (one of the four Ps) will include design of the company website. Differentiation refers to a company's efforts to set its product or service apart from the competition, and positioning is placing the brand (whether store, product, or service) in the consumer's mind in relation to other competing products based on product traits and benefits that are relevant to the consumer. It has been said that, "in some cases, strategy just happens because a market and a product find each other and grow organically. However, small businesses that understand the power of an overarching marketing strategy, filtered and infused in every tactical process, will usually enjoy greater success."

KEY TAKEAWAYS

- The marketing strategy process consists of company vision, company mission, marketing objectives, and the marketing strategy itself.
- The company vision: Where do we see the business going?
- The company mission: Why does our business exist?
- Marketing objectives: What do we want to accomplish with our marketing strategy?
- Marketing strategy: How will we accomplish our marketing objectives?

- Marketing objectives should be SMART: specific, measurable, achievable, realistic, and time-based (i.e., have a specific time frame for accomplishment).
- Small businesses should limit the number of objectives to three or four to increase the chances that they will be achieved.
- E-marketing objectives must be included with traditional marketing objectives.
- E-marketing and traditional marketing should be integrated to create seamless marketing strategies and tactics.
- Marketing strategy involves segmenting the market, selecting a target or targets, making differentiation and positioning decisions, and designing the marketing mix. The design of the product will include design of the company website.

EXERCISES

1. Develop the marketing objectives for Frank's All-American BarBeQue restaurant in Darien, Connecticut.
2. Explain the differences between an on-ground marketing strategy and an online marketing strategy.

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6.2.4: Segmentation and the Target Market

Learning Objectives

- Explain segmentation and the target market.
- Explain why segmentation, the target market, differentiation, positioning, and website decisions are so important for a small business.
- Describe the marketing strategy decision areas for each element of the marketing mix.

Whether market segments and target markets are selected on the basis of intuition, marketing research, or a combination of the two, they are the basis for creating an effective marketing mix for any small business. Segmentation and target market decisions must be made for both on-ground and online customers.

Segmentation

Market segmentation, dividing a market into relatively homogeneous subgroups that behave much the same way in the marketplace, is the necessary precursor to selecting a target market or target markets. The challenge is knowing which group(s) to select. Many small business owners have a good intuitive sense of the segments that make sense for the business, and they choose to go with that intuition in devising their marketing strategy. However, that intuition may not be precise or current enough to be of the most help in planning a marketing strategy. Marketing research can be of help here, even to the smallest of businesses.

Marketing research can help the small business identify and refine the segments that offer the greatest opportunities. Part of that process will be to identify segments that meet the requirements of **measurability**, **substantiality**, **stability**, **accessibility**, **actionability**, and **differential response**. Meeting these requirements will increase the chances for successful segmentation.

- **Measurability.** Is it easy to identify and estimate the size of a segment? A small business that moves forward without a clear definition of its market segments is working blind. Intuition can only go so far. Are there people who are interested in freshly baked cookies for dogs (it would seem so), and how many of these people are there? (Check out Happy Hearts Dog Cookies.)
- **Substantiality.** Is the segment large and profitable enough to justify an investment? A small business may not require a huge number of customers to be profitable, but there should be enough people interested in the product or the service being offered to make operating the business worthwhile. Fancy designer clothes for dogs, for example, is a business that can survive—but not everywhere (see www.ralphlauren.com/search/index.jsp?kw=pup&f=Home).
- **Stability.** Stability has to do with consumer preferences. Are they stable over time? Although segments will change over time, a small business needs to be aware of preferences that are continuously changing. Small businesses can be more nimble at adapting their businesses to change, but too much volatility can be damaging to a business's operations.
- **Accessibility.** Can a business communicate with and reach the segment? A small business interested in women who work outside the home will present greater communication challenges than will stay-at-home wives and mothers.
- **Actionability.** Is a small business capable of designing an effective marketing program that can serve the chosen market segment? There was a small manufacturer of low-priced cigarettes in Virginia that found it difficult to compete with the big brands and other established lower-priced brands such as Bailey's. The manufacturer's solution was to sell to Russia where "Made in Virginia, USA" worked very well with customers and retailers.
- **Differential response.** The extent to which market segments are easily distinguishable from each other and respond differently to company marketing strategies. For the small business that chooses only one segment, this is not an issue. However, the small manufacturer of ramen noodles in New York City needs to know whether there are different segments for the product and whether the marketing strategy will appeal to those segments in the same positive way.

Once multiple segments have been identified, it is necessary to select a target market or target markets. If only a single segment has been identified, it becomes the target market.

Target Market

The selection of a **target market** or target markets will be based on the segments that have been identified as having the greatest potential for the business. A target market refers to one or more segments that have been chosen as the focus for business operations. Only some of the people in the marketplace will be interested in buying and/or using a company's product or service,

and no company has the resources to be all things to all people. Resources are always finite, but this will especially be the case for the small business, so all marketing efforts should be directed as precisely as possible.

Selecting the target market should be guided by several considerations:

- **Financial condition of the firm.** Limited resources may dictate the selection of only one target market.
- **Whether the competition is ignoring smaller segments.** If yes, this may be a ready-made target market.
- **Is the market new to the firm?** If yes, concentrating on one target market may make the most sense.
- **Specific need or want.** Does the proposed target market have a specific need or want for the product or the service?
- **Ability to buy.** Does the proposed target market have the resources to buy the product or the service?
- **Willingness to buy.** Is the proposed target market willing to buy the product or the service?
- **Will this target market be profitable?** There needs to be enough demand to make money.

Choosing the right target market is a critical part of the marketing strategy of a small business. The target market should be the best match for a company's products and services, thus helping to maximize the efficiency and effectiveness of its marketing efforts.

If a small business wants to go with a **niche market**, the same considerations apply. A niche market is a small, more narrowly defined market that is not being served well or at all by mainstream product or service marketers. The great advantage of pursuing a niche market is that you are likely to be alone there: "other small businesses may not be aware of your particular niche market, and large businesses won't want to bother with it." Ideally, a small business marketing to a niche market will be the only one doing so. Niches are very important to small businesses that want to sell pricey chocolates (see, for example, www.cocoadolce.com/about.php). They focus on niches such as weddings, seasonal offerings, and specialty items. They also sell online in order to reach a broader market.

KEY TAKEAWAYS

- Market segments and target markets are the basis for creating an effective marketing mix.
- Segmentation and target market decisions must be made for both on-ground and online customers.
- Market segmentation precedes the selection of a target market.
- There are many ways to segment a market.
- Segments must be measurable, substantial, stable, accessible, actionable, and easily distinguishable from other segments.
- The target market should be the segment or segments that show the greatest profit potential for a small business.
- A niche market is a small, more narrowly defined target market that is not being served well or at all by other businesses.

EXERCISES

1. How should the market for Frank's All-American BarBeQue be segmented for his new restaurant in Darien, Connecticut? How should Frank decide on a target market or target market(s)? Be specific. Do not assume that the Darien market is the same as the Fairfield market.
2. Assume that you work for a small manufacturer of children's hair-care products. What criteria would you use for effective segmentation? How would you then decide on a target market or target markets? Be specific.

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6.2.5: Differentiation and Positioning

Learning Objectives

- Explain differentiation and positioning.
- Explain why differentiation and positioning are so important for an online marketing strategy and an on-ground marketing strategy.
- Understand that a successful differentiation strategy cannot be copied by competitors.
- Understand that there are many ways to differentiate a product or a service.
- Understand that successful positioning of a small business or its brand is built on a well-defined target market combined with solid points of differentiation.

Differentiation and positioning considerations are relevant to each element of the marketing mix as well as to on-ground and online marketplaces. The small business should be working toward a **competitive advantage**—"the ability to perform in one or more ways that competitors cannot or will not match."

Differentiation

Differentiation, setting yourself apart from the competition, is one of the most important and effective marketing tools available to small business owners. Effective differentiation can put a business (or a brand) in the top position among the competition, but an ineffective differentiation strategy can leave a business buried in the middle or at the bottom of the pack. A successful differentiation strategy cannot be imitated by competitors—but it can bring you great success with consumers.

Video Clip: Business Differentiation

Differentiation is everyone's goal, but few are able to achieve it.

A YouTube element has been excluded from this version of the text. You can view it online here.

Small businesses, whether business-to-consumer (B2C) or business-to-business (B2B), can differentiate their companies or brands in many different ways: quality, service, price, distribution, perceived customer value, durability, convenience, warranty, financing, range of products/services offered, accessibility, production method(s), reliability, familiarity, product ingredients, and company image are all differentiation possibilities. There are others as well, limited only by the imagination. One way to uncover differentiation possibilities is to examine customer experience with a product or a service by asking the following questions:

- How do people become aware of their needs for a product or a service?
- How do customers find a company's offering?
- How do customers make their final selection?
- How do consumers order and purchase the product or the service?
- What happens when the product or the service is delivered?
- How is the product installed?
- How is the product or the service paid for?
- How is the product stored?
- How is the product moved around?
- What is the consumer really using the product for?
- What do consumers need help with when they use the product?
- What about returns or exchanges?
- How is the product repaired or serviced?
- What happens when the product is disposed of or no longer used?

No matter what the bases are for differentiating a company or a product, the decision should be made carefully with the expectation that the difference cannot be imitated. When customers are asked whether they can tell the difference between a particular small business and its closest competitors, the answer will hopefully be yes.

Video Clip: The “Murals Your Way” Advantage

How Murals Your Way sets itself apart from other wall mural companies.

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Video Clip: Bedbug Dog Sniffs Up Profits

An unusual means of differentiation.

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Positioning

Positioning is about the mind of the consumer: placing a company or a brand (sometimes they are the same, e.g., Carbonite, CakeLove, and Sugar Bakery & Sweet Shop) in the consumer’s mind in relation to the competition.

The positioning decision is often the critical strategic decision for a company or a brand because the position can be central to customers’ perception and choice decisions. Further, because all elements of the marketing program can potentially affect the position, it is usually necessary to use a positioning strategy as a focus for developing the marketing program. A clear positioning strategy can ensure that the elements of the marketing program are consistent and supportive.

Both big and small businesses practice positioning, but small businesses may not know it as positioning. The small business owner thinks about positioning intuitively, does not use the terminology, and does not always know how to promote the position. Additionally, in many if not most small businesses, “the positioning of products is based on the opinions of the business owner, his or her family, and selected friends and family.” This notwithstanding, an understanding of positioning should be in every small business owner’s tool kit.

Video Clip: Small-Business Market Position

Small-business owners must figure out how the company should be positioned.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: What Is Market Positioning?

A discussion of positioning.

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Successful positioning of a small business or its brand is built on a well-defined target market combined with solid points of differentiation. There are six approaches to positioning that the small business owner should consider:

1. **Positioning by attribute.** The most frequent positioning strategy. The focus is on a particular attribute, a product feature, or customer benefit. CakeLove in Maryland positions itself as “cakes from scratch” with natural ingredients (not the least of which is butter, lots of it).

Video Clip: Welcome to CakeLove

An introduction to CakeLove bakery.

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2. **Positioning by price/quality.** A very pervasive approach to positioning. Some small companies and brands offer more in terms of service, features, or performance, and a higher price serves to signal this higher quality to the customer. As an example, Derry Church Artisan Chocolates are very expensive, but they position themselves as having a very high quality that justifies a high price.
3. **Positioning by use or application.** Focuses on how a product is used or different applications of the product. A solitary custom tailoring shop located in a downtown professional office area could position itself as the only tailor where you can conveniently go “for lunch.”
4. **Positioning by product user.** The focus shifts from the product to the user. KIND Snacks are cereal bars positioned as a snack bar for those who are interested in a snack that is wholesome, convenient, tasty, healthy, and “economically sustainable and socially impactful.” It is a great snack for hikers and campers.

5. **Positioning by product class.** Focuses on product-class associations. A cleaning service that uses only green products and processes can position itself as the green choice in cleaning services. Healthy Homes Cleaning is an example of a green cleaning business.
6. **Positioning with respect to a competitor.** Comparing a small business brand to its competitors. Some comparisons will be very direct; others will be subtle. A small manufacturer that does not miss delivery times and makes products that are free of flaws can position itself on the basis of timely delivery and manufacturing excellence.

Joe's Redhots' Business Positioning Strategy

Joe's Redhots will sell premium-quality hot dogs and other ready-to-eat luncheon products to upscale businesspeople in high-traffic urban locations. *Joe's Redhots* will be positioned versus other luncheon street vendors as "the best place to have a quick lunch." The reasons are that *Joe's Redhots* have the cleanest carts; the most hygienic servers; the purest, freshest products; and the best value. Prices will be at a slight premium to reflect this superior vending service. *Joe's Redhots* will also be known for its fun and promotional personality, offering consumers something special every week for monetary savings and fun.

The challenge for a small business is to decide which approach to positioning a company or a brand is the best fit. This decision "often means selecting those associations which are to be built upon and emphasized and those associations which are to be removed or de-emphasized." In the process of writing a positioning statement, something that is encouraged as a way to keep the business on track, be aware of the difference between a broad positioning statement and a narrow positioning statement. A broad statement should encompass enough to allow a company to add products without the need to create a new positioning statement on a frequent basis; a narrow positioning statement puts a company in a "specialist" position in its market. The following are some examples:

- **Broad position statement.** "Professional money management services for discerning investors."
- **Narrow position statement.** "Equity strategies for low-risk investors."
- **Broad position statement.** "Elegant home furnishings at affordable prices."
- **Narrow position statement.** "Oak furniture for every room in your house."

KEY TAKEAWAYS

- Differentiation and positioning considerations are relevant to each element of the marketing mix as well as the on-ground and online marketplaces.
- Differentiation and positioning can contribute to the competitive advantage of a small business.
- Differentiation is one of the most important and effective marketing tools available to a small business owner.
- Small businesses, both B2B and B2C, can differentiate their companies or brands in many different ways.
- Ideally, differentiation should be done in a way that cannot be imitated by the competition.
- Positioning is about placing a company or a brand in the mind of the consumer in relation to the competition. It is always comparative.
- Small businesses practice positioning as much as larger companies do, but they may not use the terminology.
- All small business owners should understand what positioning is and how they can use it to their advantage.

EXERCISES

1. Although Frank's All-American BarBeQue has a very loyal following in Fairfield, Connecticut, developing a marketing plan and strategy for the Darien store will require specific statements of differentiation and positioning. What should they be? Remember that the Darien market may be similar to the Fairfield market, but the two markets should not be seen as identical.
2. Continuing with the scenario about the small manufacturer of hair-care products for children, how would you differentiate and position the product for competitive advantage?

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6.2.6: Marketing Strategy and Product

Learning Objectives

- Understand why product is the key element in the marketing mix.
- Identify the multiple decisions and considerations that factor into product or service development.
- Describe the three product layers and explain why small businesses should pay attention to them.
- Explain the importance of product design to marketing strategy.
- Understand the role of packaging to product success.
- Explain what a brand is and why it is probably a company's most important asset.
- Explain the implications of the product life cycle for the marketing mix.
- Understand that a company's website is part of its product or service, whether or not the company sells anything online.
- Explain the decision areas for the company website.

The key element in the marketing mix is the product. Without it, price, promotion, and place are moot. The same is true for marketing strategy. Fulfilling a company's vision and mission and achieving its marketing objectives must be led by the product.

There are multiple decisions and considerations that factor into product or service development: features and benefits, product mix, design, brand, the product life cycle, and the company website. Knowing product development issues can be very helpful for even the smallest business that is looking to keep its current product line responsive to the customers while also looking to expand its product line as the company grows (if growth is desired).

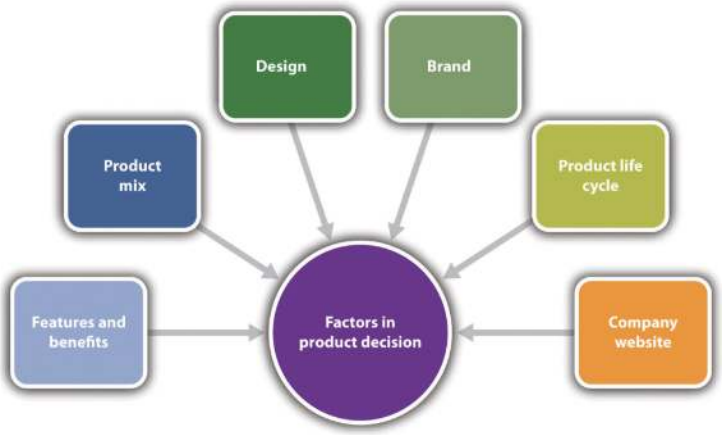


Figure 6.2.6.1: Factors in Product or Service Decisions

Product Features and Benefits

A product has multiple layers: core, augmented, and symbolic. These three layers can help a small business owner understand the product features and benefits that will best deliver value to current and prospective customers. These layers also provide the bases for differentiating and positioning the product. The product layers refer to both products and services and business-to-consumer (B2C) or business-to-business (B2B) customers.

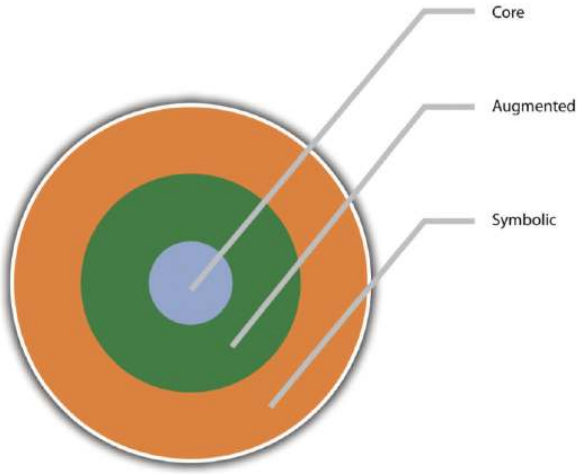


Figure 6.2.6.2: The Product Layers

The **core layer** is the nuts and bolts of a product, its physical anatomy, and its basic features. It is also the basic benefit or problem solution that B2C or B2B customers are looking for. Someone buying an airline ticket, for example, is buying transportation. Someone buying an ice cream cone is buying a delicious and fun treat. The core layer is also where considerations of **quality** begin. Quality "refers to overall product quality, reliability, and the extent to which [the product or the service] meets consumers' needs," and the perception of quality has the greatest impact on customer satisfaction. Decisions about design, manufacturing, preparation, ingredients, service delivery, component parts, and process materials all reflect a business's philosophy about quality. The **augmented layer** is where additional value is added via things such as packaging, promotion, warranties, guarantees, brand name, design, financing opportunities where appropriate, prompt and on-time service, and additional services that may enhance a product. The augmented layer for Southwest Airlines is its well-known brand name, its packaging and promotion as a "fun" flying experience, and its "bags fly free" policy. The ice cream cone that is purchased in an old-fashioned ice cream parlor will likely be considered of greater value to many customers than the ice cream cone purchased at a Dairy Queen. It is this layer where many marketing mistakes are made because opportunities are missed. The **symbolic layer** captures the meaning of a product to a consumer—its emotional and psychological connections. There are many loyal customers of Southwest Airlines because they really enjoy flying with them. It is inexpensive, convenient, and fun. The old-fashioned ice cream parlor will engender nostalgia and create powerful emotional ties. The most serious marketing errors are made when the symbolic product layer is either ignored or not understood. The power of symbolism should never be underestimated.

Every small business should look at its products within the context of the product layers. It is the creativity and imagination of the small business owner with the product layers that can set a business apart. They provide an excellent basis for dissecting an existing product to see where opportunities may have been missed, features could be added or changed, and features or enhancements could be explained more effectively in promotional activities. The product layers should also be used to develop new products that the business plans to introduce.

Product Mix

All small businesses have a product mix, the selection of products or services that is offered to the marketplace. With respect to the product mix for small companies, a company will usually start out with a limited product mix. However, over time, a company may want to differentiate products or acquire new ones to enter new markets. A company can also sell existing products to new markets by coming up with new uses for its products. No matter the approach, the product mix needs to be created so that it is responsive to the needs, wants, and desires of the small business's target market.

For small businesses engaged in e-marketing, product selection is a key element for online success. Part of the challenge is deciding which products to market online because some products sell better online than others. If a business has a brick-and-mortar presence, a decision must be made whether all the inventory or only part of it will be sold online. Items that sell well online change over time, so it is important to keep up to date on the changes. A second decision to be made is the number of items in the catalog

(i.e., the number of items you will sell). Given intense online competition and shoppers' desires for good selections, there needs to be a critical mass of products and choices—unless a company is lucky enough to have a very narrow niche with high demand. If a company has only one or two products to sell, the situation should be evaluated to determine whether selling online will be profitable.

Product Design

In his book, *Re-imagine! Business Excellence in a Disruptive Age*, Tom Peters devotes two chapters to the importance of design to business success. He says that design is "the principal reason for emotional attachment (or detachment) relative to a product service or experience"—and he quotes Apple's CEO, Steve Jobs, in saying that design is the "fundamental soul of a man-made creation." This is true whether the product comes from a big business or a small business.

Product design involves aesthetic properties such as color, shape, texture, and entire form, but it also includes a consideration of function, ergonomics, technology, and usability as well as touch, taste, smell, sight, and sound. The pulling together of these things, as appropriate to the specific product or service being designed, should result in a design that matches customer expectations. "Design represents a basic, intrinsic value in all products and services."

Design offers a powerful way to differentiate and position a company's products and services, often giving company a competitive edge. Improved profit margins from increased sales and increased market share are often the result. It is essential to get the visual design of a product right for the market you are appealing to. It can make the difference between selling a product—or not.

Design is particularly important in making and marketing retail services, apparel, packaged goods, and durable equipment. The designer must figure out how much to invest in form, feature development, performance, conformance, durability, reliability, repairability, and style. To the company, a well-designed product is one that is easy to manufacture and distribute. To the customer, a well-designed product is one that is pleasant to look at and easy to open, install, use, repair, and dispose of. The designer must take all these factors into account.

The arguments for good design are particularly compelling for smaller consumer products companies and start-ups that do not have big advertising dollars.

Quirky.com is a small business that has taken product design to a whole new level: collaboration. First seen as a "bold but ultimately wild-eyed idea," Quirky recently secured $6 million in venture financing. A company like this could be very helpful to a small business that is looking to introduce a new product.

Video Clip: Quirky's Ben Kaufman on Innovation

An innovative approach to product design: collaboration.

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Design issues also apply to services. Some of the design issues for services that are delivered in a store (e.g., dry cleaning, repair, and restaurant) are the same as for any retail store: the design of the physical space, the appearance of the personnel, the helpfulness of the personnel, the ease of ordering, and the quality of service delivery. For services that are performed at a customer's home or at a business site, the design issues include timeliness; the appearance and helpfulness of personnel; the quality of installation, service, and repair; and the ease of ordering the service. The special characteristics of services (i.e., **intangibility**, **perishability**, **inseparability**, and **variability**, as defined in Figure 6.2.6.3 present design challenges that are different from those faced by physical products.

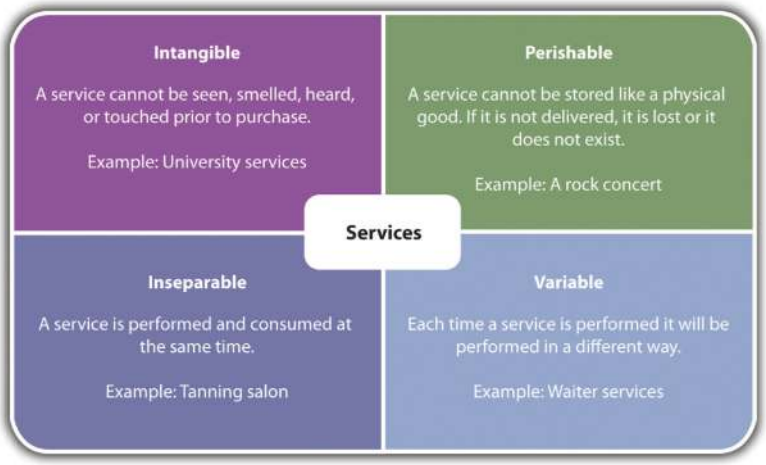


Figure 6.2.6.3: The Characteristics of Services *Source: Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 264–68.*

Whether a small business is offering a product, a service, or a combination of the two to either the B2C or B2B marketplace, there is no question that excellent product design is a gateway to business success.

Packaging Design

The design of the product or the service package is another decision component of the product. **Packaging** can be defined as "all the activities of designing and producing the container for a product." Packages "engage us consciously and unconsciously. They are physical structures but at the same time, they are very much about illusion. They appeal to our emotions as well as to our reason." Thus the package communicates both emotional and functional benefits to the buyer, and it can be a powerful means of product differentiation. A well-designed package can build brand equity and drive sales. A poorly designed package can turn the customer off and can lead to wrap rage—the anger and frustration that results from not being able to readily access a product, which often leads to injuries. Although difficult-to-open packaging may be seen as necessary by the manufacturers and retailers, it does not do much for a positive customer experience.

Video Clip: Wrap Rage

Wrap rage: what it is about, with examples.

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Video Clip: Opening Plastic Clamshells with a Can Opener

Plastic clamshell packages inspire wrap rage. They are easier to open if you start with a can opener.

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Brand

A **brand** is defined by the American Marketing Association as "a name, term, sign, symbol, or design, or a combination of them, intended to identify the goods or services of one seller or group of sellers and to differentiate them from those of competitors… A brand may identify one item, a family of items, or all items of that seller. If used for the firm as a whole, the preferred term is trade name." A brand is a promise to the consumer that certain expectations will be met, a promise that—if broken—may result in the loss of that customer. A company's brand is probably its most important asset.

Video Clip: A Brand Is More Than a Logo

What a brand is all about.

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Building a brand is an ongoing process for a small business because it wants a memorable identity. It is important for the business to constantly monitor its brand to ensure that it represents the core values and needs of its existing and potential customers. The brand needs to reach people on an emotional level because customers ultimately make decisions on an emotional level, not a logical level. For this reason, a small business should think in terms of tapping into as many senses as possible with its brand. “Almost our entire understanding of the world is experienced through our senses. Our senses are our link to memory and can tap right into emotion.” Scenting the air of a store with a fresh fragrance could be a powerful contributor to the store’s brand.

Whether a small business wants to keep its brand (but may be monitoring it) or is looking to **rebrand** (changing the brand), there are four fundamental qualities of great brands that should be kept in mind:

1. They offer and communicate a clear, relevant *customer promise*, such as fun, speedy delivery, or superior taste.
2. They *build trust* by delivering on that promise. Keeping a customer informed when something goes wrong can help build and retain trust.
3. They drive the market by *continually improving* the promise. A small business should always be looking to make things better for its customers. Think in terms of the total customer experience.
4. They seek further advantage by *innovating beyond the familiar*. If a small business focuses on the customer experience, there are undoubtedly ways to improve the brand by adding the unexpected.

The ultimate objective is to have a brand that delivers a clear message, is easy to pronounce, confirms a company’s credibility, makes an emotional connection with the target market, motivates the buyer, and solidifies customer loyalty.

Video Clip: Good Branding Will Build a Company

A strong branding and marketing strategy is an investment that will pay dividends for years to come.

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Video Clip: Small Business Branding Tips

A small business owner talks about the importance and mechanisms of creating a strong and memorable company brand.

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Product Life Cycle

Every product has a life span. Some are longer than others. The pet rock had a very short life span. The automobile is still going strong. Some products or services experience an early death, not able to make it very far out the door. Take, for example, Colgate Kitchen Entrees (yes, as in the toothpaste); Cosmopolitan Yogurt (off the shelves in eighteen months); and Ben-Gay Aspirin (the idea of swallowing Ben-Gay was not a winner).

Even the big guys make mistakes, so small businesses are not immune from product goofs. The products that do make it, however, go through what is known as the **product life cycle (PLC)**, defined as “the performance of the product in terms of sales and profits over time.” The traditional PLC is shown in Figure 6.2.6.4 "The Traditional Product Life Cycle".

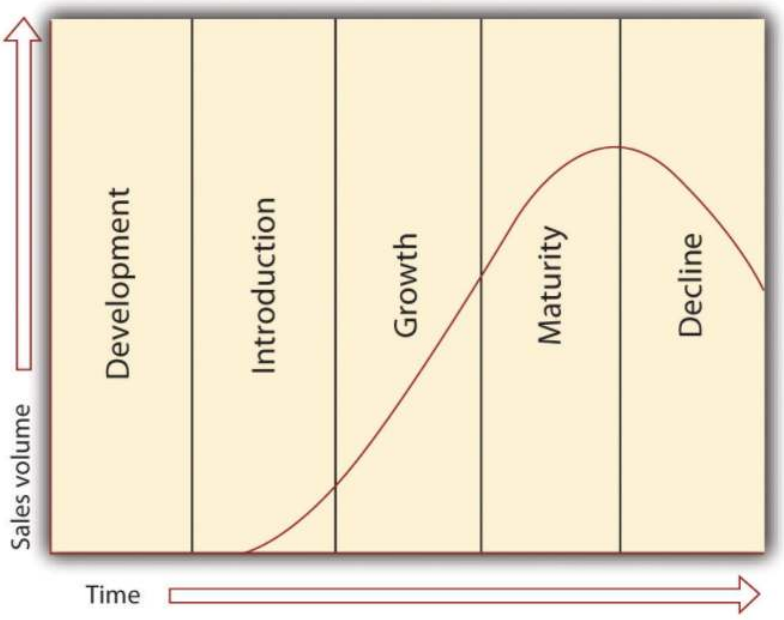


Figure 6.2.6.4: The Traditional Product Life Cycle *Source: "The Product Life Cycle," NetMBA, accessed December 2, 2011, http://www.netmba.com/marketing/product/lifecycle*.

Small-business owners should understand the PLC because there are specific implications for marketing strategy. The **product development (incubation) stage** is when a product is being prepared for sale. There are costs but no sales. The **product introduction stage** is when a product is available to buy for the first time. Sales will generally be low but increasing, marketing expenses will be high, and profits will be typically low or nonexistent. The focus of the marketing strategy will be to create awareness, establish a market, and create demand for the product. The **product growth stage** is when sales grow rapidly as the target market adopts a product and competition enters the marketplace once it observes the success. Marketing strategy should focus on differentiation and building a brand preference. There is substantial profit improvement. Rapid growth must be managed carefully so that the company does not succeed into failure. The **product maturity stage** is characterized by slow growth because most of the buyers interested in a product have bought it. Sales may increase but slowly due to intense price competition. Profits stabilize or decline. The marketing strategy must focus on getting people to switch brands by using special promotions and incentives. The **product decline stage** is when sales decline and profits erode. A product has become obsolete because of an innovation (think VHS to DVD to Blu-Ray) or the tastes of the target market have changed. The marketing strategy works to reinforce the brand image of the product. The product may be dropped from the product line or rejuvenated if possible and practical.

There are many small business owners who may not see the PLC as applying to their products or services. After all, accounting services are accounting services, a luncheonette is a luncheonette, and hardware is hardware. Thinking this way would be a mistake. Accounting practices change, people's tastes change, hardware solutions change, and government regulation inserts itself. What is successful today may not be successful tomorrow. The PLC provides guidance for watching how a product or a service progresses in the marketplace so that the necessary marketing strategy steps can be taken.

The New Product Development Process

If the development of a new product is being considered, the following steps are suggested as guidance:

- **Generate new product ideas.** Search for ideas for new products.
- **Screen new product ideas.** Make sure the product fits the target market and the overall mission of the business.
- **Develop and evaluate new product concepts.** Develop product concepts and determine how consumers will view and use the product.
- **Perform a product business analysis.** Calculate projected business costs, return on investment, cash flow, and the long-term fixed and variable costs. Long-term fixed costs are production costs that do not vary with the number of units produced (e.g.,

annual rent). Long-term variable costs are production costs that vary with the number of units produced (e.g., selling more hot dogs will require more hot dogs, ketchup, mustard, and relish).

- **Design and develop the product.** Develop a product prototype. A product prototype is an exact match to the product description developed in the concept development and evaluation stages. It is a sample.
- **Test market the product.** Introduce the product to a market to find out how the product will be received when it is introduced for real. The test market should be as close as possible in terms of characteristics (e.g., demographics) as the target market. For a small business, an appropriate test market might be a few select customers.
- **Launch the product or the service.** The product is introduced to the full marketplace.

The Company Website

A company's website is part of its product or service. The conventional wisdom is that all businesses should have a website. The reality is that there are many small businesses that do very well for themselves without a web presence. The small local deli, accounting or insurance services, a legal firm, a liquor store, or a dental office may not see the need for a website. At the same time, customers are increasingly expecting a web presence, so any small business that does not have a website runs the risk of losing sales because of it. The time may also be approaching when not having a website will be perceived as odd, with questions raised as to the seriousness of the business. Every small business without a website should determine whether this matters to them or not.

This section about the company website is targeted to the small business that has a web presence already or is planning to have one. A small business owner should have a basic understanding of website design to contribute to the discussion and communicate effectively when working with professionals—as well as to organize the owner's visceral reaction when it is time to evaluate other websites, plan the company's website, or revise the company's current website. In addition, any commitment to e-marketing requires a website.

Stanford University's Persuasive Technology Lab found that people quickly evaluate a website by visual design alone, with the visual design setting the tone for the user's experience. "Image is everything online. Good design evokes trust, makes navigation clear, establishes branding, appeals to target customers, and makes them feel good about doing business with the website they are on. Design does not have to be expensive for it to work. It does, however, need to represent an organization and appeal to a visitor. Professional design is not something organizations spend money on; it is something *they invest in to support trust, positioning, and long-term marketing*" (emphasis added).

This section of the chapter discusses website objectives and the fundamental design elements: layout, color, typography, graphics, interactivity, navigation, usability, content, and performance. User experience is also discussed.

Video Clip: Web Design Mistakes Small Businesses Make

Mistakes that small businesses should watch for when designing their websites.

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Website Objectives

"The goal of any Web site is to deliver quality content to its intended audience and to do so with an elegant design." **Website objectives** define what a company wants its website to do. For example, a website can build awareness of the business; build awareness of particular brands or services; distribute information to supporters, customers, and stakeholders on products or issues; sell products or services; build relationships with customers; develop a new marketing strategy or reinforce an existing strategy; manage an event (e.g., online registration and payment); build the company image; and gather marketing research by collecting data from users or conducting online surveys. Whichever objective or combination of objectives is chosen, each objective should meet the criteria discussed in "The Marketing Strategy Process". Clear-cut objectives will increase the chances that a company's website design and content will work to achieve those objectives.

Website Layout

Layout refers to the positioning of the various elements that comprise a web page: where each text object will be positioned on each page or screen, the width and length of columns, the amount of space that will be placed between the lines of text, the alignment to be used (e.g., left or right), whether the page will be text only or use more advanced designs (e.g., multiple

columns), and the placement of graphics. Layout is important because it is one of the first things a visitor perceives when landing on a website. Research shows that “web users spend 69% of their time viewing the left half of the page and 30% viewing the right half, [so] a conventional layout is thus more likely to make sites profitable.”

Color

Color is a powerful component of design. It affects mood and emotion, and it evokes associations with time and place. For example, psychedelic color combinations take us back to the 1960s, and turquoise and yellow combinations remind us of art deco in the 1950s. For websites, color is important in defining a site’s environment because “people see color before they absorb content.” A lasting color impression occurs within ninety seconds and accounts for 60 percent of acceptance. What are the implications for website design? Decisions regarding color can be highly important to success.

The key to the effective use of color in website design is “to match the expectations of the target audience. Financial services sites tend to use formal colors (e.g., green or blue) with simple charts to illustrate the text but not many pictures. Sites directed at a female audience tend to feature lighter colors, usually pastels, with many pictures and an open design featuring lots of white space. Game sites are one type of site that can get away with in-your-face colors, Flash effects, and highly animated graphics.”

Colors should be selected that reflect the purpose of the site and enhance the design. Understanding the meaning of color and the cultural use of color and how colors interact is important in website design to convey the right tone and message and evoke the desired response to the site. The wrong choice could adversely affect a visitor’s experience at the site, which could adversely affect a company’s sales and image.

Video Clip: Color Psychology in Web Design

Insights into color and its importance in website design.

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Color Perceptions for Business

“The following list provides the traditional meanings of common colors and suggests compatible business usage:

- **Pink.** Romance, love, friendship, delicacy, feminine; ideal for relationship coaches, florists, and breast cancer awareness sites.
- **Purple.** Royalty, spiritual, transformation, creativity, new age; ideal for spirituality-based or new-age businesses and businesses in the creative realm.
- **Blue.** Solid, communication, calm, wisdom, trust, reassuring; ideal for financial businesses, insurance companies, and lawyers.
- **Green.** Growth, money, abundance, fertility, freshness, health, environment; ideal for grocers, environmental businesses, therapists, healthcare businesses.
- **Red.** Energy, strength, passion; ideal for bold businesses based on power and for professionals; use in combination with black.
- **Black.** Power, sophisticated, elegant, formal, style, dramatic, serious; ideal for fine dining establishments; commonly used as an accent color.
- **Gold and yellow.** Wealth, wisdom, prestige, power, energy, joy, clarity, light, intelligence, optimism; ideal for the construction industry.
- **White.** Purity, goodness, simplicity, clean; ideal for almost every business.
- **Brown.** Friendship, earthy, comfort, content, reliable, sturdy; ideal for businesses involved in administrative support.
- **Orange.** Vibrant, enthusiasm, energy, warmth; ideal for creative businesses and teachers.
- **Gray.** Security, staid, quality, professional, stable; ideal for the legal industry.”

Typography

“**Typography** is the art of designing a communication by using the printed word.” More specifically, it is the use of **typefaces (or fonts)** in a design. Typeface refers to a particular type or font (e.g., Times New Roman and Arial). Typography is an integral part of web design and plays a role in the aesthetics of the website. About 95 percent of the information on the web is written language, so it is only logical that a web designer should understand the shaping of written information (i.e., typography). It is possible to blow away more than 50 percent of website visitors and readers by choosing the wrong typeface.

Graphics

Graphics, defined as pictures, artwork, animations, or videos, can be very effective if used correctly. Graphics can provide interest, information, fun, and aesthetics, but they can also take forever to load, be meaningless or useless, not fit on the screen, and use colors that are not **browser-safe colors** (i.e., colors that look the same on PC and Macintosh operating systems). Images enhance a web page, but they should be selected and placed carefully.

Graphics should be used to "convey the appropriate tone of your message. As the old saying goes, a picture is worth a thousand words. Make sure your images correspond to the text and are appropriate to the business you offer. For example, an audiologist shouldn't use a picture of a woman holding her glasses because the spotlight should be on hearing." Graphics should also help create a mood, or a sense of place. The use of graphics has to be thoroughly considered because they slow the loading of a website.

It has been shown that quality images boost sales and enhance the visitor experience. "Consumers who browse products on websites want to see the products they're considering for purchase represented by the highest quality image possible… People do not buy what they cannot see, so the higher the quality and resolution of [the] imagery, the better [the] results will be." The key for any small business that wants graphics on its website is to consider how the graphics will add value to the user experience. The graphics should be for the direct benefit of the user, not the business. Do not get carried away with lots of images and animations because they can make a web page very hard to read. Graphics are a major part of the design, not just afterthoughts.

Site Navigation

People will not use a website if they cannot find their way around it. If web users cannot find what they are looking for or figure out how the site is organized, they are not likely to stay long—or come back. "The purpose of **site navigation** is to help visitors quickly and easily find the information they need on a website. Among the questions considered in site navigation are, How will visitors enter a site? How will visitors use the site? How will they find out what is available at the site? How will they get from one page to another and from one section to another? How will visitors find what they are looking for?"

Site navigation must be easy, predictable, consistent, and intuitive enough so that visitors do not have to think about it. "Designing effective navigation can also entice your visitors to try out the other things you offer on your site." The key to understanding navigation is to realize that if it is too hard to use or figure out, web visitors will be gone in a nanosecond, perhaps never to be seen again. What does this mean to a small business? Lost sales and lost opportunities.

Site Usability

A website's **usability**, or ease of use, "can make or break an online experience, and it is directly correlated to the success of the site." Website usability measures the quality of a user's experience when interacting with a website, and it works hand in hand with site navigation. According to usability.gov, usability is a combination of five factors:

1. **Ease of learning.** How fast can a user who has never seen the **user interface** before learn it sufficiently well to accomplish basic tasks? The user interface is the way a person interacts with a website.
2. **Efficiency of use.** Once an experienced user has learned to use the website, how fast can he or she accomplish tasks?
3. **Memorability.** If a user has used the website before, can he or she remember enough to use it effectively the next time or does the user have to start over again learning everything?
4. **Error frequency.** How often do users make errors while using the website, how serious are these errors, and how do users recover from these errors?
5. **Subjective satisfaction.** How much does the user like using the website?

Usability is necessary for survival on the Internet. If a website is difficult to use, people will leave, and they may be inclined to tell everyone they know on Facebook and Twitter about their negative experiences. It is as simple—and as serious—as that. Small-business owners should consider postlaunch usability testing to help ensure the best user experience. Three free tools are HubSpot's Website Grader, SiteTuners, and Google Analytics.

Site Interactivity

Site interactivity is about things on a company's website site that prompt some kind of action from visitors. Visitors become engaged with the site, they stay longer, they look deeper into the site to see what the company is offering, they are less likely to

jump to another site, and they feel that they are part of a community and connected. This will keep them coming back to the site.

There are many ways in which a small business can provide interactivity on its site. The following are some examples:

- Free calculators for calculating payments when something is being financed
- Surveys, polls, or quizzes
- Blogs, bulletin boards, and discussion forums
- Facebook and Twitter links
- Searchable database of frequently asked questions
- Site search engine
- Interactive games, puzzles, and contests
- Articles that engage visitors, allowing them to add comments or opinions
- Three-dimensional flip-books (e.g., Gorenje Kitchens showcase a range of products, thus engaging the visitor while flipping through the book.)

The sources of interactivity on a website are limited only by a small business owner's creativity and, of course, budget. However, it should never be a question of saying yes or no to interactivity. It is a matter of how much, what kind, and where. Remember that when customers feel compelled to do something, they are that much closer to buying.

Content

Content refers to all the words, images, products, sound, video, interactive features, and any other material that a business puts on its website. It is the content that visitors are looking for, and it is what will keep them on the site. High-quality content will also keep people interested so that they come back for more. "A poorly and ineffectively 'written' website has an adverse impact on the efficiency of the website. Moreover, it also gives a negative impression of the brand [or company] behind it. Without good 'content' a website is an empty box."

Good content is relevant, customer-centric (i.e., it is written in the language and words of the target audience(s) that visit the website), and complies with what we know about how people read online content. They don't. They scan it—because it takes 25 percent longer to read the same material online than it does to read it on paper. If a company's content does not fit its target audience(s), the website will not generate good results.

Most small businesses may think that they must generate all website content. However, some of the best and most successful content may be the easiest to create: the content generated by website users. Interestingly, it is not uncommon for user-generated content to get higher search engine rankings than a business's home page, not an insignificant fact. User-generated content includes the following:

- Message boards
- Product reviews
- New uses for a company's products (e.g., using a dishwasher to cook a whole salmon)
- Testimonials or case studies (how users solved problems)
- Social media pages
- Twitter feeds
- Video contest submissions
- Interviews with users
- Online groups or communities such as LinkedIn or Ning

The gold standard of user-generated content is customer reviews. Customer reviews can increase site traffic by as much as 80 percent, overall conversions by 60 percent, and the average order value by 40 percent. With respect to the posting of both positive and negative reviews, it has been shown that "users trust organizations that post both negative and positive reviews of their product *if* organizations address the feedback constructively."

There are many factors that will contribute to the success of a small business website. However, the website will not do as well as it should, and it will not reach its full potential, without good quality content.

Video Clip: The Value of the About Page

Why the “About” page is so important to a business website.

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Product Display

How a website displays products will impact the success of the website. As a result, product display should be seen as a website design issue. Key decisions that should be made for each category of product that is available on the website include the choice of which products to feature, how to provide product detail pages (an individual page for each product is preferable because there is more room for product details), the sort options that will be available to the shopper (e.g., price), and where items on special will be placed on the page (the upper right corner is recommended).

Performance

No matter how well designed a website is, and no matter how high the quality of content, a website that takes too long to load will lose visitors. A website’s **loading speed** determines how fast the pages respond to a user request. Faster site speed is preferred by the users who want an optimal browsing experience, and the small business that wants increasing incoming connections and high sales. Users want faster speeds.

Visiting a fast-loading site is a pleasant experience. Visiting a slow-loading site is not. Surveys now show that a person will wait less than three seconds (perhaps even less) for a webpage to load before leaving, with a one-second delay possibly meaning a 7 percent reduction in sales. Google claims that the amount of site traffic drops by 20 percent for every 0.5 seconds of load time.

There are several factors that slow down the loading time for a website, not the least of which is the connection speed of the user’s computer. This is out of the control of the web designer and the site owner (the small business). The biggest culprit, however, is a large graphic or several small graphics on a single page. There are ways around this, known by any credible website designer. The impact of “slow down” features should be tested before the site launches and monitored afterwards. The small business owner can take advantage of some of the popular tools that are available, usually for free, to measure a company’s website speed: YSlow (a Firefox extension); Google Page Speed (a Firefox add-on); or Webmaster Tools. Once the problem areas have been identified, steps can be taken to make improvements. The goal is to have an interesting and speedy site.

KEY TAKEAWAYS

- The key element in the marketing mix is the product. Without it, price, promotion, and place are moot.
- All products and services have three layers: core, augmented, and symbolic.
- All small businesses have a product mix, the selection of products or services that is offered to the marketplace.
- Product selection is a key element for online success because some products will sell better online than others.
- Product design is the principal reason for emotional attachment or detachment relative to a product, a service, or an experience. It presents a powerful way to differentiate and position a company’s products and services.
- The product or service package communicates both emotional and functional benefits to the buyer, and it can be an important means of product differentiation.
- A company’s brand is probably its most important asset.
- The product life cycle refers to a product’s life span.
- A company’s website is part of its product or service. Website objectives must be developed and decisions must be made about the fundamental design elements of layout, color, typography, graphics, interactivity, usability, content, product display, and performance.

EXERCISES

1. Select two small business websites or use websites specified by your professor. Evaluate the two sites. Be sure to note your impressions of the site’s performance.
2. Frank’s All-American BarBeQue has a very basic website: the store’s location, hours, and some of the menu. Frank’s son, Robert, has extensive experience with website design. How do you think he would advise his father on fully using the website for competitive advantage?

3. For each of the following, describe the core, augmented, and symbolic layers.
    a. a gift shop
    b. a dry cleaner
    c. a dance studio
    d. highway paving materials
4. Some marketers believe that product performance (functions) makes the most difference when consumers evaluate products. Other marketers maintain that the looks, feel, and other design elements of products (form) are what really make the difference. *Make the case:* Product functionality is the key to brand success OR product design is the key to product success.

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6.2.7: Marketing Strategy and Price

Learning Objectives

- Understand the role of price in the marketing mix and to a company.
- Understand the different pricing strategies that a small business can follow.
- Understand price-quality signaling and its importance to the pricing decision.
- Understand that the price of a product or a service lets customers know what to expect from a business.

Marketing, whether online or on-ground, is the only activity that generates revenue for most small businesses, and the price element in the marketing mix accounts for that. **Price** can be defined very narrowly as the amount of money charged for a product or a service. However, price is really more than that. It is "the sum of all values (such as money, time, energy, and psychic cost) that buyers exchange for the benefits of having or using a good or service." Ultimately, the meaning of price will depend on the viewpoints of the buyer and the seller.

Deciding on a price for its products or services is one of the most important decisions that a small business will make. The price of a product or a service must be a price that the company's target market is willing to pay and a price that generates a profit for the company. If this is not the case, the business will not be around for long.

Choosing the right pricing strategy is not an easy thing to do because there are so many factors involved. For example, competition, suppliers, the availability of substitute products or services, the target market, the image and reputation of a business, cost and profit objectives, operating costs, government regulation, and differentiation and positioning decisions will all impact price. Pricing is a complex activity, often seen as an art rather than a science. For small businesses that are marketing or want to market online, pricing strategies are even more complicated. For example, online buyers have increasing power that leads to control over pricing in some instances (e.g., online bidding on eBay). There is also **price transparency** where buyers and sellers can easily and quickly view and compare prices for products sold online, and some companies use **dynamic pricing** by varying prices for individual customers.

There are several pricing strategies available to the small business owner. However, having the lowest price is not typically a strong position for small businesses because larger competitors can easily destroy any small business that is trying to compete on price alone. Think Walmart. The best choice for a small business will be the strategy that helps the business reach its sales and profit objectives, enhances the reputation of the company, satisfies the target market, and sends the correct price-quality signal. **Price-quality signaling** occurs when the cost of a good or a service reflects the perceived quality of that product or service. However, pricing objectives must be formulated before a pricing strategy can be selected.

Pricing Objectives

Pricing objectives (i.e., what the company wants to accomplish with its pricing strategy) should be related to a company's objectives and should follow the decision about where a company wants to position its products or services. Different small businesses in the same industry may have different pricing objectives based on size of the business; in-house capabilities; and whether the focus is on profit, sales, or government action.

- **Sales-based objectives.** Increasing sales volume and market share relative to the competition may involve **penetration pricing**, where a business prices a new product below that of the competition to quickly penetrate the market at the competitor's expense, acquire a large market share, and then gradually raise the price. This objective might be appropriate for a small business that is introducing a new product or service to a very competitive marketplace.
- **Profit-maximization objectives.** Quickly recovering the costs of product development while providing customer value may involve **price skimming**, where a new product is priced higher than that of the competition to maximize profit. This objective would work for a small business with customers who are more concerned with quality, uniqueness, and status rather than price. However, a product's image and quality must warrant the high price.
- **Status-quo-based objectives.** Used to minimize the impact of competitors, government, or channel members and to avoid a sales decline, these objectives are reactive rather than proactive, so they should be adopted for the short term only. Small businesses must be able to meet the needs of their target market.

Pricing Strategy

Once the pricing objectives are set, a small business must determine a pricing strategy. The small business owner can consider a variety of approaches. Discount pricing, cost-based pricing, prestige pricing, even-odd pricing, and geographic pricing are discussed here. In general, traditional pricing strategies can also be applied to the online environment. How goods and services are priced tells consumers a lot about what to expect from a small business.

Discount Pricing

A small business might choose a **discount pricing** strategy if it is looking to drive traffic and sales short term or if it wants to be permanently seen as the value leader in an industry. Discount pricing is used with customers who buy in large quantities, customers who buy during off-peak times (seasonal), promotions used to increase traffic, and **loss leaders** (products that are discounted to get customers in the door in the hope that they will also buy more profitable products). Discount pricing can be used in the online environment in ways similar to brick-and-mortar stores. If the discounting is short-term, inventory can be reduced, and revenues are increased temporarily. An important disadvantage, however, is that customers often associate low price with low quality, particularly if a brand name is unfamiliar. A discount pricing strategy could lead to a product or a service being perceived as low quality. Also, price reductions can be easily matched by the competition, eliminating any but the earliest advantage.

Cost-Based Pricing

Cost-based pricing is a very simple approach. A company figures out how much it costs to make a product or deliver a service and then sets the price by adding a profit to the cost. For example, if it costs a small toy manufacturer $10 to make its signature stuffed animal (taking into account fixed and variable costs) and the company wants a 20 percent profit per unit, the price to the retailer will be $12.

Cost-based pricing is very easy to use. It is flexible (allowing different profit percentages to be added to different product lines), allows for easy price adjustments if costs go up or down, and is simple to calculate. On the downside, cost-based pricing ignores product demand, what the competition is doing with pricing, and positioning, and it provides no incentive for cost efficiencies.

Prestige Pricing

Prestige pricing (or premium pricing) taps into the belief that a high price means high quality. Although this relationship exists in many instances, it is not true in all cases. Nonetheless, prestige pricing is “a strategy based on the premise that consumers will feel that products below a particular price will have inferior quality and will not convey a desired status and image.” A small children’s clothing store that carries only top-of-the-line merchandise would use a prestige pricing strategy. Clothing from this store would be seen as having a higher perceived value than clothing from Macy’s but perhaps comparable in value to clothing from Bloomingdale’s, Nordstrom, or Neiman-Marcus.

Prestige pricing can be very effective at improving brand identity in a particular market. However, it is not typically used when there is direct competition because such competition tends to have a downward effect on pricing. Unique products usually have the best chance of succeeding with prestige pricing.

Even-Odd Pricing

Also known as the “nine and zero effect,” **even-odd pricing** can be used to communicate quality or value. It assumes that consumers are not perfectly rational, which is true. Emotion plays a much larger role in consumer behavior than rationality.

Even-numbered pricing, or setting selling prices in whole numbers (e.g., $20), conveys a higher-quality image. A small, high-end gift shop, for example, would use even pricing for most if not all its products, with odd-numbered prices (e.g., $18.97) used for products that are on sale. Odd-numbered prices give consumers the impression that they are getting a great value. It is a psychological effect with no basis in logic. But it does work in practice.

Geographic Pricing

Some small companies will use a **geographic pricing** strategy. This pricing strategy takes the geographic location of a customer into consideration, the rationale being that distribution can increase product delivery costs and thus the cost of the product. Taxes, the cost of advertising, competitors who benefit from government subsidies, consumer demand, differences in costs of living, and

the general cost of doing business are other factors that enter into the decision to use geographic pricing. Small businesses that sell outside the United States would likely encounter the need for geographic pricing. This strategy might also be appropriate when selling in different states.

KEY TAKEAWAYS

- Marketing is the only activity that generates revenue for most small businesses.
- Price accounts for revenue.
- Determining a price for its products or services is one of the most important decisions that a small business will make.
- There are many factors involved in choosing the right pricing strategy.
- Having the lowest price is not typically a strong position for small businesses.
- Pricing objectives should be created before a pricing strategy is selected.
- In general, traditional pricing strategies can be applied to the online environment.
- Discount pricing, cost-based pricing, prestige pricing, even-odd pricing, and geographic pricing are pricing strategies that can be considered by a small business.
- How goods and services are priced tells consumers a lot about what to expect from a small business.

EXERCISES

1. Frank's All-American BarBeQue is planning to significantly expand its takeout business. Currently, customers come into the restaurant and order from the menu. With the new Darien facility and website, customers will be able to order online or fax an order to the restaurant. Frank and Robert have been arguing over how to structure the takeout portion of their operations. Frank wants to maintain the approach where customers order items from the menu. Robert believes that in today's world, it would be more convenient for customers to order complete prepackaged meals. Father and son have argued about the nature of these meals. Frank has suggests a limited number of standard meals that could be prepared during the day and sold in the evening when commuters are returning home. However, this might mean that excess inventory would be built up on unwanted items. Robert wants to offer greater variety. These would include a main course, two side dishes, and a dessert. Because there could be a large number of combinations, most would have to be made after the receipt of an order. The "rush" to make these meals would drive up costs. How would you go about pricing these two types of meals?
2. Visit two small businesses—one that you think would use even-numbered pricing and one that you think would use odd-numbered pricing. Were you right? If not, how would you describe their pricing strategies? Be as specific as you can.
3. Visit NapaStyle, and analyze its pricing strategy.
4. Select a product or a service that you purchased recently from an on-ground small business and an online small business. The two businesses should be different. Evaluate the price that you paid. What appears to be the pricing strategy of each business? Do you think the price was fair? Why or why not? How would you assess the value that you received for the price you paid? Tip: If you are not sure whether an online business can be considered a small business, type in the name of the business plus "corporate HQ" into Google or your preferred search engine. The search should return results that include the number of employees. As long as the company has fewer than five hundred employees, you are all set.

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6.2.8: Marketing Strategy and Place

Learning Objectives

- Understand the role of place in the marketing mix and the importance of place to a company.
- Understand the different distribution strategies that a small business can follow.
- Explain the importance of logistics to small businesses.

No matter how great a product or a service may be, customers cannot buy it unless it is made available to them on-ground or online or both. This is the role of the **place** P in the marketing mix—to get a product or a service to the target market at a reasonable cost and at the right time. Channels of distribution must be selected, and the physical distribution of goods must be managed.

Channels of Distribution

A small business may choose the direct, retail, wholesale, service, or hybrid channels. In general, business-to-business (B2B) distribution channels parallel those of business-to-consumer (B2C) businesses.

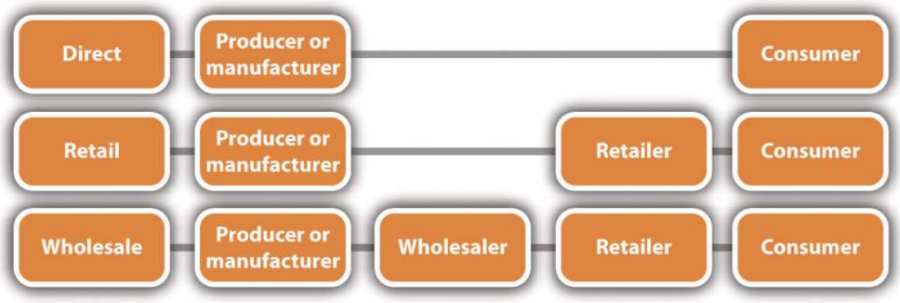


Figure 6.2.8.1: Channels of Distribution, Direct, Retail and Wholesale

Direct Channel

Many small businesses use the **direct channel**. The direct channel involves selling directly to the final consumer with no **intermediaries** (retailers and wholesalers, also known as middlemen) in the process. The direct channel provides close contact with the customer and full control of all aspects related to the marketing of a company's products. The Sugar Bakery & Sweet Shop in East Haven, Connecticut (winner of the Food Network's 2010 "Cupcake Wars"), uses the direct channel, as does the local farmer when selling fruits and vegetables to the local population. Michael Dell started out by selling computers from his dorm room, and the founders of Nantucket Nectars began their business by selling their home-brewed fruit drinks to boaters in Nantucket Harbor. Many B2B sellers also use the direct channel. Consolidated Industries, Inc., for example, sells helicopter parts directly to Sikorsky Aircraft and airline parts directly to Boeing.

Video Clip: Sugar Bakery & Sweet Shop

The story of the winner of the Food Network's 2010 "Cupcake Wars."

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: iPhone App Beefs Up Sausage Sales

How an iPhone app has made business easier and better for a mobile sausage vendor.

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Service businesses use the direct channel because there is no way to do otherwise. Services are performed and consumed at the same time, so there is no role for intermediaries. Tanning salons, home repair services, legal services, real estate services, and medical services all deliver directly to the consumer. Online services are also delivered directly to the final consumer, such as Carbonite and Legal Zoom.

The Internet has increased the opportunities for small businesses to use the direct channel as the only means of distribution or as an additional sales channel. For example, Vermont Teddy Bear in Shelburne, Vermont, uses the Internet as its primary sales channel. Its only other channel is its on-ground factory tours that are offered year-round.

Video Clip: Vermont Teddy Bear Company

How the company started and how it has grown. It now makes 5,000 bears a day.

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Retail Channel

Many small businesses may choose to produce or manufacture products and distribute them to retailers for sale. This is considered an **indirect channel** because the retailer is an **intermediary** between the producer or manufacturer and the final consumer. If a small business that makes one-of-a-kind, handcrafted picture frames sells its frames to a picture-framing business that in turn sells the frames to its customers, this would be an example of using the retail channel. An online business that sells products made by several producers or manufacturers would also be using the retail channel—and would be called an e-tailer.

Video Clip: Future Vision of Retailing

Microsoft's vision of future retailing.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: YOUReality Retail Visualization Product

A new software product that enables customers to interact with products in their own space—really, really cool.

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Although selling through retailers may expand the distribution coverage to a small business's target market, the business must give up some control over pricing and promotion. In addition, the business should expect to get a wholesale price from the retailer that is significantly lower than what it would get if it sold directly to the final consumer.

Wholesale Channel

Wholesalers are also **intermediaries**. A wholesaler is "a [large or small] business that sells to retailers, contractors, or other types of businesses (excluding farms), but not to the general public (or at least not in any significant amount)." A small business that chooses to use wholesalers is also using an **indirect channel** of distribution. Using a wholesaler makes sense when a business makes a product that it wants to sell in many stores that would not be easily or conveniently reachable through the direct channel or the retail channel. For example, Kathleen King's small gourmet baked goods company (now known as Tate's Bake Shop) earns much of its annual revenue from the wholesale distribution of its baked goods to approximately one hundred gourmet shops on Long Island, in New York City, and in other states. Her products can be viewed online at www.tatesbakeshop.com, and her story—including some valuable business lessons that she learned along the way—can be viewed in the following video.

Video Clip: Tate's Bake Shop

The story of Kathleen King's gourmet baked goods business—and some important business lessons learned.

A YouTube element has been excluded from this version of the text. You can view it online here.

Although any small business that uses wholesalers will see a reduction in profit, there are several advantages to wholesaling. For example, wholesalers are able to sell and promote to more customers at a reduced cost, they can deliver more quickly to buyers because wholesalers are closer to them, and wholesalers can inventory products, thereby reducing inventory costs and risks to their suppliers and customers. Small businesses that produce only one or a few products commonly use the wholesale channel of distribution. Retail outlets may not be placing orders from the small business because it is not known. The wholesaler can put the product in front of them.

Multichannel Distribution

A small business may choose a **multichannel distribution system (or hybrid channel)**. This channel option uses two or more channels of distribution to reach one or more customer segments, offering customers multiple purchase and communication options. The multichannel approach offers three important advantages:

1. **Increased market coverage.** More customers are able to shop for a company's product in more places, and customers who buy in more than one channel are often more profitable than one-channel customers.
2. **Lower channel cost.** Selling by phone or online is cheaper than selling via personal visits to small customers.
3. **More customized selling.** A technical sales force could be added to sell more complex equipment.

The hybrid approach works well for small businesses. Tate's Bake Shop sells directly through its store in Southampton, New York, and online. It sells indirectly to gourmet retailers such as Sugar and Spice in Chappaqua, New York, through its wholesalers. Local restaurants also use the multichannel approach when customers can order online or by phone and then pick up the food at the restaurant.

Physical Distribution (Logistics)

Physical distribution (logistics) involves "all the activities involved in the physical flow and storage of materials, semifinished goods, and finished goods to customers in a manner that is efficient and cost-effective." Logistics can be performed by the producer or the manufacturer, intermediaries, or the customer. Deciding on the right logistics solution may be the differentiator that puts a company ahead of its competition. Logistics are relevant to both online and on-ground companies.

The costs of logistics can account for as much as 10–35 percent of a company's gross revenues, so any money that can be saved can lead to more affordable products for consumers and increased profitability. The costs will vary by several factors (e.g., industry sector, company location, and company size). Retailers that offer a wide assortment of products will spend more on logistics because transportation and storage costs will increase as the number of carried products increases.

Video Clip: Logistics

UPS Commercial: We Love Logistics. A fun insight into what logistics are all about.

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Logistics involve the following four primary functions: transportation, warehousing, inventory control, and order processing.

1. **Transportation.** The transportation choices for a small business will determine whether products will arrive at their destination in good condition and on time. Transportation costs will increase product price. The choices include truck, rail, air, water, and pipeline. Table 6.2.8.1: compares these choices. The selection of the best mode or combination of transportation modes depends on a variety of factors, including cost, speed, appropriateness for the type of good, dependability, and accessibility. All these things will affect customer value and customer satisfaction.

Table 6.2.8.1: Characteristics of Different Modes of Transportation

Mode	Percentage of Total Transportation	Cost	Speed	Product Examples*
Rail	42	Medium	Lower	Coal, stone, cement, oil, grain, lumber, and cars
Truck	28	Higher	Higher	Perishables, clothing, furniture, and appliances
Pipeline	16	Lower	Low	Oil, gas, chemicals, and coal as a semifluid
Water	13	High	Low	Coal, stone, cement, oil, grain, and cars
Air	0.4	High	High	Jewelry, perishables, electronics, wine, and spirits

*Small businesses are represented in each of the product examples given.

Source: Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 308.

2. **Warehousing.** Producers and manufacturers must store goods before they are sold because production and consumption rarely match. Some inventory may be kept at or near the point of production or manufacture, but the rest is located in warehouses. Some warehouses also provide assembly, packaging, and promotional display construction services…all for a fee, of course.
3. **Inventory control. Inventory control** is about ensuring that goods are where customers want them when they want them. In other words, it is about avoiding the "out of stock" situation that irritates customers. Small-business owners must understand how much inventory will be needed to address their customers' needs on a timely basis and at the appropriate cost (think pricing strategy). High inventories are undesirable because they may lead to obsolete products, depressed sales of new models, and liquidation prices that may change customer expectations in the future. Small businesses should think of inventory as a wasting asset: it does not improve with time and, in fact, becomes less valuable with every day that passes—taking up space and incurring heat, light, power, handling, and interest charges. Every day that shows inventory and no sales will also show no profit. The goal is to keep inventory as low as possible.
4. **Order processing.** Every small business should want to shorten the elapsed time between an order's receipt, delivery, and payment. Although there are typically multiple steps involved, the reality is that the longer the cycle, the lower the customer's satisfaction, the higher the company's costs, and the lower the company's profits. Streamlining the process should be a priority.

There are several things that small businesses can do to increase the efficiency and the effectiveness of their logistics. For example, a business can select a logistics company that is industry-specific (e.g., wine or clothing) because that company will understand the shipping needs of the products or use small business logistics services from UPS or FedEx.

Logistics management also includes supply chain management.

Place and the Website

For small businesses that sell online or hope to sell online, the company website "places" the product or the service in the hands of the customer. As a result, there are several decisions that must be made to facilitate the process so that customers can have a good online experience and be less inclined to abandon their shopping carts and leave the site without making a purchase.

- **Better sorting and searching.** Make it easier for shoppers to find what they are looking for.
- **Multibrand combinations in a single cart.** If multiple brands are carried, make it possible to combine shopping carts across brands and apply promotions on the entire cart.
- **Clarity on price and delivery rate.** Prices and delivery rates should be marked clearly, with no ambiguity.
- **Multiple payment options.** Offer more than credit cards.
- **Check-out options.** Do not require a customer to register before completing checkout.
- **Provide a product search engine.** The larger and more complex the product selection, the more a product search engine is needed. Shoppers can search by product name; product type; price; product attributes, such as color, size, or material; or brand either alone or in combination.
- **Two clicks to buy.** The fewer the number of clicks to buy, the greater the chances that a shopper will do just that.
- **Customer support.** Offer customer support throughout the buying process. Make it easy to communicate with a real person; spell out the company's warranty, refund, and return policies; ensure privacy and security; and let shoppers know if you put cookies on their computers.
- **Fulfilling orders.** Ideally, send each customer an e-mail confirming when the order is completed, remind the shopper to print the order details, and provide a tracking number with a direct link to the carrier's website so that the shopper can follow the progress of shipment.

Shopping cart abandonment, or leaving a website without buying any of the items in the shopping cart, is something that affects almost every Internet retailer, including small businesses. Cart abandonment estimates range from 20 percent to 60 percent. An understanding of why shoppers are abandoning their carts should lead to some serious thinking during website design and operation. Table 6.2.8.2 gives examples of why shoppers abandon a purchase. Because shipping is the number one reason why shoppers abandon their shopping carts, think very carefully about what the shipping charges will be.

Table 6.2.8.2: Why Online Shoppers Abandon Their Shopping Carts

High shipping charges	46%
Wanted to comparison shop	37%
Lack of money	36%
Wanted to look for a coupon	27%
Wanted to shop offline	26%
Could not find preferred payment option	24%
Item was unavailable at checkout	23%
Could not find customer support	22%
Concerned about security of credit card data	21%

“Digital Window Shopping: The Long Journey to ‘Buy’” *McAfee, Inc.*, accessed December 1, 2011, www.mcafeesecure.com/us/resources/whitepapers/digital_window_shopping.jsp.

KEY TAKEAWAYS

- Understand that place is about getting the product or the service to the target market where customers want it, when they want it, and at a reasonable cost.
- A small business may choose the direct, retail, wholesale, service, or hybrid channels or some combination of these channels.
- In general, B2B distribution channels parallel those of B2C businesses.
- The direct channel involves selling to the final customer with no intermediaries involved.
- Service businesses use the direct channel only because services are performed and consumed at the same time.
- The retail channel is considered indirect because the retailer is an intermediary between the producer or manufacturer and the final customer.
- The wholesale channel is also an indirect channel. The wholesaler is placed between the producer or manufacturer and the retailer.
- The multichannel distribution system (hybrid channel) uses two or more channels to reach one or more customer segments.
- Logistics are about getting materials, semifinished goods, and finished goods to customers efficiently and cost-effectively. They can be handled by the producer or the manufacturer, intermediaries, or the customer.
- Logistics include decisions related to warehousing, transportation, inventory control, and order processing. These decisions are relevant to both online and on-ground companies.
- Websites play an important role in “placing” goods and services into the hands of customers.
- It is important to reduce the number of customers who abandon their shopping carts (i.e., leave the website without purchasing the items in their shopping carts).
- Shopping cart abandonment is common among online retailers. Shoppers abandon their carts for a variety of reasons, the most important one being high shipping charges.

EXERCISES

1. In the Appendix, you will find the business plan for Frank’s All-American BarBeQue. This plan examined several possible locations for a second restaurant. Frank and Robert considered several factors when evaluating alternative towns as possible locations. Some of these included population size, average income, travel times, and percentage of population. Based on the data, they selected Darien, Connecticut. Do you agree with the decision? Why or why not? Do you think other factors should have been considered? If yes, what would you recommend?

2. Assume that you own a small business that specializes in gift baskets for children. You have been satisfied with your success so far but are anxious to spread your wings. You sell online as well as on-ground and have received several notes from potential online customers expressing their disappointment that you distribute the gift baskets only in the New England area. You have decided to find out what logistics would be involved in shipping to San Francisco, California; Dallas, Texas; Chicago, Illinois; and Anchorage, Alaska. Discuss the transportation mode(s) that would best fit your company for each area.
3. Visit Levenger, Carbonite, and ZipCar. How do these small businesses get their products or services "into the hands" of the customer? Think broadly and creatively.

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6.2.9: Marketing Strategy and Promotion

Learning Objectives

- Understand the role of promotion in the marketing mix and its importance to a company.
- Understand the different ways that a small business can promote its products or services.
- Explain the differences and similarities in the marketing communications mix of online and on-ground businesses.

Promotion, the fourth P in the marketing mix, is now more commonly referred to as **marketing communications**. Marketing communications can be defined as "the means by which firms attempt to inform, persuade, and remind customers—directly or indirectly—about the products and brands they sell. In a sense, marketing communications represent the 'voice' of the company and its brands and are a means by which it can establish a dialogue and build relationships with consumers." Marketing communications are all about getting the word out about a company's products and services because customers cannot buy what they do not know about, and, in the process, creating more of a two-way relationship with customers than was typical of the more traditional notion of promotion. A further conceptual iteration is the term **integrated marketing communications (IMC)**, which is "the coordination and integration of all marketing communication tools, avenues, and sources within a company into a seamless program designed to maximize the communication impact on consumers, businesses, and other constituencies of an organization." Small-business owners should be familiar and comfortable with all three terms because at least one of them will be the basis of conversations with vendors, employees, and other businesses. However, from a small business management perspective, IMC should be the guiding philosophy for a company.

Prior to selecting and designing any communications, however, objectives must be established for the marketing communications program.

IMC Objectives

Every small business must decide what it wants to accomplish with its IMC plan. Although many IMC plans may be oriented toward a single objective, it is possible for a program to accomplish more than one objective at a time. The problem is that this may be confusing to potential customers. IMC objectives can fall into seven major categories: increase demand, differentiate a product (stressing benefits and features not available from competitors), provide more information about the product or the service (more information seen as being correlated with greater likelihood of purchase), build **brand equity** (the value added to a brand by customer perceptions of quality and customer awareness of the brand), reduce purchase risk (important for new products and gaining new customers of current products), stimulate trial (to build new brands and rejuvenate stagnant brands), and brand recognition. As with all objectives, IMC objectives must meet the SMART (specific, measurable, achievable, realistic, and time-based) criteria.

Marketing Communications Mix

The **marketing communications mix** for a small business, either pure-play or brick-and-click, will consist of some combination of the following major modes of communication: advertising, sales promotion, events and experiences, public relations (PR) and publicity, direct marketing, interactive marketing, word-of-mouth communication, and personal selling. Each mode of communication has its own advantages and disadvantages, which should all be considered carefully before any final selections should be made.



Figure 6.2.9.1:The Marketing Communications Mix *Source: Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 473.*

Advertising

Advertising is "any paid form of nonpersonal presentation and promotion of ideas, goods, or services by an identified sponsor." Advertising is around us all the time—for example, ads are on television and radio, in newspapers and magazines, in train stations and on trains, on the sides and inside of buses, in public restrooms, in taxis, on websites, and on billboards. Ads can also be found in other places, and the locations are limited only by the creativity of the company placing the ads.

Small businesses must choose **advertising media** (e.g., radio, television, newspapers, billboards, the Internet, and magazines) based on its product, target audience, and budget. A local travel agency selling spring getaways to college students, for example, might post flyers on campus bulletin boards, run ads in the campus newspaper (for the students) and local newspapers (for the parents), and run ads on the college radio station. Examples of tried and true advertising media for small businesses include the yellow pages, newspaper and magazine advertising, direct mail, business cards, vehicle advertising, radio and cable television advertising, bench/bus stop advertising, local website advertising, e-mail advertising, eBay listings, community involvement, and cross-promotion (joining forces with other businesses). Even advertising in the big leagues is not out of the question for a small business. Salesgenie.com decided to advertise during Super Bowl XLII in February 2008, choosing to risk major capital to connect with the huge Super Bowl customer base.

Advertising on the Internet is also a consideration for the marketing communications mix of any business with a web presence. According to Lorrie Thomas, author of *Online Marketing*, online advertising "can rocket your web marketing into the stratosphere" if it is done correctly. If not done correctly, however, it will "blast a giant crater in your budget." Online advertising includes the following entities: **banner ads** (image ads that range in size and technical capability); **e-mail advertising** (ads in newsletters, an ad in another company's e-mail, e-mailing a list with a dedicated message, or a company advertising to its own customers with its own e-mail list); **news site advertising** (placing ads on news, opinion, entertainment, and other sites that the audience frequents); **blog advertising** (buying ads directly on popular blogs); **social media advertising** (advertising on sites such as Twitter, Facebook, and LinkedIn); and **affiliate marketing** (company A places an ad for its product on the site of company B; company A then pays company B an agreed-on fee when a customer clicks on the ad and buys something.) Another possibility is Google AdWords. A small business can promote itself alongside relevant Google search results and on Google's advertising network. This allows a business to reach people who are already looking online for information about the products and services that a business offers.

Video Clip: Attracting Consumer Attention through Advertising

Relating ads to the target market, making ads appealing, and including the element of surprise.

A YouTube element has been excluded from this version of the text. You can view it online here.

Advertising offers several advantages to the small business. For example, advertising is able to reach a diverse and geographically dispersed audience; it allows the seller to repeat a message many times; and it provides the opportunity for dramatizing the company and its products through the artful use of print, color, and sound. However, the audience does not feel obligated to pay attention or respond to an ad. Whether the advantages of advertising outweigh the costs and disadvantages is something that must be decided by each small business.

Sales Promotion

Given the expense of advertising and the fact that consumers are exposed to so many advertising messages every day, many companies correctly believe that advertising alone is not enough to get people to try a product a product or a service. Enter lower-cost sales promotion techniques. **Sales promotion** refers to the variety of short-term incentives to encourage trial or purchase of a product or a service. Examples of commonly used sales promotions include contests, sweepstakes, coupons, premiums and gifts, product samples, rebates, low-interest financing, price discounting, point-of-sale displays, and frequent user or loyalty programs. These promotions can be used by and offer several advantages to small businesses:

- **Attracting new customers with price.** A reduced price could lure customers away from the competition. For example, a small electronics store that is competing with a large retailer could offer a discounted price on a popular cell phone for a limited time.
- **Gain community favor.** By offering a promotion that helps a worthy cause, you can create a good name for the business. Donate a portion of sales to the local food bank, buy clothing for the homeless, or donate to the local animal shelter to help pay veterinarian bills.
- **Encourage repeat purchases.** Rewards and loyalty programs can be very successful for small businesses. Coffee clubs are popular (buy so many coffees at the regular price and you get one cup free), but this approach can work for sandwiches at a deli, bags of bird food or dog food at the local pet store, shoe repairs at the local cobbler, dry cleaning services, and virtually any other kind of business.
- **Entice reluctant customers.** Giving away a free product or service is usually a good way to get people to try a product or a service for the first time, the hope being that it will lead to a purchase. However, the product or the service has to be good enough to stand on its own so that when the “free” unit is gone, the person will come back to buy.
- **Providing information.** It can be very effective if you run a promotion that helps provide information to potential customers to help them make a decision. This works especially well for products or services that are complicated or unfamiliar to customers, for example, software or product usage (particularly for business-to-business [B2B] customers), financial services, investment services, or estate planning. Free on-ground seminars or **webinars or webcasts** (seminars or presentations that are delivered online and that are typically an hour in length) can be very effective at gaining new customers or clients.

Sales promotions can be delivered to the customer in a variety of ways, such as snail mail (US Postal Service), in person, in local new newspapers and regional editions of national magazines, on television and radio, in e-mail, on websites, and in electronic coupons that are sent to a customer’s mobile device. Groupon, which is described as the hottest thing in retail marketing right now, offers customers coupons at local businesses: everything from restaurants to spas to painting lessons to sleigh rides.

Video Clip: Learn How Groupon Works!

A hot new source of coupons for local businesses.

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Events and Experiences

Events and experiences are “company-sponsored activities and programs designed to create daily or special brand interactions.” A small business could choose to sponsor a Halloween costume event for pets or an entertainment event, such as a battle of the bands, to raise money for local scholarships. Participation in a local business fair could provide exposure for a product or a service and the opportunity to experience the product if that is possible. A local restaurant could participate in a chili competition. Factory tours and company museums, both of which can also be virtual, can offer great experiences for customers.

There are several advantages to events and experiences: (1) A well-chosen event or experience can be very effective because the consumer gets personally involved. (2) Experiences are more actively involving for consumers because they are real time. (3) Events are not hard sell, and most consumers will appreciate the softer sell situation.

Events and experiences also tap into the importance of the customer experience. Today, customers "want products, communications, and marketing campaigns to deliver experiences. The degree to which a company is able to deliver a desirable customer experience—and to use information technology, brands, and integrated communications and entertainment to do so—will largely determine its success." By having special events, a small business will stand out from the rest, and they will create desirable publicity for the company.

Public Relations and Publicity

Public relations (PR) and **publicity** are designed to promote a company's image or its individual products. A small business can also use PR to clarify information in response to negative publicity. (Publicity usually being "an outcome of PR that is produced by the news media and is not paid for or sponsored by the business involved.") Traditional PR tools include press releases and press kits that are sent to the media to generate positive press on behalf of the business. A press kit, the most widely used PR tool, pulls together company and product information to make a good, solid first impression. (Be sure to print the company's website address on everything.) A press kit can be particularly useful for small businesses, although the smallest of businesses may not see the need. Other common platforms include speeches, seminars (online and offline), brochures, newsletters, annual reports, charitable donations, community relations, and company magazines. Increasingly, companies are using the Internet: interactive social media, such as blogs, Twitter, and Facebook; home-page announcements for specific occasions (e.g., messages of sympathy for the victims of a disaster); and e-mail.

Social media services such as Google Alerts and TweetBeep can be very helpful for managing a company's reputation. **Reputation management** "is the process of tracking other's opinions and comments about a company's actions and products, and reacting to those opinions and comments to protect and enhance the company's reputation." Both services notify the business when the company name is mentioned. Addressing extremely negative comments immediately is very important for any small business with a web presence.

Most small businesses are not likely to have PR departments. Instead, there will be one person whose job includes—among many other things—PR and publicity. The key is for PR and marketing to work closely together so that "every piece of communication produced by the company speaks with one voice."

Getting publicity for a small business is usually free. Stories about events and experiences might be of interest to the media. One great idea is to have a group of people outside the business with positive picketing, holding signs such as "Low prices" or "Beware of friendly employees." This was actually done by a small business, and it resulted in the business being on the front page of the local paper.

PR and publicity tend to be underused by all businesses. However, PR and publicity should be particularly appealing to the small business because of the following three distinct qualities:

- **High credibility.** News stories and features are more authentic and credible to readers.
- **Ability to catch buyers off guard.** PR can reach prospects who prefer to avoid salespeople and advertisements.
- **Dramatization.** PR has the potential for dramatizing a company or a product.

Direct Marketing

Direct marketing is the "promotion of a product from the producer directly to the consumer or business user without the use of any type of channel members." Common direct marketing platforms include catalogs; direct mailing; telemarketing; television shopping; electronic shopping; fax mail; voice mail; blogs; websites; e-mail; direct response radio, television, and Internet; social media, such as Facebook and Twitter; and mobile devices. Because channel members are bypassed, direct marketing normally allows for greater profitability; perhaps more importantly, however, it can develop stronger brand loyalty with customers.

Video Clip: What Is Direct Marketing?

A brief explanation of direct marketing.

A YouTube element has been excluded from this version of the text. You can view it online here.

Direct marketing is about using information to educate, establish trust, and build a company (or someone in it) as an authority. This can be accomplished in multiple ways, such as website copy, a one-time piece of direct mail, a series of articles that build on one

another, a webcast or webinar, or a blog. There is no one more qualified to educate the market about a need than a small business owner: “They’re the ones who will know their audience and what they’ll find unique, irresistible, and compelling. They’re the best people to craft the message. Everything else in the organization can be outsourced, but the knowledge that a small business owner has about the people they serve, that can’t be replicated.”

Direct marketing offers several advantages to both the business-to-consumer (B2C) and B2B small businesses:

- **Flexible targeting.** A business can identify, isolate, and “talk” with well-defined target markets. This can translate into a higher conversion and success rate than if you tried to communicate with everyone in the mass market.
- **Customized messages.** Can be prepared to appeal to the addressed individual.
- **Up-to-date.** Messages can be prepared quickly.
- **Multiple uses.** Direct marketing can be used to sell, but it can also be used to test new markets, trial new products or customers, reward existing customers to reward loyalty, collect information for future campaigns, or segment a customer base.
- **Lower cost per customer acquisition.** The cost can be significantly less than other marketing methods.
- **Control and accountability.** Direct marketing offers great control and accountability than other marketing methods.
- **Swift and flexible.** Direct marketing is swift and flexible in achieving results.

Interactive Marketing

Interactive marketing refers to “online activities and programs designed to engage customers or prospects and directly or indirectly raise awareness, improve image, or elicit sales of products and services.” Everything is personalized and individualized—from the website content to the products being promoted. The audience is engaged with the brand, with customers getting the chance to reshape and market it in their own unique way. Forrester Research forecasts that interactive marketing expenditures will reach $55 billion by 2015, accounting for 21 percent of all expenditures on marketing. The greatest growth is projected to come from social media, with the next biggest growth sector being mobile marketing.

Common interactive marketing tools include e-mail, websites, online shopping, videos, webinars and webcasts, blogs, and social media such as Facebook and Twitter. Because e-mail, websites, online shopping, webinars and webcasts have been mentioned previously, the focus here will be on videos, blogs, and social media. Using online videos has become an increasingly popular strategy in small business marketing. Consumers are much more likely to visit a company after viewing its video, and they can be up to 40 percent more likely to make some sort of contact. Online video content is becoming increasingly popular with avid Internet users, so a small business should consider creating a video for its website. The content can be created easily, and it can be posted on the company’s website as well as in other locations on the Internet (YouTube or on the company’s blog, for instance) to get more page views. According to Ad-ology’s 2011 Small Business Marketing Forecast, 45 percent of US small businesses with fewer than 100 employees plan to use online video. This reflects the fact that small businesses are becoming increasingly savvy about how to use the Internet to market their products and services. Paul Bond Boots, a small US maker of custom-made cowboy boots that are individually handmade to fit, features five really cool videos on its website. Recently, the company has turned to the Internet for most of its sales.

A **blog** “is a web page made up of usually short, frequently updated posts that are arranged chronologically—like a what’s new page or a journal.” Business blogs, as opposed to personal blogs, are used as a company communication tool to share a company’s knowledge and expertise, build additional web traffic, connect with potential customers, develop niche markets, give the business a human face, help reputation management, and provide a free avenue for press releases. For an example, visit Michael Chiarello’s blog at www.michaelchiarello.com. If his name is not familiar, he is the founder of NapaStyle, a high-end small business retailer with both an on-ground and online presence.

Blogs are fairly simple to set up, and they are a great way to keep website content fresh. However, even though small businesses hear much about blogs these days, creating one must be considered carefully. Blogs today “have evolved into multimedia communities where bloggers (and the blogging community) have grown in size, stature, and impact to eclipse all but the largest media outlets.” But this does not mean that it is essential for every small business to have a blog. Maintaining a blog takes a lot of time and energy—and then there need to be people to read it. After careful consideration, it may be better to focus a company’s promotional efforts elsewhere.

Social media "generally refers to websites featuring user-generated content or material created by visitors rather than the website publishers. In turn, these sites encourage visitors to read and respond to that material." Social media is changing the way that people communicate and behave. Social media outlets such as Facebook, LinkedIn, and Twitter are, among other things, driving purchases—and they should be seen "like a virtual cocktail party where all attendees can discuss [a company's] products, services, experiences, and new ideas."

The top four social media networks are Twitter, Facebook, LinkedIn, and YouTube. This is true in general and for small businesses in particular. Overall, small businesses use social media sites for lead generation, monitoring what is being said about their businesses, keeping up with the industry, improving the customer experience, and competitive intelligence. Many small businesses in the B2B sector are already using social media for business as a resource, to engage in initiatives, or both. However, companies with more than one hundred employees are more active than smaller companies.

Despite the hype surrounding social media, and the fact that many small businesses are already connected, small businesses must still consider the use of social media just as carefully as the other modes of marketing communications. Social media has not worked out well for some small businesses that have used it, so each business must decide what social media is expected to do for the company, and then it must be used well and strategically. When considering whether or how to factor social media into an IMC strategy, consider these words from Lisa Barone, co-founder and chief branding officer at *Outspoken Media*, "In 2011, if you're not using social media to gain attention over your competitors, you can bet they're using it to gain attention over you." This will undoubtedly continue to be the case.

Video Clip: Social Media

The top five things you should know about social media.

A YouTube element has been excluded from this version of the text. You can view it online here.

Personal Selling

A small business owner needs to connect with customers before a sale can take place. Sometimes personal selling is the best way to do that. **Personal selling**, "the process of communicating with a potential buyer (or buyers) face-to-face with the purpose of selling a product or service," is absolutely essential in the marketing communications mix of a small business. History has shown that the most successful entrepreneurs have been skilled salespeople who were able to represent and promote their companies and products in the marketplace. It stands to reason that successful small business owners should have the same sales skills.

Although personal selling plays an important role in the sale of consumer products, it is even more important in the sale of industrial and business products. More than four times as many personal selling activities are directed toward industrial and business customers than toward consumers. Regardless of the type of customer or consumer, however, the objectives of personal selling are the same:

- **Building product awareness.** A salesperson should educate customers and consumers on new product offerings.
- **Creating interest.** Because personal selling is a person-to-person, and often a face-to-face, communication, it is a natural way for getting customers and consumers to experience a product for the first time. Creating interest goes hand-in-hand with building product awareness.
- **Providing information.** A large part of the conversation with the customer focuses on product information.
- **Stimulating demand.** The most important objective of personal selling by far is persuading customers and consumers to make a purchase.
- **Reinforcing the brand.** Most personal selling focuses on building long-term relationships with customers and consumers. However, strong relationships can be built only over time, and they require regular communication.

Like all other forms of marketing communications, personal selling offers both advantages and disadvantages. On the plus side, personal selling is flexible and dynamic, providing companies with the best opportunity to tailor a message to satisfy customers' needs. Personal selling's interactive nature also makes it the most effective promotional method for building relationships with customers, particularly in the B2B market, and it is the most practical promotional method for reaching customers who are not easily reached through other methods. Personal selling can help a small business build strong, loyal relationships with customers and consumers.

On the minus side, the biggest disadvantage may be the negative perceptions that many people have of salespeople: pushy, annoying, slippery, and willing to do anything for the sale—whether legal or not. The reality, of course, is that most salespeople (unfortunately, not all) do not fit this stereotype. The successful salesperson is the person who focuses his or her efforts on satisfying customers over the long term as opposed to his or her own selfish interests. Also on the negative side is the high cost of personal selling. Personal sales contacts are very expensive, with the costs incurred (compensation plus sales support) whether the sale is made or not. Then there are the costs of training the sales staff on product knowledge, industry information, and perhaps selling skills. Depending on the size of the company, small businesses will have varying numbers of salespeople, so some of the costs will vary as well.

The traditional sales process is typically seen as a series of six steps:

1. **Prospecting and qualifying.** Locating potential customers who have a need for a product and the ability to pay for it. For example, prospects for a small electric motor company would be all the businesses that use small electric motors. Prospects can be found through a variety of sources, including current customers, trade directories, business associates, and newspaper or magazine articles.
2. **Preapproach.** It is important to learn as much about a prospect as you can. For example, you want to know about the prospect's needs, attitudes about available products and brands, critical product attributes and benefits desired, and current vendor(s).
3. **Presentation and demonstration.** This is where the salesperson tells the product "story" to the buyer: the product's features, advantages, benefits, and value. It is important not to spend too much time on product features because benefits and value will most directly influence the purchase decision. It is also important to ask questions and listen carefully to a prospect's answers because they will provide valuable insights into the prospect's needs.
4. **Overcoming objections.** You should expect customers to pose objections. The key to overcoming these objections is to maintain a positive approach, ask the prospect to clarify the objections, and respond to the objections by reiterating the major benefits of the product or the service and pointing out additional features, guarantees, service, and anything else that would address the objections.
5. **Closing.** This is when the salesperson asks the prospect to buy the product. The request can be direct, or the salesperson can encourage the purchase by using a trial closing approach like asking, "Would you like us to finance product A for you?" Closing the sale is understandably the most difficult step for many salespeople because of the fear that the prospect will say no.
6. **Follow-up and maintenance.** These activities are necessary for customer satisfaction and repeat business. They are key to establishing the strong long-term relationships that every small business desires and needs. The salesperson should schedule a follow-up call to ensure proper installation, instruction, servicing, and troubleshooting and resolution should any problems be detected. Always remember that unhappy customers will defect to competition—and they will spread negative comments about the company. Because it is much cheaper to retain an old customer than to obtain new ones, it is in a company's best interests to provide good follow-up and maintenance services.

Although these steps are helpful as a way to summarize the kinds of things that are relevant to personal selling, the Internet has revolutionized the selling process. The traditional process just described has become largely obsolete, with roles changing. Web searches and online content help prospective customers or clients do their own prospecting and qualifying. This eliminates the most time-consuming part of the traditional sales process. A company's website becomes the first sales presentation and, as a result, is critical in moving a prospect toward a sale. In short, all employees must be fully integrated into web marketing because web marketing is the primary driver of the sales process. The more web-savvy you are, the greater the chances that your selling will beat the competition.

Video Clip: Small Business Selling

An overview of personal selling.

A YouTube element has been excluded from this version of the text. You can view it online here.

KEY TAKEAWAYS

- Promotion and marketing communications are relatively synonymous terms.
- IMC is about pulling all the marketing communications together to convey a consistent message.

- Small-business owners should be familiar and comfortable with the terms *promotion*, *marketing communications*, and *integrated marketing communications (IMC)*.
- There are multiple categories of IMC objectives.
- The marketing communications mix for a small business will consist of some combination of advertising, sales promotion, events and experiences, PR and publicity, direct marketing, interactive marketing, and personal selling. This mix is applicable to both pure-play and brick-and-click businesses.
- There is a lot of hype about blogs and social media. They can be very effective, but they have not worked well for all small businesses that have used them. They should be considered carefully before inclusion in a company's IMC strategy.

EXERCISES

1. Frank's All-American BarBeQue has historically taken a very low-key approach to promoting the business, choosing to rely on word-of-mouth communication. Robert believes that Frank needs to increase the sophistication of the marketing communications. Design an IMC plan for Frank's BarBeQue. Keep the following in mind: (1) Frank's is a small business with a very limited IMC budget; (2) advertising in prime time and national television are not options; and (3) Frank's is selling both food and its BBQ sauces.
2. Choose two products or services that you purchased recently from small businesses, one from an online business and one from an on-ground business. The products should be different from those chosen for price. For each product or service, identify the various media that were used to promote the product or the service and analyze the marketing communications mix. Do you agree with the marketing communications mix that was used? What recommendations would you make for change? Tip: If you are not sure whether an online business can be considered a small business, type in the name of the business plus "corporate HQ" into Google or your preferred search engine. The search should return results that include the number of employees. As long as the company has fewer than five hundred employees, you are all set.

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6.2.10: The Three Threads

Learning Objectives

- Understand the role of marketing strategy in delivering customer value.
- Explain how marketing strategy can positively and negatively impact cash flow.
- Explain how digital technology and the e-environment are impacting marketing strategy.

Customer Value Implications

Marketing plays a key role in creating and delivering value to the customer, but it is the establishment of a strong link between customer value requirements and the major value-producing activities of a firm that is the foundation on which the delivery of superior customer value is based. Marketing strategy provides that strong link.

A customer's decision to buy will always be contingent on the strategic effectiveness of the marketing mix: the ability of the product or the service to meet the needs, wants, and desires of the customer; a price that is attractive when compared with possible alternatives; the availability of the product or the service in an on-ground or online place that is in sync with the customer's needs; and an integrated marketing communications (IMC) program that creates awareness, provides information, and persuades. Although the different elements of the marketing mix will be of differing importance depending on the customer and the situation, it all begins with the product. Well-designed and well-made products will usually come out ahead on the customer value scale. Innovative channels of distribution, such as Redbox for DVDs, gourmet and ethnic food carts, kiosks in airports for selling small electronics products, and conducting financial transactions on a smartphone, can all add to customer value. Social media as a part of the IMC mix can be a particularly great way to create customer value because a consumer's social network can be used as a communication channel to spread the word about a product's characteristics, quality, benefits, and value. Salespeople also create value for customers by helping to identify creative and cost-effective solutions to customer problems, making the customer buying process easier, and creating a positive customer experience. Pricing is always tricky, but there should be a clear and positive link between the price that customers pay and what customers see as the value received in return.

Cash-Flow Implications

An efficient and effective marketing strategy will keep costs down and stimulate sales. A small business owner could not ask for more as a way to realize a positive cash flow. However, the reality is that things will not go as planned most of the time, and this will wreak havoc with cash flow. This means that the marketing strategy should be developed and implemented within the context of a cash-flow strategy so that when things do not go as planned, you can make appropriate adjustments.

One of the biggest temptations for creating cash flow when money is tight is cutting the price as a way to stimulate sales. Think very carefully before doing this. The price reduction may generate more sales, but you may send unintended negative signals to customers about quality and value. You may also trigger a price cut by competitors that eliminates the benefits of your own price cut. A better strategy would be to maintain the price and offer the customer more value—as long as that additional value does not end up costing you more in money in the long run.

Digital Technology and E-Environment Implications

The opportunities for using digital technology and the e-environment in marketing strategy have exploded as the technologies continue to develop and become more sophisticated. Strategic decisions can be made more quickly, with information that can be compiled and analyzed more completely and faster than ever before. The Internet offers an information bonanza and myriad opportunities for implementing the marketing strategy.

Mobile commerce continues to be one of the biggest trends to affect small business owners. More than 48 percent of Americans who own smartphones use them for shopping, so integrating mobile commerce into the marketing strategy should be strongly considered. Many small businesses that already use mobile commerce are seeing positive results. Aaron Maxwell, founder of Mobile Web Up, reported that one client has already seen 10 percent growth per month. Since early 2011, small companies have increasingly been drawn to **quick-response (QR) codes** to target customers on the go. These high-tech bar codes are scanned with smartphone cameras, after which company and/or product content pops up on the screen. The customer then chooses to act or not

act based on the content. The Ethical Bean Coffee Company in Vancouver, British Colombia, uses this technology in its train ads. Customers scan the code in an ad, a coffee menu pops up on their screens, and they can order a cup of coffee to be picked up at one of the Ethical Bean coffee shops. There are some challenges with using this technology, including cost, but it is worth considering for the marketing communications strategy.

Mobile technologies, such as wireless Internet and cellular Internet access, have significantly impacted personal selling, making it possible for salespeople to access needed information at any time. Key business applications are increasingly being made available through a browser rather than being loaded on a salesperson's computer—again being accessible anywhere or anytime. Online video conferencing and web or phone conferencing allow for electronic presentations in lieu of face-to-face meetings. Sales training can be delivered over the Internet, and RSS feeds or e-mail enable salespeople to be notified quickly when new training material is available.

The marketing strategy of a small bank could include targeting the increasing number of small business owners that are starting to do their banking on the go. Customers can check balances, transfer funds, and take and send pictures of checks for remote deposit. It has been estimated that at least 50 percent of small businesses will do their banking through mobile devices by the end of 2013. For the very small business, raising cash to proceed with the marketing strategy can actually be done through **crowdfunding**, the practice of securing small amounts of money from multiple contributors online. Margaret Broom of New Haven, Connecticut, used Peerbackers.com to raise money for renovating a new space for a yoga studio. In 45 days she raised $10,000 from more than 100 contributors, with average contributions of $15 to $20. The funds do not need to be paid back because they are contributions. However, some businesses give their contributors products or services from the business as an appreciation.

Video Clip: Susie's Lemonade

How wireless technology can provide communication and distribution support.

A YouTube element has been excluded from this version of the text. You can view it online here.

KEY TAKEAWAYS

- Marketing strategy plays a key role in delivering customer value.
- Marketing strategy should be developed within the context of a cash-flow strategy.
- Digital technology and the e-environment continue to offer significant opportunities for small businesses.

EXERCISE

You run a small, specialized electronics firm that produces unique and highly sophisticated products. Your sales are evenly split between military contracts and commercial aviation. Two years ago, during a recent economic downturn, your business was under considerable cost pressure. To reduce costs, you switched from two American-based suppliers to a Taiwanese manufacturer. Last week, a national newspaper released a story that revealed that this Taiwanese manufacturer was using counterfeit chips produced in mainland China. This is clearly illegal, but things were made even worse by the speculation that the Chinese-made chips might be mechanisms that could be used in cyber warfare. It looks as though there will be at least one congressional investigation that will examine the national security issues associated with the counterfeit chips. Unfortunately, your firm was prominently mentioned in the article as one of the firms that had purchased a large number of these chips. This could have a major impact on a firm of your size.

1. What should you do?
2. How would you develop a marketing communications plan to deal with this crisis?
3. How would you deal with the anticipated cash-flow crisis?
4. How should you handle the issue of customer value?

Disaster Watch

Robert has spent the last year building his Internet business. He registered his domain name shortly after developing his idea. Three months were then spent waiting for his web developer to create a custom website built to his specifications. Just when Robert thought his online venture was going to die on the vine, his web guru called to ask if Robert wanted to see the site.

Robert quickly typed in the URL of his domain. There, for all to see, was his website. The online catalog was complete, the merchant account had been set up—and has been for two weeks because he has been paying the monthly fees in anticipation of the site launch date. The e-mail at the domain is configured, and Robert's online business is underway.

Search engine optimization helps to drive traffic to Robert's site. He sends out e-mail messages to everyone on his mailing list to let them know that his online venture is now open for business. Sales started slowly, as expected, but they grew steadily. The twenty-third sale was as exciting as the first.

On the morning of the business's one-year anniversary since buying his domain name, Robert goes to the office and turns on his computer with thoughts of checking his e-mail. His e-mail program announces an error. Something about "could not connect to server."

Robert's first thought was that perhaps the hosting company was having a network issue. He decides to wait for half an hour… but gets the same error. He decides to wait another ten minutes and try again. If it still does not work then, he plans to call his hosting company.

Ten minutes go by. The error keeps showing up. One more try. The error pops up again. Robert picks up the phone and calls the hosting company. Once he gets a tech on the phone, he explains the situation, saying that he needs his e-mail up and running so that he can follow up on the orders that came into the store last night. The next ten minutes are spent double-checking settings on the e-mail program. Still nothing works.

Eventually, someone at the hosting company thinks to check the domain name. **DISASTER!** The domain name had expired at midnight. No business can be conducted, and some people may think he has gone out of business.

What does Robert have to do now?

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SECTION OVERVIEW

6.3: The Marketing Plan

6.3.1: Chapter Introduction

6.3.2: The Need for a Marketing Plan

6.3.3: The Marketing Plan

6.3.4: The Three Threads

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6.3.1: Chapter Introduction

The New Britain Rock Cats were founded in 1983 in New Britain, Connecticut. They are the double-A minor league baseball affiliate of the Minnesota Twins major league baseball club, competing in the Eastern League. The 2011 season marked the 29th anniversary of Eastern League Baseball in New Britain.

There is a rich history of baseball in New Britain, and the Rock Cats are the Nutmeg State's oldest, continuously operating professional sports franchise. From Cy Young Award–winners to most valuable players (MVPs) and batting champions to rookie of the year award winners and all-stars, New Britain has been an enormously productive foundation for major league baseball. Over four million fans have seen professional baseball in New Britain over the years. The Rock Cats have many notable alumni, including MVPs Jeff Bagwell (third baseman) and Mo Vaughn (first baseman). All-stars include Brady Anderson (outfielder), Ellis Burks (outfielder), Aaron Sele (right-handed pitcher), John Valentin (shortstop), and Cy Young Award winner Roger Clemens.



Figure 6.3.1.1: The New Britain Rock Cats. *Source: Reprinted with permission from the New Britain Rock Cats official website: http://web.minorleaguebaseball.com/index.jsp?sid=t538.*

In 2000, the club was sold to a group of investors headed by a local attorney, Coleman Levy, and William Dowling, a former New York Yankees executive vice president. Dowling is the president and CEO of the club, and Levy is the vice president. With a substantially new front office and new increased promotions, the club saw every attendance record fall, passing the 300,000 mark for the past 3 years.

The Rock Cats see themselves as selling affordable family entertainment, not baseball. They target women and children. They integrated the Internet into their marketing activities three years ago and have found it very useful for selling tickets. They also have a Facebook and Twitter presence. About 3 years ago, they spent $5,000 for a professionally prepared marketing research report. As Dowling commented, "It made the company more sophisticated."

The marketing planning process is relatively informal, with everyone participating. There is no formal document. Dowling's philosophy is that if something costs less than $1,000, "go do it." If it costs more than $1,000, "justify it." The Rock Cats are run out of a small office in New Britain. The communication among the staff is regular and effective. Here is an instance in which a formal marketing plan does not seem necessary. Whatever they are doing, it is working just fine. But, as you see in the video, things change quickly in the minor league baseball business and the Rock Cats are now the New Britain Bees and play a summer schedule in a collegiate affiliated league while the Rock Cats have moved up the road to Hartford and are now the Hartford Yard Goats affiliated with the Colorado Rockies

Video Clip: Rock Cats Baseball

A fun look at what the Rock Cats offer to fans.

A YouTube element has been excluded from this version of the text. You can view it online here.

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6.3.2: The Need for a Marketing Plan

Learning Objectives

- Understand why a small business should have a marketing plan.
- Understand the implications of not having a marketing plan.

Many small businesses do not have a marketing plan, choosing instead to market their products and services on an intuitive, sometimes seat-of-the-pants basis. As long as there is regular and effective communication with the rest of the people in the organization, a formal written plan may not be necessary. However, as the business grows and regular and effective communication becomes more difficult, a written marketing plan should be seriously considered. For the small businesses that do have a marketing plan, few actually use it.

There are many reasons why so many small businesses do not have marketing plans. Among the reasons are the following:

- They do not have enough knowledge of marketing.
- They take a scatter-gun approach to marketing.
- They do not know how to go about developing a marketing plan.
- They do not have enough money to do marketing properly.
- They do not have enough time to do marketing properly.
- They do not have good people or resources to help them with marketing.

This tells us that understanding what a marketing plan is all about and how a marketing plan can be put together simply and inexpensively are invaluable parts of a small business owner's tool kit.

What Is a Marketing Plan?

A **marketing plan** "is a written document that summarizes what the marketer has learned about the marketplace and indicates how the firm plans to reach its marketing objectives. It contains tactical guidelines for the marketing programs and financial allocations over the planning period." A marketing plan provides a specific marketing direction for a small business and is a very valuable tool if it is done correctly. Because the ultimate purpose of the plan is to generate efficient, profitable action, the marketing plan should consist of usable, practical instructions that are designed to ensure that resources are properly applied.

Marketing plans can range from a one-page summary to more than one hundred pages. Although it is said by some that the ideal marketing plan length for a stand-alone document (i.e., a document that is not part of the total business plan for a company) is twenty to fifty pages, the length of a marketing plan for a small business can be any length that will satisfy the needs of the business. The page count of the plan may not be a good way to measure the adequacy of the plan. The marketing plan should be measured by readability and summarization. A good marketing plan will provide the reader with a good general idea of its main contents even after only a quick skim in fifteen minutes or less. No matter the length, the plan should be practical, to the point, with useful graphics as appropriate, and worded clearly with no flowery or legalistic language.

The plan should cover one year, which is often the best way to think about marketing for the small company. This is not to say that you should not also think about the long term. It just means that things change more rapidly in the short term. People leave, markets evolve, and customers come and go. Consideration should be given to two to four years down the road.

Because small business owners have very little time to spend on writing an elaborate marketing plan, it is worth considering using software or online templates to put the plan together. One software program is Marketing Plan Pro. The number one best-selling marketing plan software tool for building small business marketing plans for several years, Marketing Plan Pro provides step-by-step guidance, easy forecasts and budgets, customization options, execution guidance, and several sample plans across a wide variety of business types. Marketing plan assistance is also available through the Small Business Administration (SBA) and the Service Corps of Retired Executives (SCORE) program. SCORE—a nonprofit association dedicated to educating entrepreneurs and helping small businesses start, grow, and succeed—is an SBA resource partner that has been mentoring small business owners for more than forty years.

Why Have a Marketing Plan?

A marketing plan is a very important part of the small business roadmap to success. The plan drives action and points the way. There are many good reasons for developing a marketing plan, including the following:

- It forces you to identify the target market. A company's best customers, and hopefully the ideal customer, should be in the target market.
- You get a higher return on investment (ROI). Every dollar will work harder when it is focused.
- It forces you to think about both short- and long-term marketing strategies. Focusing only on the short term can be devastating to the future of the company.
- It provides a basis on which to evaluate a company against its industry or market in terms of strengths, weaknesses, opportunities, and threats.
- You can eliminate waste by building efficiency. Limited resources can be allocated to create the greatest return.
- It will be easier to see where past decisions have helped or hindered the growth of a business. The plan will provide a guide for measuring progress and outcomes.
- It will help you to minimize risk, mistakes, and failures.
- It helps you to establish a timeline, keeping people accountable for the growth and success of operation.
- It gives clarity to who does what, when, and with what marketing tools.
- It lays out a company's game plan. If people leave, if new people arrive, if memories falter, if events bring pressure to alter the givens, the information in the written marketing plan is a reminder of what you agreed on.

What If There Is No Marketing Plan?

In *Alice in Wonderland*, Alice encounters the Cheshire cat. He asks her where she is going. She answers that she does not know. The Cheshire cat answers that any road will take her there. It is clear that Alice did not have a marketing plan. David Campbell has a similar philosophy as reflected in the title of his book: *If You Don't Know Where You're Going, You'll Probably End Up Somewhere Else*. Without a marketing plan, a small business could be moving at great speed…but in the entirely wrong direction.

Because many small businesses seem to operate successfully without a marketing plan, depending on how you want to define successfully, the absence of a marketing plan does not mean automatic failure. However, there are some distinct disadvantages to not having a marketing plan. The following are some examples:

- Not having a marketing plan, whether it be a stand-alone document or a section in the business plan, will put you at a significant disadvantage when trying to get any type of business loan.
- Not having a marketing plan can push a business into a meandering mode that could result in slowed growth, missed opportunities, and ignored threats.
- The target market may not be defined correctly.
- Not having a marketing plan may force you to focus on the short term with little or no attention to the long term. This can be devastating to the future of a company.
- Potential efficiencies will not be realized.
- Risk will likely increase.

In short, not having a marketing plan means that you will not realize the advantages of having one. Even if you are an owner-only business, a marketing plan can provide a discipline and a structure for growing the business—if that is desired. On the other hand, if an owner is perfectly satisfied with where and how things are, a marketing plan will most likely not be helpful. Just remember that change is constant. Without a marketing plan, a business may not be ready for change.

KEY TAKEAWAYS

- Many small businesses do not have a marketing plan.
- There are many reasons why small businesses do not have a marketing plan. One very important reason is that they do not know how to develop a plan.
- A marketing plan provides a specific marketing direction for a small business. The ultimate purpose of the plan is to generate efficient, profitable action.

- Although a marketing plan should cover one year in detail, this does not mean that a business should ignore the longer term.
- There are many reasons why small businesses should have a marketing plan, not the least of which is that a marketing plan can help the business minimize risk, mistakes, and failures.
- Without a marketing plan, a small business could be moving at great speed… but in the wrong direction.
- Not having a marketing plan means that the business cannot realize the many benefits of having one.
- A marketing plan may not be for all businesses. If one is happy with where and how a business is, one may think that a marketing plan is not needed. Remember, though, that change will happen, and a business may not be ready for it without a marketing plan.

EXERCISE

At Frank's All-American BarBeQue, Frank is pleased with the profitability of the business and the standing that the company has in the local community. Not as pleased is Frank's son, Robert, who thinks that the business can be bigger and better. The new store that is opening in neighboring Darien, Connecticut, is a good start, but Robert still thinks that the business is not realizing its full potential. A business plan has been prepared except for the marketing plan section. Robert wants to develop the marketing plan for Frank's, but his father is balking at the idea. His father's position is, "If it ain't broke, why fix it?" Taking the position of Robert, make the case for preparing a marketing plan for Frank's. Think critically when developing your argument, integrating specifics from Frank's business. Resist the temptation to simply list the advantages of having a plan versus the disadvantages of not having a plan. Frank will need to see something much more persuasive than this.

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6.3.3: The Marketing Plan

Learning Objectives

- Understand the components of a marketing plan.

Although there is no universally accepted format for a marketing plan, the requirements can be grouped into the seven sections identified in Figure 6.3.3.1. The marketing plan can be a stand-alone document or a section of the business plan. If it is part of the business plan, it will duplicate information that is presented in other sections of the business plan.

A solid marketing strategy is the foundation of a well-written marketing plan, and the marketing strategy should have on-ground and online components if the small business has or wants to have a web presence. The online portion of the marketing plan should be a plan that can be implemented easily, be changed rapidly as appropriate, and show results quickly.



Figure 6.3.3.1: The Marketing Plan

Executive Summary

The executive summary is a one- to two-page synopsis of a company's marketing plan. The summary gives a quick overview of the main points of the plan, a synopsis of what a company has done, what it plans to do, and how it plans to get there. The executive summary is for the people who lack the time and interest to read the entire marketing plan but who need a good basic understanding of what it is about.

Executive Summary Example

Sigmund's Gourmet Pasta

Note: The marketing plan for Sigmund's Gourmet Pasta is a sample small business marketing plan provided by and copyrighted by Palo Alto Software. Permission has been given to the authors to use this plan as the basis for this chapter. This plan will be used throughout this chapter to illustrate marketing plan concepts. Additional complete sample marketing plans for small businesses are available at http://www.mplans.com.

Sigmund's Gourmet Pasta will be the leading pasta restaurant in Eugene, Oregon, with a rapidly developing consumer brand and growing customer base. The signature line of innovative, premium pasta dishes include pesto with smoked salmon, pancetta, and

peas linguine in an Alfredo sauce, lobster ravioli in a lobster sauce, and fresh mussels and clams in a marinara sauce. Sigmund's Gourmet Pasta also serves distinct salads, desserts, and beverages. All desserts are made on-site.

Sigmund's Gourmet Pasta will reinvent the pasta experience for individuals, families, and takeout customers with discretionary income by selling high-quality, innovative products at a reasonable price; designing tasteful, convenient locations; and providing industry-benchmark customer service. Our web presence enhances our brand.

To grow at a rate consistent with our objectives, Sigmund's is offering an additional $500,000 in equity. Existing members will be given the first option to subscribe to the additional equity to allow each of them to maintain their percentage of ownership. The portion not subscribed by existing members will be available to prospective new investors.

Vision and Mission

The **vision statement** tries to articulate the long-term purpose and idealized notion of what the business hopes to be in terms of growth, values, employees, contributions to society, and so forth—that is, where the owner sees the business going. Self-reflection by the business founder is a vital activity if a meaningful vision is to be developed.

Vision Statement Examples

Mobile News Games: Developer of Mobile Games Relating to Current News Events

> *"Our vision is to provide people with a brief escape of fun over the course of their normal day. We do this by providing them with timely interactive games that they can access on their mobile devices—games that are easy to play and have some connection with current pop culture news."*

Neon Memories Diner

"Neon Memories Diner is a place for family togetherness organized around a common love of the traditional American diner and the simpler times of the '50s and '60s. Neon Memories Diner transcends a typical theme restaurant by putting real heart into customer service and the quality of its food so that its unique presentation and references to times past are just part of the picture."

By contrast, the **mission statement** for the marketing plan looks to articulate the more fundamental nature of the business (i.e., why the business exists). A company's mission is its sense of purpose—the reason why the owner gets up every day and does what he or she does. It captures the owner's values and visions, along with that of the employees (if applicable) and community plus suppliers and stakeholders. It literally is the foundation of a company's future. As such, the mission statement is an important foundation of a business's marketing plan. It is common for the mission statement to appear in the marketing strategy section of the marketing plan. It is also common for the plan to include either a vision statement or a mission statement but not both.

Mission Statement Examples

Disney. "To make people happy."

Coca-Cola. "To refresh the world… in body, mind, and spirit."

Organic Body Products, Inc. (Small Business). "To provide high-quality skincare and body care products to women who want what goes on their bodies to have as high a quality as what goes in their bodies."

Sigmund's Gourmet Pasta (Small Business). "Sigmund's Gourmet Pasta's mission is to provide the customer the finest pasta meal and dining experience. We exist to attract and maintain customers. When we adhere to this maxim, everything else will fall into place. Our services will exceed the expectations of customers."

Situation Analysis

The **situation analysis** gives a picture of where a company is now in the market and details the context for its marketing efforts. Although individual analyses will vary, the contents will generally include relevant information about current products or services, sales, the market (defining it and determining how big it is and how fast it is growing), competition, target market(s), trends, and keys to success. These factors can be combined to develop a **SWOT analysis**—an identification of a company's strengths, weaknesses, opportunities, and threats—to help a company differentiate itself from its competitors.

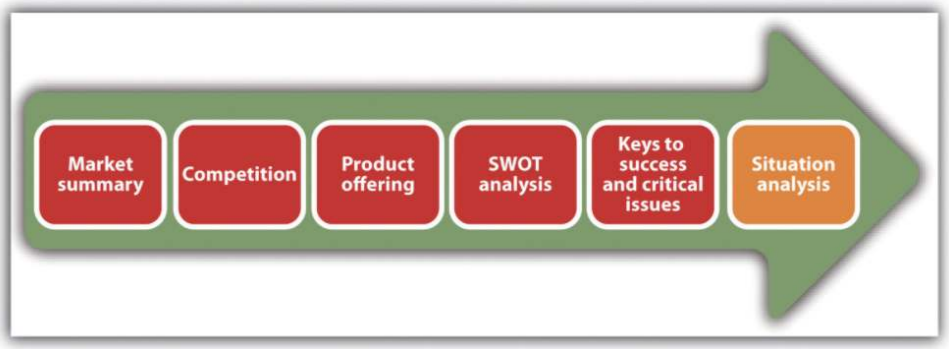


Figure 6.3.3.2: Situation Analysis

As the title implies, the **market summary** summarizes what is known about the market in which a company competes, plans to compete, or both. This summary may be all that is read, so it must be short and concise. The market summary should include a description of the market and its attributes, market needs, market trends, and market growth.



Figure 6.3.3.3: Market Summary

Market Summary Example

Introductory Paragraph: Sigmund's Gourmet Pasta

Sigmund's Gourmet Pasta possesses good information about the market and knows a great deal about the common attributes of our most prized and loyal customers. Sigmund's Gourmet Pasta will leverage this information to better understand who is served, their specific needs, and how Sigmund's can better communicate with them.

The Market and Its Attributes

This section of the marketing plan is where a company's customers are identified. If a business has an online presence or wants to have one, information needs to be generated for online customers as well. Some, perhaps most but not all, of a company's online customers will come from the company's on-ground customers. This depends on the company's marketing strategy. However, a web presence can considerably expand a company's market.

The information that should be provided about customers is as follows:

1. All relevant demographic (e.g., age and gender) and lifestyle or behavior (e.g., activities, interests, and spending patterns) information. This information can be linked to important differences in buyer behavior.

Demographics for Sigmund's Gourmet Pasta

- Male and female
- Ages 25–50, this segment makes up 53 percent of the Eugene market according to the Eugene Chamber of Commerce
- Young professionals who work close to the location
- Yuppies
- Have attended college and/or graduate school
- Income over $40,000"Pasta Restaurant Marketing Plan:

Behavior and Lifestyle Factors for Sigmund's Gourmet Pasta

- Eat out several times a week
- Tend to patronize higher-quality restaurants
- Are cognizant about their health
- Enjoy a high-quality meal without the mess of making it themselves
- When ordering, health concerns in regard to foods are taken into account
- There is a value attributed to the appearance or the presentation of food

2. The location of the customers (local, regional, national, or international). There are often distinct differences in buyer behavior based on geographic location, so it is important to know what those differences are to tap into them. For example, grits are a common breakfast item in the South, but they are not a menu staple anywhere else in the United States.

Geographics for Sigmund's Gourmet Pasta

- Sigmund's immediate geographic target is the city of Eugene with a population of 130,000.
- A 15-mile geographic area is in need of Sigmund's services.

3. An assessment of the size of the market and its estimated growth. There should be enough of a market to justify a business's existence in the first place. Even a niche market must be large enough to offer profitability potential. At the same time, a company will want the market to grow so that the business can grow (assuming growth is desired). If, on the other hand, a company wants to remain small, market growth is not as important—except that it may present opportunities for new competitors to enter the marketplace.

Market Size for Sigmund's Gourmet Pasta

- The total targeted population is estimated at 46,000.
- The target markets are individuals, families, and takeout.

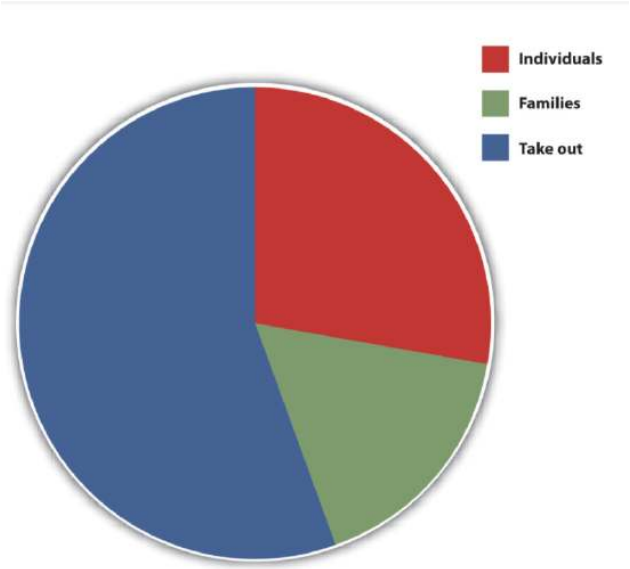


Figure 6.3.3.4: Target Markets—Sigmund's Gourmet Pasta *Source: "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 2, 2011, http://www.mplans.com/pasta_restaura...nalysis_fc.php. Reprinted by permission of Palo Alto Software.*

Estimated Market Growth for Sigmund's Gourmet Pasta

In 2010, the global pasta market reached $8 billion. Pasta sales are estimated to grow by at least 10 percent for the next few years. This growth can be attributed to several different factors. The first factor is an appreciation for health-conscious food. Although not all pasta is "good for you," particularly cream-based sauces, pasta can be very tasty yet health conscious at the same time. Pasta is seen as a healthy food because of its high percentage of carbohydrates relative to fat.

Another variable that contributes to market growth is an increase in the number of hours our demographic is working. Over the last five years, the number of hours spent at work of our archetype customer has significantly increased. As the number of work hours increases, there is a high correlation of people who eat out at restaurants. This is intuitively explained by the fact that with a limited number of hours available each day, people have less time to prepare their meals, and eating out is one way to maximize their time.

Table 6.3.3.1: Projected Market Growth—Sigmund's Gourmet Pasta*

Potential Customers	Growth (%)	2011	2012	2013	2014	2015	CAGR (%)**
Individuals	8	12,457	13,454	14,530	15,692	16,947	8.00
Families	9	8,974	9,782	10,662	11,622	12,668	9.00
Takeout	10	24,574	27,031	29,734	32,707	35,978	10.00
TOTAL	9.27	46,005	50,267	54,926	60,021	65,593	9.27
*All numbers are hypothetical.							
** Compound annual growth rate.							

Source: Adapted from "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, http://www.mplans.com/pasta_restaura...trategy_fc.php.

4. An identification of market needs and how a business plans to meet them. Without knowing and understanding market needs, it is extremely difficult to create a marketing mix that will successfully meet those needs. There are instances of small businesses that are successful because of an intuitive sense for what the market needs, but these businesses may eventually experience

limited growth opportunities because their intuition can take them only so far. Market needs change, so small businesses must adapt quickly to those changes. They cannot adapt to changes they do not know about.

Identifying and Meeting Market Needs for Sigmund's Gourmet Pasta

Sigmund's Gourmet Pasta is providing its customers with a wide selection of high-quality pasta dishes and salads that are unique and pleasing in presentation, offering a wide selection of health-conscious choices, and using top-shelf ingredients. Sigmund's Gourmet Pasta seeks to fulfill the following benefits that are important to their customers:

- **Selection.** There is a wide choice of pasta and salad options.
- **Accessibility.** The patron can gain access to the restaurant with minimal waits and can choose the option of dine-in or takeout.
- **Customer service.** Patrons will be impressed with the level of attention that they receive.
- **Competitive pricing.** All products/services will be competitively priced relative to comparable high-end pasta and Italian restaurants.

5. An identification of market trends. Just as it is important to understand market needs, a small business should be able to identify where the market is going so that its marketing mix can be adjusted accordingly. Capitalizing on market trends early in the game can offer a powerful competitive advantage.

Identifying Market Trends for Sigmund's Gourmet Pasta

The market trend for restaurants is headed toward a more sophisticated customer. The restaurant patron today relative to yesterday is more sophisticated in several different ways.

- **Food quality.** The preference for high-quality ingredients is increasing as customers learn to appreciate the qualitative difference.
- **Presentation/appearance.** As presentation of an element of the culinary experience becomes more pervasive, patrons are learning to appreciate this aspect of the industry.
- **Health consciousness.** As Americans, in general, are more cognizant of their health, evidenced by the increase in individuals exercising and health-club memberships, patrons are requesting more healthy alternatives when they eat out. They recognize that an entrée can be both quite tasty and reasonably good for you.
- **Selection.** People are demanding a larger selection of foods. They no longer accept a limited menu.

The reason for this trend is that within the last few years, restaurant offerings have increased, providing customers with new choices. Restaurant patrons no longer need to accept a limited number of options. With more choices, patrons have become more sophisticated. This trend is intuitive as you can observe a more sophisticated patron in larger city markets such as Seattle, Portland, or New York, where there are more choices. People are also increasingly expecting a web presence for restaurants. This presence includes a website, a membership on Facebook, and oftentimes a Twitter presence. The importance of a website and the use of social media cannot be underestimated.

Competition

Every marketing plan should include an assessment of the competition: who they are, what they offer, their growth rates (if known), and their market share (if known). Market share is defined as the percentage of total sales volume in a market that is captured by a brand, a product, or a company. Think of the market as a pie, with each slice being a "share" of that pie. The larger the slice, the larger the percentage of sales volume captured by a brand, a product, or a company. With all this knowledge, a business will be in the best position to differentiate itself in the marketplace. However, while the sales figures of a business are easily accessible, it is not likely that the owner will have either total market sales figures or growth rate, sales figures, and market share information for the competition. This information, if available at all, is usually available from trade associations and market research firms, with the likelihood being even less if the information desired is about other small businesses. Competitor websites and Internet searches may prove helpful, but because most small businesses are privately held, the information available online will be limited. As a result, you will be restricted in the information that you can collect about the competition to things that can easily be observed in person or are available on company websites. Examples include product selection, price points, service quality, and product quality.

Competition should be addressed in terms of being direct or indirect. **Direct competition** refers to competition from similar businesses or products, whereas **indirect competition** refers to competition from alternative, substitutable businesses or products. In the case of Sigmund's Gourmet Pasta, direct competition would come from other restaurants that serve pasta. Indirect competition would come from other types of full-service restaurants, fast food, the freezer- or prepared-foods areas in the grocery store, delis, preparation services that target the home, and even online businesses that sell prepared foods (DineWise). Many if not most small business marketing plans address only direct competition.

Direct Competition for Sigmund's Gourmet Pasta

1. **National Competition**
   - **Pastabilities.** Offers consumers their choice of noodles, sauces, and ingredients, allowing customers to assemble their dishes as they wish. Food quality is average.
   - **PastaFresh.** Has a limited selection, but the dishes are assembled with high-quality ingredients. The price point is high, but the food is quite good.
   - **Pasta Works.** Offers pasta that is reasonably fresh, reasonably innovative, and at a lower price point. The company was sold a few years ago, and consequently, the direction of management has been stagnant lately, which has resulted in excessive employee turnover.
   - **Perfect Pasta.** Offers medium-priced pasta dishes that use average ingredients, no creativity, and a less than average store atmosphere. Sigmund's is not sure how this company has been able to grow in size as their whole product is mediocre at best.
2. **Local Competition**
   - **Restaurant A.** This is an upscale Italian restaurant with a limited selection of pasta dishes. Although the selection is limited and pricey, the dishes are quite good.
   - **Restaurant B.** An Italian restaurant with a decent pasta selection; however, the quality is inconsistent.
   - **Restaurant C.** An upscale restaurant with a large wine selection and good salads. Everything else is mediocre at best and overpriced. Service can often be poor.

Product or Service Offering

The marketing plan must be very clear about the product or the service that is being offered to the marketplace because the product drives the creation of the marketing mix and the marketing strategy. An error in product identification and definition can wreak havoc in the company and in the marketplace because misdirected marketing actions can occur. The responsibility for the product definitions rests squarely with the owner. For example, if a business is a live theater that features very sophisticated plays, would you define the product as entertainment or art? The answer to this question will have major implications for a company's marketing strategy.

The product or the service offering must also consider a company's website because a web presence will be an important part of what is offered to customers.

Service Offering for Sigmund's Gourmet Pasta

Sigmund's has created gourmet pastas and salads that are differentiated and superior to competitors. Customers can taste the quality and freshness of the product in every bite. The following are the characteristics of the product:

- Sigmund's pasta dough is made with Italian semolina flour.
- All cheeses are imported.
- Vegetables are organic and fresh with three shipments a week.
- Meats are all top-shelf varieties and organic when possible.
- Wines are personally selected by the owner.

At Sigmund's, food is not a product; the experience of dining is a service. Sigmund's prides itself on providing service that is on par with fine dining. This is accomplished through an extensive training program and hiring only experienced employees.

At a Glance—The Prototype Sigmund's Store

- Location: an upscale mall, a suburban neighborhood, or an urban retail district

- Design: bright, hip, clean
- Size: 1,200–1,700 square feet
- For people who dine in, an interactive dining experience will be available through the iPad. A virtual wine cellar application will allow diners to flip through Sigmund's assortment of wines and make an educated decision. Diners will be able to spin the bottles around to view the back label, read reviews, view the vineyard on Google maps, search wine by price and region, and see information about food pairings.
- Employees: six to seven full time
- Seating: 35–45
- Types of transactions: 80 percent dine-in, 20 percent takeout

Sigmund's website will educate prospects with an eye toward encouraging them to try the restaurant and then return. Site visitors will be informed about the menu and the restaurant's commitment to quality in using homemade pasta made with Italian semolina flour, imported cheeses, organic vegetables that are delivered three times a week, and top-shelf meats. The website will not sell things directly.

Prospective customers will be encouraged through the warm and friendly atmosphere of the website. A photo gallery will provide a visual tour of the restaurant to demonstrate its décor and atmosphere. The pages of the website will include the following:

- The mission and vision of the restaurant, including a profile of the founder, emphasizing wine expertise
- A discussion of the commitment to top-quality ingredients and a top-quality customer dining experience
- A slide show virtual tour of the restaurant
- Dining-in and takeout menus
- Directions, hours, and contact information (both telephone and e-mail)
- Links to Facebook and Twitter
- Customer comments

SWOT Analysis

A **SWOT analysis** combines the key strengths and weaknesses within a company with an assessment of the opportunities and threats that are external to the company. This analysis can provide powerful insights into the potential and critical issues affecting a business. A strength is an asset or a resource, tangible or intangible, internal to a company that is within its control. What does the company do well? What advantages does the company have over its competition? You should look to identify the positive aspects internal to a business that add value or offer a competitive advantage. Examples of strengths are the quality of employees, company reputation, available capital and credit, established customers, unique channels of distribution, intellectual property, location, and facilities.

Strengths for Sigmund's Gourmet Pasta

- Strong relationships with vendors that offer high-quality ingredients and fast/frequent delivery schedules
- Excellent staff who are highly trained and very customer attentive
- Great retail space that is bright, hip, clean, and located in an upscale mall, a suburban neighborhood, or an urban retail district
- High customer loyalty among repeat customers
- High-quality food offerings that exceed competitors' offerings in quality, presentation, and price

Video Clip: Rebirth of the American-Made Baseball Mitt

The strengths of the Insignia company.

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A weakness is a factor internal to a company that may cause it to have a less competitive position in the marketplace. A company can have control over this factor and should look to improve or remove it to successfully accomplish its marketing objectives. Weaknesses detract from the value of a business. Examples of weaknesses are lack of expertise, limited resources, bad location, poor facilities, inferior customer service and customer experience, difficulty in hiring and retaining good people, and weak brand recognition.

Weaknesses for Sigmund's Gourmet Pasta

- Sigmund's name lacks **brand equity**. Brand equity is the commercial value of all associations and expectations (positive and negative) that people have of a brand based on all the experiences they have had with the brand over time. The greater the positive brand equity, the more power in the marketplace.
- A limited marketing budget to develop brand awareness.
- The struggle to continually appear to be cutting edge.

An opportunity is an attractive external factor that represents the reason a business exists and prospers. You have no control over opportunities, but you can take advantage of them to benefit the business. Opportunities will come from the market, the environment, or the competition, and they reflect the potential that can be realized through marketing strategies. Examples of opportunities include market growth, a competitor going out of business, lifestyle changes, demographic changes, and an increased demand for a product or a service.

Opportunities for Sigmund's Gourmet Pasta

- Growing market with a significant percentage of the target market still not aware that Sigmund's Gourmet Pasta exists.
- Increasing sales opportunities in takeout business that can be enhanced even further by our web presence.
- The ability to spread overhead over multiple revenue centers. Sigmund's will be able to spread the management overhead costs among multiple stores, decreasing the fixed costs per store.

Video Clip: Vinyl Makes a Comeback

A small company in Brooklyn, New York, takes advantage of the opportunity presented by the surging interest in vinyl records.

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A threat is an external factor beyond a company's control that could place a marketing strategy, or the business itself, at risk. Threats come from an unfavorable trend or development that could lead to deteriorating revenues or profits (such as high gasoline prices); a new competitor that enters the market; a public relations (PR) nightmare that leads to devastating media coverage; a gender discrimination lawsuit; a shift in consumer tastes and behavior that reduces sales; government regulation; an economic slump; or the introduction of a "leapfrog" technology that may make a company's products, equipment, or services obsolete. Threats can come from anywhere and at any time, and a small business may be particularly vulnerable because of its size. At the same time, a small business may be nimble enough to effectively deal with threats because of its small size.

Threats for Sigmund's Gourmet Pasta

- Competition from local restaurants that respond to Sigmund's Gourmet Pasta's superior offerings
- Gourmet pasta restaurant chains found in other markets coming to Eugene
- A slump in the economy reducing the customer's disposable income for eating out

Video Clip: Historic Paper Company Thrives

Surviving threats and taking advantage of opportunities.

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Performing a SWOT analysis is a valuable exercise. It might help an owner identify the most promising customers, perhaps even the ideal customer. The analysis is meant to improve a customer's experience with a company, so the person who will benefit most from a SWOT analysis is the customer.

Keys to Success and Critical Issues

The **keys to success** are those factors that, if achieved, will lead to a profitable and a sustainable business. Identifying these factors should be based on an understanding of the industry or the market in which a small business is competing because these things play a critical role in success and failure.

Focusing on three to five of the most important success factors makes sense for a small business. However, the actual number will be a function of the business. Whatever the number, the keys to success may change from time to time or year to year as the industry or the market changes. Examples of key success factors include the hiring and retention of excellent employees, successful

new product introductions, a strong supplier network, a low-cost structure, retaining existing customers, a strong distribution network or channel, a cutting edge manufacturing process, and customer service.

Keys to Success for Sigmund's Gourmet Pasta

Location, location, location.

Sigmund's site selection criteria are critical to its success. Arthur Johnson, the former vice president of real estate for Starbucks, helped us identify the following site selection criteria:

- Daytime and evening populations
- Shopping patterns
- Car counts
- Household income levels

Critical Issues for Sigmund's Gourmet Pasta

Sigmund's Gourmet Pasta is still in the speculative stage as a retail restaurant. Its critical issues are as follows:

- Continue to take a modest fiscal approach; expand at a reasonable rate, not for the sake of expansion in itself but because it is economically wise to do so
- Continue to build brand awareness that will drive customers to existing stores as well as ease the marketing efforts of future stores

Marketing Strategy

The marketing strategy section of the marketing plan involves selecting one or more target markets, deciding how to differentiate and position the product or the service, and creating and maintaining a marketing mix that will hopefully prove successful with the selected target market(s)—all within the context of the marketing objectives. It also includes a web strategy for the small businesses that have or want to have a web presence. By aligning online marketing with on-ground efforts, a company will be in a much stronger position to accomplish marketing and overall company objectives. It will also be presenting a consistent style and message across all points of contact with its target audience.

Introduction to Marketing Strategy for Sigmund's Gourmet Pasta

Sigmund's advertising budget is very limited, so the advertising program is simple. Sigmund's will do direct mail, banner ads, and inserts in the *Register Guard*, which are likely to be the most successful of the campaigns. (We will also use our website and social media to promote the business.) Lastly, Sigmund's will leverage personal relationships to get articles about Sigmund's in the *Register Guard*. Friends who have had their restaurants featured in the *Register Guard* have seen a dramatic increase of sales immediately after the article was published.

Marketing Objectives

Marketing objectives are what a company wants to accomplish with its marketing strategy. They lay the groundwork for formulating the marketing strategy, and although formulated in a variety of ways, their achievement should lead to sales. The creation of marketing objectives is one of the most critical steps a business will take. Both online and on-ground objectives must be included. A business must know, as precisely as possible, what it wants to achieve before allocating any resources to the marketing effort.

Marketing Objectives for Sigmund's Gourmet Pasta

1. Maintain positive, steady growth each month.
2. Generate at least $40,000 in sales each month.
3. Experience an increase in new customers who become long-term customers.
4. Realize a growth strategy of one store per year.
5. Achieve one thousand Facebook fans in six months.
6. Achieve a Twitter follower base of five hundred people in six months.

You should note that the first and third objectives in this sample marketing plan do not meet some of the SMART criteria—specific, measurable, achievable, realistic, and time-based (a stated time frame for achievement). These two objectives are not specific enough to be measurable, and they may not be realistic. This will make it difficult to determine the extent to which they have been or can be accomplished.

Target Market

The target market is the segment that has been identified as having the greatest potential for a business. A segment is a relatively homogeneous subgroup that behaves much the same way in the marketplace. The identification of segments is a necessary precursor to selecting a target market. The more precise the target market is, the easier it will be to create a marketing mix that will appeal to the target market.

Target Markets for Sigmund's Gourmet Pasta

The market can be segmented into three target populations.

1. **Individuals.** People who dine by themselves.
2. **Families.** A group of people, either friends or a group of nuclear relatives, dining together.
3. **Takeout.** People who prefer to eat Sigmund's food in their own homes or at a location other than the actual restaurant.

Sigmund's customers are hungry individuals between the ages of 25 and 50, making up 53 percent of Eugene (according to the Eugene Chamber of Commerce). Age is not the most defined demographic of this customer base, as all age groups enjoy pasta. The most defined characteristic of the target market is income. Gourmet pasta stores have been very successful in high-rent, mixed-use urban areas, such as Northwest 23rd Street in Portland. These areas have a large day and night population consisting of business people and families who have household disposable incomes over $40,000.

Combining several key demographic factors, Sigmund's profile of the primary customer is as follows:

- Sophisticated families who live nearby
- Young professionals who work close to the location
- Shoppers who patronize high-rent stores

Positioning

The **positioning** section of the marketing plan reflects the decisions that have been made about how a company plans to "place" its business in a consumer's mind *in relation to* the competition. Is a particular business seen as a high-priced or a low-priced alternative? Is a business considered a high-quality or a medium-quality alternative? Is the delivery time to customers better, worse, or the same as that of the competition? There are many different approaches to positioning that the small business owner should consider, but the selected approach should be the one that puts the company or the brand in the best light. Keep in mind that a good positioning strategy will come from a solid understanding of the market, the customer, and the competition because this knowledge will provide a basis for comparing one business with others.

Positioning for Sigmund's Gourmet Pasta

Sigmund's Gourmet Pasta will position itself as a reasonably priced, upscale, gourmet pasta restaurant. Eugene consumers who appreciate high-quality food will recognize the value and unique offerings of Sigmund's Gourmet Pasta. Patrons will be singles and families, ages twenty-five to fifty.

Sigmund's Gourmet Pasta positioning will leverage its product and service competitive edge:

- **Product.** The product will have the freshest ingredients, including homemade pasta, imported cheeses, organic vegetables, and top-shelf meats. The product will also be developed to enhance presentation. Everything will be aesthetically pleasing.
- **Service.** Customer service will be the priority. All employees will ensure that customers are having the most pleasant dining experience. All employees will go through an extensive training program, and only experienced people will be hired.

By offering a superior product, coupled with superior service, Sigmund's will excel relative to the competition.

Video Clip: Small Business Market Position

Market position refers to how the general public views the business or the product.

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Video Clip: Small Business Market Position Tips

Choose a unique position for a business or a product.

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Video Clip: Choosing a Small Business Market Position

Look ten to fifteen years into the future when thinking about positioning.

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Marketing Strategy Pyramid

The **marketing strategy pyramid** assumes that the marketing strategy is built on concrete tactics that are built on specific, measurable marketing programs—activities with budgeted expenses, well-defined responsibilities, deadlines, and measurable results.



Figure 6.3.3.5: Marketing Strategy Pyramid *Tim Berry, "What Is the Marketing Strategy Pyramid, Where Did It Come From?," BPlans, accessed December 2, 2011, http://www.bplans.com/ask-bplans/640...d-it-come-from.*

The strategy at the top of Figure 6.3.3.5 focuses on well-defined markets and user needs. The second level consists of the tactics that you use to satisfy user needs and communicate with the target market. The third level is where specific programs are defined. It is this framework that is built into the sample marketing plans that are available through Palo Alto Software in Sales and Marketing Pro and at www.mplans.com. However, it is a solid approach that can be used in any marketing planning situation.

Strategy Pyramid for Sigmund's Gourmet Pasta

The single objective is to position Sigmund's as the premier gourmet pasta restaurant in the Eugene, Oregon, area, commanding a majority of the market share within five years. The marketing strategy will seek to first create customer awareness regarding the services offered, develop that customer base, and work toward building customer loyalty and referrals.

The message that Sigmund's will seek to communicate is that Sigmund's offers the freshest, most creative, health-conscious, reasonably priced, gourmet pasta in Eugene. This message will be communicated through a variety of methods. The first will be direct mail. The direct mail campaign will be a way to communicate directly with the consumer. Sigmund's will also use banner ads and inserts in the *Register Guard*. This will be particularly effective because the *Register Guard* is a popular local paper that is consulted when people are looking for things to do in Eugene. The restaurant's website will also encourage patronage because the warm and friendly atmosphere of the site will reflect the atmosphere of the actual restaurant. Facebook and Twitter followers along with customer comments will also add to brand awareness.

The last method for communicating Sigmund's message is through a grassroots PR campaign. This campaign will leverage personal relationships with people on the staff of the *Register Guard* to get a couple of articles written about Sigmund's. One will be from the business point of view, talking about the opening of the restaurant and the people behind the venture. This is likely to be run in the business section. The second article will be a food review. In speaking with many different retailers and restaurateurs, significant increases of traffic have followed articles in the *Register Guard*. Because of this level of effectiveness and low/zero cost, Sigmund's will work hard to get press in the *Register Guard*.

Marketing Mix

A company's marketing mix is its unique approach to product, price, promotion, and place (distribution)—the four Ps. The marketing mix is the central activity in the implementation of a company's marketing strategy, so the decisions must be made carefully. It is through the marketing mix that marketing objectives will be achieved. The final determination of the marketing mix requires inputs from other areas, such as purchasing, manufacturing, sales, human resources, and finance.

Marketing Mix for Sigmund's Gourmet Pasta

Sigmund's marketing mix consists of the following approaches to pricing, distribution, advertising and promotion, and customer service.

- **Pricing.** Sigmund's pricing scheme is that the product cost is 45 percent of the total retail price.
- **Distribution.** Sigmund's food will be distributed through a model in which customers can either call in their orders or place them online and come to the restaurant to pick them up or come into the restaurant, place their orders, and wait for them to be completed.
- **Advertising and promotion.** The most successful advertising will be banner ads and inserts in the *Register Guard* as well as a PR campaign of informational articles and reviews within the *Register Guard* and coupons available on the website. The first-timer discount coupon and code will be prominently displayed on the website's home page to encourage prospects to become customers. Coupons will also be available for repeat customers once per month. Holiday specials will be offered on Valentine's Day, Easter, Mother's Day, and Father's Day.
- **Social media.** Sigmund's Gourmet Pasta will establish a Facebook page that will allow users to engage directly with the company by posting likes, dislikes, and ideas to the Wall, which will be answered directly by management. Customers will be encouraged to become fans of the Facebook page and then share the page with their friends. Sigmund's will also establish a Twitter presence.

Video Clip: How To Use Twitter For Business

A tutorial about using Twitter for business.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: What a Business Needs to Do to Connect More on Twitter

A humorous look at why a business should use a picture, not its business logo, on Twitter.

A YouTube element has been excluded from this version of the text. You can view it online here.

Marketing Research

Marketing research is about gathering the information that is needed to make business decisions, which should be an ongoing process. A marketing plan should be based on marketing research. The research can range from something very simple conducted by the owner or an employee to a more sophisticated study that is prepared by a marketing research firm. The overall goal of the research, however, is to help a company offer products that people will want, at an appealing price, in the place where they want to buy them. The research should also help a company decide how to promote its products so that people will be aware of them. People cannot buy what they do not know about.

Marketing Research for Sigmund's Gourmet Pasta

During the initial phases of developing the marketing plan, several focus groups were held to gain insight into a variety of patrons of restaurants. These focus groups provided useful insight into the decisions and decision-making processes of consumers.

An additional source of dynamic market research is a feedback mechanism based on a suggestion card system. The suggestion card system has several statements that patrons are asked to rate in terms of a given scale. There are also several open-ended questions that allow the customer to freely offer constructive criticism or praise. Sigmund's will work hard to implement reasonable suggestions to improve its service offerings as well as show its commitment to customers that their suggestions are valued. This suggestion system will also be incorporated into our website so that customers can provide feedback online.

The last source of market research is competitive analysis and appreciation. Sigmund's will continually patronize local restaurants for two reasons. The first is for competitive analysis, providing Sigmund's with timely information regarding the service offerings of other restaurants. The second reason is that local business owners, particularly restaurant owners, are often part of an informal fraternal organization where they support each other.

Financials

The financials section of the marketing plan should provide a financial overview of the company as it relates to the marketing activities. Typically addressed in this section are the breakeven analysis, a sales forecast, and an expense forecast and how they link to the marketing strategy.

Breakeven Analysis

A **breakeven analysis** is used to determine the amount of sales volume a company needs to start making a profit. A company has broken even when its total sales or revenues equal its total expenses. However, a breakeven analysis is not a predictor of demand, so if a company goes into the marketplace with the wrong product or the wrong price, it may never reach the break-even point.

The most relevant types of costs that must be considered when preparing a breakeven analysis are **fixed costs** and **variable costs**. Fixed costs are costs that must be paid whether or not any units are produced or any services are delivered. They are "fixed" over a specified period of time or range of production. Rent, insurance, and computers would be considered fixed costs because they are outlays that must occur before a company makes its first sale.

Variable costs are recurring costs that must be absorbed with each unit or service sold. These costs vary directly with the number of units of product or the amount of service provided. Labor costs and the cost of materials are examples of variable costs.

Breakeven Analysis for Sigmund's Gourmet Pasta

The breakeven analysis indicates that $23,037 in monthly revenue will be required to reach the break-even point. The analysis assumes a 45 percent annual variable cost and a $22,000 estimated monthly fixed cost.



Figure 6.3.3.6: Sigmund's Breakeven Analysis. *Source: "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 2, 2011, http://www.mplans.com/pasta_restaurant_marketing_plan/situation_analysis_fc.php. Reprinted by permission of Palo Alto Software.*

Sales Forecast

A company's **sales forecast** is the level of sales that a company expects based on a chosen marketing plan and an assumed marketing environment. The sales forecast does not establish a basis on which to decide how much should be spent on marketing. Rather, it is the result of an assumed marketing expenditure plan. A sales forecast can be very helpful in creating important milestones for a business. However, it is still an educated guess. No matter what a company forecasts, it will typically make less than expected.

Sales Forecast for Sigmund's Gourmet Pasta

The first two months will be used to get the restaurant up and running. By the third month, things will get busier. Sales will gradually increase, with profitability being achieved by the beginning of the new year.

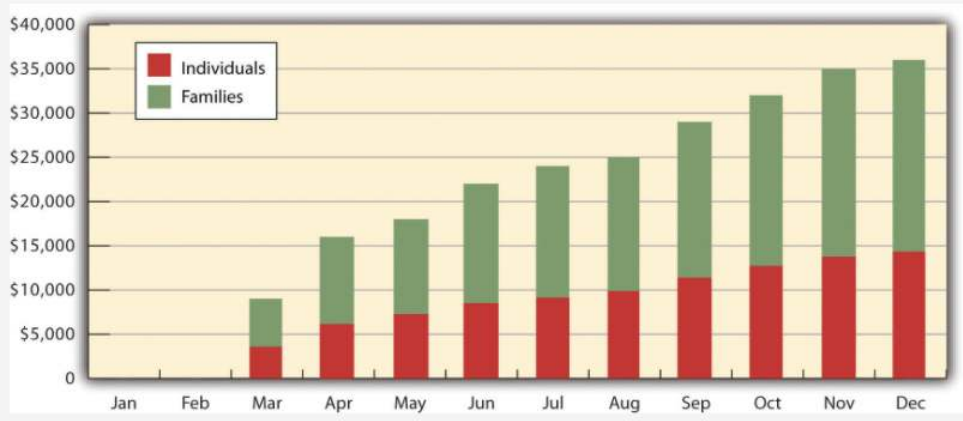


Figure 6.3.3.7: Sigmund's Sales Forecast. *Source: "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 2, 2011, http://www.mplans.com/pasta_restaura...nalysis_fc.php. Reprinted by permission of Palo Alto Software.*

Table 6.3.3.2: Sigmund's Forecast of Sales and Direct Cost of Sales

Category	2011	2012	2013
Sales			
Individuals	$103,710	$262,527	$327,424
Families	$150,304	$380,474	$474,528
Total sales	$254,014	$643,001	$801,952
Direct Cost of Sales			
Individuals	$46,669	$118,137	$147,341
Families	$67,637	$171,213	$213,538
Total direct cost of sales	$114,306	$289,350	$360,879
Note: Sigmund's separated sales on the basis of its target market, but it did not include a separate sales forecast for takeout. It should have.			

Source: "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," *Mplans.com*, accessed December 1, 2011, http://www.mplans.com/pasta_restaura...nalysis_fc.php.

Expense Forecast

A company's **expense forecast** is a tool that can be used to keep its operations on target. The forecast will provide indicators when corrections or modifications are needed for the proper implementation of the marketing plan. An expense forecast is vital for a

company and its sales goals because it will keep the company on track and keep costs down; however, a company will typically spend much more than expected. If a company is not sure what to include in its expense forecast, there are online templates that can provide assistance (see www.chic-ceo.com/userfiles/ExpenseForecast.pdf for sample templates).

Expense Forecast for Sigmund's Gourmet Pasta

Marketing expenses are to be budgeted so that they are ramped up for months two through four and then lower and plateau from month five to month ten. Restaurants typically have increased business in the fall. This generally occurs because during the summer, when the weather is nice and it does not get dark until late, people tend to eat out less. From month ten to month twelve, the marketing costs will increase again.

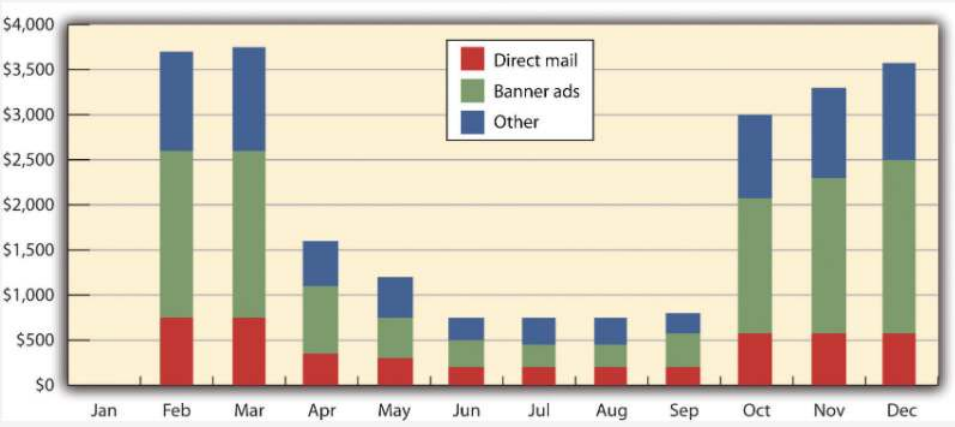


Figure 6.3.3.8: Sigmund's Expense Forecast *"Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 2, 2011, http://www.mplans.com/pasta_restaura...nalysis_fc.php. Reprinted by permission of Palo Alto Software.*

Table 6.3.3.3:Sigmund's Marketing Expense Budget

Category	2011	2012	2013
Direct mail	$5,267	$5,605	$5,421
Banner ads	$11,704	$12,455	$12,047
Other	$7,022	$7,473	$7,228
Total sales and marketing expenses	**$23,993**	**$25,533**	**$24,696**
Percentage of sales	9.45%	3.97%	3.08%
Note: These marketing expenses do not account for website, social media, or coupon redemption expenses, and they do not reflect the cost of preparing marketing materials (e.g., the direct mail pieces, the coupons, and the banner ads). For the sake of convenience, we can include these expenses in the "Other" category. However, there should be separate figures for these expenses. Also, it should be made clear what kinds of expenses are included as "Other."			

Source: "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," *Mplans.com*, accessed December 1, 2011, http://www.mplans.com/pasta_restaura...nalysis_fc.php.

Implementation, Evaluation, and Control

This last section of a marketing plan outlines what a company will do to implement the plan, evaluate its performance, and monitor and adjust plan implementation through controls. In other words, this section of the plan is all about numbers, results, and timelines.

Implementation

Implementation is about the day-to-day activities that effectively put a marketing plan into action and focuses on who, where, when, and how: Who will do that? Where to start and when? When to do that? How to do that? Effective implementation can give a business the edge in a market with similar marketing plans simply because any company that is better and faster at execution is sure to have the advantage in terms of market share. This will be true for a small business of any size. There is, however, no such thing as a one-time implementation of a marketing plan. Rather, it is a process that evolves with the product or the service.

Several steps are recommended for the proper implementation of a marketing plan. Examples include the following:

1. **Be sure to always check progress.** Know what is working and what is not working. Doing so will help you stay on top of programs that need work and can build on programs that are working.
2. **Be sure to reward employees for jobs well done.** When goals are met, deadlines are met, and so forth, make sure to congratulate the people responsible for these goals and deadlines.
3. **Always try new things.** A company should never sit on its hands. The market is always changing, so a company should also change. Learn to adapt.
4. **Don’t jump ship too soon.** Give the plan time to work. If it is not working, do not give up. Work with the team. Let them help the company succeed.
5. **Be open to ideas.** Some employees may have a better idea about the reality of the market than the owner has. Listen to them. Hear what they have to say.

Implementation Milestones for Sigmund’s Gourmet Pasta

The following milestones identify the key marketing programs. It is important to accomplish each one on time and on budget.

Table 6.3.3.4: Sigmund’s Implementation Milestones

Milestones	Start Date	End Date	Budget	Manager	Department
Advertising					
Marketing plan completion	1/1/2011	2/1/2011	$0	Kevin	Marketing
Banner ad campaign #1	2/1/2011	4/1/2011	$3,754	Kevin	Marketing
Banner ad campaign #2	10/1/2011	1/1/2011	$4,900	Kevin	Marketing
Total advertising budget			**$8,654**		
Direct Marketing					
Direct mail campaign #1	2/1/2011	4/1/2011	$1,689	Kevin	Marketing
Insert campaign #1	2/1/2011	4/1/2011	$2,252	Kevin	Marketing
Direct mail campaign #2	10/1/2011	1/1/2011	$2,205	Kevin	Marketing
Insert campaign #2	10/1/2011	1/1/2011	$2,940	Kevin	Marketing
Total direct marketing budget			**$9,086**		
Web development				Outside firm	Marketing
Totals			**$17,741**		

Note: The web development milestone was added to acknowledge that this activity still needs to be scheduled and budgeted. It was not part of the original sample marketing plan. Under normal conditions, the dates and numbers for web development would also be included.

Source: "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," *Mplans.com*, accessed December 1, 2011, http://www.mplans.com/pasta_restaura...nalysis_fc.php.

Evaluation

The evaluation section of the marketing plan is about assessing the strengths and weaknesses of a marketing plan to improve its effectiveness. Without an evaluation process, a company will not know whether its marketing campaign is effective or whether it is spending too much or too little money to achieve its goals. The evaluation process, if done correctly, will allow a company to continually improve its tactics and assess the results of its marketing efforts. Thus it is important to set up a timely process to track, capture, and analyze collected data as it is collected. If this is done on a regular basis, a marketing activity (e.g., banner advertising) that doesn't work can be changed to more effective tactics (e.g., advertising in the local paper) that do work.

There are many ways to evaluate how well a company is doing. The following are some of the ways:

1. **Look at sales (or fee) income.** Sales or fee income should be increasing. However, some small businesses will have longer sales cycles than others, so it might be better to measure the number of new leads generated, or the number of appointments, or the number of billable hours achieved. Also remember that discounts, variances in fees, and promotional pricing will affect total sales volume. If a company is selling online and on-ground, look at the path of both income streams.
2. **Ask clients or customers.** Find out where and how clients and customers heard about the business. Most businesses never ask this question, so they miss out on valuable insights into how clients and customers pick a product or a service.

3. **Does advertising and/or promotional activity produce direct responses?** It should. If not, a company should work to find out why not. This is also relevant for a web presence. A company should want to know how site visitors found out about the company.
4. **Check the conversion rate.** How successful is a business at closing the sale? Has it improved? If a company is selling online, how many site visitors are actually buying something?
5. **Does the plan have a positive return on investment (ROI)?** Does it bring in enough new or repeat business to justify the expense? A company should evaluate the cost-effectiveness of each specific online and on-ground marketing activity so that it can change or eliminate unproductive activities. There are online tools available to help companies with this evaluation. As an example, a free ROI calculator is available at www.cymbic.com/tools/roi_calc.php.

To best evaluate the effectiveness of a marketing plan, it will be necessary to track each type of marketing activity in the plan. The data and techniques will vary widely depending on product type and market—and whether a company has an online presence only or both an on-ground presence and an online presence. However, most small businesses should select the simplest route possible because of the lower costs and the limited need for very sophisticated tracking. The following are some common and very doable tracking techniques for the small business:

- **Advertising efficiency.** The number of inquiries generated by an advertisement and the cost per inquiry. This applies to both online and traditional advertising.
- **Sales promotion efficiency.** The number of inquiries generated by a promotion (e.g., a coupon or a banner ad) and the percentage of coupons or vouchers redeemed. This also applies to online and traditional sales promotion activities.
- **Sales closure rate.** The number of sales closed compared to sales leads. Collect data for both online and on-ground sales.
- **Direct marketing.** The number of inquiries or customers generated by a direct marketing activity. Direct marketing uses a variety of channels, such as direct mail, telemarketing, e-mail, interactive television, websites, mobile devices, door-to-door leaflet marketing, broadcast faxing, voicemail marketing, and coupons.
- **Web analytics.** One of the big benefits of having a web presence is that there is a vast amount of tracking and statistics available to the site owner. Small-business owners will want to know things such as where site traffic comes from, how they got to the site, what search words or phrases were used, how many people are viewing the site, how many people are buying if you are selling something, the geographic location of site visitors, and the time each visitor spends on the site. Website analysis tools can track the ways people use a website while helping the owner make sense of the mountain of data that a site generates.

Video Clip: Using Web Analytics Tools

How analytics tools can help you make informed decisions about online endeavors.

A YouTube element has been excluded from this version of the text. You can view it online here.

Small-business owners may choose to have the web analytics performed by an outside vendor or use inexpensive analytics tools such as Google Analytics.

Video Clip: Three Important Questions to Ask Google Analytics

How Google Analytics helps to answer the three most important questions about a website.

A YouTube element has been excluded from this version of the text. You can view it online here.

- **Social media metrics.** If social media is part of a company's marketing plan, the owner will want to find out whether it is worth all the time and effort involved. The goal is to be able to draw lines and connect the dots between social media participation and sales or perhaps something else like brand recognition. Twitter metrics are fairly simple, beginning with the number of followers you have. However, it is the number of retweets you get that will be an indication of the messages that are actually resonating with customers. This is a measure of social influence. Klout is a free tool that measures your online influence on a scale of 1 to 100. This information can guide you to identifying strengths and weaknesses. It is also important to tap into the analytics provided by LinkedIn and Facebook. Perhaps the best approach for a small business to measure its social media effectiveness is to choose an easy-to-understand and easy-to-use web analytics package. Google Analytics was mentioned previously. Another good choice would be the software available from HubSpot because this company focuses specifically on the needs of small and medium-sized businesses.

Marketing Calculators

The Internet is a wonderful place. You can find most anything there. The following are three free marketing calculators that you might find useful in measuring the effectiveness of marketing: These calculators were obtained from and self-described at www.mplans.com/marketing_calculators.

1. **Pay-per-click ROI calculator**. This calculator determines the ROI for pay-per-click advertising campaigns. Based on a campaign's results and costs, the ROI can be calculated.
2. **Conversion rate calculator**. Even the most successful websites convert only a fraction of their visitors into paying customers. A company can increase its sales by upping its conversion rate, attracting more traffic to the site, or encouraging buyers to spend more money. This handy calculator experiments with these variables. Enter the number of visitors and total orders and see what an increase in conversion can do.
3. **E-mail marketing ROI calculator**. E-mail marketing campaigns to interested prospects who have opted to receive a company's e-mail messages is a great way to increase direct sales. This simple calculator makes it easy to see the ROI from various campaigns, based on expected costs and response levels. It can be used to test different scenarios and test results.

Evaluation for Sigmund's Gourmet Pasta

Unfortunately, the marketing plan for Sigmund's Gourmet Pasta does not address the evaluation of its marketing activities. They should have provided information about the plans for measuring and evaluating the effectiveness of its banner ads, direct mail, and insert campaigns.

Controls

There is no planning without control, the process of monitoring a proposed plan as it proceeds and adjusting it when necessary. Every business needs someone to take responsibility for pushing things along. A good schedule and budget should make it easy to monitor progress, but when things fall behind schedule or there are cost overruns, you must be ready to do something about it and adapt the plan accordingly. From time to time, the owner must step back and ask whether the plan is working. What can you learn from mistakes, and how can you use what you know to make a better marketing plan for the future?

In addition to setting a schedule and measuring and evaluating the effectiveness of marketing activities, a marketing plan needs to say how it will be controlled. Although there are many approaches to control, the small business owner will likely look to activities such as sales analysis (monthly and annual revenue), expense analysis (monthly and annual expenses), feedback from customer satisfaction surveys, and the observation of competitor activities in response to the marketing plan (marketing research). The organization of the marketing function itself can also be seen as a means of control.

Marketing Plan Control for Sigmund's Gourmet Pasta

The marketing plan for Sigmund's Gourmet Pasta includes implementation milestones, the marketing organization, and **contingency planning** as controls for their marketing plan. Implementation was discussed previously. Contingency planning is a formal process to manage a crisis, whether it comes from inside or outside a company. A contingency plan involves potential problem identification, prioritizing the problems in a list of most probable, and developing planned steps to limit the harm to a company if the potential problem becomes real. It would have been helpful if Sigmund's marketing plan had included other controls as well. The more specific a marketing plan is about its controls, the better the chances that those controls will be carried out successfully.

Marketing Organization

Kevin Lewis, the owner, is primarily responsible for marketing activities. This is in addition to his other responsibilities, and he depends on some outside resources for graphic design work and creativity.

Contingency Planning

Difficulties and risks include the following:

- Problems generating visibility
- Overly aggressive and debilitating actions by competitors
- An entry into the Eugene market of an already existing, franchised gourmet pasta restaurant

Worst-case risks may include the following:

- Determining that the business cannot support itself on an ongoing basis
- Having to liquidate equipment or intellectual property to cover liabilities

KEY TAKEAWAYS

- There is no universally accepted format for a marketing plan. The plan can be a stand-alone document or a section of the business plan.
- A marketing plan has several critical sections: executive summary; vision and mission; situation analysis; marketing objectives; marketing strategy; financials; and implementation, evaluation, and control.
- The executive summary is a one- to two-page synopsis of the marketing plan.
- The vision statement tries to articulate the long-term purpose and idealized notion of what a business hopes to be—that is, where the owner sees the business going.
- The mission statement looks to articulate the more fundamental nature of a business—that is, why the business exists.
- The situation analysis gives a picture of where a business is now in the market and provides the context for marketing efforts. This analysis includes a market summary, competition, product offerings, the SWOT analysis, keys to success, and critical issues.
- The marketing strategy section of the plan involves selecting one or more target markets, deciding how to differentiate and position a product or a service, and creating and maintaining a marketing mix that will hopefully prove successful with the selected target market(s)—all within the context of marketing objectives. It also includes a web strategy for small businesses that have or want to have a web presence.
- The financials section of the marketing plan should provide a financial overview of a company as it relates to its marketing activities. For the small business, this should typically include a breakeven analysis, a sales and direct cost of sales forecast, and a forecast of marketing expenses.
- The implementation, evaluation, and control section of the marketing plan should include how a company will put the plan into action, evaluate whether the plan is working, and monitor and adjust implementation of the plan through marketing plan controls.

EXERCISE

In a group of four or five students, develop a marketing plan for Frank’s All-American BarBeQue. Be sure to draw from the business plan in the Appendix.

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6.3.4: The Three Threads

Learning Objectives

- Understand how having a marketing plan contributes to customer value.
- Understand how having a marketing plan can impact cash flow.
- Understand how digital technology and the e-environment impact the marketing plan.

Customer Value Implications

Marketing is all about ascertaining and providing customer value, so it should be no surprise that there needs to be a strong linkage between a small business marketing plan and customer value. **Customer value** is the amount of benefits that a customer realizes from a product or a service as compared to the costs associated with acquiring those benefits. Because a marketing plan provides a specific marketing direction for a small business, the plan necessarily captures how it plans to deliver value to customers. The specific consideration of product, price, place, and promotion should all be geared to appealing to the target market or markets. This "appeal" must be based on understanding the value that customers are seeking—as the business understands it. The product should also be positioned in a way that reflects value by setting it apart from the competition for easy recognition and comparison. In short, the marketing plan should be the embodiment of a business's **customer value proposition**—that is, the whole cluster of benefits a business is promising to deliver to a customer.

Cash-Flow Implications

It is not uncommon for a business to spend three times as much as expected and make three times less than expected. This combination is not good for any company's cash flow. It is, therefore, critical that marketing plan expenses be as tight as possible without sacrificing quality (as defined by the business), with every effort being made to keep costs low. This implies the efficient use of employee time on marketing activities, competitive bidding for outside vendors, very careful attention paid to the costs of media and their effectiveness so that promotional campaigns that are not working are replaced with campaigns that look more promising and more cost-effective, and web presence measurement and evaluation to ascertain what efforts are not working so that the costs of those efforts can be replaced with something more cost-effective.

Digital Technology and E-Environment Implications

Digital technology and the e-environment are becoming more important to the small business every day. With specific respect to the marketing plan, **technology** can enter the process at multiple points. The following are a few examples:

- Digital technology makes it easy to develop a plan that is responsive to the needs of any size small business. Sales and Marketing Pro from Palo Alto Software is specifically geared to the needs of small business. The templates can be edited to fit the needs of the business, and both companies provide excellent customer support.
- When implementing the plan, digital technology makes it possible for salespeople to have quick access to the right information about inventory and pricing through a company's website, smartphones, and iPads.
- Technology can help a company quickly customize offers for top-tier customers or personalize discounts for those who buy a specific product.
- New technology tools and document management services can now analyze customer preferences, niche markets, regional buying habits, and more to help small businesses focus efforts and resources. The possible result is a more focused marketing plan.
- Software solutions are also available for managing sales (e.g., Salesforce). These solutions are typically very inexpensive.

The **e-environment** has also had an impact on developing the marketing plan. The following are some examples:

- Online options provide new channels for small businesses to communicate and market their products and services and also offer the capability to deliver customized, one-to-one messages.
- Small businesses can now plan to reach out to their target markets for little to no cost due to several new options for promotion that previously did not exist (e.g., e-mail, blog postings, podcasting, and online community forums).
- SurveyMonkey, a do-it-yourself survey program, can be used to find out customer likes, dislikes, and demographic profiles.

- A multitude of online tools are available to measure online and on-ground marketing activities. This includes the all-important measurement of website activity. Examples include free web analytics tools, such as Google Analytics and HubSpot, and free marketing calculators.

KEY TAKEAWAYS

- The marketing plan should be an embodiment of the customer value proposition of a business.
- The marketing plan should represent a commitment to keeping costs as low as possible without sacrificing quality. This will help the company's cash flow.
- Both digital technology and the e-environment can make important contributions to the development, implementation, evaluation, and control of the marketing plan.

EXERCISE

Your boss is struggling with the company's marketing plan. He knows that a plan is needed, but he is really crunched for time—as usual. You have suggested to him that there is a much easier and cost-effective way to develop the plan by using digital technology and the Internet. He agrees but does not have the time to check into the options. He has asked you to do it for him. Prepare a list of options that includes an explanation of each option and a discussion of how each option will contribute to customer value and keep costs down. Be as specific as possible but do not overwhelm him with paper. He will not have the time to read it.

Disaster Watch

What Now?

MaryAnn has always wanted her own real estate office. She earned her real estate license as soon as she was eligible and was able to land a position with the top realtor in the area. As she gained sales experience, she studied for her broker's license and obtained it on the "fast track." Her plan was to open her own office as soon as she felt confident that she had enough experience under her belt.

Her office, Power Real Estate, is now open, and MaryAnn has done well in building a business and establishing a good reputation for results. One of the things she noticed in her years of real estate experience was that many people were wary of letting real estate agents sell their homes because they did not believe the agents would aggressively try to sell them fast enough. In response to this reluctance, MaryAnn developed and aggressively marketed a "Twenty-Point Power Marketing Plan" that would result in a client's house being sold in thirty days or less. She knew it was risky, but so far things have worked out well.

Then the housing collapse occurred. MaryAnn found herself swamped with homeowners anxious to sell before being hit with foreclosure. She quickly found out that she could no longer sell homes in thirty days or less because there was a housing glut. She now sees her reputation at risk because of the housing glut. Her marketing plan is down the drain. What should she do? She does not see closing her office as an option she wants to consider.

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7.1.1: Introduction



Figure 7.1.1.1: Focusing time and energy on planning a business can help an entrepreneur avoid or minimize legal issues. (credit: modification of “hammer books law court lawyer” by “succo”/Pixabay, CC0)

Entrepreneurial businesses are the heart of the US economy. Small businesses—those with fewer than 500 workers—employ almost one-half of the US workforce (47 percent according to the US Census Bureau’s Annual Survey of Entrepreneurs)[1] and are responsible for offering thousands of new products and services each year. The information in this chapter can help entrepreneurs successfully start and operate a business. Startups function best when the owners have a strong understanding of the legal aspects of entrepreneurship. Important legal issues such as business structure (entity selection), incorporation process, taxation, capital acquisition, and employment policies require that entrepreneurs obtain good advice and make sound decisions before they commence operations. They must make additional decisions that relate to the role of the business in the community, which is a key component of corporate social responsibility. The combination of good advice and sound decisions will help entrepreneurs successfully navigate a complex matrix of considerations.

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7.1.2: Business Structures - Overview of Legal and Tax Considerations

Learning Objectives

By the end of this section, you will be able to:

- Understand why a business's purpose is an important role in the initial business structure decision
- Identify major types of business structures (corporation, LLC, partnership, sole proprietorship, joint venture)
- Distinguish between for-profit and not-for-profit purposes and structures

The structure of a new business creates the legal, tax, and operational environment in which the business will function. In order to choose a business structure, entrepreneurs need to have a clear understanding of the type of business they seek to establish, the purpose of the business, the location of the business, and how the business plans on operating.

For example, a business that plans to qualify as a nonprofit—Section 501(c) of the Internal Revenue Code—will be treated differently from a business that aims to earn a profit and distribute the profits to its owners. Therefore, the first step in any entrepreneurial endeavor is to establish the nature and purpose of the business.



Figure 7.1.2.1: There are several basic business structures: sole proprietorships, partnerships, corporations, and hybrid forms. Partnerships may be structured as a general partnership (GP), a limited partnership (LP), or a limited liability partnership (LLP). Hybrids are usually formed as a limited liability company (LLC) or a joint venture (JV). The designations of "C" and "S" corporations refer to which chapter of the Internal Revenue Code they appear in; B corporations are structured to meet standards of serving certain social purposes. (CC BY 4.0; Rice University & OpenStax)

One of the most important initial decisions an entrepreneur must make, from a legal perspective, is the legal organization of a business, called the **business structure** or *entity selection*. The choices are varied, with several basic entities, each with several variations, resulting in multiple permutations.

Many business ventures, regardless of humble beginnings, may have the potential to evolve into significantly larger business ventures. This is what makes the initial decisions so important. The founders should think through every step of business development, beyond the inception or formation, and consider the possible paths of the business. How an entrepreneur organizes the business, or which business structure they choose, will have a significant impact on both the entrepreneur and the business.

Business structure options include traditional choices such as corporations, partnerships, and sole proprietorships, and hybrid entities such as limited liability companies (LLCs), limited liability partnerships (LLPs), and joint ventures (JVs). Each structure carries different requirements to set up, different requirements to fulfill (such as taxes and government filings), and varying

ownership risks and protections. Entrepreneurs should consider these factors as well as the expected business growth in selecting a structure, while being aware that the structure can and should change as the business venture grows.

For example, if you think you want to share authority, responsibilities, and obligations with other people, your best choice would likely be a partnership, in which other people contribute money and help manage the business. Alternatively, if you prefer to manage the business yourself, a better choice for you might be a single-member LLC, assuming you can borrow money from a lender if needed. Conversely, if you think your idea is so popular that you may grow rapidly and want the ability to raise capital by selling interests in your business through equity or debt, then a corporation would be your best choice. You should obtain legal and tax advice about your structure.

ARE YOU READY?

Becoming an Informed Entrepreneur

If you are an entrepreneur with an idea for a startup, ask yourself if you are ready to make important decisions. How much do you know about taxation, incorporation, or liability? If you don't know at least some of the basics, you may have to depend on a lot of advice from accountants and attorneys, and that is very expensive. If you spend too much money on advice, you have too little left for something else such as advertising and marketing.

Establishing a Business Purpose

A clear understanding of the business purpose helps direct the entrepreneur toward the most appropriate business structure. The **business purpose** is the reason the entrepreneur forms the company and determines who benefits from it, whether it is the entrepreneur, customers, or some other entity. (The business purpose is different from a business mission or vision.) Drafting the expectations of the entrepreneur and how the business will operate, with a careful analysis of how the business will generate cash flows, realize profits, and to whom the business will owe its primary obligations, is the start of determining the appropriate business structure. A written business plan will help the entrepreneur develop the best legal structure in which the business is to operate because the legal structure of the business should be tied to the nature of the business.

Once the entrepreneur is clear on the nature and purpose of the business, consideration of the business structure follows. The first consideration is whether the entity is being created to produce a profit for its owners or shareholders, or whether it will be structured as a not-for-profit entity. A second factor is the state of incorporation, as state law defines each business's creation, with different states permitting different types of entities and various legal protections. Additional considerations include how the structure facilitates bringing in new investors, allows the owners to transfer profits out of the business, and supports a potential subsequent sale of the entity. Taxation is also a crucial aspect of business success, and the business structure or entity directly affects how it is taxed.

ARE YOU READY?

Drafting a Business Purpose

Can you write an outline of a business purpose? Try this: Your university's tutoring center is crowded, and those students who need extra help are struggling to find it. You have decided to start a new company to match those students with student tutors at your university. Who determines how much a tutor can charge? Is it a set price, a surge pricing model like Uber, or is it up to the tutor? How much of a profit do you make? In essence, you must determine the purpose of your business. Read this IRS article about shared-economy businesses to learn more.

For-Profit versus Not-for-Profit Businesses

Owners form businesses for one of two purposes: to make a profit or to further a social cause without taking a profit. In either case, there are multiple options in terms of how a business is structured. Each structure carries its own tax consequences determined by the owners' financial requirements and how the owners want to distribute profits. The structure, in turn, determines the appropriate income tax return form to file.

Characteristics of For-Profit Businesses

A **for-profit business** is designed to create profits that are distributed to the owners. There are multiple entity structures used in for-profit business entities including corporations, LLCs, partnerships, and sole proprietorships. Many for-profit business owners seek some form of limited liability, and thus form a corporation or an LLC, each of which carries with it specific legal attributes. Additionally, for-profit business entities are subject to a variety of local, state, and federal taxes and filings. Liability and tax issues will be discussed later in this chapter.

For-profit businesses are commercial entities that generally earn revenue through the sales of products or services, whereas nonprofits are organized for social purposes. Nonprofits are allowed to provide assets or income to individuals only as fair compensation for their services. For-profit businesses can be either privately owned (such as an LLC) or publicly owned and traded (such as a corporation). Publicly held and traded corporations sell stock or interests, and must abide by special rules to protect shareholders, whereas privately owned businesses may be less regulated. Regulations may vary by state and by type of incorporation.

Characteristics of Not-for-Profit Organizations

A **not-for-profit organization (NFPO)** is usually dedicated to serve the public interest, further a particular social cause, or advocate for a common shared interest. They must follow particular regulations regarding eligibility, government lobbying, and tax-deductible contributions. In financial terms, a not-for-profit organization uses its surplus revenues to achieve its ultimate objective, rather than distributing its income to the organization's shareholders, partners, or members. Common examples of not-for-profits include educational organizations such as schools, colleges, and universities; public charities such as the United Way; religious organizations such as places of worship; foundations; trade organizations; and issue-advocacy groups. Other organizations also considered NFPOs include nongovernmental organizations, civil society organizations, foundations that provide funding for various activities, and private voluntary organizations.

Nonprofits are usually tax-exempt as categorized by the US Internal Revenue Service (IRS), meaning they do not pay income tax on the money they receive for their organization. These types of organizations are created under state law (but also subject to federal and local laws) and are typically created for the common good.

To operate as a not-for-profit business, most states require that the entrepreneur create a corporation that has the specific purpose of acting in the public interest. This type of corporation does not have owners but has directors charged with running the organization for the public good, subject to bylaws. Some states only require a minimum of one director, whereas other states may require three or more directors. This is an important consideration for an entrepreneur because the nonprofit corporation will need the approval of all of the directors, and not just one person for its creation. Careful vetting of the directors is the best policy of any entrepreneur since directors have a duty to the corporation.

Because state laws vary, a not-for-profit corporation created for the common good in one state needs permission from another state to operate in that state. The permission is typically an approval from the other state's secretary of state memorialized in the form of official documents or permits. When operating in different states, the entrepreneur needs to make sure that the business follows all laws, rules, and regulations for each state.

Another issue to consider is the creation of a not-for-profit business organization for a particular purpose. One example of a special-purpose organization is an alumni organization, usually incorporated as a 501(c)(3) nonprofit, which incorporates to raise money for a college or university for a specific reason, such as student scholarships. Alternatively, a booster club may incorporate to receive donations for a single function, such as the women's soccer team. These organizations may need additional approvals prior to the creation or start of operations, depending upon state and local legal requirements. Each state typically has different requirements; depending on the federal tax regulation under which the entrepreneur is attempting to qualify, there may be additional federal regulations. This is why the entrepreneur needs to fully understand the purpose of the business they are starting and the legal operating environment before selecting the business structure. While NFPOs play an important role, most entrepreneurs form for-profit businesses; therefore, the remainder of this chapter will focus primarily on for-profit business entities.

ENTREPRENEUR IN ACTION

Determining the Purpose of Your Business—Profit versus Non-Profit, or a Little of Both?

The Approach Used by Gravity Payments' Entrepreneur Dan Price



Figure 7.1.2.2: Gravity Payments has led the way in exploring how employee and C-level salaries function for the company in terms of profits, living wages, and ethical considerations related to those issues. (credit: modification of photo provided by Gravity Payments)

Sometimes, a business may be a for-profit company yet act in a way that some may think exhibits a not-for-profit philosophy. Most startups must address their business purpose. In other words, is the primary purpose of the business to enrich the owners or is it to spread the benefits of success to the workers? The history of Gravity Payments illustrates this issue.

In 2011, an employee earning $35,000 a year told his boss at Gravity Payments, a credit-card payment business, that his earnings were not sufficient for a decent life in expensive Seattle. The boss, Dan Price, who co-founded the company in 2004, was somewhat surprised, as he had always taken pride in treating employees well. Nevertheless, he decided his employee was right. For the next three years, Gravity gave every employee a 20 percent annual raise. Still, profit continued to outgrow wages, so Price announced that over the next three years, Gravity would phase in a minimum salary of $70,000 for all employees. He reduced his own salary from $1 million to $70,000 to demonstrate the point and help fund the company-wide salary increase. The following week, 5,000 people applied for jobs at Gravity, including a Yahoo executive who took a pay cut to transfer to a company she considered fun and meaningful to work for.

Price recognized that low starting salaries were antithetical to his values and to what he felt was a large part of his business purpose. A majority of the initial cost of his approach to employee salaries was absorbed by making less profit, yet revenue continues to grow at Gravity, along with the customer base and the workforce. Price believes that managers should measure purpose, impact, and service as much as profit.

- Do you think an entrepreneur can successfully operate a for-profit business while paying its workers substantially more than the competition?

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7.1.3: Corporations

Learning Objectives

By the end of this section, you will be able to:

- Distinguish between C Corporations, S Corporations, and B Corporations
- Distinguish between privately and publicly held corporations
- Explain how corporations are taxed

A **corporation** is a complex business structure created by filing the appropriate documents with the state of incorporation. They are created when the original incorporators (owners) file a formal document called the articles of incorporation, or other similar documentation, with a state agency, often the secretary of state's office or the state division of corporations. Corporations operate as a separate legal entity apart from the owners. The owners are called shareholders and can be individuals, other domestic or foreign corporations, LLCs, partnerships, and other legal entities. Corporations may be for-profit or not-for-profit.



STATE OF [STATE]
CERTIFICATE OF INCORPORATION
A STOCK CORPORATION

The undersigned Incorporator, desiring to form a corporation under pursuant to the General Corporation Law of the State of [State], hereby certifies as follows:

1. The name of the Corporation is _____.
2. The Registered Office of the corporation in the State of [State] is located at _____ (street), in the City of _____ , County of _____ Zip Code _____. The name of the Registered Agent at such address upon whom process against this corporation may be served is _____.
3. The purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of [State].
4. The total amount of stock this corporation is authorized to issue is _____ shares (number of authorized shares) with a par value of $ _____ per share.
5. The name and mailing address of the incorporator are as follows:
   Name _____
   Mailing Address _____
   _____ Zip Code _____

By: _____
Incorporator

Name: _____
Print or Type

Figure 7.1.3.1: This is a sample short form of the document that is filed with the Secretary of State's Office to form a corporation. (CC BY 4.0; Rice University & OpenStax)

Incorporating a company means that the corporation operates as an entity that has some of the same rights as an individual. For example, individuals and corporations can sue and be sued, and corporations have the rights to own property, to enter into and enforce contracts, to make charitable and political donations, to borrow and lend money, and to operate a business as if the corporation were an individual. Most states require a corporation to be registered in that state in order to conduct business operations and to enter into and defend lawsuits in that state, especially if the business was incorporated in a different state. Registration is not the same as forming the initial corporation; it is simply the process of filing informational documents by entities that have already been incorporated in another state. States also tax the operations or sales a corporation makes in the state in which it has certain operations.

Overview of Corporations

Corporations are the only type of entity that the law allows to sell shares of stock. No other entity, like an LLC or a partnership, may do so. Those individuals or other entities that buy stock become shareholders and own the corporation. Some corporations have millions of shareholders, and others have as few as one. State incorporation laws vary: Some require at least three shareholders, but others allow a one-owner business to incorporate. Thus, an entrepreneur may start a company as the sole owner of the company and later incorporate and sell shares of stock or bonds to other investors in the company.

Corporations sell, or issue, stock to raise **capital**, or money, to operate their businesses. The holder of a share of stock (a shareholder) purchases a piece of the corporation and has a claim to a part of its assets and earnings. In other words, a shareholder is now an owner of the corporation. Thus, a share of stock (also called equity) is a type of security that signifies proportionate ownership in the issuing corporation. Stocks are bought and sold predominantly on stock exchanges, although there can also be a private sale between a seller and a buyer. These transactions have to conform to a very complex set of laws and government regulations (e.g., the Federal Securities Acts of 1933/34), which are meant to protect investors.

Use of a corporation allows the entrepreneur to shield themselves, and other owners, from personal liability for most legal and financial obligations. The benefit of limited liability is one of the primary reasons entrepreneurs incorporate. However, the administration of a corporation requires more formality than other types of entities, such as sole proprietorships and partnerships. A corporation must follow the rules for such entities. The requirements include maintaining bylaws, holding annual shareholder and director meetings, keeping minutes of shareholder and director major decisions, ensuring that officers and directors sign documents in the name of the corporation, and importantly, maintain separate bank accounts from their owners and keep detailed financial and corporate records. A failure to follow the rules could lead to the loss of limited liability, known as “piercing the corporate veil.”

WORK IT OUT

Piercing the Corporate Veil of Limited Liability

As we have discussed, entrepreneurs should generally form a separate legal entity to limit personal liability arising from business obligations, such as contracts. Incorporating or organizing as an LLC can limit owners’ personal liability to the extent of their investments. This liability shield is not without exception, however: in particular, a situation called “piercing the corporate veil.” A recent 2018 case example (Woodruff Construction, LLC v. Clark, No. 17-1422 [Iowa Ct. App. Aug. 15, 2018]) demonstrates this point.

Factual Overview: The defendant was the sole owner of a corporation and entered into a contract to remove sludge for the plaintiff at a waste treatment facility. The defendant never completed the work. The plaintiff sued and won a $400,000 judgment against the corporation for breach of contract. However, the plaintiff was not able to collect from the corporation due to insufficient assets. The plaintiff then asked the court to pierce the veil of the corporation, which would allow recovery from the corporate owner’s personal finances.

Piercing the Veil: Evidence showed that although the defendant kept a separate bank account for the corporation, he had commingled its funds with his personal finances, which is a distinct violation of fiduciary duty. He used the bank accounts for the corporation interchangeably with other bank accounts. Furthermore, the defendant did not follow required corporate formalities because he had no bylaws or resolutions, no voting records, and no documentation of or minutes from shareholder meetings.

Finding: The court allowed the plaintiff to pierce the corporate veil. This means that the defendant, the sole owner of the corporation, had to pay over $400,000 out of his personal funds. (Note: Although it is true that LLCs have fewer formal requirements, this case would likely have had the same result if the owner were an LLC because the rules are essentially the same for piercing the veil of limited liability.)

Critical Thinking:

- How can you protect yourself from this happening to you?

Most corporations use a three-part (or tripartite) approach to ownership and management. After the corporation is created and operations start, the shareholders typically elect a board of directors, and the board has oversight responsibilities for the operations

of the company. The board then appoints officers who are responsible for the day-to-day operations of the corporation.

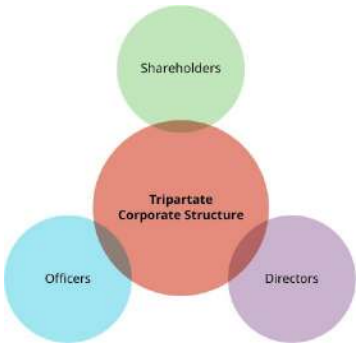


Figure 7.1.3.2: In a tripartite approach, three groups are involved in owning and managing a corporation. Shareholders elect directors who appoint officers. Shareholders are owners, and directors/officers may be, and typically are, shareholders. (CC BY 4.0; Rice University & OpenStax)

For small organizations, state law allows shareholders to directly manage a company without using a board of directors. This type of corporation is a closed corporation or a closely held corporation, and is common for entrepreneurial startups. State incorporation law, coupled with federal tax law under the IRS, regulates the formation and operation of a closely held corporation. The basic rules state that, generally, a closely held corporation is a corporation that has more than 50 percent of the value of its outstanding stock owned (directly or indirectly) by five or fewer individuals at any time during the last half of the tax year.

C Corporations, S Corporations, and B Corporations

The categorization of corporations as either C corporations or S corporations is largely a tax distinction. An **S corporation** is a "pass-through" entity, where shareholders report and claim the business's profits as their own and pay personal income taxes on it. Alternatively, the government taxes a **C corporation** at the corporate level, and then levies taxes again on the owners' personal income tax returns if corporate income is distributed to the shareholders as dividends.

Conversely, the distinction between B corporations and C or S corporations is not one based on taxes at all, but rather on purpose and approach. A certified **B corporation** is a business that meets a very high standard of social and environmental performance, public transparency, and accountability to balance profit with social purpose. B corporations can also be C corporations or S corporations. Figure 7.1.3.3 summarizes these types of corporations.

The Unique Nature of B Corporations and/or Benefit Corporations

A new form of nontraditional, for-profit corporation is the benefit corporation, which may or may not also be a B corporation. While *B corporations* and *benefit corporations* share some common goals, B corporations go through a certification process. Becoming a certified B corporation is a formal process that involves compliance with various standards and an audit of this compliance (managed by the B corporation organization). The essence of these new B corporations is that "they recognize the imperative to do no harm and create positive impact throughout the value chain." According to the B corporation organization, these certified businesses are legally required to consider the impact of their decisions on their workers, customers, suppliers, community, and the environment. As of 2019, there are approximately 3,000 certified B corporations in sixty-five countries, covering 150 different industries. The B corporation certification is somewhat like a seal of approval for businesses voluntarily trying to be socially responsible. A benefit corporation is a corporation recognized by a governmental agency under state law (about thirty states now recognize benefit corporations with legal requirements of higher purpose, accountability, and transparency) but does not carry the certification of a B corporation. However, in terms of purpose as related to corporate social responsibility, the two entities are very similar.

The benefit corporation's objective is directed toward maximization of benefits for all stakeholders, meaning that the company benefits any person with an interest or concern in the business. It does not only maximize stockholder profits. Maximization of stakeholder benefits is directed through the corporate charter of a benefit corporation. The state of incorporation directs how benefit corporations are created, but generally, this "new governance model broadens the perspective of traditional corporate law by incorporating concepts of purpose, accountability, and transparency with respect to all corporate stakeholders, not just stockholders." This means that the use of this type of business structure needs to be carefully considered by the entrepreneur

because the responsibility of the business will include consideration of the stakeholders outlined in the corporate charter, not just the profit maximization for the shareholders.

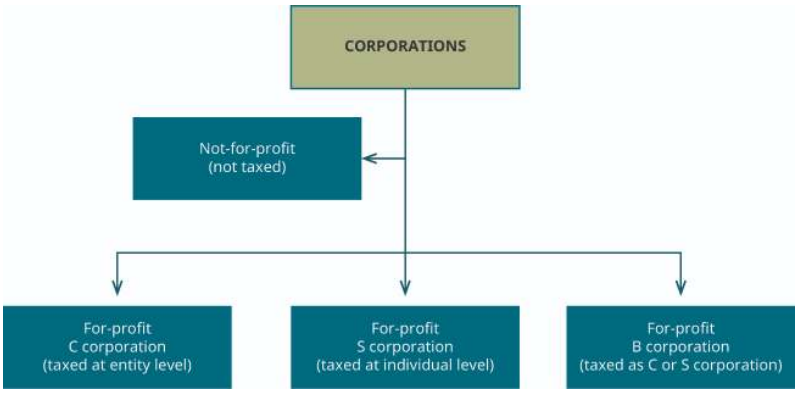


Figure 7.1.3.3: C corporations, S corporations, and B corporations are all types of for-profit corporations, in contrast to a not-for-profit corporation. (CC BY 4.0; Rice University & OpenStax)

ARE YOU READY?

B Corporation Certification

The B corporation website explains the process for becoming a B corporation. This involves three specific steps: Verified Performance, Legal Accountability, and Public Transparency. Go to https://bcorporation.net/about-b-corps and read about B corporations to learn what requirements they need to meet to be allowed to display the following B corporation logo shown in Figure 7.1.3.4.



Figure 7.1.3.4: In order to become a certified B corporation, a company must go through an external audit of compliance with each of the requirements of the B corporation. (credit: modification of “Runa B Corp Label” by “Lelepanne”/Wikimedia Commons, CC0)

Privately Held versus Publicly Held Corporations

Terminology relating to whether a company is publicly or privately owned can sometimes be confusing. For example, large corporations such as Exxon or Amazon are private corporations, but their stock is publicly held. This means that any member of the investing public can own stock in the corporation. A true public corporation is, in reality, a quasi-governmental entity, an entity owned or sponsored by the government. Government-owned corporations include the US Postal Service, the Corporation for Public Broadcasting, AmeriCorps, and Amtrak. Government-sponsored corporations include Freddie Mac and Fannie Mae, mortgage-related entities. A privately held corporation, common in Europe, is a company that does not allow members of the investing public to own stock. The founder’s family or friends, or perhaps a private group of investors such as a venture capital firm, may hold it. Examples include Facebook before it went public in 2012, or Cargill or Mars.

Publicly Traded Corporations

A publicly held corporation is, as described, an entity in which members of the investing public own the stock. A term commonly applied to such corporations is a *publicly traded corporation*, meaning that the stock can be bought and sold in the public marketplace, such as the New York Stock Exchange. A publicly traded corporation has more access to investors and thus more

capital, but it must operate under a formal set of rules established by the Securities and Exchange Commission and Congress, assuming the shares are sold publicly in the United States. Audits of publicly traded companies also have to follow the rules of the Public Company Accounting Oversight Board (PCAOB). "The PCAOB oversees the audits of public companies and broker-dealers in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports." Following the SEC and PCAOB rules emphasizes investor protection but can be complex, as it increases both startup and operating costs for the venture due to increased regulation and reporting.

A publicly traded company is required to have a board of directors with a dual mandate to both consult with management regarding the strategic direction of the company and oversee company performance. The board of directors does not manage the company, and the members are separate from management. The board will have numerous committees to assist in its functionality, and one of the committees is the audit committee. The audit committee of a publicly traded company must hire an outside auditor approved by the PCAOB to audit the books of the publicly traded company. Further, the chief executive office and chief financial officer of the publicly traded company must sign a certification of earnings report, guaranteeing their truthfulness. The rules and regulations with which compliance is required are more demanding for a publicly traded company than for a privately held or closely held company.

Closely Held Corporations

A closely held corporation, also known as a close corporation, is the same as a privately held corporation for the purposes of securities laws. However, the concept has a secondary meaning related to management structure. A close corporation is also a management structure for a corporation that is often selected by small companies that use the less-formal management style of a general partnership yet retain the limited liability of a corporation. In essence, there are fewer formalities for a close corporation, and it allows greater control for the small group of shareholders.

A close corporation is required to have an annual shareholder meeting and keep corporate minutes. All of this detail is required to be recorded in the corporate records, even if there is just one shareholder. Sole proprietors using a corporation as a business structure must follow the rules regarding corporations in the state in which they were incorporated. Some states may even dissolve a corporation that does not have an annual meeting or keep proper corporate records. When a corporation is dissolved, the shareholders become personally liable for corporate debts, and shareholders' limited liability is lost. Managing a closely held company requires the entrepreneur to follow state guidelines while operating the corporation accordingly.

The shares of a closely held corporation are not traded on the open market and typically have just a few shareholders. Closely held corporations have fewer reporting requirements than publicly traded companies and typically are not required to have audited financial statements, unless the corporate charter says otherwise. Audited financial statements are costly and are required for publicly traded companies. The audited financial statements help investors buying and selling stock in the stock market value shares and are not necessarily needed for a closely held corporation. However, it is difficult to value a closely held corporation because there is no ready market for the ownership shares.

Not-for-Profit Corporations

Nonprofit corporations are created in one a state but may operate or solicit donations in other states. A nonprofit corporation operating or soliciting donations in multiple states needs to register to operate as a nonprofit corporation in every state in which it operates.

Not-for-profit corporations are organized in a similar fashion to for-profit corporations, with a board of directors and officers, but they have no shareholders, stock, or owners. The stakeholders of a non-for-profit corporation play an important role, monitoring overhead and allocation of funds. Since most of the funds are donations and are tax deductible, public watchdogs may monitor the financial statements of federally tax-exempt organizations. The fact that the Internet provides easy access to financial data related to federally tax-exempt nonprofits provides watchdog organizations easy access to financial data and the ability to analyze the operations and compensation for the nonprofit's organizers and employees.

ENTREPRENEUR IN ACTION

Bombas: Achieving Profit and Nonprofit Goals

In a 2017 interview with Robin Roberts of ABC News, Bombas socks co-founder David Heath said: "Back in 2011, I came across a quote on Facebook that said…that socks were the number one most requested clothing item in homeless shelters." So

he decided to start a new company that was an overnight success, boosted by an appearance on *Shark Tank* in 2014. He created his company, Bombas, with co-founding entrepreneur Randy Goldberg. They founded their company with the goal of giving back to the community by donating socks to the homeless, with its actual product idea as a secondary goal. They have donated over 25 million items through more than 2,500 partners across the country.



Figure 7.1.3.5: This is a pair of Bombas socks. (credit: modification of "Bombas Socks" by Tony Webster/Flickr, CC BY 2.0)

Bombas is now a successful sock company that uses a business entity as a way to address the shortage of sock donations in homeless shelters. Heath and Goldberg spent two years inventing pairs of high-quality socks with extras such as reinforced foot beds and anti-blister tabs, coupled with contoured seaming. For these entrepreneurs though, it was not just about sock technology, it was about doing something meaningful at the same time—a combination of profit and nonprofit goals. Therefore, they made a commitment to those in need, and since 2013, the company has donated more than 10 million pairs of socks to homeless shelters, due to their buy one, give one model of marketing socks.

The socks that Bombas donates to the homeless are not cheap throw-away token socks. Rather, they have been designed for their homeless wearers, for example, with antimicrobial treatment to prevent bacteria if they cannot be washed as frequently and reinforced seams for durability, since the homeless do not have the money to keep buying new ones.

In essence, the company makes customers, and the company partners with the homeless.

- Is Bombas really paying for this project to help the homeless or is the customer?
- Is Bombas just facilitating the good idea and customers are paying for it, or do you think Bombas is also contributing some of its profit?

LINK TO LEARNING

Go to the Bombas website to watch the video that explains what they do as part of their B corporation commitment.

Overview of Corporate Taxation

All for-profit corporations are subject to income tax at the federal level, and usually at the state level as well. Regardless of tax elections, both C- and S corporations are subject to taxation.

Tax planning is a major issue for most corporations and may explain some key decisions, such as where they are located. That could involve decisions about which state the corporate headquarters are in, or even in which nation the headquarters are located. This is because tax laws may vary significantly by both state and nation.

The current federal income tax rate for corporations in 2019 is 21 percent, down drastically from 35 percent, which was the rate prior to 2018. Many states add a state-level income tax, ranging from 2 percent to 12 percent, while some states such as Texas do

not have a corporate income tax in an effort to attract corporations to the state.

Taxation of C Corporations

C corporations pay corporate income taxes on profits made. Individual shareholders are also subject to personal income taxes on any dividends they receive. Most attorneys and accountants refer to this concept as the double taxation disadvantage. However, the historical tax disadvantage has been recently reduced because of the decrease in the income tax rate paid by C corporations by the Tax Cuts and Jobs Act. This decrease, in turn, reduces the double tax disadvantage. Further, the ability to retain and reinvest profits in the company at a lower corporate tax rate is an advantage.

A C corporation does come with a degree of added formality, or as some may refer to it, red tape. According to most states' corporation laws, as well as federal tax and securities laws, the corporation must have company bylaws and must file annual reports, financial disclosure reports, and financial statements. They must hold at least one meeting each year for shareholders and directors where minutes are taken and maintained to display transparency. A C corporation must also keep voting records of the company's directors and a list of the owners' names and ownership percentages.

Despite the tax implications, the C corporation structure is the only one that makes sense for most large US businesses because it allows for the wide-scale sale of a large amount of stock to the general investing public without limits. A C corporation can have an unlimited number of shareholders that are individuals or other business entities, and are either US citizens or foreign nationals.

Taxation of S Corporations

As previously discussed, the S corporation is a corporate entity in which the firm's profit is passed through its stockholders (shareholders), usually in proportion to their investment—this is known as pass-through taxation. Essentially, this amounts to tax management by the corporate owners. The IRS taxes the corporate profits at the personal income tax rates of the individual shareholders. S corporations (S stands for "small"), also called subchapter S corporations, must comply with several important restrictions with which entrepreneurs must comply.

S corporations have a limit on shareholders. Unlike with C corporations, the Internal Revenue Code limits the number of S corporation shareholders to 100 or fewer, and owners can only be individuals, (or estates and certain types of tax-exempt entities). Additionally, the individual shareholders must also be US citizens or legal permanent residents. Furthermore, S corporations may only have one class of stock, whereas C corporations may have multiple classes. For example, in a C corporation, there might be voting shares, nonvoting shares, common shares (the type most people buy), and preferred shares (which are repaid first in the event of bankruptcy).

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7.1.4: Partnerships and Joint Ventures

Learning Objectives

By the end of this section, you will be able to:

- Describe the ownership structure of a partnership
- Describe the ownership structure of a joint venture
- Summarize the advantages and disadvantages of partnership and joint venture structures

A **partnership** is a business entity formed by two or more individuals, or partners, each of whom contributes something such as capital, equipment, or skills. The partners then share profits and losses. A partnership can contract in its own name, take title to assets, and sue or be sued.

A **joint venture** is, in essence, a temporary partnership that two businesses form to gain mutual benefits, such as sharing of expenses and to work toward shared goals and the associated potential revenue. Joint ventures share costs, risks, and rewards. A joint venture, for example, can help speed up expansion of your business by gaining access to additional equity, new markets, or new technology. Partnerships and joint ventures share many similarities, but they do have some important differences.

Overview of Partnerships

State law governs the formation and operation of all partnerships. It would be too lengthy to cover the laws of all fifty states; therefore, this section contains some generalizations that may vary according to jurisdiction. Federal law has very limited applicability to partnerships, primarily in the area of federal income taxation. A **general partnership** is created when two or more individuals or entities agree to work together to operate a business for profit. A partnership generally operates under the terms of a written partnership agreement, but there is no requirement that the agreement be in writing. In many instances, the only requirement is that two or more parties come together to operate a business for profit.

Entrepreneurs need to be careful because a general partnership can be informally created by the actions of two or more people or entities pursuing a business for profit while sharing management duties. State courts may deem these actions the creation of an informal or even formal partnership. For this reason, if two entities or people come together to purse a joint business operation or strategy, the parties should document the pursuit of the business venture in a written agreement. Many state laws require that some forms of a partnership use a formal written partnership agreement or articles of partnership. If the venture is of a shorter duration, it might be better to enter into an agreement documenting a joint venture. In either case, the entrepreneur needs to have a clear understanding of the exact business relationship before embarking on a new venture, and a partnership agreement can and should outline those details.

A partnership agreement addresses many important topics, including the monetary investment of each partner, their management duties and other obligations, how profits or losses are to be shared, and all the other rights and duties of the partners.

Partnerships can take many forms, including general partnerships (GPs), limited partnerships (LPs), limited liability partnerships (LLPs), and, in some states, limited liability limited partnerships (LLLPs). All states require the registration of any limited liability entity. In GPs, liability of the owners is considered “joint and several,” meaning that not only is the partnership entity liable, so too is each general partner.

The liability of partners, therefore, may be limited by the creation of an LP. A **limited partnership** requires at least one general partner and one or more limited partners. A limited partner’s liability is typically capped at their investment, unless they take on the duties of a general partner. The general partner is personally liable for all of the operations of the LP.

LPs have been around for many years and allow investors to provide funding for a business, while limiting their investment and personal risk. LPs are commonly used in businesses that require investment capital but do not require management participation by LP investors. Examples include real estate where the LP buys commercial real estate, making and funding movies or Broadway plays, and drilling oil and gas wells.

Some states have relatively recently started to allow variations on the LP structure and offer businesses the option of forming a related type of partnership entity. These **limited liability partnerships** are common with businesses such as law firms and

accounting firms. The partners are licensed professionals, with limited liability for financial obligations related to contracts or torts, but full liability for their own personal malpractice. The primary difference between LLCs and LLPs is that LLPs must have at least one managing partner who bears liability for the partnership's actions. An LLP's legal liability is the same as that of an owner in a simple partnership. Entities that are formed with a founding partner or partners—commonly law firms, accounting firms, and medical practices—often structure as an LLP. In this situation, junior partners typically make decisions around their personal practice but don't have a legal voice in the direction of the firm. Managing partners may own a larger share of the partnership than junior partners.

The final type of partnership is a limited liability limited partnership (LLLP), which allows the general partner in an LP to limit their liability. In other words, an LLLP has limited liability protection for everyone, including the general partner who manages the business.

Advantages and Disadvantages of General Partnerships

The GP is a very common business structure in the US. It is created when two or more individuals or entities come together to create, own, and manage a business for profit. A GP is not technically required to have a written agreement, or to file or register with the state government. However, GPs should have their business structures described in writing, so that the entities working together have an understanding of the business and the business relationship.

When a GP is created, one partner is liable for the other partner's debts made on behalf of the partnership, and each partner has unlimited liability for the partnership's debt. This creates a problem when one partner disagrees with the source or use of funds by another partner in terms of capital outlay or expenses. Each partner in a GP has the ability to manage the partnership; if something negative happens such as an accident (called a tort) that injures people and produces liability—like a chemical spill, auto accident, or contractual breach—each of the partners is personally liable with all of their personal assets at risk. Also, the partners are liable for the taxes on the partnership, as a GP is a pass-through entity, where the partners are taxed directly, but not at the partnership level.

It should be noted that GPs may be a useful structure in certain situations because they are relatively easy and inexpensive to form. The expanding use of LPs, LLPs, and LLLPs is discussed in the preceding text, but the popularity of GPs has been on the decline. However, as long as the business does not have a high likelihood of liability-producing accidents or situations, a GP can work. An example might be two partners offering graphic design or photographic services. However, due to the different risks associated with them, GPs are often not the best choice of business entity. Other types of entities offer the protection of limited liability and are thus better choices in most circumstances.

Taxation of Partnerships

Partnerships are considered pass-through entities, whether they are GPs, LPs, or LLPs. Therefore, the partnership's profits are not taxed at the entity level, like with a C corporation, but the profits are passed through to the partners, who claim the income on their own tax returns. The partners pay income taxes on their share of distributed partnership profits (disclosed on a Schedule K-1 form from the partnership to the individual partners). Thus, there is no such thing as a partnership tax rate.

If the entity is a joint venture that is organized and run as a partnership, then it is taxed the same way, even if the partners are corporations. The profits are distributed, and each corporation pays its own taxes. If, in the alternative, the joint venture formed a separate distinct corporation, then it pays taxes as a corporation.

LINK TO LEARNING

See the University of Richmond Law School's good summary of the pros and cons of GPs to learn more.

Joint Ventures: Business Entities Doing Business Together

A joint venture occurs when two or more individuals or businesses agree to operate a for-profit business venture for a specific purpose. A joint venture is similar to a legal partnership but different in terms of purpose and duration. Usually, joint ventures are used for a single purpose and a limited period. One example of a joint venture involved BMW and Toyota working together to research how to improve the batteries in electric cars, a single purpose, over a period of limited duration, envisioned to be ten years.

Companies enter into a joint venture often to avoid the appearance of the creation of a partnership, because partnerships tend to create long-term obligations between the partners, while a joint venture is a limited business enterprise. Typically, two business entities operate a business together on a joint project. The joint venture agreement allows the entities to pursue a specific business objective while keeping their other business operations and ventures separate.

A joint venture is not recognized as a taxable entity by the IRS. The entrepreneur can use a joint venture agreement to develop a business enterprise, and if the business enterprise is successful, a new entity can be created to take over the operations of the joint venture and move the business to the next level. For this reason, a joint venture can be a good way test a business concept. If successful, then the operations and assets can be rolled into another entity that supports investment from outside investors. The use of a joint venture also allows the parties to test drive the relationship between the entities: to develop a business venture with less risk.

Joint ventures can involve parties that are large or small, or from private or public sectors, or they can involve a combination of types of entities, most often resulting in a joint venture that is formed as a corporation or LLC. For example, the public company Google and the private entity NASA formed a joint venture to improve Google Earth. Likewise, a joint venture might be something smaller, such as an arrangement between a freelance IT engineer, a graphic designer, and a social media consultant to create a new cell phone app. Figure 7.1.4.1 summarizes the relationships of the businesses in a joint venture.

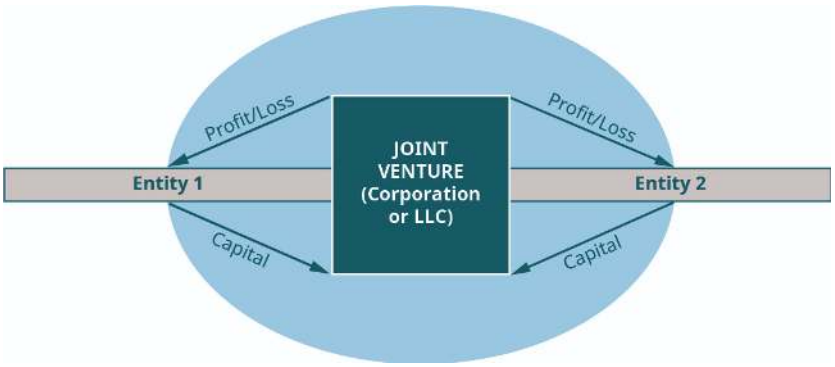


Figure 7.1.4.1: Joint ventures are separate business entities, most often owned and operated by two other business entities. (CC BY 4.0; Rice University & OpenStax)

WHAT CAN YOU DO?

Challenges Facing Small Farmers

Sometimes, small businesses are at a disadvantage due to size. We can see an example of this disadvantage in the field of agriculture. The cost of new agricultural equipment is very high, and land may be prohibitively expensive. These costs put small farms under pressure to compete by increasing the size of their operations. If you owned a small farm and were looking to expand, how could you use a joint venture?

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7.1.5: Limited Liability Companies

Learning Objectives

By the end of this section, you will be able to:

- Describe the ownership structure of a limited liability company
- Explain how limited liability companies are taxed
- Summarize the advantages and disadvantages of the limited liability company structure

A **limited liability company** is a hybrid of a corporation and a partnership that limits the owner's liability. The big advantage that LLCs have over GPs is in the protection of owners from personal liability. Thus, an LLC is similar to a corporation in that it offers owners limited liability.

The advantage that LLCs have when compared to corporations, especially for entrepreneurs, is that they are easier to form and less cumbersome to operate because there are fewer regulations and laws governing LLC operations. Although LLCs tend to be easier to create, they still require a filing of articles of formation with the state and the creation of an operating agreement. Owners of an LLC can be individuals and other business entities. The entrepreneur can use the flexibility of an LLC to create a business structure suitable to the operational and tax needs of the business.

In 1977, Wyoming was the first state to allow the LLC format—most states started allowing them in the early 1990s. In contrast, corporations have been around since the early nineteenth century. LLCs now significantly outnumber corporations, with some estimates indicating that four times as many LLCs are formed as corporations,[16] with the total number of LLCs nearing 20 million compared to about 2 million corporations. Each state may permit varying types of LLCs, with different types of formation agreements and operating agreements.

When evaluating the use of an LLC as the structure for your business, it is important to know that there are some constraints on the use of an LLC. In most states, a nonprofit business cannot be an LLC. Additionally, most states do not permit banks or insurance companies to operate as LLCs.

Overview of LLCs

The owners of an LLC are called members. The owner (if a single-member LLC) or owners often run the company themselves. These are called member-managed LLCs. The daily operations of the LLC can also be delegated to a professional manager, which is called a manager-managed LLC. If the original organizer of the LLC chooses, they can organize an LLC in which the owners (members) will have little or no management responsibility because it has been delegated to a professional manager. These options when drafting an LLC's operating agreement allow an LLC to operate in different ways, so that an entrepreneur can develop a business structure best suited to the needs of the business.

As long as the members (owners) do not use the LLC as an alter ego and/or commingle personal funds with LLC funds, the LLC provides the corporate shield of limited liability to the investors. If the LLC is operated to protect a sole proprietor, this might become an issue if the sole proprietor commingles funds. Commingling funds or assets gives rise to the sole proprietor or other members of a multi-owner LLC being liable for all of the debts of the LLC. Generally, the ownership of an LLC is represented by percentages or units. The term *shares* is not used in operating agreements because LLCs cannot sell shares of stock like a corporation can; thus, owners are not technically shareholders.

Taxation of LLCs

Entrepreneurs are able to make decisions regarding the taxation of LLCs. The government can tax the business as a corporation or as an individual. This choice may involve more than simply a tax rate decision; it might involve ownership and management issues, as well other financial considerations. However, this section will focus on the tax decision aspect of the issue.

A multi-owner LLC's default taxation is as a partnership, meaning profits pass through and are taxed on the owner's federal tax return. However, LLCs can elect to be taxed as either a partnership or a corporation. Single-member LLCs can also be taxed as a sole proprietorship or as a corporation. The fact that an LLC can select its method of taxation as either a C corporation, S corporation, or partnership allows the entrepreneur flexibility in creating the business structure of their choosing. Note, however,

that tax laws change. For example, the Tax Cuts and Jobs Act of 2017 may make formation as an S corporation more attractive to some entrepreneurs than formation as an LLC, at least as far as taxation is concerned. You should seek advice from a tax accountant to ensure that you are able to make decisions based on the most current regulations.

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7.1.6: Sole Proprietorships

Learning Objectives

By the end of this section, you will be able to:

- Describe the ownership structure of a sole proprietorship
- Explain the advantages and disadvantages of operating as a sole proprietor

A **sole proprietorship** is a business entity that is owned and managed by one individual and has very little formal structure and no mandatory filing/registration with the state. This type of business is very popular because it is easy and inexpensive to form. The owner, called a sole proprietor, is synonymous with the business and is therefore personally liable for all debts of the business. Sole proprietors do not pay separate income tax on the company, instead reporting all losses and profits on their individual tax returns.

Overview of Sole Proprietorships

Entrepreneurs solely operating their own businesses are called sole proprietors. According to the Tax Foundation, there are more than 23 million sole proprietorships in the US, far more than any other type of business entity. This statistic means that the sole proprietorship is by far the most common business structure, even though the business is not legally separate from its owner. The primary reason that many entrepreneurs choose the sole proprietorship format is that they do not have to make a choice, get professional advice, or spend any money. An entrepreneur who just starts doing business is automatically a sole proprietorship unless they elect to become a different type of entity and file that paperwork. An entrepreneur who becomes a sole proprietor does not necessarily have to go to an attorney or an accountant, or file any documents, making a sole proprietorship quick, easy, and cheap to form and operate.

Another development related to the decision to be a sole proprietor is the rapid growth of the gig economy. Some individuals prefer to work on their own rather than become a full-time employee. Being a gig worker falls somewhere between being a business owner and being an employee, so many gig workers, ranging from drivers for a ride-sharing company to instructional designers, operate as de facto contractors who are sole proprietors.

However, there remains a debate about whether these gig workers should be deemed sole proprietors. Recently, California passed a new law, signed by Governor Gavin Newsom, which extends wage and benefit protections to many thousands of workers who were previously self-employed sole proprietors working in the gig economy. The new law is based on the presumption that when workers are misclassified as independent contractors rather than as employees, they lose basic benefits such as a minimum wage, paid sick days, and health insurance.

The sole proprietorship is the simplest method to operate a business—often under the owner's name—and the owner is typically taxed directly by the IRS by attaching a Schedule C (Profit or Loss) form to the owner's individual tax return. In order to document one's income, instead of being provided a Form W-2 from one's employer, many self-employed individuals receive one or more 1099-MISC (Miscellaneous Income) forms from clients, which typically demonstrate that the taxpayer is operating a sole proprietorship. Sole proprietors are allowed to deduct their business expenses related to their income and, as both employer and employee, are required to pay the full amount of employment taxes for Social Security and Medicare.

An owner can also operate under a DBA or "doing business as" filing. A DBA is filed at the relevant state or local government office where the sole proprietor wants to operate under an assumed name. Technically, this is not a new organization: It is just a different name. Any business entity may file for a DBA to operate under an assumed name, and many individuals operate under a DBA to indicate the type of services they are providing, such as Smith's Roofing Company. It is not uncommon for an individual to name a sole proprietorship using LLC or Co. in its name; however, an individual operating under a DBA or assumed name is not provided any of the protections provided to a corporation of LLC, even if Inc. or LLC is used in the assumed name. A sole proprietor needs to consider the impact of using an assumed name prior to creating a DBA.

Advantages and Disadvantages of Sole Proprietorships

The sole proprietor is personally liable for everything. A sole proprietor is the investor, owner, and manager of the business enterprise. The sole proprietor is personally liable for all of the taxes and any unpaid debts of the business venture. The sole

proprietor also has no business to sell and can sell only assets related to the business. The sole proprietorship is the easiest business to start but has almost no differentiation from the individual starting the business.

Taxation of Sole Proprietorships

A sole proprietorship is not taxed as an entity. All profits pass through to the owner who pays individual income taxes on all profits earned. It does not matter whether the owner takes the money out of the business or leaves it in the business; all profits are taxed to the individual owner. This is an area that requires significant planning and may be a potential disadvantage, depending on how the individual owner's personal rate compares to the corporate rate.

Other Low-Risk Entry Structures in Entrepreneurship

Over the past decade, various alternatives to traditional employment have become popular, leading many to become entrepreneurs rather than employees. The US Bureau of Labor Statistics reported that, in 2019, there are 55 million people in who are "gig workers," which is more than 35 percent of the US workforce. That percentage is expected to increase to 43 percent by 2020. This offers both an opportunity and a challenge. There is a modicum of security when one is an employee of a company, which may not exist in the same way for someone who is freelancing or working as a contractor. There are many examples today of people becoming small entrepreneurs. This process goes by a variety of names, such as the sharing economy, the gig economy, the peer economy, or the collaborative economy. Maybe it means driving for a company such as Lyft, Uber, or GrubHub, or perhaps offering services through TaskRabbit, UpWork, or LivePerson.

ARE YOU READY?

Online Resources for the Gig Economy

The website business UpWork provides a platform for individuals to offer their services to large companies on a freelance or contract basis. Do you have skills as a web, mobile, or software developer, or perhaps in the area of data analytics? The UpWork website says that over 5 million businesses use people listed on UpWork, including companies such as Microsoft and General Electric.

Offering your services in this new manner is not controlling of what type of entrepreneurial enterprise you want to be. You can do most of these types of things as a sole proprietor, an LLC, or an S corporation. According to the Tax Foundation, over the past thirty-five years, the number of C corporations has declined significantly, while the total number of pass-through businesses including LLCs, S corporations, partnerships, and sole proprietorships has tripled to over 30 million. According to estimates, there are only 1.7 million C corporations, whereas there are 7.4 million LLCs, partnerships, and S corporations, and a whopping 23 million sole proprietorships. The explanation for these statistics is really quite simple. LLCs have quickly become one of the most popular business structures due to ease of formation and operation. Likewise, sole proprietorships are quick, easy, and low cost compared to corporations, which are more difficult and expensive to form and operate. The choice is open and depends on the variables discussed in this chapter.

ENTREPRENEUR IN ACTION

Nic & Luc Jam

In an interview with the Balance, entrepreneur Leroy Bautista summarized his path to becoming a small business owner. He worked in high-end restaurants and successful catering companies for two decades before he was laid off during the economic downturn. Bautista didn't sulk or settle for a lousy job. Rather, he saw it as a chance to finally do what his coworkers and friends had been telling him to do: go out on his own, making his sauces and vinaigrettes, and selling them at local markets. It was out of necessity that the Nic & Luc company was born.

Originally selling just a few flavors, he now sells almost twenty flavors. For many small businesses, the word "local" is used as a marketing ploy, but for Nic & Luc, it is part of the business purpose and a core value. Bautista thinks it is important to support other local businesses like himself.

This is not a story that someone like Bezos or Gates might tell: It is much more basic, but it demonstrates how people at all levels are becoming business owners. Each one of them, including Leroy Bautista in this story, must make decisions about

> mundane things such as taxes, and liability; it can’t be all about jam.

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7.1.7: Additional Considerations - Capital Acquisition, Business Domicile, and Technology

Learning Objectives

By the end of this section, you will be able to:

- Describe the capital acquisition opportunities available to different types of business structures
- Explain how the advantages and disadvantages of where a business is registered should inform the decision of where to create a business domicile
- Understand the role technology considerations may play in selecting a business structure

In addition to the main entity selection topics already discussed, such as ownership structure and taxation, there are other considerations that entrepreneurs might want to consider. For example, when choosing a business format, a founder would be interested in how to raise capital to use in the business.

Another issue to consider includes where to form a new business, since formation is largely a state issue, and there are fifty different states from which to choose. This has the potential to affect multiple aspects of one's business, including income and sales tax issues, government regulation, and litigation situs (location). For example, some states, such as Wyoming and South Dakota, have no corporate income or gross receipts tax at all; other states, such as California and New York, do have a state corporate income tax. For more information on the variation between all 50 states, see the following website operated by Cornell Law School: https://www.law.cornell.edu/wex/corporations.

Capital Acquisition

Once an entrepreneur has created a business plan, the next requirement is to capitalize the business venture. If the entrepreneur wants to start out small, a sole proprietorship is all that is needed, although even for small businesses, this structure carries a high degree of risk. Basically, the entrepreneur can simply start working on the business venture. If the entrepreneur's business venture is larger, raising capital becomes a major issue. This can be done though bank loans or investors.

Entrepreneurs eventually need capital to grow their business. Capital typically comes in the form of cash. Entrepreneurs need to consider the business structure they select for raising cash in the future if they plan to grow their business. Banks, family members, friends, or others can lend cash to an entrepreneur. These types of loans may not give the lenders ownership rights in the company. The lenders may take a lien on the assets of the business venture but do not necessarily have the right to run the business. Management is typically left to the owners when borrowing funds, but when a company receives investment funds, the investor also receives an equity share in the business and may be involved in management.

Owners and investors may want to have the right to operate the business or may want the investment structured in such a fashion so that the investors only participate in the profits or losses of the business, but do not operate the business. Depending upon the type of the business and the expectations of the entrepreneur and possible owners, this needs to be considered before creating a company. An entrepreneur raising capital needs to consider what participation is desired from investors and the timing of the needed capital. Remember, investors become owners, whereas lenders are not owners.

Capital is required at every step of a business. There can be lines of credit to finance operations as receivables are collected, and there can also be long-term borrowing for purchases of big-ticket assets required to operate the business. The difference between a loan and an investment is that the loan principal and interest must be paid back. However, an investment allows the investor to participate in the profits and losses of the business, but does not need to be repaid because investors can get a return on their investment by selling their interest in the business. Finding a good balance between how much ownership the entrepreneur wants to relinquish versus how much of the profits need to be paid to finance the business is key. The entrepreneur needs to determine this balance as the company grows. For example, Amazon started as a Washington state corporation named Cadabra, Inc., operating out of Jeff Bezos' garage, and then through several transactions became the world's largest online retailer incorporated as a Delaware corporation with its ownership shares AMZN traded on the NASDAQ.

Growing companies will have different rounds of outside investment. Never consider that the first outside investment received will be the last investment. There will be more than one round of financing in most companies. As the investment and financing

changes, there will be changes in the corporate structure of the business venture. Just like Amazon, a company can start in one's garage and then go on to be a company listed on a major stock exchange with a worldwide reach. Each step of the way takes careful planning.

Legal and tax issues are directly related to the agreements between entrepreneurs and their investors. The written agreements should spell out the corporate structure with specific details of the arrangement between the two. The business structure will drive the tax circumstances of the investment, business, and owners. This may change with new investors, so agreements should be flexible. Many times, a new investment in the same business may be created in which the new business structure purchases the assets of the old business structure. This event will change all of the agreements evidencing the structure of the venture.

Agreements describing how the owners share in profits and losses, and how the owners share in making decisions about the business venture can and do change. Many owners and entrepreneurs desire that their company become a publicly held corporation. This is a company with its ownership shares traded on a public exchange. The ease of buying and selling shares on a public exchange typically increases the value of the company. Therefore, many investors desire that shares ultimately become publicly traded. A company may start as a sole proprietorship, become an LLC, and then be converted into a corporation with its ownership shares traded on a public stock exchange. In the circumstance where the company is growing, the business structure will change over time.

Many publicly traded companies start as a privately held corporation before going public through an initial public offering (IPO). A recent example is Spotify, which in a 2018 IPO raised $9.2 billion. A closely held corporation, which is essentially the same as a privately held company, has no public market for its stock. The owners, as members or shareholders, have more control over the directions of the company, until the company is taken public.

The assets of a closely held company can be sold to a company that is publicly traded, such as a reverse merger, or can be used to create a company that will pursue an IPO. Both of these are complicated endeavors that require audited financial statements, the assistance of lawyers and outside accountants, and the use of an investment bank. Each step of the way, the entrepreneur gives up some equity and control in the company in exchange for investment money to help the company grow. Most small companies becoming public will (but are not required to) list on a stock market like the Nasdaq SmallCap market or the Nasdaq National Market System. This development provides the company direct access to international capital markets and many new investors.

The issues that investors tend to look at include transferability or sale of their ownership interest, ability to raise additional capital, and protection of the investors' assets outside of the investment. If the entrepreneur is unconcerned about investment from outsiders, these considerations are not as important. Another issue is the ability to raise capital through banks or by using the SBA to guarantee a loan through a participating bank. The first step in getting an SBA loan is determining that the "business is officially registered and operates legally." This means that the borrowing business is a company that is registered in a state to do business. An entrepreneur can borrow up to $4.5 million (the SBA limit), to fund operations. However, the first step is to create a proper business entity to which the bank can loan the money or in which an investor can invest. The typical entities to which banks lend money and investors invest money are partnerships, LLCs, or corporations. To create these entities, an entrepreneur needs to file the appropriate paperwork within a given state.

In addition to traditional sources of funding, including borrowing, taking on partners, and selling stock through an underwriter, there is a relatively new source of capital for small business entrepreneurs that is an important addition to the capital acquisition options for startups. **Equity crowdfunding** involves a startup raising capital through the online sale of securities to the general public.

In 2012, Congress enacted new legislation called the Jumpstart Our Business Startups (JOBS) Act, which amended US securities laws to enable small businesses to use a variation on a technique known as crowdfunding. Crowdfunding is already in use as a way to donate money to consumers and businesses through web portals such as GoFundMe, but those sites do not offer SEC-compliant sales of securities in a business, as the JOBS Act now permits. Emerging growth companies (EGCs) seeking capital are now able to raise equity capital more easily and at a lower cost. This new type of funding should help level the playing field for EGCs and is viewed by many as a way of democratizing access to capital.

An example of success using this new method of financing for entrepreneurial startups is Betabrand. This San Francisco-based retail clothing company doubles as a crowdfunding platform. The company facilitates the use of its platform for crowdsourcing clothing concepts and prototypes, and their conversion into actual products by raising capital through their website.

LINK TO LEARNING

The Crowdfunder website connects to one of several different business-oriented equity crowdfunding websites. It offers EGCs or small business several avenues of funding, including equity, convertible notes, and debt. The primary advantage is the ability to raise equity capital without big fees, lots of federal regulations, and red tape.

Business Domicile: State and Local Considerations

There are multiple reasons why an entrepreneur may want to consider geographic location when forming and operating a business. Of course, one practical consideration is where the entrepreneur lives, at least in terms of operating a small local or regional business. However, there are other important considerations, such as differing formation/incorporation laws, widely varying levels of regulation, different types of permitting, and other relevant factors. As a rule, a corporation is considered a citizen of both its state of incorporation and the state of its principal place of business.

The state where a person lives is not necessarily the state in which they must form and/or operate the business. For example, if a person lives in the New York City metro area, they might well have a choice of New York or New Jersey, or even Connecticut, Delaware, or Pennsylvania. The same may be true for the metro areas of other large cities. Additionally, even if a person lives in the middle of North or South Dakota, they might choose to start a business in another jurisdiction, such as Delaware, Alabama, or Wyoming, due to favorable formation regulations. The following section discusses the issue of choice of jurisdiction when forming a limited liability entity such as a corporation or an LLC.

Choice of State When Incorporating/Registering Your Business

Business entities seeking the protection of limited liability must be registered with a state. This typically includes corporations, LLCs, and LPs. Additionally, if a corporation seeks to sell stock to investors in a specific state (called an intrastate offering), it must be registered in that state. The first step is to select the type of entity to be created and then file the appropriate paperwork with the state. Each entity is typically created through the office of the secretary of state (or, in the case of Kentucky, Massachusetts, Pennsylvania, and Virginia, the secretary of the commonwealth), with each state having a different process for creating the entity. The Balance, a small business resource website, lists all state government offices in which to file the appropriate paperwork (https://www.thebalancesmb.com/secret...bsites-1201005).

Forming a business in the state where the entrepreneur is physically located is generally the easiest way to create the entity through which the entrepreneur will conduct business. Some entrepreneurs choose to create their business entity in other states for privacy reasons or for tax savings. The entrepreneur will still have to file and pay taxes in every state in which the business operates and will have to register its presence in the state in which it is physically located. Some investors might prefer out-of-state incorporation, and the entrepreneur needs to remember that the corporation will be subject to taxes, filing requirements, and other fees imposed by each state of operation and the state of incorporation.

Delaware is a particularly popular state in which to incorporate due to the ease of regulations regarding ownership structure and business-friendly laws; Nevada and Wyoming are popular as well for the same reasons. The reason these states are popular is that initial fees are cheap, there are little or no renewal fees, and the states emphasize asset protection. While Delaware, Nevada, and Wyoming offer good reasons to incorporate, they are not best choice for every business. If a business incorporates in one state but does business primarily in another, in all likelihood, it may very well have to pay the second state's fees and/or taxes in addition to those of the first state. Entrepreneurs need to consider cost and ease of operations when determining the state in which to create their business entity.

Multistate Taxation

Most businesses have a website and are glad to sell products to any buyer, regardless of where the buyer is located. Amazon is an example of a company that capitalized on the concept of Internet sales. Amazon collects sales tax from all forty-five states that have a statewide sales tax because it owes tax in every state and city in which it operates.

Multistate taxation is not something that most small businesses consider, but it is an issue that can arise in many different circumstances. For example, professional basketball players may be taxed by the state, or even the city, in which they play. This means that an NBA player could owe taxes in over 20 states if he went to every game. Just sitting on the bench in 20 different states could trigger multistate taxation, and, if the team plays in other countries, foreign taxes could also be owed. This is true for

every sport and every business that operates in multiple states or other countries. It is not only multibillion-dollar corporations that are affected, but small businesses and individuals as well.

Most online multistate businesses now collect and pay sales taxes in those states with a sales tax. This was not always the case, however. For years, Amazon and other online retailers sold products without collecting any state or local sales taxes at all. The legal requirement that companies did not have to collect sales taxes in a state unless they have a "physical presence," such as warehouses, offices, and/or employees, gave online companies carte blanche to ignore state and local taxes for many years." Until the 2018 US Supreme Court decision in *South Dakota v. Wayfair*, states generally did not require online sellers to collect and remit sales tax to the state. However, this case changed the rules by creating the concept of an **economic nexus**, a virtual connection with a state based on sales volume or number of transactions. This now means, in most states, that if your business meets a threshold of $100,000 in sales in that state, it may now require you to collect sales tax on online transactions. Therefore, your online business may have to collect and remit sales tax to as many as forty-five states (five states do not have a sales tax). All entrepreneurs need to develop an understanding of how the Internet and the related tax laws and regulations will affect their planned business operations. Creating a company in another state will no longer automatically avoid multistate taxes and regulations.

Technology Considerations

Most new entrepreneurs have some familiarity with technology, whether something as basic as social media or more advanced as extensive website development skills. However, most small businesses face challenges in the areas of information technology security and compliance with legal and regulatory requirements.

Not all small businesses face these challenges. They are most common in companies that handle private information, such as health records or credit card data. The storage and protection of this type of information must comply with government regulations. For example, a small government IT contractor that deals with any type of classified governmental information would need to ensure classified information was protected per regulations and not at risk of exposure. In the healthcare field, recent hacks of patient health data, some of which are handled by small businesses such as a solo practice physician's office, demonstrate the challenges of data protection. It is a significant challenge for companies with relatively small budgets to protect data. Technology security adds large costs and requires skilled personnel, for any business, large or small. Figure 7.1.7.1 summarizes the choices of business structure discussed throughout this chapter.

Entities	Owners	Liability	Taxes	Formation	Management	Capital
C Corporation	Unlimited number of shareholders allowed	No personal liability of shareholders for liabilities of corporation	Taxed on profits, shareholders also taxed on dividend	Articles of Incorporation, Bylaws, Resolutions, Stock Certificates	Board of Directors, Officers	Shareholders purchase stock, which creates capital for the corporation
S Corporation	100 shareholders allowed	No personal liability of shareholders for liabilities of corporation	Not taxed as corporation; profits are passed through to shareholders who pay taxes	Articles of Incorporation, Bylaws, Resolutions, Stock Certificates, IRS S Corp election form	Board of Directors, Officers; if close corporation, owners can manage directly without a board	Shareholders purchase stock, which creates capital for the corporation
Sole Proprietor	One owner	Total personal liability for liabilities of business	Owner pays taxes	Usually no government filing required; DBA form needed if using an assumed name	Owner manages business	Owner puts in own capital and/or borrows from bank
General Partnership	Unlimited number of general partners	General partners have personal liability	Profits passed through to general partners who pay taxes	Usually no government filing required; General Partnership Agreement	General partners have equal management rights unless they agree otherwise	Partners contribute capital
Limited Partnership (LP)	Unlimited number of general and limited partners	General partners have personal liability; limited partners do not have personal liability	Entity not taxed; profits passed through to partners who pay taxes	Limited Partnership Certificate, Limited Partnership Operating Agreement	General partner can manage the business; limited partners do not participate in management	General and limited partners contribute capital
Limited Liability Company (LLC)	Unlimited number of members allowed	Member does not have personal liability	Taxed as a partnership	Articles of Organization or Formation, Operating Agreement	Managed by members collectively or managed by a single member	Members contribute capital

Figure 7.1.7.1: The characteristics of different business entities [C-Corporation, S-Corporation, Sole Proprietor, General Partnership, Limited Partnership (LP), and Limited Liability Company (LLC)] are provided in terms of owners, liability, taxes, formation, management, and capital. (CC BY 4.0; Rice University & OpenStax)

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7.1.8: Mitigating and Managing Risks

Learning Objectives

By the end of this section, you will be able to:

- Explain Enterprise Risk Management and how a company uses it
- Describe litigation and financial risks
- Describe common insurance needs

Risk management is key to operating any business in a profitable fashion. There are many risks facing an entrepreneur when starting and operating a new business venture. The trick is to eliminate risks that will hurt the venture, while taking on risks that will provide for long-term profitability. The risks facing the entrepreneur need to be initially identified as part of developing a business plan and revisited regularly in ongoing operations. Preparation for adverse events affecting a new business venture is necessary, but being too pessimistic or allowing fear of adverse events to stop an entrepreneur from taking any risk will keep a business venture from achieving its greatest potential and profit.

It is important that an entrepreneur develop an understanding of the risks of the business environment. The risks include liability risks stemming from contracts and torts, sometimes referred to as operating risks, regulatory compliance risks, financial risks, and strategic risks, including taxation. Understanding how the business structure is used to operate the business venture allows the entrepreneur to develop a plan to manage business growth and understand business risk.

Enterprise Risk Management

Profitable ventures develop a strong **enterprise risk management** program, which is an integrated, cross-disciplinary approach to monitoring risk. An organization needs to look at both long-term and short-term risks at all levels of the organization, and these risks need to be evaluated from all stakeholders' perspectives and developed into an entity-wide program.

Enterprise risk management attempts to address the specific risks discussed in the preceding section by implementing a risk program that enables a business to identify and manage risk. Specifically, a business will go through a process that involves a multistage process of risk identification, risk assessment, and risk abatement. Examples of risks that businesses face include those from natural causes, economic causes, and human causes.

Natural causes of risk include disasters such as hurricanes and flooding, as well as earthquakes or other catastrophes that result in loss of life and property, as well as business interruption. For example, a business in New Orleans could be flooded by a hurricane. This results in damage to facilities and products, and threatens the lives of workers. In order to counter such causes, businesses need to plan ahead for business continuity, take out comprehensive insurance coverage, and have an evacuation/shut-down plan in place.

Economic causes of risk include global events leading to rising prices of raw materials, currency fluctuation, high interest rates, and, of course, competition from other companies in the same industry. An example of this would be unpredictable trade wars with China, leading to tariffs.

Human causes of risk refer to actions by employees, contractors, and those persons over which a company has control. These events can include torts stemming from negligence at work, labor strikes, shortages of qualified trained workers, and corporate mismanagement. An example of this type of risk would include embezzlement of money by an internal financial executive.

The use of a comprehensive approach allows a business entity to review and combine all risks into a functional perspective that allows the entrepreneur to evaluate risks and integrate new risks as different opportunities become more important to the business venture. Businesses sometimes use a risk matrix to assess or characterize the probability and impact of risk. The use of such a tool can help a business quantify risk and decide whether to undertake an activity based on its level of risk.

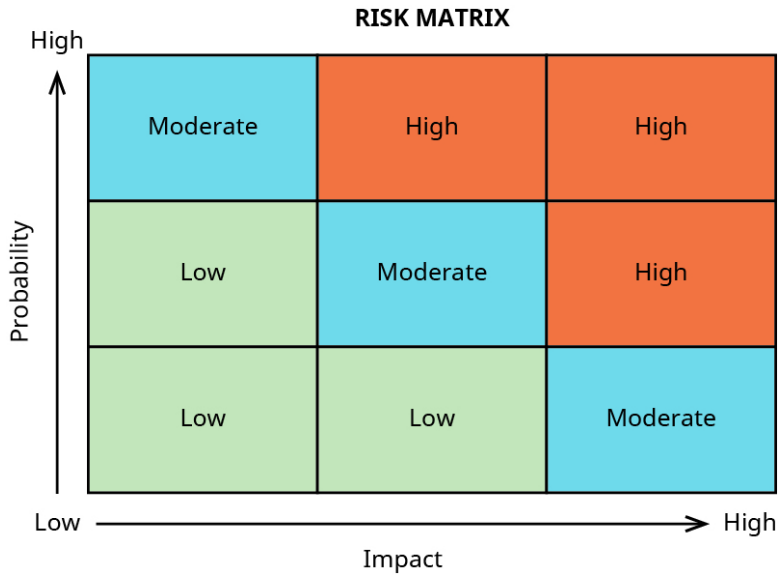


Figure 7.1.8.1: A risk matrix can be a useful tool to assess the likelihood and severity of risk that a venture may have. (CC BY 4.0; Rice University & OpenStax)

Risk appetite is important for a business venture to consider, both when creating its business structure and during ongoing operations. Table 7.1.8.1 shows an overview of the considerations a business venture should entertain in both its creation and operation.

Table 7.1.8.1: Risk Appetite

Risk Item	Consideration
Existing risk profile	Current level and distribution of risks across the business and across risk categories
Risk capacity	Amount of risk the business can support while pursuing its objectives
Risk tolerance	Amount of variation the business can tolerate while pursuing its objectives
Risk attitude	Management's attitudes toward growth, risk, and return

COSO's *Enterprise Risk Management, Understanding and Communicating Risk Appetite* outlines these considerations for assessing a business's appetite for risk.

This is the basic approach to evaluating a new venture's appetite for risk. Determining and understanding the risks facing a new venture should start during the preparation of the business venture's written business plan and should continue through the operations of the venture.

LINK TO LEARNING

The Committee of Sponsoring Organizations of the Treadway Commission, also known as COSO, deals with risk management. The mission statement of the COSO is "to provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations."

Legal Risk and Protection

Business operations of any sort need to follow business regulations and laws. The failure to follow business regulations may lead to fines, lawsuits, or even criminal penalties. **Legal risk** stems primarily from a breach of contract and/or the commission of a tort. Common examples of this type of risk includes product liability lawsuits. These lawsuits are frequently very expensive class action

lawsuits or regulatory investigations of dangerous products. There are many famous case examples including automobiles, asbestos, pharmaceutical drugs, breast implants, and airplanes.

Other lawsuits stem from contracts, including borrowing money from a bank. The business has an obligation to pay it back, or it breaches a covenant within a contract. Other common types of contracts are those used in selling services and products, leasing real estate, and other similar contractual obligations.

Due to liability risks, business owners and investors are always looking for ways to limit their personal liability. Incorporation is a standard risk protection strategy for this potential problem, as are the use of other types of limited liability structures such as LLCs. This is one of the main advantages of properly operated corporations and LLCs, which allow for limited personal liability of owners and investors. Partners in GPs and sole proprietors are personally liable for all of the debts of the business, even beyond their own investment in the business.

However, a particular challenge for small business entrepreneurs is that even when they form a corporation or LLC, many lenders, landlords, and other entities providing credit to a small business circumvent the limited liability protection by requiring owners and investors to personally guarantee the debts of the business operations. This means that the owner who personally guarantees the credit will have to pay back the obligation if the business cannot. An owner can obtain insurance or borrow money for such guarantees. LLCs and corporations do protect their owners, shareholders, and members from a number of different tort claims, such as personal injury lawsuits and claims made directly against the organization.

Financial Risk and Protection

An entrepreneur needs money to launch a business, whether that comes in the form of loans from family, their own savings, or investors. The founder will be expected to put their own money at risk, whether in the form of a loan to their own business or equity in their own business. If they do not have any “skin in the game,” then others will not be interested in loaning them money. This means that if the business fails, it will have repercussions for the owner, even if they operate as a corporation or LLC. This is the essence of **financial risk**: starting a new business with insufficient funds to sustain operations over an extended period of time.

Any new business owner needs to have a sound financial strategy as a part of the overall business plan. This should show income projections, the liquid assets that will be required to break even, and the expected return on investment for all investors in the first five-to-ten-year timeframe. Failure to accurately plan could mean that the entrepreneur risks business closure and bankruptcy, and investors get nothing.

Insurance Protection

Risk management and protection are enhanced with the purchase of different types of **insurance**, which involves spreading risk over a large number of people (policyholders). If a company is a corporation, it may need directors’ and officers’ liability insurance to indemnify the directors and officers if they get sued. Another insurance policy many companies get is called errors and omissions insurance, and this insurance coverage protects employees in negligence claims and cases if employee theft. Other types of insurance policies that most businesses carry include automobile insurance, health insurance, property insurance, and cyber/data breach insurance. Insurance coverage for a business venture needs to be specific to the business structure and its operations. Keep in mind that not all risks can be insured against—for example, a bad economy that leads to a loss of business or a bad decision by the owner to enter a market that does not work out.

Information Technology/Cybersecurity for Small Businesses

According to the SBA, the risk of hacking, ransomware, and customer privacy are equally as significant for most small businesses as for larger ones. The SBA has set guidelines related to cybersecurity for entrepreneurs. The SBA recommends the ten-step action plan shown in Table 7.1.8.2.

Table 7.1.8.2: Small Business Administration Recommendations for Cybersecurity

Step	Action
1	Protect against viruses, spyware, and other malicious code
2	Secure your networks
3	Establish security practices and policies to protect sensitive information
4	Educate employees about cyber threats and hold them accountable
5	Require employees to use strong passwords and change them often
6	Employ best practices on payment cards
7	Make backup copies of important business data and information
8	Control physical access to computers and network components
9	Create a mobile device action plan
10	Protect all pages on your public-facing websites and apps, not just the checkout and sign-up pages

The Federal Communications Commission joins the SBA in the preceding recommendations. For more information, see the following website: https://www.fcc.gov/general/cybersec...small-business.

WHAT CAN YOU DO?

Managing Payment Data

If you operate a small business, are you prepared to deal with hackers who break into your website and steal credit card data from consumers who bought your products online? Small businesses running an e-commerce site must comply with the Payment Card Industry Data Security Standard (https://www.pcisecuritystandards.org/). This is a regulation that could cause severe legal risk for entrepreneurs if your system is compromised, and credit card data are stolen. Consumers rightfully expect and demand a safe online experience when they visit your site. Have you paid an expert to evaluate your system and install the best security system? It may be costly, but perhaps not as expensive as the damages you could be ordered to pay by a court if credit card data are hacked.

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7.1.9: Key Terms

B corporation
business that meets a very high standard of social and environmental performance, public transparency, and accountability to balance profit with social purpose

business purpose
reason the entrepreneur forms the company and determines who benefits from it, whether it is the entrepreneur, customers, or some other entity

business structure
legal organization of a business; also called *entity selection*

C corporation
corporation taxed the corporate level, and then again on the owners' personal income tax returns if corporate income is distributed to the shareholders as dividends

capital
money raised for operating a business

corporation
complex business structure created by filing the appropriate documents with the state of incorporation

economic nexus
virtual connection with a state based on sales volume or number of transactions

enterprise risk management
integrated cross-disciplinary approach to monitoring risk

equity crowdfunding
raising of capital through the online sale of securities to the general public

financial risk
starting a new business with insufficient funds to sustain operations over an extended period of time

for-profit business
business structure designed to create profits that are distributed to the owners

general partnership
business created when two or more individuals or entities agree to work together to operate a business for profit

insurance
spreading risk over a large number of people (policyholders)

joint venture
temporary partnership in which two different enterprises combine for the purpose of mutual benefits such as sharing of expenses and to work toward shared goals and the associated potential revenue

legal risk
risk stemming primarily from a breach of contract, a regulatory violation, and/or the commission of a tort

limited liability company (LLC)
hybrid of a corporation and a partnership that limits the owner's liability

limited liability partnership (LLP)

business arrangement for professional partnerships, such as law firms or accounting firms, in which partners are licensed professionals, with limited liability for financial obligations related to contracts or torts, but full liability for their own personal malpractice

limited partnership (LP)

business arrangement that has at least one general partner and one or more limited partners

not-for-profit organization (NFPO)

business structure that is usually dedicated to furthering a particular social cause or for advocacy related to a common shared interest by using its surplus revenues to achieve its ultimate objective

partnership

business entity formed by two or more individuals, or partners, each of whom contributes something such as capital, equipment, or skills

privately held corporation

company that does not allow members of the investing public to own stock; instead, it is owned by the founder's family or friends, or a private group of investors

public corporation

quasi-governmental entity, a corporation owned or sponsored by the government

publicly held corporation

entity in which members of the investing public own the stock

S corporation

"pass-through" entity, also known as a small corporation, where shareholders report and claim the business's profits as their own and pay personal income taxes on it

sole proprietorship

business entity that is owned and managed by one individual that has very little formal structure and no mandatory filing/registration with the state

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7.1.10: Summary

7.1.2 Business Structures: Overview of Legal and Tax Considerations

Being an entrepreneur carries with it the responsibility to make significant decisions, the first of which is to decide the business purpose: For example, who should benefit from the creation of the entity? The second important decision to make is whether you are going to be a for-profit or not-for-profit business. This decision is closely related to the business's purpose and is not necessarily controlled by how much revenue you think you might have but rather by who is going to "own" the entity and what it does with the profit it makes. A third decision to make is the type of business entity or structure. Choices include corporation, LLC, partnership, and sole proprietorship.

7.1.3 Corporations

When forming a corporation, there are numerous choices. One choice is whether to form a C- or S corporation. This is primarily a tax decision, with C corporations being taxed as corporations, and S corporations being taxed as partnerships. Which one is the best for you depends on a number of variables, including how many shareholders you aim to have and how much of the revenue you want to leave in the corporation versus take out of it in the form of dividends, considering possible double taxation issues. Another choice is whether you want to go through the process of becoming a certified B corporation through adherence to a number of social/sustainability guidelines. Finally, you must decide if you eventually want your equity (stock) to be publicly held, as it is in most large companies, or privately held, which may give you more control but limit access to capital.

7.1.4 Partnerships and Joint Ventures

Partnerships are a popular form of doing business. Within the structure of partnerships, there are multiple entities or structures. Making the choice can be rather complicated because an ill-informed choice could result in legal problems. Choices include a GP, LP, LLP, and LLLP, each with a different set of circumstances that might make it the right or wrong choice. The factors that would play a role in selecting which type of partnership to form include business purpose, management structure, taxation, and liability. In addition to partnerships, a related type of entity is a joint venture. Joint ventures can be combinations of two or more business entities that decide to come together for a limited period of time for a specified purpose.

7.1.5 Limited Liability Companies

LLCs have become, over the past twenty-five years, one of the most popular business entities for new startups. The phenomenal growth in LLCs is due to a straightforward equation: easy formation + easy operation + limited liability = popularity. LLCs offer entrepreneurs several qualities that they seem to like: They are low cost, low maintenance, protect the owner's personal assets from liability, and offer flexible taxation choices.

7.1.6 Sole Proprietorships

The sole proprietorship structure or entity is the most common form of doing business in the US. It is easy and inexpensive to form, is directly managed by the owner, and is subject to minimal regulation in terms of its formation and/or operation. However, with these good points are also some drawbacks. The owner has unlimited personal liability for all business-related obligations, which makes using this form of business very risky. Additionally, the only way a sole proprietor can remain that way and get access to capital is to borrow money from the bank or a perhaps a family member. Sole proprietorships cannot sell stock like a corporation can nor can they take on more partners as in a partnership or LLC.

7.1.7 Additional Considerations: Capital Acquisition, Business Domicile, and Technology

Multiple considerations play a role in the selection of the best business structure for each entrepreneur. This decision flows from the entrepreneur's vision of how the proposed business will operate and affects all aspects of business operations. The decision includes issues related to legal liability, taxation, and the ability to raise capital. This process may also include consideration of the best state to form and operate in, as a result of taxation, regulation, and other related matters.

7.1.8 Mitigating and Managing Risks

Risk is part of the equation for any startup business. There is no way to protect against every risk. However, there is a way to identify risk, plan for it, manage it, mitigate against it, and protect against it to an extent. The key to understanding and dealing with risk is not to take a utopian approach to a business startup, thinking that it will never happen to you. Risk is omnipresent. Statistically, some unexpected things will happen. Thus, the best approach to risk is to consider and implement strategies to help you and your business deal with it such as incorporation, insurance, and monitoring.

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7.1.11: Review Questions

1. A not-for-profit business _____.
    a. Is allowed to retain earnings for use within the organization
    b. Must distribute profits to shareholders
    c. Must turn over to the government any excess earnings
    d. Can pay dividends to shareholders
2. The term “for-profit corporation” means which of the following?
    a. The business must make a profit or forfeit its status.
    b. The business may make or lose money without changing its status.
    c. The business is not allowed to sell stock to the public.
    d. The business must have more than 100 shareholders.
3. Which of the following business structures often involve two or more businesses starting a new business together?
    a. Sole proprietorship
    b. General partnership
    c. Joint venture
    d. Corporation
4. How is an S corporation taxed?
    a. At the entity level as a corporation
    b. At the owner level as if it were a partnership
    c. At both the entity and owner levels
    d. At a special lower rate of income tax
5. A public corporation is _____.
    a. Owned or sponsored by the government
    b. Owned by member of the investing public
    c. Owned by a combination of public and private investors
    d. None of these choices are correct
6. A C corporation is taxed _____.
    a. At the entity level
    b. At the individual level
    c. At both the entity and individual levels potentially
    d. Only at the state level, not federal
7. Limited liability partnerships (LLPs) _____.
    a. Are normally used for firms that consist of licensed professionals such as lawyers or accountants
    b. Can be used for partnerships that sell services but not goods
    c. Are used for firms that do business across state lines
    d. Require that the stock be owned by fewer than 100 shareholders
8. A joint venture _____.
    a. Must be a corporation
    b. Can choose to be any type of entity
    c. Must be either a partnership or a C corporation
    d. None of these choices are correct
9. General partners have what type of liability?
    a. Limited
    b. Joint and several
    c. Joint only
    d. Personal only

10. Of all the business entity choices, LLCs are the most like _____.
    a. S corporations
    b. C corporations
    c. Sole proprietorships
    d. Joint ventures
11. LLC owners are called _____.
    a. Members
    b. Shareholders
    c. Limited equity investors
    d. Directors
12. LLCs offer flexible tax treatment, meaning _____.
    a. They can be taxed like corporation
    b. They can be taxed like partnerships
    c. They can be taxed like proprietorships
    d. All choices are correct.
13. Sole proprietorships offer limited liability _____.
    a. If you register it with the state
    b. If you elect to be taxed as a corporation
    c. If you have an SBA loan guarantee
    d. Sole proprietorships never have limited liability.
14. A sole proprietorship _____.
    a. Pays taxes at the highest corporate rate
    b. Pays taxes at the lowest corporate rate
    c. Pays taxes at the individual rate
    d. None of these choices are correct.
15. Sole proprietorships _____.
    a. Must register with the state
    b. Are similar to general partnerships in terms of liability
    c. Are similar to LLCs in terms of liability
    d. Are not allowed by law to operate outside of the US
16. States can levy a sales tax on items sold online to a customer in a different state if _____.
    a. The business has a nexus with that state
    b. There is an contract between the business and the state comptroller
    c. The items sold are over $300
    d. The business is one that only sells foreign-made items
17. As a general rule, LLCs, GPs, and SPs are taxed as _____.
    a. Corporations
    b. Not taxed
    c. Individuals
    d. Taxed twice, once as entity and once as individuals
18. Entrepreneurs can choose what state to incorporate in, and many choose _____.
    a. New York
    b. Delaware
    c. California
    d. Texas
19. Enterprise risk management includes _____.

a. Identifying risk
b. Risk assessment
c. Risk abatement
d. All of the choices are correct.

20. A business owner can insure against all but which one of the following?

a. Earthquakes
b. A bad economy
c. Flooding
d. Hurricanes

21. Examples of risk facing a business include _____.

a. Human risks
b. Economic risks
c. Natural risks
d. All of the choices are correct.

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7.1.12: Discussion Questions

1. Distinguish between for-profit and not-for-profit entities.
2. What are the distinguishing characteristics of a B corporation?
3. Why would an entrepreneur choose to operate an S corporation rather than a C corporation?
4. What are the choices of entities for operating as a group of engineers?
5. How does a joint venture differ from the other business structures?
6. Distinguish between LLC and LLPs.
7. Why are there more sole proprietorships than any other business entity in the US?
8. What are the general guidelines used to determine where your business must pay sales taxes for sales made online?
9. Identify the common types of risks that a business may face.

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7.1.13: Case Questions

1. The Big University football team, a member of the Southeastern Conference (SEC), brings in over $100 million a year in revenue, including TV rights, ticket sales, and bowl games. Seats to a game cost well over $100, and coaches are paid millions of dollars (more than anyone else at Big U, including the president). However, despite enormous revenues, universities and their football teams are considered not-for-profit organizations and pay no taxes on the $100+ million their football programs bring in. Should a university football program be allowed to exist as a not-for-profit organization?
2. Jen started a new sustainability-oriented business six years ago, making single-serve coffee pods out of recyclable paper, rather than plastic. Her company, Jen's Pod, is now experiencing rapid growth. Jen started her company as an LLC but has been considering making a decision to incorporate. What are some of the advantages of changing to a C corporation?
3. You are headed off to college. Some close family members decide it would be a good idea to buy a house in the college town and then rent it out to students, with you also living there and actively managing it. Assuming you and your family buy it, what form of business would you select?
4. Jackson owns and runs a small computer repair business, a sole proprietorship, out of his home, with one employee. He also goes to small businesses at their locations, mostly cleaning viruses and doing other small maintenance tasks and repairs. A family physician's office calls him in for a repair. He sends his employee to do the repair. Unknown to him, his employee makes a copy of patients' personal information and sells it on the dark web. Jackson ends up being sued, and the plaintiffs ask the court to allow them to access Jackson's personal, nonbusiness bank account that also has his spouse's funds in the account. Can the plaintiffs take that money?

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7.1.14: Suggested Resources

7.1.2 Business Structures: Overview of Legal and Tax Considerations

The Small Business Administration (SBA) has a great “tool box” for entrepreneurs. Tools include information on how to create a business plan and how to qualify for government contracts. It also has free online training classes and a list of networking events. Go to this link, and then click on “Create a Business Plan” and get started. SBA: https://www.sba.gov/tools

7.1.3 Corporations

A cost-effective solution for obtaining business counsel is the Service Corps of Retired Executives (SCORE), which provides free advice for small businesses and entrepreneurs. The SCORE organization is the nation’s largest nonprofit network of volunteer, expert business mentors, with more than 10,000 volunteers in 300 chapters. You can find them at: https://www.score.org/

7.1.4 Partnerships and Joint Ventures

The IRS website has a clear explanation of partnerships with regard to taxation, regarding both income tax and employment/payroll taxes. You might find enough information here to help reduce the time you spend with a CPA, saving your company a lot of money: https://www.irs.gov/businesses/small...d/partnerships

7.1.5 Limited Liability Companies

The SBA has an excellent website for LLC owners. It has information about multiple topics including comparisons with other structures, and links to other websites that offer good advice: https://www.sba.gov/business-guide/l...ness-structure

7.1.8 Mitigating and Managing Risks

North Carolina State University, Poole College of Management, has an excellent enterprise risk management initiative. It has a wealth of helpful information for entrepreneurs on this topic: https://erm.ncsu.edu/library/article...-erm-framework

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SECTION OVERVIEW

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7.2.3: Partnerships - Sharing the Load

7.2.4: Corporations - Limiting Your Liability

7.2.5: Specialized Forms of Business Organization

7.2.6: Franchising - A Popular Trend

7.2.7: Mergers and Acquisitions

7.2.8: Trends in Business Ownership

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7.2.1: Introduction

Learning Objectives

After reading this chapter, you should be able to answer these questions:

- What are the advantages and disadvantages of the sole proprietorship form of business organization?
- What are the advantages of operating as a partnership, and what downside risks should partners consider?
- How does the corporate structure provide advantages and disadvantages to a company, and what are the major types of corporations?
- What other options for business organization does a company have in addition to sole proprietorships, partnerships, and corporations?
- What makes franchising an appropriate form of organization for some types of business, and why does it continue to grow in importance?
- Why are mergers and acquisitions important to a company's overall growth?
- What current trends will affect the business organizations of the future?



Figure 7.2.1.1: (Credit: pxhere / Attribution CC0 Public Domain)

EXPLORING BUSINESS CAREERS

Jessica MacLean

Sole Proprietor. In most any elementary school classroom, at least one child's answer to the question, "What do you want to do with your life?" will be, "A lawyer." One of the most popular careers, lawyers are powerful figures in society, shaping our laws and ensuring that we adhere to them. Their prominence and power have led to the stereotype of rich, career-driven lawyers, often leaving no room in our minds for those who truly want to bring justice to the world. However, Jessica MacLean, a lawyer focusing primarily on women's rights, is quick to say that, as with many stereotypes, that is only one side of the story. "I know because I lived that—I was on my way to being a successful corporate lawyer. But I realized what I was doing and how different that was from why I'd started practicing. So I walked away from it all to start my own practice."

Nervous about the prospect of private practice, she has chosen to operate as a sole proprietorship for now. Sole proprietorships are easy to set up for people who want to work on their own, prefer direct control of the business, and desire the flexibility to sell the business or close the doors at any time. "For me, it's the best choice because I am not responsible for or to anyone else. I can easily dissolve the business if I find it is not proceeding how I'd planned. More positively, too, if it does succeed, I know that success is due to my hard work.

Indeed MacLean's law career was not always in corporate law. She turned her sights toward law after a gender and communications professor at DePaul University suggested her argumentative style might be an asset in that profession. "She said I needed to tone it down for class—that the other students seemed afraid to speak up—but then asked if I'd ever considered being a lawyer." MacLean, who had always been interested in issues of justice and legality surrounding women, took her professor's advice and made the leap into law.

While in law school, she clerked for the city of Chicago in their department of personnel's sexual harassment office and volunteered for the Cook County state's attorney's office in the domestic violence division. The cases she worked on were emotionally trying. Despite the difficulty of the cases, she was drawn to them, compelled by the people she helped and the change she was able to effect. After school, she continued in related practice, working first for the Cook County state's attorney's office.

After several years with the state's attorney's office, she needed a change. It was then that MacLean decided to work for a corporation, a form of business that you will learn about in this chapter. "Why did I switch to corporate law? I think I was burnt out, to some extent. It's so hard to work on those cases, day after day. I needed to see if I would be better somewhere else."

Having enjoyed the rewards of working with the state's attorney's office and a corporation and being a sole proprietor, in 2014 MacLean joined a limited liability partnership (LLP, a form of business that you will learn about in this chapter) firm in Chicago. As her needs changed, the form and type of business organization she has worked for has changed also.

This chapter discusses sole proprietorships, as well as several other forms of business ownership, including partnerships and corporations, and compares the advantages and disadvantages of each.

With a good idea and some cash in hand, you decide to start a business. But before you get going, you need to ask yourself some questions that will help you decide what form of business organization will best suit your needs.

Would you prefer to go it alone as a *sole proprietorship*, or do you want others to share your burdens and challenges in a *partnership*? Or would the limited liability protection of a *corporation*, or perhaps the flexibility of a *limited liability company (LLC)*, make more sense?

There are other questions you need to consider too: Will you need financing? How easy will it be to obtain? Will you attract employees? How will the business be taxed, and who will be liable for the company's debts? If you choose to share ownership with others, how much operating control would they want, and what costs would be associated with that?

Sole proprietorships are the most popular form of business ownership, accounting for 72 percent of all businesses, compared with 10 percent for partnerships and 18 percent for corporations. Because most sole proprietorships and partnerships remain small, corporations generate approximately 81 percent of total business revenues and 58 percent of total profits.

Most start-up businesses select one of these major ownership forms. In the following pages, we will discover the advantages and disadvantages of each form of business ownership and the factors that may make it necessary to change from one form of organization to another as the needs of the business change. As a company expands from small to midsize or larger, the form of business structure selected in the beginning may no longer be appropriate.

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7.2.2: Going It Alone - Sole Proprietorships

What are the Advantages and Disadvantages of the Sole Proprietorship Form of Business Organization?

Jeremy Shepherd was working full-time for an airline when, at the age of 22, he wandered into an exotic pearl market in China, searching for a gift for his girlfriend. The strand of pearls he handpicked by instinct was later valued by a jeweler back in the States at 20 times what he paid for it. Jeremy cashed his next paycheck and hurried back to Asia, buying every pearl he could afford. Founded in 1996, his company Pearl Paradise was brought online in 2000. Shepherd chose the **sole proprietorship** form of business organization—a business that is established, owned, operated, and often financed by one person—because it was the easiest to set up. He did not want partners, and low liability exposure made incorporating unnecessary.

Fluent in Mandarin Chinese, Japanese, and Spanish and immersed in Asian culture, Shepherd believed the internet was the way to market his pearls (http://www.pearlparadise.com). Offering a wide range of pearl jewelry through 14 websites worldwide, his company sells as many as 1,000 items per day. The recent addition of an exclusive Los Angeles showroom allows celebrity customers to shop by appointment. With $20 million in sales annually, PearlParadise.com is the industry leader in terms of sales and volume.

Table 7.2.2.1: Comparison of Forms of Business Organization

Form	Number	Sales	Profits
Sole Proprietorships	72 percent	4 percent	15 percent
Partnerships	10 percent	15 percent	27 percent
Corporations	18 percent	81 percent	58 percent

Advantages of Sole Proprietorships

Sole proprietorships have several advantages that make them popular:

- *Easy and inexpensive to form*. As Jeremy Shepherd discovered, sole proprietorships have few legal requirements (local licenses and permits) and are not expensive to form, making them the business organization of choice for many small companies and start-ups.
- *Profits all go to the owner*. The owner of a sole proprietorship obtains the start-up funds and gets all the profits earned by the business. The more efficiently the firm operates, the higher the company's profitability.
- *Direct control of the business*. All business decisions are made by the sole proprietorship owner without having to consult anyone else.
- *Freedom from government regulation*. Sole proprietorships have more freedom than other forms of business with respect to government controls.
- *No special taxation*. Sole proprietorships do not pay special franchise or corporate taxes. Profits are taxed as personal income as reported on the owner's individual tax return.
- *Ease of dissolution*. With no co-owners or partners, the sole proprietor can sell the business or close the doors at any time, making this form of business organization an ideal way to test a new business idea.

Disadvantages of Sole Proprietorships

Along with the freedom to operate the business as they wish, sole proprietors face several disadvantages:

- *Unlimited liability.* From a legal standpoint, the sole proprietor and the company are one and the same, making the business owner personally responsible for all debts the company incurs, even if they exceed the company's value. The owner may need to sell other personal property—their car, home, or other investments—to satisfy claims against the business.
- *Difficulty raising capital*. Business assets are unprotected against claims of personal creditors, so business lenders view sole proprietorships as high risk due to the owner's unlimited liability. Owners must often use personal funds—borrowing on credit

cards, second-mortgaging their homes, or selling investments—to finance their business. Expansion plans can also be affected by an inability to raise additional funding.

- *Limited managerial expertise.* The success of a sole proprietorship rests solely with the skills and talents of the owner, who must wear many different hats and make all decisions. Owners are often not equally skilled in all areas of running a business. A graphic designer may be a wonderful artist but not know bookkeeping, how to manage production, or how to market their work.
- *Trouble finding qualified employees.* Sole proprietors often cannot offer the same pay, fringe benefits, and advancement as larger companies, making them less attractive to employees seeking the most favorable employment opportunities.
- *Personal time commitment.* Running a sole proprietorship business requires personal sacrifices and a huge time commitment, often dominating the owner's life with 12-hour workdays and 7-day workweeks.
- *Unstable business life.* The life span of a sole proprietorship can be uncertain. The owner may lose interest, experience ill health, retire, or die. The business will cease to exist unless the owner makes provisions for it to continue operating or puts it up for sale.
- *Losses are the owner's responsibility.* The sole proprietor is responsible for all losses, although tax laws allow these to be deducted from other personal income.

The sole proprietorship may be a suitable choice for a one-person start-up operation with no employees and little risk of liability exposure. For many sole proprietors, however, this is a temporary choice, and as the business grows, the owner may be unable to operate with limited financial and managerial resources. At this point, the owner may decide to take in one or more partners to ensure that the business continues to flourish.

CATCHING THE ENTREPRENEURIAL SPIRIT

Work-Life Balance Important in Small Business

According to a survey released by the Wells Fargo/Gallup Small Business Index, about two-thirds of small business owners are satisfied with how they balance their personal lives and work schedules, and the New York Enterprise Report survey found that they work twice as much as regular employees. The survey also found that 33 percent of small business owners work more than 50 hours per week, while 25 percent reported working over 60 hours per week. A survey by Gallup finds 39 percent of small business owners working over 60 hours per week.

The 2016 Annual Bank of the West Small Business Growth Survey found that 62 percent of the respondents reported the stress of ownership as worse than what they had originally imagined. At the same time, the same people indicated that being a small business owner puts them in charge of their destiny, offers freedom, and is more rewarding than ever imagined. Over two-thirds of small business owners, according to a survey, said they were satisfied with their personal work-life balance, and almost 90 percent said they were satisfied with being a small business owner in general. Dennis Jacobe, chief economist at Gallup, argues, "People see the benefits more closely tied to them when they're the owner," he says. "Working hard and long is a natural aspect of the kind of people willing to start their own business."

But if employees have trouble balancing work and life, odds are they will have less confidence in you as a leader, a recent study shows. The study, which polled more than 50,000 U.S. workers from various markets including professional services, consumer goods, and financial services, found that employees who strike a positive balance between home and work were 11 percent more likely to praise their leaders' ability to set a clear direction.

The Society for Human Resource Management's (SHRM) research also shows work-life balance has a great impact on how employees feel about their leaders. Jennifer Schramm, a manager in SHRM's workplace trends and forecasting research department, predicts that as companies try to maximize the productivity of each employee, work-life balance and the resulting employee satisfaction will become increasingly more important. And research shows that happy employees can yield happy returns for businesses.

Critical Thinking Questions

1. Many small business owners expect their employees to be as committed and to work as hard as they do. How would you avoid falling into that trap while still demanding the best from your workers?
2. As a small business owner, consider some strategies to ensure an appropriate work-life balance for your employees.

CONCEPT CHECK

1. What is a sole proprietorship?
2. Why is this a popular form of business organization?
3. What are the drawbacks to being a sole proprietor?

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7.2.3: Partnerships - Sharing the Load

What are the Advantages of Operating as a Partnership, and What Downside Risks Should Partners Consider?

Can **partnerships**, an association of two or more individuals who agree to operate a business together for profit, be hazardous to a business's health? Let's assume partners Ron and Liz own a stylish and successful beauty salon. After a few years of operating the business, they find they have contrasting visions for their company. Liz is happy with the status quo, while Ron wants to expand the business by bringing in investors and opening salons in other locations.

How do they resolve this impasse? By asking themselves some tough questions. Whose view of the future is more realistic? Does the business actually have the expansion potential Ron believes it does? Where will he find investors to make his dream of multiple locations a reality? Is he willing to dissolve the partnership and start over again on his own? And who would have the right to their clients?

Ron realizes that expanding the business in line with his vision would require a large financial risk and that his partnership with Liz offers many advantages he would miss in a sole proprietorship form of business organization. After much consideration, he decides to leave things as they are.

For those individuals who do not like to "go it alone," a partnership is relatively simple to set up. Offering a shared form of business ownership, it is a popular choice for professional-service firms such as lawyers, accountants, architects, stockbrokers, and real estate companies.

The parties agree, *either orally or in writing*, to share in the profits and losses of a joint enterprise. A *written partnership agreement*, spelling out the terms and conditions of the partnership, *is recommended* to prevent later conflicts between the partners. Such agreements typically include the name of the partnership, its purpose, and the contributions of each partner (financial, asset, skill/talent). It also outlines the responsibilities and duties of each partner and their compensation structure (salary, profit sharing, etc.). It should contain provisions for the addition of new partners, the sale of partnership interests, and procedures for resolving conflicts, dissolving the business, and distributing the assets.

There are two basic types of partnerships: *general and limited*. In a **general partnership**, all partners share in the management and profits. They co-own the assets, and each can act on behalf of the firm. Each partner also has unlimited liability for all the business obligations of the firm. A **limited partnership** has two types of partners: one or more **general partners**, who have unlimited liability, and one or more **limited partners**, whose liability is limited to the amount of their investment. In return for limited liability, limited partners agree not to take part in the day-to-day management of the firm. They help to finance the business, but the general partners maintain operational control.

There are also limited liability partnerships (LLP), which are similar to a general partnership except that partners are not held responsible for the business debt and liabilities. Another type is a limited liability limited partnership (LLLP), which is basically a limited partnership with addition of limited liability, hence protecting the general partner from the debt and liabilities of the partnership.

Advantages of Partnerships

Some advantages of partnerships come quickly to mind:

- *Ease of formation.* Like sole proprietorships, partnerships are easy to form. The partners agree to do business together and draw up a *partnership agreement.* For most partnerships, applicable state laws are not complex.
- *Availability of capital.* Because two or more people contribute financial resources, partnerships can raise funds more easily for operating expenses and business expansion. The partners' combined financial strength also increases the firm's ability to raise funds from outside sources.
- *Diversity of skills and expertise.* Partners share the responsibilities of managing and operating the business. Combining partner skills to set goals, manage the overall direction of the firm, and solve problems increases the chances for the partnership's success. To find the right partner, you must examine your own strengths and weaknesses and know what you need from a

partner. Ideal partnerships bring together people with complementary backgrounds rather than those with similar experience, skills, and talents. In the table below, you'll find some advice on choosing a partner.

- *Flexibility.* General partners are actively involved in managing their firm and can respond quickly to changes in the business environment.
- *No special taxes.* Partnerships pay no income taxes. A partnership must file a partnership return with the Internal Revenue Service, reporting how profits or losses were divided among the partners. Each partner's profit or loss is then reported on the partner's personal income tax return, with any profits taxed at personal income tax rates.
- *Relative freedom from government control.* Except for state rules for licensing and permits, the government has little control over partnership activities.

Perfect Partners
Picking a partner is both an art and a science. Someone may have all the right credentials on paper, but does that person share your vision and the ideas you have for your company? Are they a straight shooter? Honesty, integrity, and ethics are important, because you may be liable for what your partner does. Be prepared to talk about everything, and trust your intuition and your gut feelings—they're probably right. Ask yourself and your potential partner the following questions—then see how well your answers match up: 1. Why do you want a partner? 2. What characteristics, talents, and skills does each person bring to the partnership? 3. How will you divide responsibilities—from long-range planning to daily operations? Who will handle such tasks as marketing, sales, accounting, and customer service? 4. What is your long-term vision for the business—its size, life span, financial commitment, etc.? 5. What are your personal reasons for forming this company? Are you looking to create a small company or build a large one? Are you seeking a steady paycheck or financial independence? 6. Will all parties put in the same amount of time, or is there an alternative arrangement that is acceptable to everyone? 7. Do you have similar work ethics and values? 8. What requirements will be in the partnership agreement?

Disadvantages of Partnerships

Business owners must consider the following disadvantages of setting up their company as a partnership:

- *Unlimited liability*. All general partners have unlimited liability for the debts of the business. In fact, any one partner can be held personally liable for all partnership debts and legal judgments (such as malpractice)—regardless of who caused them. As with sole proprietorships, business failure can lead to a loss of the general partners' personal assets. To overcome this problem, many states now allow the formation of *limited liability partnerships (LLPs),* which protect each individual partner from responsibility for the acts of other partners and limit their liability to harm resulting from their own actions.
- *Potential for conflicts between partners.* Partners may have different ideas about how to run their business, which employees to hire, how to allocate responsibilities, and when to expand. Differences in personalities and work styles can cause clashes or breakdowns in communication, sometimes requiring outside intervention to save the business.
- *Complexity of profit sharing.* Dividing the profits is relatively easy if all partners contribute equal amounts of time, expertise, and capital. But if one partner puts in more money and others more time, it might be more difficult to arrive at a fair profit-sharing formula.
- *Difficulty exiting or dissolving a partnership*. As a rule, partnerships are easier to form than to leave. When one partner wants to leave, the value of their share must be calculated. To whom will that share be sold, and will that person be acceptable to the other partners? If a partner who owns more than 50 percent of the entity withdraws, dies, or becomes disabled, the partnership must reorganize or end. To avoid these problems, most partnership agreements include specific guidelines for transferring partnership interests and buy–sell agreements that make provision for surviving partners to buy a deceased partner's interest. Partners can also purchase special life insurance policies designed to fund such a purchase.

Business partnerships are often compared to marriages. As with a marriage, choosing the right partner is critical. So if you are considering forming a partnership, allow plenty of time to evaluate your and your potential partner's goals, personality, expertise, and working style before joining forces.

CONCEPT CHECK

1. How does a partnership differ from a sole proprietorship?
2. Describe the four main types of partnerships, and explain the difference between a limited partner and a general partner.
3. What are the main advantages and disadvantages of a partnership?

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7.2.4: Corporations - Limiting Your Liability

How Does the Corporate Structure Provide Advantages and Disadvantages to a Company, and What are the Major Types of Corporations?

When people think of corporations, they typically think of major, well-known companies, such as Apple, Alphabet (parent company of Google), Netflix, IBM, Microsoft, Boeing, and General Electric. But corporations range in size from large multinationals with thousands of employees and billions of dollars in sales to midsize or even smaller firms with few employees and revenues under $25,000.

A **corporation** is a legal entity subject to the laws of the state in which it is formed, where the right to operate as a business is issued by state charter. A corporation can own property, enter into contracts, sue and be sued, and engage in business operations under the terms of its charter. Unlike sole proprietorships and partnerships, corporations are taxable entities with a life separate from their owners, who are not personally liable for its debts.

When launching her company, Executive Property Management Services, Inc., 32-year-old Linda Ravden realized she needed the liability protection of the corporate form of business organization. Her company specialized in providing customized property management services to mid and upper-level corporate executives on extended work assignments abroad, often for three to five years or longer. Taking care of substantial properties in the million-dollar range and above was no small responsibility for Ravden's company. Therefore, the protection of a corporate business structure, along with carefully detailed contracts outlining the company's obligations, were crucial in providing Ravden with the liability protection she needed—and the peace of mind to focus on running her business without constant worry. Note that an LLC does not provide unlimited protection; you can still get in trouble for such things as mingling personal and business funds.

MANAGING CHANGE

Pacific Sun's Golden Glow

It all started as a little surf shop in 1980 in Newport Beach, California. It wasn't called PacSun then. It wasn't even all that different from other shops carrying surfboards and wax, except for one thing. The founders had a better idea.

During Southern California's wet, cool winters, the beaches got empty, and the surf store business went dry. Where did everyone go? To the mall, of course. Their idea—to be the first surf shop to move into California's popular mall locations—worked. The company soon grew to 21 stores, selling such popular name brands as Billabong, Gotcha, CatchIt, Stussy, and Quiksilver, as well as its own private-label brands.

What began as a little surf shop became a leading mall-based specialty retailer in the fast-growing surf, skate, and hip-hop apparel markets. With close to a thousand stores in the United States and Puerto Rico and sales topping $1 billion, how did the founders make the leap from selling and waxing surfboards to being a major player in the youth apparel market? How has Pacific Sunwear of California, Inc. (**http://www.pacsun.com**) succeeded when thousands of other clothing companies failed?

"We listen and we change," says the CEO of Pacific Sun. "The kids have the answers, so we listen to get the trends, the solutions, and find out what we are doing right." To remain on the cutting edge of teen tastes, the company hosts an open house every Wednesday at its corporate headquarters in Anaheim, California, where vendors present their wares to PacSun's savvy team of buyers. Being able to distinguish between short-lived fads and actual trends is important when making merchandise choices. The company's focus on "active brand management" is what kept its sales climbing.

The founders' philosophy had served their business well. In 1993, the 60-store company sold stock to the public. It had grown to over 1,000 stores in 50 states and Puerto Rico, with 12,000 employees. The company's PacSun stores cater to a completely different customer than its d.e.m.o. hip-hop stores. In April 2006, PacSun launched its third concept, One Thousand Steps, a footwear store.

With changing trends and online shopping challenges facing many brick-and-mortar retailers, companies such as Wet Seal and Quicksilver filed for bankruptcy in 2015, and PacSun filed for bankruptcy in April 2016. At the time of bankruptcy filing, the company had 593 PacSun stores employing approximately 2,000 employees. In September 2016, PacSun emerged from the

bankruptcy after it cut debt and closed stores. The company also turned over all of its stock to the private equity firm Golden Gate Capital, its senior lender.

As its business took off, PacSun successfully made the leap from the small sole proprietorship form of business organization to corporate retailing giant. Facing changing trends and technologies, the firm hit a bump in the road and is working hard to reestablish. The company is indeed a thousand steps away from its humble beginnings.

Critical Thinking Questions

1. How did PacSun manage its evolution from a small, local business to a leading mall-based specialty retailer? What could be the reasons for its missteps resulting in the bankruptcy filing?
2. What form of business organization might PacSun have chosen when it started, and what might have prompted it to change as it grew?

Corporations play an important role in the U.S. economy. Corporations account for only 18 percent of all businesses but generate 81 percent of all revenues and 58 percent of all profits. Company type and size vary; however, when you look at the top companies by revenue in the United States or globally, they include many familiar names that affect our daily lives.

In the United States, according to *Fortune* magazine, the top three corporations in the 2017 were (1) Walmart Stores (revenue: $485.9 B), (2) Berkshire Hathaway (revenue: $223.6 B), and (3) Apple (revenue: $215.6 B), whereas *Forbes* magazine found that the top three corporations were (1) Berkshire Hathaway (revenue: $222.9B), (2) Apple (revenue: $217.5B), and (3) JPMorgan Chase (revenue: $102.5B). By comparison, the top three companies in 2017 according to the *World Economic Forum* were (1) Apple, (2) Alphabet, and (3) Microsoft. These corporations rise and fall on the various lists based on their revenue in a given year and how the organizations measure revenue and the time frames that they use.

The Incorporation Process

Setting up a corporation is more complex than starting a sole proprietorship or partnership. Most states base their laws for chartering corporations on the Model Business Corporation Act of the American Bar Association, although registration procedures, fees, taxes, and laws that regulate corporations vary from state to state.



Figure 7.2.4.1: *(Credit: Mike Mozart/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

Incorporated in 1969, Walmart is one of America's most popular retail stores. Opened as Walmart Discount City by retailer Sam Walton in 1962, the retailer quickly established a strong brand image. Today, Walmart operates in more than 28 countries, and the Walmart icon is among the most recognizable trademarks in all of business. *What steps must companies take to become incorporated?*

A firm does not have to incorporate in the state where it is based and may benefit by comparing the rules of several states before choosing a state of incorporation. Although Delaware is a small state with few corporations actually based there, its procorporate policies make it the state of incorporation for many companies, including about half the Fortune 500. Incorporating a company involves five main steps:

- Selecting the company's name
- Writing the *articles of incorporation* and filing them with the appropriate state office, usually the secretary of state
- Paying required fees and taxes
- Holding an organizational meeting
- Adopting bylaws, electing directors, and passing the first operating resolutions

The state issues a corporate charter based on information in the articles of incorporation. Once the corporation has its charter, it holds an organizational meeting to adopt bylaws, elect directors, and pass initial operating resolutions. Bylaws provide legal and managerial guidelines for operating the firm.

Articles of Incorporation
Articles of incorporation are prepared on a form authorized or supplied by the state of incorporation. Although they may vary slightly from state to state, all articles of incorporation include the following key items: • Name of corporation • Company's goals • Types of stock and number of shares of each type to issue • Life of the corporation (usually "perpetual," meaning with no time limit) • Minimum investment by owners • Methods for transferring shares of stock • Address of the corporate office • Names and addresses of the first board of directors

The Corporate Structure

As Figure 7.2.4.3 shows, corporations have their own organizational structure with three important components: stockholders, directors, and officers.

Stockholders (or shareholders) are the owners of a corporation, holding shares of stock that provide them with certain rights. They may receive a portion of the corporation's profits in the form of dividends, and they can sell or transfer their ownership in the corporation (represented by their shares of stock) at any time. Stockholders can attend annual meetings, elect the board of directors, and vote on matters that affect the corporation in accordance with its charter and bylaws. Each share of stock generally carries one vote.

The stockholders elect a **board of directors** to govern and handle the overall management of the corporation. The directors set major corporate goals and policies, hire corporate officers, and oversee the firm's operations and finances. Small firms may have as few as 3 directors, whereas large corporations usually have 10 to 15.

The boards of large corporations typically include both corporate executives and outside directors (not employed by the organization) chosen for their professional and personal expertise. Outside directors often bring a fresh view to the corporation's activities because they are independent of the firm.

Hired by the board, the *officers* of a corporation are its top management and include the president and chief executive officer (CEO), vice presidents, treasurer, and secretary, who are responsible for achieving corporate goals and policies. Officers may also be board members and stockholders.

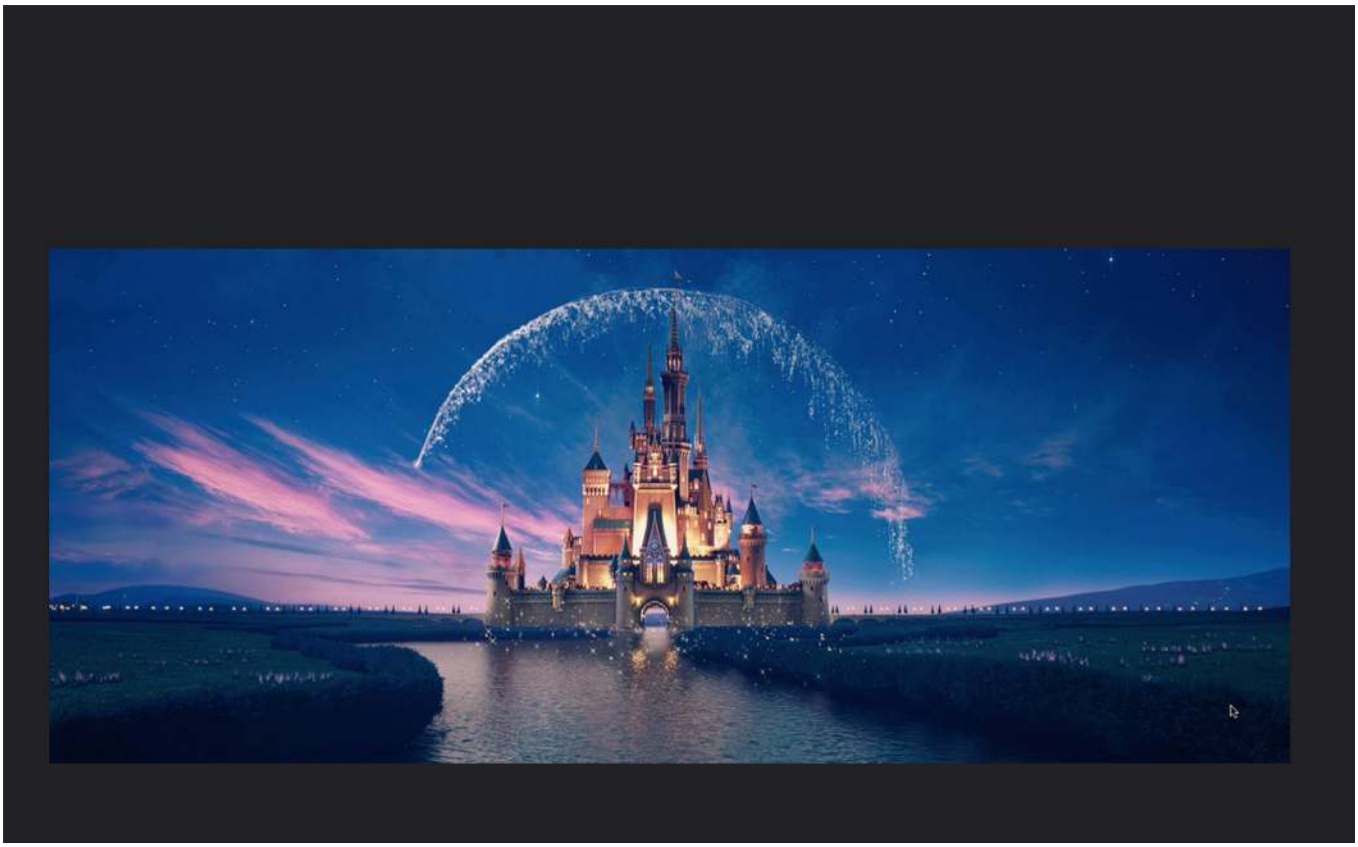


Figure 7.2.4.2: *(Credit: Marc Levin/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

When Walt Disney cast his now-famous mouse as Steamboat Willie back in the 1920s, he had little idea that his animation project would turn into one of the largest entertainment companies in the world. The house that Walt built, with its magical theme parks, movie studios, and product lines, is overseen today by visionary directors with accomplished backgrounds in media, technology, and government. *What important tasks and responsibilities are entrusted to Disney's board of directors?*

Advantages of Corporations

The corporate structure allows companies to merge financial and human resources into enterprises with great potential for growth and profits:

- *Limited liability.* A key advantage of corporations is that they are separate legal entities that exist apart from their owners. Owners' (stockholders') liability for the obligations of the firm is limited to the amount of the stock they own. If the corporation goes bankrupt, creditors can look only to the assets of the corporation for payment.
- *Ease of transferring ownership.* Stockholders of public corporations can sell their shares at any time without affecting the status of the corporation.
- *Unlimited life.* The life of a corporation is unlimited. Although corporate charters specify a life term, they also include rules for renewal. Because the corporation is an entity separate from its owners, the death or withdrawal of an owner does not affect its existence, unlike a sole proprietorship or partnership.
- *Tax deductions.* Corporations are allowed certain tax deductions, such as operating expenses, which reduces their taxable income.
- *Ability to attract financing.* Corporations can raise money by selling new shares of stock. Dividing ownership into smaller units makes it affordable to more investors, who can purchase one or several thousand shares. The large size and stability of corporations also helps them get bank financing. All these financial resources allow corporations to invest in facilities and human resources and expand beyond the scope of sole proprietorships or partnerships. It would be impossible for a sole proprietorship or partnership to make automobiles, provide nationwide telecommunications, or build oil or chemical refineries.

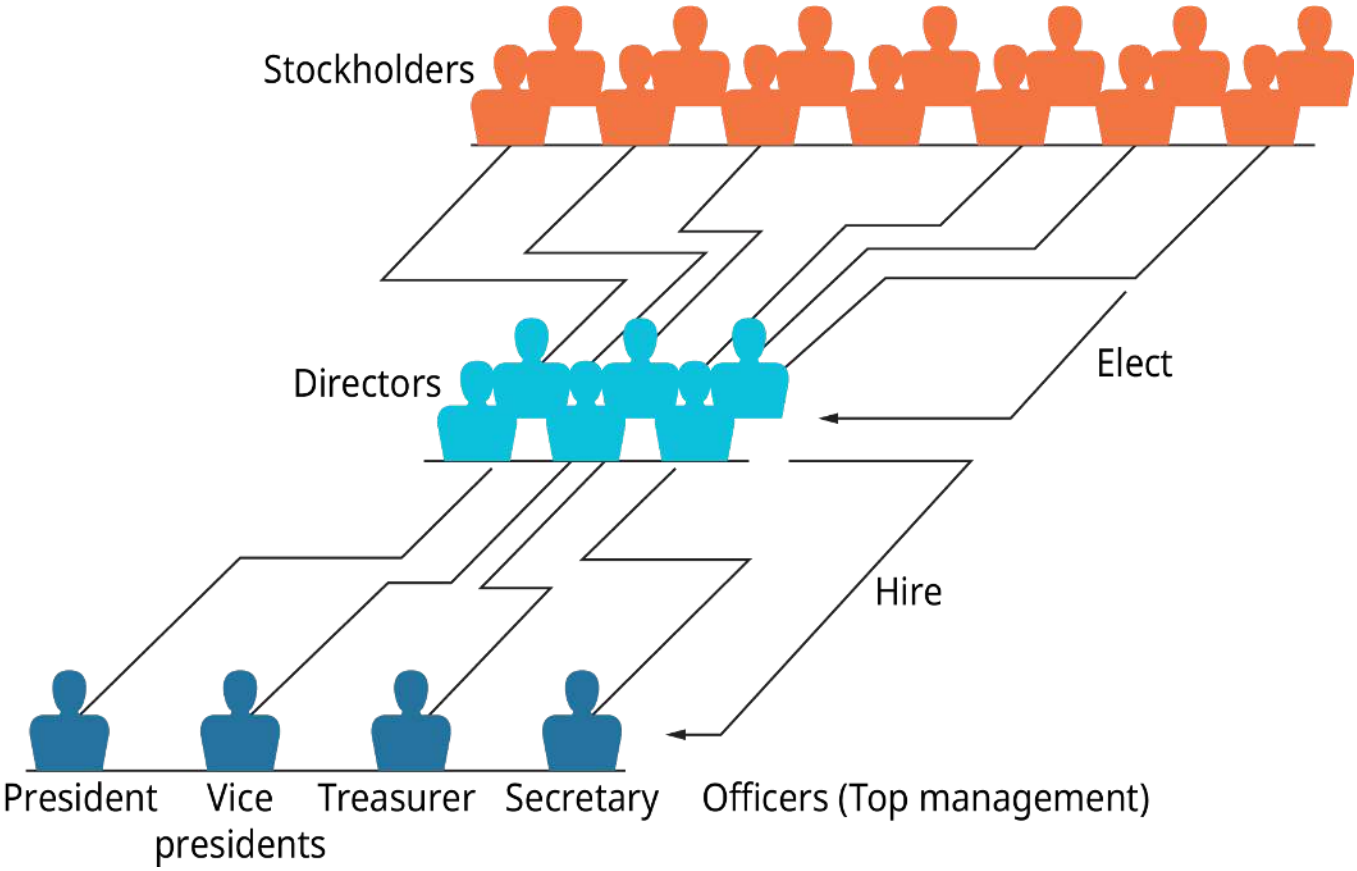


Figure 7.2.4.3: Organizational Structure of Corporations. *Attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license*

Disadvantages of Corporations

Although corporations offer companies many benefits, they have some disadvantages:

- *Double taxation of profits.* Corporations must pay federal and state income taxes on their profits. In addition, any profits (dividends) paid to stockholders are taxed as personal income, although at a somewhat reduced rate.
- *Cost and complexity of formation.* As outlined earlier, forming a corporation involves several steps, and costs can run into thousands of dollars, including state filing, registration, and license fees, as well as the cost of attorneys and accountants.
- *More government restrictions.* Unlike sole proprietorships and partnerships, corporations are subject to many regulations and reporting requirements. For example, corporations must register in each state where they do business and must also register with the Securities and Exchange Commission (SEC) before selling stock to the public. Unless it is closely held (owned by a small group of stockholders), a firm must publish financial reports on a regular basis and file other special reports with the SEC and state and federal agencies. These reporting requirements can impose substantial costs, and published information on corporate operations may also give competitors an advantage.

Types of Corporations

Three types of corporate business organization provide limited liability.

The **C corporation** is the conventional or basic form of corporate organization. Small businesses may achieve liability protection through S corporations or limited liability companies (LLCs).

An **S corporation** is a hybrid entity, allowing smaller corporations to avoid double taxation of corporate profits as long as they meet certain size and ownership requirements. Organized like a corporation with stockholders, directors, and officers, an S corporation is taxed like a partnership. Income and losses flow through to the stockholders and are taxed as personal income. S corporations are allowed a maximum of 100 qualifying shareholders and one class of stock. The owners of an S corporation are not personally liable for the debts of the corporation.

A newer type of business entity, the **limited liability company (LLC)**, is also a hybrid organization. Like S corporations, they appeal to small businesses because they are easy to set up and not subject to many restrictions. LLCs offer the same liability protection as corporations as well as the option of being taxed as a partnership or a corporation. First authorized in Wyoming in 1977, LLCs became popular after a 1988 tax ruling that treats them like partnerships for tax purposes. Today all states allow the formation of LLCs.

The table below summarizes the advantages and disadvantages of each form of business ownership.

Advantages and Disadvantages of Major Types of Business Organization		
Sole Proprietorship	Partnership	Corporation
Advantages		
Owner receives all profits.	More expertise and managerial skill available.	Limited liability protects owners from losing more than they invest.
Low organizational costs.	Relatively low organizational costs.	Can achieve large size due to marketability of stock (ownership).
Income taxed as personal income of proprietor.	Income taxed as personal income of partners.	Receives certain tax advantages.
Independence.	Fundraising ability is enhanced by more owners.	Greater access to financial resources allows growth.
Secrecy.		Can attract employees with specialized skills.
Ease of dissolution.		Ownership is readily transferable.
		Long life of firm (not affected by death of owners).
Disadvantages		
Owner receives all losses.	Owners have unlimited liability; may have to cover debts of other, less financially sound partners.	Double taxation because both corporate profits and dividends paid to owners are taxed, although the dividends are taxed at a reduced rate.
Owner has unlimited liability; total wealth can be taken to satisfy business debts.	Dissolves or must reorganize when partner dies.	More expensive and complex to form.
Limited fundraising ability can inhibit growth.	Difficult to liquidate or terminate.	Subject to more government regulation.
Proprietor may have limited skills and management expertise.	Potential for conflicts between partners.	Financial reporting requirements make operations public.
Few long-range opportunities and benefits for employees.	Difficult to achieve large-scale operations.	
Lacks continuity when owner dies.		

CONCEPT CHECK

1. What is a corporation? Describe how corporations are formed and structured.
2. Summarize the advantages and disadvantages of corporations. Which features contribute to the dominance of corporations in the business world?
3. Why do S corporations and limited liability companies (LLCs) appeal to small businesses?

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7.2.5: Specialized Forms of Business Organization

What Other Options for Business Organization Does a Company Have in Addition to Sole Proprietorships, Partnerships, and Corporations?

In addition to the three main forms, several specialized types of business organization also play an important role in our economy. We will look at cooperatives and joint ventures in this section and take a detailed look at franchising in the following section.

Cooperatives

When you eat a Sunkist orange or spread Land O'Lakes butter on your toast, you are consuming foods produced by cooperatives. A **cooperative** is a legal entity with several *corporate features*, such as limited liability, an unlimited life span, an elected board of directors, and an administrative staff. Member-owners pay annual fees to the cooperative and share in the profits, which are distributed to members in proportion to their contributions. Because they do not retain any profits, cooperatives are not subject to taxes.

There are currently 2.6 million cooperatives with one billion members employing more than 12.5 million employees in more than 145 countries worldwide.[4]Cooperatives operate in every industry, including agriculture, childcare, energy, financial services, food retailing and distribution, health care, insurance, housing, purchasing and shared services, and telecommunications, among others. They range in size from large enterprises such as Fortune 500 companies to small local storefronts and fall into four distinct categories: consumer, producer, worker, and purchasing/shared services.

Cooperatives are autonomous businesses owned and democratically controlled by their members—the people who buy their goods or use their services—not by investors. Unlike investor-owned businesses, cooperatives are organized solely to meet the needs of the member-owners, not to accumulate capital for investors. As democratically controlled businesses, many cooperatives practice the principle of "one member, one vote," providing members with equal control over the cooperative.

There are two types of cooperatives. **Buyer cooperatives** combine members' purchasing power. Pooling buying power and buying in volume increases purchasing power and efficiency, resulting in lower prices. At the end of the year, members get shares of the profits based on how much they bought. Obtaining discounts to lower costs gives the corner Ace Hardware store the chance to survive against retailing giants such as Home Depot Inc. and Lowe's.

Founded in 1924, Ace Hardware is one of the nation's largest cooperatives and is wholly owned by its independent hardware retailer members in stores spanning all 50 states and 70 countries. In August 2017, Ace opened its 5,000th store. In 2017, the company reported its revenues in the second quarter were $1.5 billion, which was an increase of 4.6 percent from 2016's second quarter. The net income for the second quarter of 2017 was $51.1 million.

Seller cooperatives are popular in agriculture, wherein individual producers join to compete more effectively with large producers. Member dues support market development, national advertising, and other business activities. In addition to Sunkist and Land O'Lakes, other familiar cooperatives are Calavo (avocados), Ocean Spray (cranberries and juices), and Blue Diamond (nuts). CHS Inc., the largest cooperative in the United States, sells energy, supply, food, and grain.

Cooperatives empower people to improve their quality of life and enhance their economic opportunities through self-help. Throughout the world, cooperatives are providing members with credit and financial services, energy, consumer goods, affordable housing, telecommunications, and other services that would not otherwise be available to them. There are several principles that cooperatives must follow, according to San Luis Valley REC, International Co-operative Alliance, and Daman Prakash, author of *The Principles of Cooperation*. They include (1) open membership, which means that cooperatives are open to all people to use its services; (2) democratic member control, which means that organizations are controlled by their members; (3) members' economic participation, which means that members contribute equally to the capital of the cooperative; (4) autonomy, which means cooperatives are self-help organizations controlled by their members; and (5) education and training, which means that cooperatives provide education and training for their members while also electing representatives, managers, and employees.

Joint Ventures

In a **joint venture**, two or more companies form an alliance to pursue a specific project, usually for a specified time period. There are many reasons for joint ventures. The project may be too large for one company to handle on its own, and joint ventures also

afford companies access to new markets, products, or technology. Both large and small companies can benefit from joint ventures.

In 2005, South Korea's Hyundai Motor Company announced it signed a $1.24 billion deal to form a joint venture with China's Guangzhou Automobile Group. The arrangement gave the South Korean automaker access to the commercial vehicle market in China, where its passenger cars are already the top-selling foreign brand. Each side will hold equal stakes in the new entity, named Guangzhou Hyundai Motor Company. The new plant began production in 2007 with an annual capacity of 200,000 units producing small to large trucks and buses as well as commercial vehicles. According to Reuters, Hyundai made plans to build a fifth factory in China. With five factories in operation, Hyundai's annual Chinese production capacity will be 1.65 million vehicles.

CONCEPT CHECK

1. Describe the two types of cooperatives and the advantages of each.
2. What are the benefits of joint ventures?

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7.2.6: Franchising - A Popular Trend

What Makes Franchising an Appropriate Form of Organization for Some Types of business, and why does it continue to grow in importance?

When Shep Bostin decided to buy a franchise, he researched the usual suspects: Jiffy Lube, McDonald's, and Quiznos Subs. Bostin, then 38, was a top executive at a dying Gaithersburg, Maryland, technology firm, but instead of becoming another McDonald's franchisee, Bostin chose to remain a geek, albeit one who wheeled around in the signature black PT Cruiser of Geeks On Call, a company that provides on-site computer assistance via a large pool of experienced techies. Bostin made residential and commercial "house calls" for more than a decade as a Geeks On Callfranchisee. There are approximately 123 independently owned and operated Geeks On Call franchise territories in 50 states serving over 250,000 customers.

Choosing the right franchise can be challenging. Franchises come in all sizes and demand different skills and qualifications. And with somewhere around 2,500 different franchised businesses in the United States, Bostin had a lot to choose from—from cookie-bouquet peddlers and dog trainers to acupuncture specialists. The table below shows the top franchises for 2017 from various sources. *Entrepreneur's* rankings utilize among other factors costs/fees, brand strength, support, and financial strength. *Franchise Business Review* focuses on owner satisfaction, whereas *Franchise Gator* utilizes a formula with factors such as financial stability and engagement.



Figure 7.2.6.1: *(Credit: Julio Enriquez/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

Chance the Rapper was a big winner at the 2017 Grammy Awards. His win was also validation for a new business model. Chance the Rapper does not have a deal with a traditional record label but instead releases his music through streaming services. *How might this approach benefit other aspiring music artists to gain footing and become a force in the music industry?*

Top 10 Franchises for 2017	
Entrepreneur Top 10	
Franchise	**Initial investment**
1. 7-Eleven Inc.	$37K to $1.6M
2. McDonald's	$1M to $2.2M
3. Dunkin' Donuts	$229K to $1.7M
4. The UPS Store	$178K to $403K
5. Jimmy John's Gourmet Sandwiches	$330K to $558K
6. Dairy Queen	$1.1M to $1.9M
7. Ace Hardware Corp.	$273K to $1.6M
8. Wingstop Restaurant Inc.	$303K to $923K
9. Sport Clips	$189K to $355K
10. RE/MAX LLC	$38K to $224K
Franchise Business Review Top 10	
Franchise Name/ Industry	**Minimum Investment**
Visiting Angels (Senior care)	$77,985
MaidPro (Cleaning and maintenance)	$74,560
Pinot's Palette (Sports and recreation)	$63,400
Christian Brothers Automotive (Automotive)	$146,693
Home Instead Senior Care (Senior care)	$463,698
Our Town America (Advertising and Sales)	$115,000
FASTSIGNS (Business services)	$63,300
Sandler Training (Business services)	$182,329
Soccer Shots ((Child services)	$88,150
Two Men and a Truck (Services)	$36,000
Franchise Gator Top 10	
Franchise Name	**Minimum Cash Required**
Fast Signs	$100,000
Tropical Smoothie Cafe	$100,000
Marco's Pizza	$100,000
Zoup	$100,000
Mathnasium	$100,000
Christian Brothers Automotive	$80,000
Two Men and a Truck	$150,000

Top 10 Franchises for 2017	
Kiddie Academy	$200,000
Wild Birds Unlimited	$40,000
SportClips	$200,000

Chances are you recognize some of the names listed in the table above and deal with franchise systems in your neighborhood every day. When you have lunch at **Taco Bell** or Jamba Juice, make copies at FedEx Office, change your oil at Jiffy Lube, buy candles at Wicks 'n' Sticks, or mail a package at The UPS Store, you are dealing with a franchised business. These and other familiar name brands mean quality, consistency, and value to consumers. Franchised businesses provided about 8.9 million direct jobs with an $890 billion economic output for the U.S. economy.

Franchising is a form of business organization that involves a **franchisor**, the company supplying the product or service concept, and the **franchisee**, the individual or company selling the goods or services in a certain geographic area. The franchisee buys a package that includes a proven product or service, proven operating methods, and training in managing the business. Offering a way to own a business without starting it from scratch and to expand operations quickly into new geographic areas with limited capital investment, franchising is one of the fastest-growing segments of the economy. If you are interested in franchising, food companies represent the largest number of franchises.

A **franchise agreement** is a contract that allows the franchisee to use the franchisor's business name, trademark, and logo. The agreement also outlines rules for running the franchise, services provided by the franchisor, and financial terms. The franchisee agrees to follow the franchisor's operating rules by keeping inventory at certain levels, buying a standard equipment package, keeping up sales and service levels, taking part in franchisor promotions, and maintaining a relationship with the franchisor. In return, the franchisor provides the use of a proven company name and symbols, help in finding a site, building plans, guidance and training, management assistance, managerial and accounting systems and procedures, employee training, wholesale prices for supplies, and financial assistance.

Advantages of Franchises

Like other forms of business organization, franchising offers some distinct advantages:

- *Increased ability for franchisor to expand.* Because franchisees finance their own units, franchisors can grow without making a major investment.
- *Recognized name, product, and operating concept.* Consumers know they can depend on products from franchises such as Pizza Hut, Hertz, and Holiday Inn. As a result, the franchisee's risk is reduced and the opportunity for success increased. The franchisee gets a widely known and accepted business with a proven track record, as well as operating procedures, standard goods and services, and national advertising.
- *Management training and assistance.* The franchisor provides a structured training program that gives the new franchisee a crash course in how to start and operate their business. Ongoing training programs for managers and employees are another plus. In addition, franchisees have a peer group for support and sharing ideas.
- *Financial assistance.* Being linked to a nationally known company can help a franchisee obtain funds from a lender. Also, the franchisor typically gives the franchisee advice on financial management, referrals to lenders, and help in preparing loan applications. Many franchisors also offer short-term credit for buying supplies, payment plans, and loans to purchase real estate and equipment. Although franchisors give up a share of profits to their franchisees, they receive ongoing revenues in the form of royalty payments.



Figure 7.2.6.2: *(Credit: Mr. Blue Mau Mau/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

Countless franchise opportunities exist for entrepreneurs with access to start-up capital. Despite the broad range of franchise opportunities available, lists of the fastest-growing franchises are heavily weighted with restaurant chains and cleaning services. Start-up costs for a Quiznos franchise can be pricey; expenses associated with opening a Club Pilates franchise or a Visiting Angels adult care service are significantly lower. *How do entrepreneurs evaluate which franchising opportunity is right for them?*

Disadvantages of Franchises

Franchising also has some disadvantages:

- *Loss of control.* The franchisor has to give up some control over operations and has less control over its franchisees than over company employees.
- *Cost of franchising.* Franchising can be a costly form of business. Costs will vary depending on the type of business and may include expensive facilities and equipment. The franchisee also pays fees and/or royalties, which are usually tied to a percentage of sales. Fees for national and local advertising and management advice may add to a franchisee's ongoing costs.
- *Restricted operating freedom.* The franchisee agrees to conform to the franchisor's operating rules and facilities design, as well as inventory and supply standards. Some franchises require franchisees to purchase from only the franchisor or approved suppliers. The franchisor may also restrict the franchisee's territory or site, which could limit growth. Failure to conform to franchisor policies could mean the loss of the franchise.

Franchise Growth

Many of today's major franchise brands, such as McDonald's and KFC, started in the 1950s. Through the 1960s and 1970s, many more types of businesses—clothing, convenience stores, business services, and many others—used franchising to distribute their goods and services. Growth comes from expansion of established franchises—for example, Subway, Pizza Hut, and OrangeTheory Fitness—as well as new entrants such as those identified by *Entrepreneur* and *Franchise Gator*among other sources. According to *Entrepreneur* magazine, the top three new franchises in 2017 are (1) Mosquito Joe, (2) Blaze Fast-Fire'd Pizza, and (3) uBreakiFix,

whereas according to *Franchise Gator*, the top three new franchises in 2017 are (1) Mosquito Joe, (2) Digital Doc, and (3) Nurse Next Door Home Healthcare Services. On both rankings, Mosquito Joe ranks at the top. Mosquito Joe provides mosquito control treatment services for both residential and commercial clients.

Changing demographics drive franchise industry growth, in terms of who, how, and what experiences the most rapid growth. The continuing growth and popularity of technology and personal computing is responsible for the rapidly multiplying number of eBay drop-off stores, and tech consultants such as Geeks on Call are in greater demand than ever. Other growth franchise industries are the specialty coffee market, children's enrichment and tutoring programs, senior care, weight control, and fitness franchises.

The Next Big Thing in Franchising

All around you, people are talking about the next big thing—Subway is the new miracle weight-loss solution, the workout at OrangeTheory Fitness is the answer to America's fitness needs—and you are ready to take the plunge and buy a trendy franchise. But consumers' desires can change with the tide, so how do you plan an entrance—and exit—strategy when purchasing a franchise that's a big hit today but could be old news by tomorrow? The table below outlines some tips on purchasing a franchise.

International Franchising

Like other forms of business, franchising is part of our global marketplace economy. As international demand for all types of goods and services grows, most franchise systems are already operating internationally or planning to expand overseas. Restaurants, hotels, business services, educational products, car rentals, and nonfood retail stores are popular international franchises.

Franchisors in foreign countries face many of the same problems as other firms doing business abroad. In addition to tracking markets and currency changes, franchisors must understand local culture, language differences, and the political environment. Franchisors in foreign countries also face the challenge of aligning their business operations with the goals of their franchisees, who may be located half a globe away.

Tips for Purchasing a Franchise
1. Take a personality test to determine the traits that will help and hurt you and assess your strengths and weaknesses.
2. Do your research about the franchise company, its services, and your potential location, and study the field.
3. Seek assistance from tax advisors and contract specialists.
4. Focus on financials: count your money, limit liability with appropriate business structure, and look beyond.
5. Beware of franchise consultants.
6. Use the franchise disclosure document to ensure everything is clear.
7. Utilize your instincts, and follow your gut.

Is Franchising in Your Future?

Are you ready to be a franchisee? Before taking the plunge, ask yourself some searching questions: Are you excited about a specific franchise concept? Are you willing to work hard and put in long hours? Do you have the necessary financial resources? Do you have prior business experience? Do your expectations and personal goals match the franchisor's?

Qualities that rank high on franchisors' lists are passion about the franchise concept, desire to be your own boss, willingness to make a substantial time commitment, assertiveness, optimism, patience, and integrity. Prior business experience is also a definite plus, and some franchisors prefer or require experience in their field.

EXPANDING AROUND THE GLOBE

Setting Up (Sandwich) Shop in China

Lured by China's fast-food industry, estimated today at $180 billion, Jim Bryant, 50, was not the only entrepreneur to discover it is hard to do business in China. In ten years, Bryant has opened 19 Subway stores in Beijing—only half the number he was supposed to have by now—while other companies such as Chili's and Dunkin' Donuts have given up their Chinese operations altogether.

Subway, or Sai Bei Wei (Mandarin for "tastes better than others"), is now the third-largest U.S. fast-food chain in China, right behind McDonald'sand KFC, and all its stores are profitable. Although Bryant had never eaten a Subway sandwich before,

Jana Brands, the company Bryant worked for in China, sold $20 million in crab to Subway annually, so he knew it was big business. When Subway founder Fred DeLuca visited Beijing in 1994, Bryant took him to a place not on the official tour: McDonald's. It was Sunday night, and the place was packed. "We could open 20,000 Subways here and not scratch the surface," Bryant remembers DeLuca saying.

Two weeks later, Bryant called Subway's headquarters in Milford, Connecticut, and asked to be the company representative in China. He would recruit local entrepreneurs, train them to become franchisees, and act as a liaison between them and the company. He would receive half the initial $10,000 franchise fee and one-third of their 8 percent royalty fees. He could also open his own Subway restaurants. Steve Forman, the founder of Jana Brands, invested $1 million in return for a 75 percent stake.

All foreign businesses in China had to be joint ventures with local partners, so Bryant used the Chinese business practice of relying on local relationships to find a manager for his first restaurant in Beijing. The project ran into problems immediately. Work on the store was delayed, and construction costs soared. It didn't take Bryant long to realize that he and Forman had been swindled out of $200,000.

When it finally opened, the restaurant was a hit among Americans in Beijing, but the locals weren't sure what to make of it. They didn't know how to order and didn't like the idea of touching their food, so they held the sandwich vertically, peeled off the paper, and ate it like a banana. Most of all, the Chinese didn't seem to want sandwiches.

But Subway did little to alter its menu—something that still irks some Chinese franchisees. "Subway should have at least one item tailored to Chinese tastes to show they respect local culture," says Luo Bing Ling, a Beijing franchisee. Bryant thinks that with time, sandwiches will catch on in China. Maybe he's right: Tuna salad, which he couldn't give away at first, is now the number one seller. Today there are nearly 600 Subway stores in China, with China's fast-food industry estimated at over $180 billion.

Critical Thinking Questions

1. What are some of the main problems U.S. franchisors encounter when attempting to expand their business in a country such as China?
2. What steps can franchisors take to ensure a smooth and successful launch of a new franchise business in a foreign country?

So what can you do to prepare when considering the purchase of a franchise? When evaluating franchise opportunities, professional guidance can prevent expensive mistakes, so interview advisers to find those that are right for you. Selecting an attorney with franchise experience will hasten the review of your franchise agreement. Getting to know your banker will speed up the loan process if you plan to finance your purchase with a bank loan, so stop by and introduce yourself. The proper real estate is a critical component for a successful retail franchise, so establish a relationship with a commercial real estate broker to begin scouting locations. Doing your homework can spell the difference between success and failure, and some early preparation can help lay the groundwork for the successful launch of your franchised business.

If the franchise route to business ownership seems right for you, begin educating yourself on the franchise process by investigating various franchise opportunities. You should research a franchise company thoroughly before making any financial commitment. Once you've narrowed your choices, ask for the *Uniform Franchise Offering Circular (UFOC)* for that franchisor, and read it thoroughly. The Federal Trade Commission (FTC) requires franchisors to prepare this document, which provides a wealth of information about the franchisor, including its history, operating style, management, past or pending litigation, the franchisee's financial obligations, and any restrictions on the sale of units. Interviewing current and past franchisees is another essential step. And most franchise systems use computers, so if you are not computer literate, take a class in the basics.

Would-be franchisees should also check recent issues of small-business magazines such as *Entrepreneur*, *Inc.*, *Startups*, and *Success* for industry trends, ideas on promising franchise opportunities, and advice on how to choose and run a franchise. The International Franchise Association website at http://www.franchise.org has links to *Franchising World* and other useful sites.

CONCEPT CHECK

1. Describe franchising and the main parties to the transaction.
2. Summarize the major advantages and disadvantages of franchising.
3. Why has franchising proved so popular?

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7.2.7: Mergers and Acquisitions

Why Are Mergers and Acquisitions Important to a Company's Overall Growth?

A **merger** occurs when two or more firms combine to form one new company. For example, in 2016, Johnson Controls, a leading provider of building efficiency solutions, agreed to merge with Ireland's Tyco International, a leading provider of fire and security solutions, resulting in a company that will be a leader in products, technologies, and integrated solutions for the building and energy sectors. The merger is valued at $30 billion, with new Johnson Controls PLC to be based in Ireland. Currently, AT&T and Time Warner have an $85.4 billion merger pending. "Once we complete our acquisition of Time Warner Inc., we believe there is an opportunity to build an automated advertising platform that can do for premium video and TV advertising what the search and social media companies have done for digital advertising," AT&T's CEO Randall Stephenson said in a prepared statement. Mergers such as this one, in a well-established industry, can produce winning results in terms of improved efficiency and cost savings.

In an **acquisition**, a corporation or investor group finds a target company and negotiates with its board of directors to purchase it. In Verizon's recent $4.5 billion acquisition of Yahoo, Verizon was the acquirer, and Yahoo the target company.

Worldwide merger activity in the first quarter of 2017 was mixed. The volume of deals was lower but with higher dollar value. The total number of deals fell by 17.9 percent versus the first quarter of 2016; however, the overall deal value was $678.5 billion. We will discuss the increase in international mergers later in this chapter.

Types of Mergers

The three main types of mergers are horizontal, vertical, and conglomerate. In a **horizontal merger**, companies at the same stage in the same industry merge to reduce costs, expand product offerings, or reduce competition. Many of the largest mergers are horizontal mergers to achieve economies of scale. Its $1.25 billion acquisition of trucking company Overnite allowed UPS, the world's largest shipping carrier, to step up expansion of its heavy freight–delivery business, thus expanding its product offerings.

In a **vertical merger**, a company buys a firm in its same industry, often involved in an earlier or later stage of the production or sales process. Buying a supplier of raw materials, a distribution company, or a customer gives the acquiring firm more control. A good example of this is Google's acquisition of Urchin Software Corp., a San Diego–based company that sells web analytics software and services that help companies track the effectiveness of their websites and online advertising. The move enables Google to bolster the software tools it provides to its advertisers.

A **conglomerate merger** brings together companies in unrelated businesses to reduce risk. Combining companies whose products have different seasonal patterns or respond differently to business cycles can result in more stable sales. The Philip Morris Company, now called Altria Group, started out in the tobacco industry but diversified as early as the 1960s with the acquisition of Miller Brewing Company. It diversified into the food industry with its subsequent purchase of General Foods, Kraft Foods, and Nabisco, among others. Later spinning off many businesses, current product categories include cigarettes, smokeless tobacco such as Copenhagen and Skoal, cigars, e-vapor products such as MarkTen, and wines.

A specialized, financially motivated type of merger, the **leveraged buyout (LBO)**became popular in the 1980s but is less common today. LBOs are corporate takeovers financed by large amounts of borrowed money—as much as 90 percent of the purchase price. LBOs can be started by outside investors or the corporation's management. For example, the private equity firm Apollo Global Management LLC agreed to buy U.S. security company ADT Corp. in the largest leveraged buyout (LBO) of 2016.

Often a belief that a company is worth more than the value of all its stock is what drives an LBO. They buy the stock and take the company private, expecting to increase cash flow by improving operating efficiency or selling off units for cash to pay off debt. Although some LBOs do improve efficiency, many do not live up to investor expectations or generate enough cash to pay their debt.

Merger Motives

Although headlines tend to focus on mega-mergers, "merger mania" affects small companies too, and motives for mergers and acquisitions tend to be similar regardless of the company's size. The goal is often strategic: to improve overall performance of the merged firms through cost savings, elimination of overlapping operations, improved purchasing power, increased market share, or

reduced competition. Oracle Corp. paid $5.85 billion to acquire Siebel Systems, its largest competitor in the sales automation programs market.

Company growth, broadening product lines, acquiring technology or management skills, and the ability to quickly acquire new markets are other motives for acquiring a company. Yahoo Inc.'s $1 billion cash purchase of a 40 percent stake in China's biggest e-commerce firm, Alibaba.com, instantly strengthened its ties to the world's second-largest internet market.

Purchasing a company can also offer a faster, less risky, less costly option than developing products or markets in-house or expanding internationally. Amazon's 2017 purchase of Whole Foods Market, an upscale grocery chain, for $13.7 billion was a move to enter the retail grocery sector. In addition to the new product market, this move offers Amazon opportunity to sell Amazon tech products in the grocery stores as well as access to an entirely new set of data on consumers.

Another motive for acquisitions is financial restructuring—cutting costs, selling off units, laying off employees, and refinancing the company to increase its value to stockholders. Financially motivated mergers are based not on the potential to achieve economies of scale, but rather on the acquirer's belief that the target has hidden value to be unlocked through restructuring. Most financially motivated mergers involve larger companies. In January 2018, Brookfield Business Partners, a subsidiary of Canada's Brookfield Asset Management, announced that it plans to acquire Westinghouse Electric Co LLC, the bankrupt nuclear services company owned by Toshiba Corp., for $4.6 billion. Brookfield has a history of turning around distressed businesses.

Emerging Truths

Along with the technology boom of the late 1990s, merger activity also soared. Total annual transactions averaged $1.6 trillion a year. Companies were using their stock, which had been pushed to unrealistically high levels, to buy each other. When the technology bubble burst in 2000, the level of merger activity dropped as well. It fell even further after the United States was attacked on September 11, 2001. Then massive corporate wrongdoing began to surface. Stocks plummeted in reaction to these events, and merger transactions, which generally track stock market movements, fell as a result.

Today, merger activity is once again on the rise. Propelled by a solid economy, low interest rates, good credit, rising stock prices, and stockpiles of cash, 2016's $3.84 trillion of global M&A was historically a very strong year, with several blockbuster deals.

Size is definitely an advantage when competing in the global marketplace, but bigger does not always mean better in the merger business. Study results show that heady mega-mergers can, in fact, be a bust for investors who own those shares. So companies are wise to consider their options before stuffing their dollars in the biggest merger slot machine they can find. In their eagerness to snare a deal, many buyers pay a premium that wipes out the merger's entire potential economic gain. Often managers envision grand synergies that prove illusory or unworkable or buy a company that isn't what it seems—not fully understanding what they are getting.

Integrating acquisitions is both an art and a science. Acquirers often underestimate the costs and logistical nightmare of consolidating the operations of merged companies with very different cultures. As a result, they may fail to keep key employees aboard, sales forces selling, and customers happy.

Companies will always continue to seek out acquisition candidates, but the fundamental business case for merging will have to be strong. So what should companies look for to identify mergers with a better-than-even chance of turning out well?

- A purchase price that is low enough—a 10 percent premium over market as opposed to 50 percent—so the buyer doesn't need heroic synergies to make the deal work.
- A target that is significantly smaller than the buyer—and in a business the buyer understands. The more "transformational" the deal, such as entering a new business arena, the bigger the risk.
- A buyer who pays in cash and not overinflated stock.
- Evidence that the deal makes both business and financial sense and isn't purely the brainchild of an empire-building CEO. Mergers are tough—culturally, commercially, and logistically. The most important quality a company can bring to a merger may be humility.

CONCEPT CHECK

1. Differentiate between a merger and an acquisition.
2. What are the most common motives for corporate mergers and acquisitions?
3. Describe the different types of corporate mergers.

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7.2.8: Trends in Business Ownership

What Current Trends Will affect the business organizations of the future?

As we learned earlier, an awareness of trends in the business environment is critical to business success. Many social, demographic, and economic factors affect how businesses organize. When reviewing options for starting or organizing a business or choosing a career path, consider the following trends.

"Baby Boomers" and "Millennials" Drive Franchise Trends

We all hear and read a great deal about the "graying of America," which refers to the "baby boomer" generation heading toward retirement age. This unprecedented demographic phenomenon—in 2006 the first of 78 million members of the baby boomer generation turned 60—is driving the ongoing battle to stay young, slim, and healthy. Every day, 10,000 boomers are turning 65, and the trend is likely to continue until 2030. Boomers have transformed every life stage they've touched so far, and their demographic weight means that business opportunities are created wherever they go.

With their interest in staying fit, Boomers are contributing to the growth of fitness and weight-loss franchises. In just the past year, this category in *Entrepreneur*'sFranchise 500 has grown to over 50 franchisors. And according to the IHRSA, 52.9 million Americans belong to a health club—up from 39.4 million 10 years ago—so there are plenty of consumers feeding this growing trend.

Another area of boomer-driven franchise growth is eldercare. Founded in 1994, Home Instead Senior Care is recognized as one of the world's fastest-growing franchise companies in the eldercare market, with a network of over 1,000 independently owned and operated franchises in 12 countries. And as the world's population continues to age, the need for its unique services will continue to increase.

Home Instead Senior Care provides a meaningful solution for the elderly who prefer to remain at home. Compared with the annual cost for a nursing home placement ($72,000–$92,000), home care at around $45,000–$60,000 a year is somewhat more affordable. Elder quality of life is enhanced by Home Instead Senior Care's part-time, full-time, and around-the-clock services, designed for people who are capable of managing their physical needs but require some assistance and supervision. Home Instead Senior Care provides meal preparation, companionship, light housekeeping, medication reminders, incidental transportation, and errands. These services make it possible for the elderly to remain in the familiar comfort of their own homes for a longer period of time.

But the best deal yet may be adult day services, one of the fastest-growing franchises and "still one of the best-kept secrets around" according to *Entrepreneur* magazine. Based on the concept of daycare services for children, Sarah Adult Day Services, Inc. offers a franchising opportunity that meets the two criteria for a successful and socially responsible business: a booming demographic market with great potential for growth, and excellent elder care. Programs such as SarahCare centers are highly affordable for its clients, costing around $17,900 a year. The SarahCare franchise allows entrepreneurs to become part of an expanding industry while restoring a sense of dignity and vibrancy to the lives of older adults.

Millennials—individuals born between 1980 and 2000—are the largest living generation in the United States, according to Pew Research. Millennials spend more money in restaurants per capita than any previous generation. They have been recognized as changing the restaurant scene by looking for brands that offer customized food choices, quality ingredients, freshness, authenticity, transparency, and environmental and social responsibility. According to the U.S. Chamber of Commerce Foundation's report, two out of three millennials are interested in entrepreneurship. According to *Forbes* magazine, 72 percent of millennials would like to be their own boss, 74 percent want flexible work schedules, and 88 percent want "work–life integration." When it comes to owning a franchise, growth potential and meeting a flexible, fulfilling lifestyle are both something that attracts Millennials. A survey by the CT Corporation found that 60 percent of college graduates wanted to start a business after graduation, 67 percent lacked the know-how, 45 percent didn't think they could come up with a name, and 30 percent were not knowledgeable about how to market the business. Franchising is the perfect solution to these issues. For example, Chicago area native and millennial Sal Rehman grew up working in his family's diner. Sal had a dream of operating his own restaurant, and he decided to take the franchising path. In 2015, at the age of 27, Sal opened his first Wing Zone store in suburban Glendale Heights, Illinois. He currently owns five Wing Zones.

Boomers Rewrite the Rules of Retirement

At age 64, Bob Drucker could be the poster child for retirement except that the concept makes him recoil. Drucker is living his dream. He and his wife have a large house on Long Island where Drucker kicks back by floating in his pool when he's not spoiling his granddaughters with trips to Disneyland.

"The only way you can get me out of here is to carry me out," Drucker says, referring to RxUSA, the online pharmacy he founded and runs in Port Washington, New York. "I love my work, and I cannot imagine sitting home and doing nothing."

Drucker is not alone. Today's boomers are working longer at their jobs and embracing postretirement second careers, which often means starting their own small business. As retirees opt to go into business for themselves, they are choosing different forms of business organizations depending on their needs and goals. Some may start small consulting businesses using the simple sole proprietorship form of business organization, while couples or friends might choose to become partners in a retail or franchise venture.

The more healthy and energetic the baby boomer generation remains, the more interested it is in staying active and engaged—and that may mean postponing retirement or not retiring at all. The annual retirement survey by Transamerica Center for Retirement Studies found that as this record number of Americans approaches retirement age, many are not slowing down. In fact, 51 percent of boomers plan to work in some capacity during their retirement years, and 82 percent indicated that they will not retire at or before age 65.

Mergers and Foreign Investment Boom, Too

After shunning big deals for more than three years, corporate America has launched a new merger wave. In 2016, North American companies announced deals totaling almost $2.0 trillion. Many of these deals were large ones, with the largest deal, announced in 2016, AT&T's merger with Time Warner for over $85 billion. In addition, foreign merger activity has reached a new high. Worldwide deal volume in 2015 was 44,000 transactions totaling $4.5 trillion. In 2016, the number of transactions increased to over 48,000, one of the most active periods of merger activity to date. Non-U.S. companies accounted for about two-thirds of the transactions. European companies' cross-border transactions led the way, with deals totaling more than one trillion dollars. The increase is the result of improving economic growth and better stock prices.

This current boom in mergers feels different from earlier merger mania, however. New players are entering the arena, and the number of U.S. and foreign companies making cross-border acquisitions has increased. Whether these new mergers will be good for the global economy remains to be seen. Transactions that lead to cost savings, streamlined operations, and more funding for research and capital investment in new facilities will have positive effects on profitability. Many deals, however, may fail to live up to the acquirers' expectations.

Foreign investment in U.S. companies has also increased dramatically. Annual foreign direct investment reached $373.4 billion in 2016. The jump is the result of a worldwide boom in mergers and acquisitions and the need to finance America's growing trade deficit, as well as the continued attraction of the U.S. economy to investors worldwide.

And what about American investment in foreign economies? It is skyrocketing as U.S. businesses seek out opportunities in developing countries. According to the Congressional Research Service Reports, the outflows from the United States into foreign countries now exceeds $6.4 trillion a year. In addition to the attraction of cheap labor and resources, U.S. companies of all sizes continue to tap the intellectual capital of developing economies such as China and India, outsourcing such functions as payroll, information technology (IT), web/email hosting, customer relationship management (CRM), and human resources (HR) to keep costs under control and enhance profitability.

CONCEPT CHECK

1. What are some of the demographic trends currently impacting American business?
2. As a prospective business owner, what could you do to capitalize on these trends?
3. What other economic trends are influencing today's business organizations?

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8.1.1: Introduction



Figure 8.1.1.1: An advertisement showcasing the features of the iBackPack.

In 2015, Doug Monahan, the CEO and founder of iBackPack of Texas, Inc., introduced a revolutionary technology package encased in a typical backpack. The iBackPack boasted the capacity to incorporate WiFi/MiFi, a battery system, smart power transfer cables, and a car-charging system—while carrying four notebook computers and their accessories. Monahan promised that the iBackPack would be a "communication hub and corresponding electrical powerhouse for students and business professionals alike." To bring the project to market, iBackPack sought crowdfunding through an Indiegogo campaign that raised $723,395 from 4,041 backers. An additional $76,694 was raised from 252 Kickstarter backers.

In 2016, iBackPack raised over $800,000 to fulfill investors' orders, but the product never materialized. The only update from the company was a Facebook post alluding to issues sourcing "safe" batteries. By 2017, the iBackPack crowdfunding campaign failed to deliver the product promised to its investors. According to an article on the website The Verge in August 2018, the founders of iBackPack were under investigation by the Federal Trade Commission. Although crowdfunding can be a great option for startups, those who abuse the system may find themselves subject to legal action.

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8.1.2: Overview of Entrepreneurial Finance and Accounting Strategies

Learning Objectives

By the end of this section, you will be able to:

- Distinguish between financing and accounting
- Describe common financing strategies for different stages of the company lifecycle: personal savings, personal loans, friends and family, crowdfunding, angel investors, venture capitalists, self-sustaining, private equity sales, and initial public offering
- Explain debt and equity financing and the advantages and disadvantages of each

The case of iBackPack demonstrates that entrepreneurial success is not guaranteed simply because a company can secure funds. **Funds** are the necessary capital to get a business, or idea, off the ground. But funding cannot make up for a lack of experience, poor management, or a product with no viable market. Nonetheless, securing funding is one of the first steps, and a very real requirement, for starting a business.

Let's begin by exploring the financial needs and funding considerations for a simple organization. Imagine that you and your college roommate have decided to start your own band. In the past, you have always played in a school band where the school provided the instruments. Thus, you will need to start by purchasing or leasing your own equipment. You and your roommate begin to identify the basic necessities—guitars, drums, microphones, amplifiers, and so on. In your excitement, you begin browsing for these items online, adding to your shopping cart as you select equipment. It doesn't take you long to realize that even the most basic set of equipment could cost several thousand dollars. Do you have this much money available to make the purchase right now? Do you have other funding resources, such as loans or credit? Should you consider leasing most or all of the instruments and equipment? Would family or friends want to invest in your venture? What are the benefits and risks associated with these funding options?

This same basic inquiry and analysis should be completed as part of every business plan. First, you must determine the basic requirements for starting the business. What kinds of equipment will you need? How much labor and what type of skills? What facilities or locations would you require to make this business a reality? Second, how much do these items cost? If you do not possess an amount of money equal to the total anticipated cost, you will need to determine how to fund the excess amount.

ENTREPRENEUR IN ACTION

Ted Herget and Gearhead Outfitters

Gearhead Outfitters, founded by Ted Herget in 1997 in Jonesboro, Arkansas, is a retail chain that sells outdoor gear for men, women, and children. The company's inventory includes clothing, footwear for hiking and running, camping gear, backpacks, and accessories. Herget fell in love with the outdoor lifestyle while working as a ski instructor in Colorado and wanted to bring that feeling back home to Arkansas. And so, Gearhead was born in a small downtown location in Jonesboro. The company has had great success over the years, expanding to numerous locations in Herget's home state, as well as to locations in Louisiana, Oklahoma, and Missouri.

While Herget knew his industry when starting Gearhead, like many entrepreneurs he faced regulatory and financial issues that were new to him. Several of these issues were related to accounting and the wealth of decision-making information that accounting systems provide. For example, measuring revenue and expenses, providing information about cash flow to potential lenders, analyzing whether profit and positive cash flow is sustainable to allow for expansion, and managing inventory levels. Accounting, or the preparation of financial statements (balance sheet, income statement, and statement of cash flows), provides the mechanism for business owners such as Herget to make fundamentally sound business decisions.

Once a new business plan has been developed or a potential acquisition has been identified, it's time to start thinking about **financing**, which is the process of raising money for an intended purpose. In this case, the purpose is to launch a new business. Typically, those who can provide financing want to be assured that they could, at least potentially, be repaid in a short period of time, which requires a way that investors and business owners can communicate how that financing would happen. This brings us

to accounting, which is the system business owners use to summarize, manage, and communicate a business's financial operations and performance. The output of accounting consists of financial statements. Accounting provides a common language that allows business owners to understand and make decisions about their venture that are based on financial data, and enables investors looking at multiple investment options to make easier comparisons and investment decisions.

Entrepreneurial Funding across the Company Lifecycle

An entrepreneur may pursue one or more different types of funding. Identifying the lifecycle stage of the business venture can help entrepreneurs decide which funding opportunities are most appropriate for their situation.

From inception through successful operations, a business's funding grows generally through three stages: seed stage, early stage, and maturity. A **seed-stage** company is the earliest point in its lifecycle. It is based on a founder's idea for a new product or service. Nurtured correctly, it will eventually grow into an operational business, much as an acorn can grow into a mighty oak—hence the name "seed" stage. Typically, ventures at this stage are not yet generating revenue, and the founders haven't yet converted their idea into a saleable product. The personal savings of the founder, plus perhaps a few small investments from family members, usually constitute the initial funding of companies at the seed stage. Before an outsider will invest in a business, they will typically expect an entrepreneur to have exhausted what is referred to as F&F financing—friends and family financing—to reduce risk and instill confidence in the business's potential success.



Figure 8.1.2.1: Funding strategies can change across different phases of the company lifecycle.

After investments from close personal sources, the business idea may begin to build traction and attract the attention of an angel investor. **Angel investors** are wealthy, private individuals seeking investment options with a greater potential return than is traditionally expected on publicly traded stocks, albeit with much greater risk. For that reason, they must be investors accredited by the federal Securities and Exchange Commission (SEC) and they must meet a net worth or income test. Nonaccredited investors are allowed in certain limited circumstances to invest in security-based crowdfunding for startup companies. Among the investment opportunities angel investors look at are startup and early-stage companies. Angel investors and funds have grown rapidly in the past ten years, and angel groups exist in every state.

An **early stage** company has begun development of its product. It may be a technical proof of concept that still requires adjustments before it is customer-ready. It may also be a first-generation model of the product that is securing some sales but requires modifications for large-scale production and manufacturing. At this stage, the company's investors may now include a few outsider investors, including venture capitalists.

A **venture capitalist** is an individual or investment firm that specializes in funding early-stage companies. Venture capitalists differ from angel investors in two ways. First, a venture capital firm typically operates as a full-time active investment business, whereas an angel investor may be a retired executive or business owner with significant savings to invest. Additionally, venture capital firms operate at a higher level of sophistication, often specializing in certain industries and with the ability to leverage industry expertise to invest with more know-how. Typically, venture capitalists will invest higher amounts than angel investors, although this trend may be shifting as larger angel groups and "super angels" begin to invest in venture rounds.

Private equity investment is a rapidly growing sector and generally invests later than venture capitalists. Private equity investors either take a public company private or invest in private companies (hence the term "private equity"). The ultimate goals of private equity investors are generally taking a private company public through an initial public offering (IPO) or by adding debt or equity to the company's balance sheet, and helping it improve sales and/or profits in order to sell it to a larger company in its sector.

Companies in the **mature stage** have reached commercial viability. They are operating in the manner described in the business plan: providing value to customers, generating sales, and collecting customer payments in a timely manner. Companies at this stage should be self-sufficient, requiring little to no outside investment to maintain current operations. For a product company, this means manufacturing a product at scale, that is, in very large volumes. For a software company or app provider, this means generating sales of the software or subscriptions under an SaaS model (Software as a Service) and possibly securing advertising revenue from access to the user base.

Companies at the mature stage have different financing needs from those in the previous two stages, where the focus was on building the product and creating a sales/manufacturing infrastructure. Mature companies have reached a consistent level of sales but may seek to expand into new markets or regions. Typically, this requires significant investment because the proposed expansion can often mirror the present level of operations. That is to say, an expansion at this level may result in doubling the size of the business. To access this amount of capital, mature companies may consider selling a portion of the company, either to a private equity group or through an IPO.

An **initial public offering (IPO)** occurs the first time a company offers ownership shares for sale on a public stock exchange, such as the New York Stock Exchange. Before a company executes an IPO, it is considered to be privately held, usually by its founders and other private investors. Once the shares are available to the general public through a stock exchange, the company is considered to be publicly held. This process typically involves an investment banking firm that will guide the company. Investment bankers will solicit institutional investors, such as State Street or Goldman Sachs, which will in turn sell those shares to individual investors. The investment banking firm typically takes a percentage of the funds raised as its fee. The benefit of an IPO is that the company gains access to a massive audience of potential investors. The downside is that the owners give up more ownership in the business and are also subject to many costly regulatory requirements. The IPO process is highly regulated by the SEC, which requires companies to provide comprehensive information upfront to potential investors before completing the IPO. These publicly traded companies must also publish quarterly financial statements, which are required to be audited by an independent accounting firm. Although there are benefits to an IPO for later-stage companies, it can be very costly both at the start and on an ongoing basis. Another risk is that if the company does not meet investors' expectations, the value of the company can decline, which can hinder its future growth options.

Thus, a business's lifecycle stage greatly influences its funding strategies and so does its industry. Different types of industries have different financing needs and opportunities. For example, if you were interested in opening a pizzeria, you would need a physical location, pizza ovens, and furniture so customers could dine there. These requirements translate into monthly rent on a restaurant location and the purchase of physical assets: ovens and furniture. This type of business requires a significantly higher investment in physical equipment than would a service business, such as a website development firm. A website developer could work from home and potentially begin a business with very little investment in physical resources but with a significant investment of their own time. Essentially, the web developer's initial funding requirement would simply be several months' worth of living expenses until the business is self-sufficient.

Once we understand where a business is in its lifecycle and which industry it operates in, we can get a sense of its funding requirements. Business owners can acquire funding through different avenues, each with its own advantages and disadvantages.

WORK IT OUT

Venture Capitalists

Consider this statement from John Mackey, the CEO of Whole Foods Market: “Venture capitalists are like hitchhikers—hitchhikers with credit cards—and as long as you take them where they want to go, they’ll pay for the gas. But, if you don’t . . . they will try to hijack the car and they will hire a new driver and throw you out on the road.” He spoke on the NPR podcast *How I Built This*.

How would you feel if the investors in the company you founded started trying to wrest control of the organization from you? What steps would you take to prepare for this situation?

Types of Financing

Although many types of individuals and organizations can provide funds to a business, these funds typically fall into two main categories: debt and equity financing. Entrepreneurs should consider the advantages and disadvantages of each type as they determine which sources to pursue in support of their venture’s immediate and long-term goals.

Table 8.1.2.1: Debt vs. Equity Financing

	Debt Financing	Equity Financing
Ownership	Lender does not own stake in company	Lender owns stake in company
Cash	Requires early and regular cash outflow	No immediate cash outflow

Debt Financing

Debt financing is the process of borrowing funds from another party. Ultimately, this money must be repaid to the lender, usually with interest (the fee for borrowing someone else’s money). Debt financing may be secured from many sources: banks, credit cards, or family and friends, to name a few. The maturity date of the debt (when it must be repaid in full), the payment amounts and schedule over the period from securement to maturity, and the interest rate can vary widely among loans and sources. You should weigh all of these elements when considering financing.

The advantage of debt financing is that the debtor pays back a specific amount. When repaid, the creditor releases all claims to its ownership in the business. The disadvantage is that repayment of the loan typically begins immediately or after a short grace period, so the startup is faced with a fairly quick cash outflow requirement, which can be challenging.

One source of debt financing for entrepreneurs is the Small Business Administration (SBA), a government agency founded as part of the Small Business Act of 1963, whose mission is to “aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns.” The SBA partners with lending institutions such as banks and credit unions to guarantee loans for small businesses. The SBA typically guarantees up to 85 percent of the amount loaned. Whereas banks are traditionally wary of lending to new businesses because they are unproven, the SBA guarantee takes on some of the risk that the bank would normally be exposed to, providing more incentive to the lending institution to finance an entrepreneurial venture.

To illustrate an SBA loan, let’s consider the 7(a) Small Loan program. Loans backed by the SBA typically fall into one of two categories: working capital and fixed assets. **Working capital** is simply the funds a business has available for day-to-day operations. If a business has only enough money to pay bills that are currently due, that means it has no working capital—a precarious position for a business to be in. Thus, a business in this position may want to secure a loan to help see it through leaner times. **Fixed assets** are major purchases—land, buildings, equipment, and so on. The amounts required for fixed assets would be significantly higher than a working capital loan, which might cover just a few months’ expenses. As we will see, loan requirements made under the 7(a) Small Loan program are based on loan amounts.

For loans over $25,000, the SBA requires lenders to demand collateral. **Collateral** is something of value that a business owner pledges to secure a loan, meaning that the bank has something to take if the owner cannot repay the loan. Thus, in approving a larger loan, a bank might ask you to offer your home or other investments to secure the loan. In a real estate loan, the property you are buying is the collateral. In a way, loans for larger purchases can be less risky for a bank, but this can vary widely from property to property. A loan that does not require collateral is referred to as unsecured.

To see how a business owner might use an SBA loan, let's return to the example of a pizzeria. Not all businesses own the buildings where they operate; in fact, a great many businesses simply rent their space from a landlord. In this case, a smaller loan would be needed than if the business owner were buying a building. If the prospective pizzeria owner could identify a location available for rent that had previously been a restaurant, they might need only to make superficial improvements before opening to customers. This is a case where the smaller, collateral-free type of SBA loan would make sense. Some of the funds would be allocated for improvements, such as fresh paint, furniture, and signage. The rest could be used to pay employees or rent until the pizzeria has sufficient customer sales to cover costs.

In addition to smaller loans, this SBA program also allows for loans up to $350,000. Above the $25,000 threshold, the lending bank must follow its own established collateral procedures. It can be difficult for a new business to provide collateral for a larger loan if it does not have significant assets to secure the loan. For this reason, many SBA loans include the purchase of real estate. Real estate tends to be readily accepted as collateral because it cannot be moved and holds it value from year to year. For the pizzeria, an aspiring business owner could take advantage of this higher level of lending in a situation where the business is buying the property where the pizzeria will be. In this case, the majority of loan proceeds will likely go toward the purchase price of the property. Both the high and low tiers of the SBA loan program are examples of debt financing.

Equity Financing

In terms of investment opportunities, equity investments are those that involve purchasing an ownership stake in a company, usually through shares of stock in a corporation. Unlike debts that will be repaid and thus provide closure to the investment, **equity financing** is financing provided in exchange for part ownership in the business. Like debt financing, equity financing can come from many different sources, including friends and family, or more sophisticated investors. You may have seen this type of financing on the TV show *Shark Tank*. Contestants on the series pitch a new business idea in order to raise money to start or expand their business. If the "sharks" (investors) want to invest in the idea, they will make an offer in exchange for an ownership stake. For example, they might offer to give the entrepreneur $200,000 for a return of 40 percent ownership of the business.

The advantage of equity financing is that there is no immediate cash flow requirement to repay the funds, as there is with debt financing. The drawback of equity financing is that the investor in our example is entitled to 40 percent of the profits for all future years unless the business owner repurchases the ownership interest, typically at a much higher **valuation**—an estimate of worth, usually described in relation to the price an investor would pay to acquire the entire company.

This is illustrated in the real-life example of the ride-sharing company Uber. One of the early investors in the company was Benchmark Capital. In the initial round of (venture capital) financing, Benchmark invested $12 million in Uber in exchange for stock. That stock, as of its IPO date in May 2019, was valued at over $6 billion, which is the price that the founders would have to pay to get Benchmark's share back.

Some financing sources are neither debt nor equity, such as gifts from family members, funds from crowdfunding websites such as Kickstarter, and grants from governments, trusts, or individuals.

ARE YOU READY?

Researching Venture Capital Sources

Perform an internet search for venture capital firms. Review their websites to determine what specific industries each firm invests in. Would your idea for a business fit with any of these firms? What are some aspects that would indicate a good fit?

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8.1.3: Special Funding Strategies

Learning Objectives

By the end of this section, you will be able to:

- Identify funding strategies used by charitable organizations
- Describe financing opportunities available to startups
- Define bootstrapping
- Describe the advantages and disadvantages of bootstrapping

It's important to recognize that not all startups are Silicon Valley tech companies. These companies create high-profile products, such as applications and websites, which can take years to become profitable or even generate revenue. Much more common are the small businesses founded every day by entrepreneurs seeking to create value in their local communities. Moreover, not all startups are founded with a profit motive in mind.

Charitable organizations, or certain nonprofit companies, are often founded for altruistic purposes, such as advancing the arts, education, and science; protecting the natural environment; providing disaster relief; and defending human rights.

Table 8.1.3.1: Charitable Missions and Example Organizations

Mission	Examples
Advance education	Teach for America, Khan Academy
Protect the natural environment	Sierra Club, Wildlife Conservation Society
Defend human rights	Amnesty International, Human Rights Watch
Provide disaster relief	American Red Cross
Support the arts	Metropolitan Museum of Art, Americans for the Arts

These goals supersede the profit motive that a traditional company would have. As a result, the funding strategies of these enterprises often differ quite dramatically from those of standard for-profit businesses. Without the emphasis on profit, it can be difficult to provide for the cost of ongoing operations. Thus, these organizations must develop a **sustainable strategy**—one that can maintain the organization's financial stability.

In the United States, such organizations can qualify for **tax-exempt status**, meaning that if there is a profit from operations, it is not typically subject to taxes. Organizations seeking this exemption must apply to the Internal Revenue Service for tax-exempt status and provide information about what kind of mission the organization carries out—charitable, scientific, educational, and so on.

Consider a museum. What is its purpose? Traditional companies provide a product or service to their customers in exchange for payment, and typically fill a need their customers have. A grocery store sells food because human beings need to eat food to survive. Although viewing paintings and sculptures is not a physical requirement for life, this experience arguably enriches our lives and helps educate and shape our society. That is why museums are founded. Consider the original mission statement of the Metropolitan Museum of Art (commonly known as the "Met") in New York City.

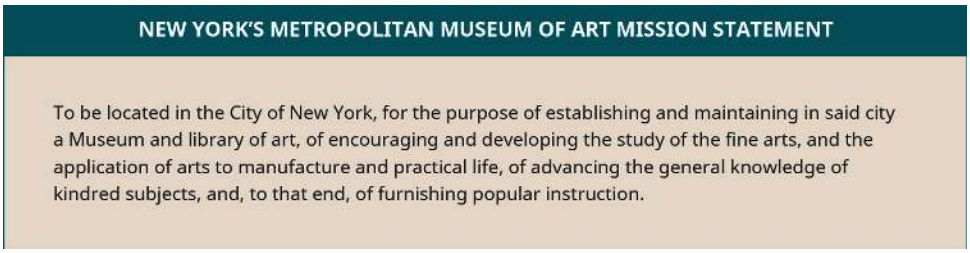


Figure 8.1.3.1: The mission statement of New York's Metropolitan Museum of Art summarizes the purpose of this entity. (CC BY 4.0; Rice University & OpenStax)

This is a different goal than that of most small businesses (providing a product or service in exchange for a profit) and, as a result, requires different financing strategies, such as a combination of program services, donations, and grants.

LINK TO LEARNING

Go to the Internal Revenue Service's website and look at the most recently updated Pub 334 Tax Guide for Small Business to learn more about the rules for income tax preparation for a small business.

Program Services

Program services are the basic offerings that a nonprofit organization provides that result in revenue, although not typically enough to cover the overall cost of running the organization. These services most closely resemble the customer interactions of a traditional business. The organization provides a product or service in exchange for a customer's money.

In our museum example, program services could take a few different forms. First, the museum likely charges a fee for admission to view the artwork and artifacts. The individual ticket price multiplied by the number of museum visitors equals the museum's ticket revenue. An established museum will have a good sense of how many visitors it has on average and can use these data to create a budget.

Another source of program service revenue for a museum could take the form of hands-on educational activities or events with guest speakers or presenters. Often museums will host local artists, or their own employees might conduct art classes or special-topic tours. These events and activities typically have a charge (revenue) beyond the regular admission cost.

Despite these revenue-generating activities, nonprofit organizations still face many funding challenges in covering all the operating costs of a normal business, such as employee wages, facility costs, and advertising. Thus, they need many different sources of income. To illustrate, the Met's 2018 program service income only made up 2.3 percent of its total revenue for the year.

Donations

One benefit to a business with a charitable mission is inherent public support, which can foster community involvement above and beyond patronage. For nonprofits, this can translate into a willingness to donate money to the organization. A **donation** is a financial gift with no expectation of repayment or receiving anything in return. A traditional business must provide something valuable to create a customer exchange: Their customers demand value in exchange for their hard-earned money.

The benefactors of a charitable organization want to help further the mission of the organization. This type of entity—whether it's a museum, a hospital, or the Red Cross—relies on the goodwill of community supporters. For the Met, with such a low percentage of revenue generated by program services, it's clear that donations and charitable gifts are vital to the organization's **financial viability**.

Grants

Another source of funding for nonprofit organizations is grants. A **grant** is a financial gift given for a specific purpose by a government agency or a charitable organization such as the Bill and Melinda Gates Foundation. Like a donation, a grant does not have to be repaid. Unlike with donations, both nonprofit and for-profit organizations can compete for grants. Whereas donations are typically given without restriction to offset the general operating expenses of the organization, grants often specify how the funds are to be used. Most grant-providing entities have an agenda or purpose behind their funding. For example, the National Institutes

of Health (NIH) provides grants “to support the advancement of the NIH mission to enhance health, extend healthy lives, and reduce the burdens of illness and disability.” This federal organization invests over $32 billion annually for medical research.

Grants can be very competitive, requiring a rigorous application process. Usually, multiple organizations apply for the same grant; the organization issuing the grant reviews the many competing applications to make its selection. Grantees generally must submit audited financial statements and are required to update the grantor subsequent to the grant award to ensure proper intended use. The NIH awards almost 50,000 grants annually, most of which are competitive. Although that is an enormous number of projects to fund, only 20 percent of applications submitted to the NIH in 2018 actually were accepted. In other words, the NIH rejected four out of every five applications. For entrepreneurs, this means that when you identify a grant that is specific to your organization’s mission, you should weigh your chances of being awarded the grant when considering it as part of your funding strategy.

To understand grants in practice, let’s further examine the NIH. The NIH Small Grant Program provides funds for activities such as the development of new research technology. This specific grant can be awarded for up to a two-year period, with funds of up to $50,000 in direct costs per year. A grant like this could provide vital support to a nonprofit startup.

Some business ventures fall somewhere between organizations completely committed to charitable work and traditional small businesses with entrepreneurs focused on social entrepreneurship. Social entrepreneurs develop products and services as solutions to societal problems. For example, the TOMS shoe company was able to create a business model through which the company gives one pair of shoes to children in need in foreign countries for every pair of shoes that a customer purchases. This practice pioneered what they refer to as “One for One.”

The company’s website describes the origins of both the company and this model, which are based on the experiences of its founder, Blake Mycoskie.



Figure 8.1.3.2: The TOMS origin story provides an example of social entrepreneurship. (CC BY 4.0; Rice University & OpenStax)

Social entrepreneurship offers the ability to effect positive change in the world without simply relying on donations. It pairs a profitable, sustainable business model with a good cause. This combination often creates positive word of mouth. It gives potential customers a good feeling about the product beyond just its style or function.

WHAT CAN YOU DO?

Social Entrepreneurship

Like the founder of TOMS, sometimes in our everyday life, we are presented with an opportunity to help people. We may even find out that we’re not alone in this desire to help. What opportunities to help—individuals, society, or environment—do you see in your own community? What are some ways that you could raise awareness around this issue?

No-Loan Finance Strategies

As you’ve learned, many startups come into being through the extensive use of debt. Although borrowing is a legitimate source of funding, it can be risky, especially if the entrepreneur is personally responsible for repayment. In practice, some entrepreneurs max out credit cards, take out home-equity loans against their primary residences, or secure other high-interest personal loans. If the entrepreneur fails to repay the loans, the result can be repossession of equipment, home foreclosure, and other legal action.

We now examine funding strategies attractive to many startups that do not require going into debt or exchanging ownership of the business for financial support (debt and equity financing). The financing methods described here are more creative funding strategies, including crowdfunding, bartering, and other methods.

Crowdfunding

Recall the story of iBackPack. This venture was originally funded by contributions through Indiegogo and Kickstarter. These websites are a form of **crowdfunding**, which involves collecting small sums of money from a large number of people. The people who contribute money are typically referred to as backers because they are backing the project or supporting the business idea.

Browsing these crowdfunding websites, you will see many different kinds of ventures seeking financial backing—from creating new board games to opening donut cafes. Each project identifies an overall specific funding goal in terms of a dollar amount. Some crowdfunding websites, such as Kickstarter, implement an "all or nothing" model in which projects do not receive any funds unless their overall funding goal is met. The amount can be exceeded, but if it is not met, the project receives nothing. For an entrepreneur utilizing this resource, selecting an attainable funding goal must be a core part of their strategy. The funding goal must also be appropriate to the scale of the project. For example, setting a goal of $50,000 may be reasonable for launching a food truck (which could be a prototype for a full restaurant), but it is a mere fraction of the cost of constructing an entire table-service restaurant, which would come closer to $750,000. An entrepreneur seeking to enter the culinary world should consider which target would be most achievable as well as most beneficial in meeting both short- and long-term goals. Also, remember that meeting the funding goal does not ensure success of the business, as was the case with iBackPack.

Entrepreneurs vying for crowdfunding usually employ some common tactics. First, they often post an introductory video that explains the project goal and the specific value proposition. (For example, a chef might seek $75,000 to open a food truck specializing in a relatively unknown cuisine.) Second, the entrepreneur provides a more detailed written summary of the project, often including specific items that the funding will pay for, such as $50,000 for a vehicle, $10,000 for graphic design and vehicle decals, and $15,000 for kitchen equipment for the truck. Last is the reward structure, which is what entices visitors to the site to fund the project, offering a return beyond their own passion for the venture. The reward structure establishes different levels of funding and ties a specific reward to each level. For example, for a contribution of $5, the chef might thank the backer on social media; for $25, the backer would get a t-shirt and a hat featuring the food truck's logo; for $100, the backer would get five free meals when the food truck opens. Fees for these crowdfunding sites vary from 5 to 8 percent. Kickstarter now requires physical products or prototypes for some startups, as well as a short video to help represent and "sell" the product.

Although this financing source offers a lot of flexibility, businesses utilizing crowdfunding can run into trouble. Certain funding levels and rewards may have limits. For example, a reward structure might offer backers contributing $1,000 a trip to the grand opening of the food truck, including airfare and hotel. These top-tier rewards can generate a lot of excitement, but the expense of flying people around the country and providing accommodations could become unmanageable. One research study stated that 84 percent of Kickstarter's top projects delivered their rewards late.

The advantage of crowdfunding is that the business receives cash upfront to launch. The downside is that the reward requires a future payment to the backers. This payment may be in the form of branded merchandise, meals, or even events or travel, so it is important for entrepreneurs to set aside part of the investment money to fund the rewards. Depending solely on generating the reward funds out of future sales is a risk that might result in upsetting the very fans who made the business possible. Since crowdfunding is managed online, another risk is upsetting the project's vocal supporters. Crowdfunding usually provides only a "kick start" for a startup, so most seed-stage companies will need additional funding from other sources to get to their first commercial launch.

Although social media can backfire, entrepreneurs can take advantage of benefits too. Crowdfunding can allow an entrepreneur to build a community around a product before it is even sold. Like-minded fans of a product can connect with each other over the internet, in the feedback section of a website, or in shared social media posts. Additionally, backers of a project can become cheerleaders for it by sharing the idea—and their enthusiasm for it—with friends, family, and coworkers. Word-of-mouth marketing can lead to more backers or future customers after launch.

Dozens of crowdfunding portals exist, including WeFunder, SeedInvest, Kickstarter, and Crowdcube. Current SEC guidelines for issuing and investing limits granted for Title III Crowdfunding include:

- A company can raise up to $1 million in aggregate through crowdfunding offerings over a twelve-month period
- Over a twelve-month period, individual investors can invest in the aggregate across all crowdfunding offerings up to:
  - $2,000 or 5 percent of the unaccredited investors net worth or yearly income if they make less than $100,000/year

- 10 percent of the lesser of their annual income or net worth, if both their annual income and net worth are equal to or more than $100,000

ARE YOU READY?

Kickstarter

Visit the Kickstarter website at https://www.kickstarter.com/ and review a few projects. What did they do well in the video pitch? What unique rewards did they offer? How would you implement a Kickstarter page for your own business idea?

Bartering

Startup companies often don't have a lot of cash assets on hand to spend, but they often have offerings that can provide value to other businesses. **Bartering** is a system of exchanging goods or services for other goods or services instead of for money. Let's consider the case of Shanti, a website designer who wants to start a business. She may want to have her business formally incorporated or may require other legal help, such as review of standard contracts. Hiring a lawyer outright for these services can be costly, but what if the lawyer needed something that a website designer could provide?

Whether the lawyer has just started his own business or has been established for several years, he may need a website created or have an old website redesigned and updated. This website overhaul could prove costly for the lawyer. But what if there were a way that both the lawyer and the web designer could get what they wanted with a resulting net cost of zero dollars? Bartering can achieve this. It should be noted that there are accounting and tax implications involved with bartering that can prevent a net zero offset of costs.

In a barter scenario, Shanti could create a website for the lawyer at the expense only of her time, which in the startup phase is often more abundant than actual cash. The lawyer could provide incorporation services or contract review in exchange, requiring no cash outlay. For many entrepreneurs, this type of exchange is appealing and enables them to meet business needs at a lower perceived cost. Although more mature firms can also use bartering, the opportunity cost is much higher. If a mature company is unable to take on a new paying client because it is doing too much free (barter) work, it may lose out on future revenue, which could potentially be a big loss. Startups, in contrast, often have excess capacity while they develop a customer base, so taking on barter work is often a low-risk, beneficial funding strategy.

Other No-Loan Funding Options

Beyond crowdfunding and bartering, startups have other options to help them get off the ground, such as funding competitions and pre-orders. Many organizations hold entrepreneurial finance contests provide financial awards to the winners. These prize funds can be used as seed money to start a new venture. For example, the New York City Public Library holds an annual business plan competition called the New York StartUP! Business Plan Competition. Applicants must complete an orientation session, attend workshops that develop skills related to the creation of a business plan, and submit a complete business plan. The first-place award yields $15,000 in prize money, which can be a great start toward turning an entrepreneurial idea into a business reality.

Another way for startups to gain financial traction is to solicit pre-orders. Consider the launch of a new book or video game. Retail stores will often solicit pre-orders, which are advance purchases of the product. Customers pay for the desired item before they even have access. For example, the entrepreneur Mitchell Harper raised $248,000 in funds before his product launched. This approach is not limited to existing, well-known franchises—startups can use it as well. Although established novel and video game franchises have big fan bases and often large advertising budgets, startups can still find effective strategies in this space.



Figure 8.1.3.3: Entrepreneurs can explore a variety of no-loan funding options. (CC BY 4.0; Rice University & OpenStax)

Companies with a prototype model of their product or a first manufacturing run can showcase the new product to potential customers, who may be interested enough to place an order. The company can use the funds received from these pre-orders to pay for the inventory. In addition to having sales staff make sales calls, new companies can attend trade shows and exhibitions to garner interest in the product. Many new products are launched in this fashion because it allows access to many potential customers in one place.

Why Bootstrapping Hurts, Then Helps

The process of self-funding a company is typically referred to as **bootstrapping**, based on the old adage that urges us to "pull ourselves up by our bootstraps." It describes a funding strategy that seeks to optimize use of personal funds and other creative strategies (such as bartering) to minimize cash outflows. In recent years, this strategy has been the fodder for shows like *Shark Tank*. These shows may make entrepreneurs think that being on TV is glamorous, or the shows may glorify the financial backing of millionaires and billionaires. We have seen that for many entrepreneurs, the reality is that there are drawbacks to bringing in outside investors to launch your venture. These drawbacks include loss of future profits and possible loss of control of the company, among others. Potential business owners must weigh the advantages and disadvantages—both short and long term—for funding their specific dream.

You've learned about financing strategies predicated on finding a willing investor or lender, but many small businesses simply don't have access to large amounts, or any amount, of capital. In these cases, aspiring business owners need lean business strategies that will yield the greatest benefit.

Bootstrapping requires entrepreneurs to shed any preconceived notions of the popular-culture image of startups. Most startups don't have trendy downtown offices, foosball tables, or personal chefs. Bootstrapping reality looks more like late nights spent clipping coupons. It involves scrutinizing potential expenses and whether each cost is really worth the investment. It can be a difficult and trying process, but without any angel investors or wealthy family backers, bootstrapping is often an entrepreneur's only option. The good news is that this approach can pay substantial dividends in the long run.

The Basics of Bootstrapping

When entrepreneurs risk their life savings, they must stretch every dollar as far as possible. Having a limited amount of capital to work with requires optimizing creative strategies to get the business launched and keep it afloat. This creativity applies to bringing customers and sales in the door as well as to managing expenses.

Understanding the ongoing costs of the business is key. In an interview on NPR's show *How I Built This*, Barbara Corcoran, one of the investors on *Shark Tank*, shares her humble beginnings in real estate brokerage. One of the things she touches on is being constantly aware of how long her money would last, given her monthly expenses. If she had $10,000 in the bank and the cost of her

rent and employees was $2,500 per month, she knew that the money would last her four months. Such constant information and vigilance are required when bootstrapping a business for success.

Employee costs are typically one of the largest expenses facing a business. Hiring traditional full-time employees can be costly; onboarding them too early can be fatal to a business's bottom line. Creative approaches to minimizing labor costs can be enormously helpful. One strategy for controlling these costs is utilizing independent contractors (freelancers) and other part-time employees. They do not work full-time for the business and may serve other companies as well. Their compensation is generally lower than that of a full-time, salaried employee, often in part because these positions do not usually come with any benefits, such as health insurance or paid time off. Using these workers to fill resource needs can help minimize costs. Once operations have begun to stabilize, it may be possible and ideal to offer full-time employment to these individuals.

Marketing is another key area for new business investment, but billboards, web ads, TV ads, and radio spots can be expensive. TV and radio ads can also be ineffective if they are aired during low-volume times, which is typically all that startups with lower budgets can afford. Fortunately, there are many low- or no-cost marking opportunities, such as word-of-mouth marketing. Doing a good job for one customer can easily lead to referrals for more business. Some social media efforts can also provide a strong return for minimal investment, although typically it is nearly impossible to gauge an effort's potential impact or success.

A new enterprise that is bootstrapping must also carefully manage operational expenses. At the beginning of operations, an entrepreneur can often minimize unnecessary expenses—even if that means forgoing an actual business location. Working out of a home office or a co-working space (such as WeWork or Impact Hub) can lead to significant savings. Renting office space can cost hundreds or thousands of dollars a month, whereas a home office typically requires no additional investment. Depending on the location, co-working spaces can provide a single workspace and technology access for as little as $50 to $100 per month, yielding substantial savings over a dedicated office suite. In larger cities, or in locations with more amenities, the monthly costs can run between $100 and $500 per month.

The Boston Beer Company, which today produces the Samuel Adams line of beers, provides a classic example of minimizing these costs in its early days. When this company first started, it owned no office space—or even a brewery. It employed other breweries as contract brewers to manufacture its beer. Its founder, Jim Koch, invested most of his time in selling to bars and restaurants, working from his car and phone booths. (This was during the 1980s.) His lean strategy was a successful application of the bootstrapping mindset. From its humble beginnings, the Boston Beer Company has become one of the largest American-owned breweries—ranked second based on 2018 sales volume by the Brewers Association. Whereas traditional thinking may dictate that a company must have an official office or headquarters, a bootstrapping mindset evaluates what the space would be used for and the trade-offs for its cost.

How Bootstrapping Hurts

The process of bootstrapping is not an easy one. It is fraught with tight budgeting and sacrifice, which can take its toll on an entrepreneur. One of the simplest bootstrapping strategies is to start a business by **moonlighting**, or treating your business venture as a second job. Employing this strategy, the entrepreneur continues to work at their regular job, say from 9:00–5:00, and then dedicates the rest of the evening and weekends to working on the business. Whereas this strategy has the obvious benefit of maintaining a comfortable level of income, this approach has a few drawbacks (Table 9.3). Moonlighting entrepreneurs cannot dedicate 100 percent of their time and energy to their new business. The time they can dedicate to it may be less efficient. After working all day at another job, a person may feel tired or burned out, so it can be difficult to change gears and press forward with full productivity.

In addition to the exhausting time investment, moonlighting can exact tolls on personal relationships. This strategy is easiest when an entrepreneur is in a life stage with few commitments. It may have an adverse effect on friendships, but in other life stages, this impact can be more significant. For example, it can detract from relationships with a partner/spouse or children, in both a decrease in focus/investment in these relationships and day-to-day challenges in work-life balance and household management for all affected. Additionally, at some point, to attract serious investors, a founder will have to commit to the project full time.

Table 8.1.3.2: Bootstrapping Advantages and Disadvantages

Advantages	Disadvantages
• No ownership given up • Forces creative solutions • Keeping costs low fuels growth	• Slow to start • Less glamorous • Owner must make personal sacrifices

Other bootstrapping strategies include negotiating the terms for payments on expenses. Often when businesses sell to other businesses, the vendor allows the customer to buy on **credit**. This means that the buyer does not have to pay at the time of purchase. Although retail customers are required to pay at the register during checkout, purchases between businesses can work on different terms, sometimes extended up to thirty, sixty, or ninety days. This extra time to pay for purchases can be a real advantage for businesses. When a business buys inventory on credit, it has the opportunity to begin selling it before it has even paid for it. For example, a clothing retailer could sell its product in stores or online, and receive cash before it had to pay its vendors. Unfortunately, when a business's cash becomes tight, an ethical dilemma can arise. When a business has more bills to pay than money to pay them with, the owner will need to make tough decisions. It can be easy to forget about or ignore amounts due to vendors, but this problem is compounded when it occurs with more and more vendors. Ultimately, it can get to the point where vendors will no longer sell to you on credit, or even at all. When a company can no longer buy inventory to sell to customers, it won't be long until it's out of business. An ethical entrepreneur will be alert to this concern and resolve it with aboveboard business decisions.

How Bootstrapping Helps

Although bootstrapping can be painful in the early years of a business, it yields significant benefits for the business owner in the long term. One of the most valued benefits of bootstrapping a business is the fact that the founder can maintain control of the company and typically retain 100 percent ownership. Although it can be easy to give up ownership in an idea because ideas come freely and don't require financial sacrifice, entrepreneurs who accept an equity financing opportunity and give up a significant portion of ownership of the business may not realize the potential detrimental outcomes. What seems glamorous on *Shark Tank* may cost a business owner more control than desired. Once you give up any amount of equity in a business, it can be difficult or expensive to get it back. Once the deal is accepted, the investor is entitled to that percentage of the profit every year the company is in business, even if that person never lifts a finger to support the enterprise. Entrepreneurs usually make those financing deals because of the benefits of the money and access to the investor's contacts. It's unlikely that Mark Cuban is going to roll up his sleeves in your food truck when things get tough. If you can avoid outside financing, you will maintain complete control and full ownership of the business, and you should weigh this benefit in your financing decisions.

Another benefit of bootstrapping is avoiding taking on debt. Whether it's in the form of credit cards or personal loans, repayment of debt can take a serious toll on any business and can be especially burdensome for new businesses. Considering that some of the debt financing sources available to entrepreneurs can bear higher-than-average interest rates, digging yourself out from underneath this financial burden is no easy task. Also, delaying outside investments allows your business to grow not only in revenue and profit, but also in market value. When potential investors come along, they will consider a higher contribution for a smaller percentage of the business.

LINK TO LEARNING

One of the most common forms of debt financing is simply a credit card. Although it may seem wise to charge many of the upfront expenses and simply pay the card's minimum monthly payment, this can be a treacherous road to go down. Try the credit card calculator to calculate how long it takes to pay off a credit using only the minimum payment. It may shock you. Try a few different amounts: $1,000; $5,000; and $10,000.

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8.1.4: Accounting Basics for Entrepreneurs

Learning Objectives

By the end of this section, you will be able to:

- Explain the accounting equation and define its parts (assets, liabilities, and equity)
- Define revenue, expenses, and income

Although financing and accounting complement and rely on each other, they are distinct. As we have seen, financing is the process of raising money. **Accounting** is the system of recording and classifying financial transactions related to a business, and summarizing and communicating those transactions in the form of financial statements. Accounting is essentially documenting what happens to money once a company receives it and thereby makes that information available for reporting to stakeholders and regulatory agencies, and informing business decisions.

At the most fundamental level, an accounting system accomplishes two goals:

1. It summarizes a business's financial performance
2. It communicates that performance to owners, managers, and outside parties

The most common approach to accounting used in the United States, and around the world, follows the basic formula shown in Figure 8.1.4.1.



Figure 8.1.4.1: The accounting equation provides the foundation of a company's financial status and outlook. (CC BY 4.0; Rice University & OpenStax)

This formula is referred to as the basic **accounting equation**. First, we'll define each of these terms, and then we'll look at an example of a simple transaction recorded using the equation.

Assets are items—such as equipment, cash, supplies, inventory, receivables, buildings, and vehicles—that a business owns and derives future use from. Potential investors want to know what resources a company has at its disposal. Business owners want to see where their money has gone. Let's return to the case of Shanti, the website designer who starts her business by purchasing a new laptop computer. The computer is an asset that Shanti has acquired for her business.

A **liability** is a debt that a company has incurred with another party, as when it borrows money from a bank or purchases materials from other suppliers. The business is required to make a future payment to satisfy that debt. For accounting purposes, we want to be able to see what the business owns (assets) compared with what it owes (liabilities). For example, if Shanti does not have sufficient cash to pay for the laptop, she may have the electronics store charge her credit card for the purchase. In that case, the credit card company pays the store, and Shanti's business now owes the credit card company for the amount of purchase (a liability).

Equity is the owner's claim on the assets of the business, that is, the difference between what they own and what they owe. Essentially, equity tells a business owner or investor how much the firm is worth after all the debt is repaid. Returning to the example of Shanti's website design business, let's compare two scenarios of startup purchases to see the effects on the accounting equation. In both cases, Shanti contributes some of her own money to the initial purchase of a laptop.

In the first scenario, shown in Figure 8.1.4.2, she contributes $1,000 to the new business.

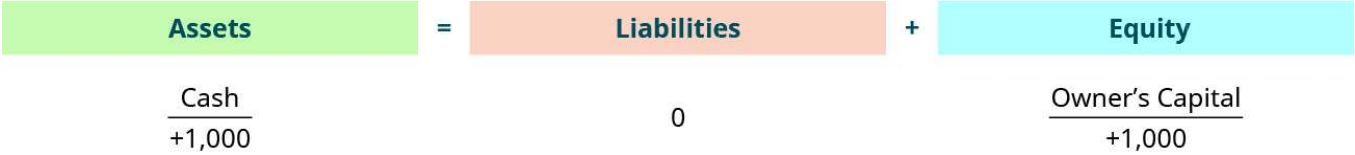


Figure 8.1.4.2: An initial $1,000 contribution by the owner is recorded in the accounting equation. (CC BY 4.0; Rice University & OpenStax)

Each element of the accounting equation has its own account in an accounting system or software package, and all changes are tracked within its account. The accounting equation must stay in balance after every transaction with assets equaling liabilities. In this case, Cash is an assets account, and Owner's Capital is an equity account. The $1,000 cash contributed is a cash asset and becomes equity that is recorded as owner's capital. At this point, Shanti can claim 100 percent of the assets of the business, which right now consist only of the cash.

If she uses all of her cash assets to purchase the laptop, the accounting equation will record this as shown in Figure 8.1.4.3.

Assets			=	Liabilities	+	Equity
Cash		Computer				Owner's Capital
+1,000				0		+1,000
−1,000		+1,000				
0		1,000		0		1,000

Figure 8.1.4.3: The purchase of a laptop computer using existing cash is recorded in the accounting equation. (CC BY 4.0; Rice University & OpenStax)

When the cash is spent, reducing the assets column to zero, a new asset account for the computer is created to record the dollar amount paid for the laptop. Again, because Shanti doesn't owe another party at the end of the transaction (because she didn't make any additional contribution), the balance of the owner's equity account remains the same. The equation shows that Shanti still owns 100 percent of the assets.

Now consider how to account for a situation in which Shanti does not have a significant amount of cash to contribute to the business. She can afford to contribute only $100 and deposits the money into the business's bank account. Fortunately, she also has access to a credit card that can be charged for business purchases, increasing her investment options.

The initial contribution to the business is recorded in the same way but with the new amount, as shown in Figure 8.1.4.4.

Assets	=	Liabilities	+	Equity
Cash				Owner's Capital
+100		0		100

Figure 8.1.4.4: An owner contribution of $100 is recorded in the accounting equation. (CC BY 4.0; Rice University & OpenStax)

The laptop still costs $1,000, but the business has only $100 in cash assets. Shanti purchases the laptop with a credit card, and the clerk finalizes the sale. Figure 8.1.4.5 shows the impact of the sale on the accounting equation.

Assets			=	Liabilities		+	Equity
Cash	Computer			Credit Card			Owner's Capital
+100	0			0			+100
−100	+1,000			+900			0
0	1,000			900			100

Figure 8.1.4.5: The purchase of the computer asset using cash and a credit card is recorded in the accounting equation. (CC BY 4.0; Rice University & OpenStax)

In both examples, Shanti reports the computer as an asset of the business that is valued at its $1,000 cost. In the first scenario, she exchanged the cash for the computer. In the second, she exchanged a smaller amount of cash for the laptop and charged the remaining amount of the purchase on a credit card. This creates a liability for the business that Shanti will need to repay in the future. Since this is an equation, both sides must be equal to each other, and this proves to be the case in both scenarios. The total assets are $1,000, and the total liabilities plus equity are also $1,000.

ARE YOU READY?

The Accounting Equation

On a sheet of paper, use three columns to create your own accounting equation for your personal assets, liabilities, and expenses. In the first column, list all of the things you own (assets). In the second column, list any amounts owed (liabilities). In the third column, using the accounting equation, calculate the net amount of the asset (equity). When finished, total the columns to determine your net worth.

Here is something else to consider: is it possible to have negative equity? It sure is . . . ask any college student who has taken out loans. At first glance there is no asset directly associated with the amount of the loan. But is that, in fact, the case? You might ask yourself why make an investment in a college education—what is the benefit (asset) to going to college? The answer lies in the difference in lifetime earnings with a college degree versus without a college degree. This is influenced by many things, including the supply and demand of jobs and employees, and the field in which you plan to work.

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8.1.5: Developing Startup Financial Statements and Projections

Learning Objectives

By the end of this section, you will be able to:

- Understand the three primary financial statements: balance sheet, income statement, and statement of cash flows
- Understand how financial projections are made and how to use the run rate and the burn rate
- Understand how to create a break-even analysis

You have learned how an accounting system classifies transactions in terms of assets, liabilities, and equity; what those transactions mean in terms of the accounting equation; and what that information says about an entity's overall financial health. Now we'll examine how to summarize those transactions in financial statements that can be shared with stakeholders. Internally, these statements are used to make decisions about the management of the company and its operations. Externally, they provide existing and potential investors with data to inform their financial support of the venture.

The information entered into the accounting system is summarized in **financial statements**, which are the output of an accounting system. We will examine three basic types of financial statements:

- The balance sheet
- The income statement
- The statement of cash flows

Each type of statement communicates specific information to its audience. Investors around the world use financial statements every day to make investment decisions.

LINK TO LEARNING

If you like quizzes, crossword puzzles, fill-in-the-blanks, matching exercises, or word scrambles, go to My Accounting Course for some fun ways to reinforce the accounting information you are learning. This website covers a variety of accounting topics including financial accounting basics and financial statements.

The Balance Sheet

The first financial statement is the balance sheet. The **balance sheet** summarizes the accounting equation and organizes the different individual accounts into logical groupings. As you previously learned, the components of the accounting equation are:

- assets—items the company owns or will benefit from; examples include cash, inventory, and equipment
- liabilities—debt or amounts the company must repay in the future; examples include credit card balances, loans payable, and so on
- equity—the share of the assets due to the owners after debt is repaid

The accounting equation itself (assets = liabilities + equity) is spelled out on the balance sheet. It is shown in two portions. On one side, all of the assets are spelled out and their amounts totaled. This total is compared to the totals in the second and third portions, which show liabilities and equity. Just as the accounting equation itself must balance, so must the balance sheet.

Figure 8.1.5.1 shows the 2020 balance sheet for Hometown Pizzeria. This is the same kind of financial statement that real-life investors use to learn about a business. You can see the main aspects of the accounting equation in each half of the statement, as well as many detailed individual accounts. This financial statement gives the reader a quick summary of what the company owns and what it owes. A potential investor will be interested in both items. The amount of liabilities is an indicator of how much the business needs to pay off before the investors will see a return on their investment.

Most balance sheets display data vertically rather than horizontally. But the vertical format still presents the two sides of the equation—except that liabilities and equity are on the bottom half of the statement. Note that the two sides still must equal each other, or balance—hence the name "balance sheet."

HOMETOWN PIZZERIA Balance Sheet For the Year Ended December 31, 2020	
Assets	
Cash	3,918
Ingredient supplies	1,720
Furniture and fixtures	5,654
Restaurant equipment	15,890
Total assets	27,182
Liabilities	
Accounts payable	1,890
Credit card payable	3,759
Total liabilities	5,649
Equity	
Owner's capital	21,533
Total liabilities and equity	27,182

Figure 8.1.5.1: This is Hometown Pizzeria's balance sheet. (CC BY 4.0; Rice University & OpenStax)

A review of the Hometown Pizzeria balance sheet lets us see what kind of assets the company has. We see cash, ingredients, and restaurant equipment—all things that would be necessary to make pizzas and sell them. We also see some liabilities. **Accounts payable** is an account that covers many different vendors that the company buys from on credit, which means the vendors let the pizzeria pay them after they have delivered their goods. These vendors could be companies that sell flour, produce, or pizza boxes. "Credit card payable" is the balance due on the credit card, which could have also been used to stock up on supplies or pay other bills.

One of the first things an investor will do is compare the total assets of a company with the total liabilities. In this case, the pizzeria reports total assets of $27,182 and total liabilities of $5,649. This means that the pizzeria owns more than it owes, which is a good sign. It actually has several times more assets than liabilities. Although it does not have enough cash to pay off all the liabilities right now, other assets have value and could be sold to generate cash.

To recap, the balance sheet summarizes the accounting equation. It tells the business owner what the company has and how it was paid for. Investors also want to understand where the company has spent its money and where that money came from. If a company is laden with debt, any investment may be immediately spent trying to get caught up with creditors, with no real impact on helping operations. Ultimately, investors want to read these financial statements to know how their money will be used.

The Income Statement

The second basic financial statement is the income statement, which provides the results of a company's operations. At the most basic level, the **income statement**—also called the **profit-and-loss statement**—describes how much money the company earned while operating the business and what costs it incurred while generating those revenues. An investor wants to know how much money the company brought in from customers and how much it had to spend to get those customers. Revenue minus expenses results in **net income**, or profit if there are funds left over.

After identifying total revenue and expenses, a business can calculate its profit margin. The **profit margin** is the profit divided into the total revenue, described as a percent. For example, if we opened a pizzeria and generated $100,000 in sales our first year and incurred $90,000 in expenses, that would result in $10,000 of net income. If we divide that net income by our $100,000 in sales, the profit margin is 10 percent. So for every dollar of sales that was generated, ten cents remained as a profit. We could save this resulting profit for future renovations, an expansion, or payment to the owners as a distribution.

A pizzeria—or any business that sells a physical product—has costs that are specific to the product sold. For example, pizza requires flour and yeast to make the dough, tomato sauce, cheese, and other toppings. We refer to these expenses as the **cost of goods sold**. These costs are the primary driver that determines whether the company can be profitable. If the selling price of a pizza is $12 and our cost of ingredients is $12, the transaction nets to zero. The company wouldn't make any money on a sale and is

simply recouping the money paid for the ingredients. This is not a feasible business model because there are many costs in addition to ingredients, such as rent on the building, employee wages, and other items.

The selling price of an item minus its direct costs—or cost of goods sold—is the **gross profit**. In a product business, this is the most important operational figure. A business needs to know how much money it makes on each sale because that gross profit pays for all other expenses. If the pizzeria sells a pizza for $12, the cost of its ingredients might be $4, so the gross profit of selling one pizza is $8. Every time the company sells another pizza, the gross profit increases. If the business sells 1,000 pizzas in a month, its sales would be $12,000, the cost of goods sold would be $4,000, and $8,000 would be left for profit.

HOMETOWN PIZZERIA
Income Statement
For the Year Ended December, 2020

Revenue	
Food and beverage sales	32,593
Expenses	
Cost of goods sold	9,777
Paper products	1,201
Rent	3,000
Salaries and wages	4,809
Utilities	2,753
Total expenses	21,540
Net income	11,053

Figure 8.1.5.2: This is Hometown Pizzeria's income statement. (CC BY 4.0; Rice University & OpenStax)

Results from Operations

As you learned earlier in this chapter, a business can create assets through debt or equity financing. After the initial investment, those assets can be employed to operate the business. For example, when Hometown Pizzeria opens, after the initial build-out of the kitchen and dining area, the business can make and serve food to customers in exchange for money. This process creates new assets in the form of cash collected from customers and becomes a third way to generate assets in a business—from operations, which we call revenue. In an ideal situation, the business would require little outside investment once operations have begun.

The amount a business earns from selling a product or providing a service is referred to as **revenue**, or sales. The costs incurred in the normal course of operations are referred to as **expenses**. For the newly opened pizzeria, payments from customers for their meals are the business revenue, whereas the cost of food ingredients, beverages, dinnerware, and paper goods—such as napkins—are the operating expenses. The balance of business revenue minus operating expenses is the profit of the business, or net income.

Before moving on to visualizing operational income, let's pause here to review some of the basic distinctions between these key terms. When a company gains new assets, those assets have to come from somewhere, usually from one of three sources. We will see these options on the right side of the equation, as we move from left to right. First, if we gain a new asset, but we have not paid for it, we have created a liability—something the business owes. This was the case when Shanti paid for her computer with a credit card. In the future, she will have to pay the credit card company, but this is a different process from an expense, as we will see later. For right now, we are gaining something new and must repay someone later.

The second source of new assets is owner investments. This was the first example we saw when Shanti deposited money in the business's bank account from her personal savings. In terms of the business, assets increased because she now had more cash than before, and on the right side of the accounting equation, we record the source of those assets—Shanti herself. So investments by the owner are another source of new assets.

The third way that the business gains new assets is from operations. When Shanti uses the assets of her business (a computer) to perform work for a customer (creating a website), this results in a sale, or revenue. Assets of the business increase because the customer pays for the work; thus, Shanti's cash increases. Again, on the right side of the equation, we record the source of that asset: revenue. Revenue is an increase in assets from customers paying for goods and services.

To illustrate, let's continue with Shanti's website design business. She purchased a computer with her personal savings and has been hired to create a website for a local business. This client agrees to pay $5,000 for the website, due on completion of the site.

Once the work on the website is complete, Shanti records the receipt of $5,000 cash as an increase to the cash account. On the right side of the equation, this is added in an account under equity for revenue.

Assets			=	Liabilities	+	Equity	
Cash	Computer					Owner's Capital	Revenue
+1,000	0			0		+1,000	0
−1,000	+1,000			0		0	0
+5,000	0			0		0	+5,000
5,000	1,000			0		1,000	5,000
Total Assets = $6,000						Total Equity = $6,000	

Figure 8.1.5.3: This shows recording a customer sale of $5,000. (CC BY 4.0; Rice University & OpenStax)

The total company assets have grown to $6,000 with the addition of the $5,000 earned and collected from this client. On the right side of the equation, equity has increased in a new column representing revenue and expenses, where revenues are positive amounts and expenses are negative amounts.

The accounting equation describes how transactions are classified within the context of balancing what a business has (assets) with how it paid for those assets (liabilities and equity). In the next section of this chapter, we will explore how this information is summarized in financial statements and how entrepreneurs and potential investors use that information.

LINK TO LEARNING

Accounting is the system of communication that allows for decision-making by individuals both inside and outside the company. For an overview of accounting, please see the video on the Investopedia website.

The Statement of Cash Flows

The third basic financial statement we will discuss is the **statement of cash flows**, which explains the sources of and uses of a company's cash.

You may wonder how the statement of cash flows differs from an income statement. The short answer is that the income statement captures events as they happen, not necessarily when the company gets paid. It records certain items, such as sales, when the work is completed. Let's return to Shanti, the website designer. As soon as she completes the client's website, the accounting system will record the *revenue*, the amount that is due from that client; this second item is referred to as **accounts receivable**. If Shanti's client is struggling financially or even goes out of business, she may never get paid for that work, but the income statement would show sales, and therefore possibly a profit. If the customer goes out of business, the business bank account will not have any evidence of a profit.

It is for this reason that the statement of cash flows was developed. It accounts for these differences, only showing activities that result in cash received or cash paid. To better understand the purpose and use of the statement of cash flows, let's first look at this statement again in the context of a pizzeria.

HOMETOWN PIZZERIA Statements of Cash Flows For the Year Ended December 31, 2020	
Cash Flows from Operating Activities	
Cash received from customers	50,000
Cash paid for ingredients and supplies	(18,000)
Cash paid for employees	(12,500)
Cash paid for interest	(3,300)
Cash paid for taxes	(3,900)
Net provided by operating activities	12,300
Cash Flows from Investing Activities	
Purchase of equipment and furniture	(55,000)
Cash Flows from Financing Activities	
Proceeds from long-term debt	60,000
Net increase (decrease) in cash	17,300

Figure 8.1.5.4: This is Hometown Pizzeria's statement of cash flows. (CC BY 4.0; Rice University & OpenStax)

As we can see in the statement of cash flows for Hometown Pizzeria, although the basic operations generate positive cash flow, a major purchase was required. This is common at the inception of a business. Not every location will come equipped with a commercial kitchen and dining area, so the business may need to purchase items such as a pizza oven and dining chairs and tables. Note that although the income statement approximates the cash flow from operations, it would not show the large outflow resulting from the initial purchase of equipment. That purchase would have been treated as an asset within the context of the accounting equation and would have been recorded on the balance sheet. So from that large difference alone, we can see why some people say that the statement of cash flows is the most important of the financial statements. It bridges the gap between the income statement and the balance sheet.

As you can see in the figure, the statement of cash flows is broken into three sections. The first is **operating activities**, the day-to-day activities of the business, including purchasing supplies, paying rent, and receiving cash from customers. This section tells a reader how effective the company's business model is at generating cash flow.

Investing activities include major purchases of equipment or facilities. For example, when Amazon develops its second headquarters, those billions of dollars spent will be recorded as investing activities. Additionally, if the company has an excess of cash, it may purchase securities such as stocks and bonds, which have a higher return on investment than a traditional bank savings account. This section tells a reader where the company spends money in terms of large acquisitions.

The third section of the statement of cash flows is **financing activities**. This section tells a reader where new infusions of cash come from. The owners of Hometown Pizzeria need to find a way to pay for the kitchen equipment and furniture. If they have such an amount in their personal savings, then they can simple contribute it to the company themselves. If they don't have the money already, they will need to seek other sources, such as loans or the types of investors discussed earlier. Generally, any financing activity is also booked in the balance sheet as well. This section of the statement explains which sources the owners used to generate outside funds coming into the business. It always indicates future requirements as well. For example, if a bank loaned the pizzeria the money, then we know it will have to be repaid in the future. So the business will need to ensure it is setting aside money to make monthly repayments. If new investors contribute money, what manner of return on investment will they be seeking? If they decide to seek regular distributions of profit, they will have to factor that in.

LINK TO LEARNING

It is a good idea to familiarize yourself with the type of information companies report each year. Peruse Best Buy's 2017 annual report to learn more about Best Buy. Take note of the company's balance sheet on page 53 of the report and the income statement on page 54. These reports have much more information than the financial statements you've seen, but as you read through them, you will notice some familiar items.

Projections

Among the most powerful tools business owners can use are projections. A **projection** is a forecast of the future operations of the business. It is a landscape for the business: What do the next few months look like? What about the next year? A projection would

outline what level of payments are expected to come in and the timing of costs incurred. This lets the business owner understand what potential financing needs to be secured.

Two key concepts related to projections are the run rate and burn rate. The **run rate** helps extrapolate into the future. For example, if the pizzeria is generating sales of $10,000 per month, that translates into an annual run rate of $120,000 per year. Multiplying the monthly amount by twelve tells us the annual amount; if we wanted quarterly projections, we would multiply the monthly amount by three. This is useful for explaining to investors what the company will look like now that it has achieved traction in generating sales.

The **burn rate** is the rate at which cash outflow exceeds cash inflow, or essentially how much money the company is expending overall each month. Before generating revenue, or generating enough to just break even, startup companies will incur losses. Understanding the pace at which the expenses exceed revenue helps business owners plan accordingly. For example, if it takes six months to renovate the pizzeria and the monthly rent is $2,000, then the burn rate is $2,000 per month and forecasts that the business will need an additional $12,000 ($2,000 × six months) available in financing on top of the cost of renovations. The location's rent must be paid, even if the pizzeria isn't yet open for business.

During the seed stage of a company, projections can also be used to show potential investors how quickly the company will make money and hopefully inspire them to invest in the venture. Just as on *Shark Tank*, projections are used during the "pitch." Investors and lenders want to see exactly how they can expect the business to perform and how quickly the company generates positive financial results.

Break-Even Analysis

Another critical part of planning for new business owners is to understand the **breakeven point**, which is the level of operations that results in exactly enough revenue to cover costs. It yields neither a profit nor a loss. To calculate the break-even point, you must first understand the behavior of different types of costs: variable and fixed.

Variable costs fluctuate with the level of revenue. Returning to Hometown Pizzeria, we see that the cost of ingredients would be a variable cost. In a previous section, we also referred to these as the cost of goods sold. Variable costs are based on the number of pizzas sold, with the goal being to buy just enough ingredients that the business doesn't run out of supplies or incur spoilage. In this example, the cost of making a pizza is $4, so the total variable costs in any given month equal $4 times the number of pizzas made. This differs from a fixed cost such as rent, which remains the same every month regardless of whether the pizzeria sells any pizzas or not.

The first step in understanding the break-even point is to calculate the contribution margin of each item sold. The **contribution margin** is the gross profit from a single item sold. Therefore, selling price minus variable costs is the contribution margin. Hometown Pizzeria's selling price of a pizza is $12. The variable cost is $4, which results in a contribution margin of $8 per pizza. This $8 will go toward paying other expenses; when those are covered, the remainder will be added to the profit. Once we understand how much each item sold contributes to other expenses, we understand how those other costs behave.

HOMETOWN PIZZERIA	
Selling price of a pizza	$12
Cost of ingredients	(4)
Contribution margin	$ 8

Figure 8.1.5.5: This is Hometown Pizzeria's contribution margin. (CC BY 4.0; Rice University & OpenStax)

The other main category of costs is fixed costs. **Fixed costs** are a set amount and do not change, regardless of the amount of sales. Previously, we referred to rent as such a cost, but most of the business's other costs operate in this manner as well. Although some costs vary from month to month, costs are described as variable only if they will increase if the company sells even one more item. Costs such as insurance, wages, and office supplies are typically considered fixed costs.

Once variable and fixed costs are determined, this information can be used to produce a break-even analysis. Calculating the break-even point is simply a matter of dividing the total fixed costs by the contribution margin. To illustrate, let's assume that Hometown Pizzeria still sells pizzas with a contribution margin of $8 each. Let's also assume that the only fixed cost is the rent of $2,000 per

month. If we wanted to know how many pizzas the owner needs to sell each month to pay the rent, we divide $2,000 by $8. This results in a break-even point of 250 pizzas. Now we know that if the pizzeria sells 250 pizzas a month, its rent is completely paid. Any additional pizzas sold add to the company's profit. If the business sells fewer than 250 pizzas, it will not generate enough income to cover the rent and will incur a loss. Whenever a business incurs a loss, the owners will need to contribute more of their own personal savings or potentially go into debt.

HOMETOWN PIZZERIA	
Total fixed costs	$2,000
Contribution margin of a pizza	÷8
Break-even point (in number of pizzas)	250

Figure 8.1.5.6: This is Hometown Pizzeria's break-even point. (CC BY 4.0; Rice University & OpenStax)

Understanding the break-even point for a business provides a great deal of insight. At the most basic level, it demonstrates how many units of a product must be sold to cover the expenses of the business and not incur a loss. It may also help business owners understand when costs are too high and decide how many units need to be sold to break even. Realizing this upfront can help entrepreneurs avoid starting a business that will result only in losses.

WORK IT OUT

Calculating Break-Even Analysis

Consider the break-even analysis tool. Using the same contribution margin provided ($8/pizza), calculate the break-even point if we chose a more expensive city. How many pizzas would we need to see if our fixed costs were $5,000 a month? What if they were $10,000 a month?

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8.1.6: Key Terms

accounting
system of recording and classifying a company's financial transactions and summarizing and communicating those transactions in the form of financial statements

accounting equation
assets = liabilities + equity

accounts payable
account that includes vendors that the company owes money to

accounts receivable
account that includes customers that owe the business money

angel investor
wealthy, private individual seeking investment options with a greater potential return than is generally available with traditional publicly traded stocks

assets
items a business owns and derives future use from

balance sheet
financial statement that summarizes a company's financial condition according to the accounting equation

bartering
exchanging goods or services for other goods or services instead of for cash

bootstrapping
funding strategy that seeks to optimize use of personal funds and other creative strategies (such as bartering) to minimize cash outflows

breakeven point
level of operations that results in exactly enough revenue to cover costs

burn rate
rate at which cash outflow exceeds cash inflow

charitable organization
nonprofit company founded for altruistic purposes

collateral
something of value pledged to secure a loan

contribution margin
gross profit from a single item sold

cost of goods sold
cost required to produce the product or service

credit
lending of funds in exchange for a promise to repay

crowdfunding

financing with investments of small amounts of money from a large number of people

debt financing
borrowing funds that must be repaid, usually with interest

donation
financial gift intended to support an organization's general operations

early stage
company lifecycle stage in which the product or service has begun development

equity
owner's interest in the assets of the business

equity financing
funds provided in exchange for a share of ownership in a business

expenses
costs incurred in the normal course of business operations

financial statement
output of an accounting system that is used to make financial decisions

financial viability
long-term financial sustainability of an organization to fulfill its mission

financing
raising money to fund the startup and operation of a business

financing activities
section of the statement of cash flows that shows where new infusions of cash are coming from

fixed assets
major purchases with a long life, such as buildings, land, and so on

fixed costs
costs that do not change, regardless of the amount of sales

funds
financial resources for acquiring assets

grant
financial gift intended to fund a specific goal or project

gross profit
selling price of a product or service minus its direct costs

income (profit-and-loss) statement
financial statement that describes how much a company earned while the business was operating and what costs were incurred to generate those revenues

initial public offering (IPO)
process by which a company lists its ownership shares on a public stock exchange

investing activities
section of the statement of cash flows that shows major purchases of equipment or facilities

liability
company's debt to another party

mature stage
company lifecycle stage in which the business has reached commercial viability

moonlighting
earning income from a source outside of one's primary employ

net income
revenue minus expenses

operating activities
section of the statement of cash flows that shows day-to-day activities of the business, such as purchasing supplies, paying rent, and receiving cash from customers

profit margin
amount by which revenue exceeds costs, typically described as a percent

program services
basic offerings that a nonprofit provides to generate a portion of its revenue to sustain operations

projection
forecast of the future operations of a business

revenue
amount a business earns through product sales or providing a service

run rate
cost of running a business over a specified period of time

seed stage
company lifecycle stage in which the business is largely still an idea

statement of cash flows
financial statement that explains the sources and uses of the company's cash

sustainable strategy
strategy that can maintain an organization's financial stability

tax-exempt status
treatment under U.S. tax law that removes the burden of taxes from nonprofit organizations

valuation
estimate of a company's worth

variable costs
costs that fluctuate with the level of revenue

venture capitalist
individual or investment firm that specializes in funding startup companies

working capital

funds available for day-to-day operations

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8.1.7: Summary

8.1.2 Overview of Entrepreneurial Finance and Accounting Strategies

Entrepreneurial financing is concerned with understanding the funding requirements for a new business and what sources of funds are available. Each source comes with different expectations and requirements. Equity financing provides the entrepreneur with maximum flexibility: Dividends are not required and can be made when cash flow is strong enough to meet all obligations of the firm. Debt financing restricts financial flexibility but can be cheaper under some circumstances. For example, SBA loans can be subsidized by the federal government. Financing is not a one-size-fits-all procedure.

8.1.3 Special Funding Strategies

For nonprofit organizations, achieving a sustainable funding strategy requires hard work, creativity, and a delicate balance of financial resources. These types of organizations need to create programs that will interest patrons who are willing to pay for activities. They also rely on the generosity of their benefactors beyond simple patronage in the form of donations, and they vie for extremely competitive grant funding.

Although loans and liabilities such as credit card debt can fund a new business, the repayment and additional interest charges are a real challenge to many entrepreneurs. Financing strategies that avoid loans, such as crowdfunding websites and bartering, offer opportunities for funding that are often more manageable.

Bootstrapping is the process of self-funding a startup business. Sometimes entrepreneurs will have no financial resources beyond their personal savings. This method of funding a business requires creative approaches to problem-solving, generating business, and managing expenses. It can be a slower, more difficult process than a company with more funding might face, but in the long run, it can benefit the company's strength and growth, and provide robust dividends to the founders.

8.1.4 Accounting Basics for Entrepreneurs

Accounting is concerned with how transactions are recorded in a way that helps entrepreneurs share information with stakeholders, including potential investors, and helps business owners make decisions about running their company.

8.1.5 Developing Startup Financial Statements and Projections

Entrepreneurs can use financial information for multiple purposes. These projections can help plan a new business. By forecasting the income and expenses of the first year, an entrepreneur can have a reasonable idea of the level of financing that may be required. Second, these projections can also show potential investors what the business will look like in the future and how long it might take them to get a return on their investment. Break-even points help illustrate a minimum amount of sales to cover expenses.

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8.1.9: Discussion Questions

1. How do funding requirements differ in each stage of a company's lifecycle? Why?
2. What are the advantages and disadvantages of different sources of financing?
3. How does collateral factor into your financing options?
4. What challenges do nonprofits face in securing financing?
5. What are some potential benefits of a crowdfunding campaign aside from the funding itself? What are some potential drawbacks?
6. What are some of the sacrifices you could see yourself having to make to bootstrap your potential business?
7. How would you work around having limited access to capital in starting your own business? What difficulties can you see in trying to do so?
8. Which external parties would be interested in obtaining a firm's financial statements?
9. Why would investors require access to financial statements?
10. How do companies use financial statements in communicating with potential investors?
11. How can an entrepreneur use preliminary financial information in planning a new business?

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8.1.10: Case Questions

1. Crowdfunding platforms, such as Kickstarter or GoFundMe, allow startups to access many different investors who may be able to contribute only small amounts in return for relatively small rewards. In the case of the iBackPack, those providing funds through Kickstarter were largely unaware of the company's postfunding operations.
   a. How did the lack of oversight harm investors?
   b. How might this situation have been different if a single angel investor had been involved?
2. Put yourself in the shoes of the manager of a nonprofit organization, such as a homeless shelter. The ultimate goal is to help people who have suffered misfortune get back on their feet. They likely cannot afford to pay or otherwise contribute to the costs of running the shelter. Thus, you must look to other sources to help pay the bills. Visit the website https://blog.hubspot.com/marketing/e...undations-list. What are some ways you might be able to attract donors for the shelter?
3. While thinking about or visiting the coffee shop in your area, look around (or visualize) and identify items or activities that are the expenses of the coffee shop. Remember, expenses for the coffee shop are related to resources consumed while generating revenue from selling coffee and related items. Do not forget about any expenses that might not be so obvious—as a general rule, every activity in a business has an associated cost.

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8.1.11: Suggested Resources

8.1.2 Overview of Entrepreneurial Finance and Accounting Strategies

Small Business Administration lending program: https://www.sba.gov/funding-programs/loans

"The Top Twenty Venture Capitalists Worldwide," *New York Times* (March 27, 2017): https://www.nytimes.com/interactive/...ists.html?_r=0

National Public Radio "How I Built This" podcast series (example episodes: Instagram, Airbnb, Spanx): https://www.npr.org/podcasts/510313/how-i-built-this

TED Radio Hour (example episodes: Big Data Revolution, Disruptive Leadership): https://www.npr.org/programs/ted-rad...ate=2019-07-05

8.1.3 Special Funding Strategies

Tax information for charitable organizations from the Internal Revenue Service: https://www.irs.gov/charities-non-pr...-organizations

Information from the National Institutes of Health on grants and the application process: https://grants.nih.gov/grants/about_grants.htm

Small Business Administration, "How to Start a Non-Profit": www.sba.gov/blogs/how-start-non-profit

Kickstarter: www.kickstarter.com

Indiegogo, "The Essential Guide to Crowdfunding": https://learn.indiegogo.com/the-esse...o-crowdfunding

Startupfest, "The $100K Investment Prize": http://www.startupfestival.com/news/...estment-prize/

G-Startup Worldwide's global startup competition: https://www.f6s.com/g-startupworldwide/

Extending Credit to Your Customers: https://fitsmallbusiness.com/invoici...-to-customers/

7 Ways to Bootstrap Your Business to Success: https://www.entrepreneur.com/article/254217

4 Must-Follow Tips for Moonlighting as an Entrepreneur: https://www.entrepreneur.com/article/298310

5 Ways Nonprofits Can Engage Donors: https://www.ama.org/publications/Mar...ge-donors.aspx

8.1.4 Accounting Basics for Entrepreneurs

Small Business Administration Introduction to Accounting Course: https://www.sba.gov/tools/learning-c...-course/364071

Accounting Coach free Accounting Basics Explanation: www.accountingcoach.com/acco...cs/explanation

Khan Academy Accounting and Financial Statements Course: https://www.khanacademy.org/economic...ancial-stateme

8.1.5 Developing Startup Financial Statements and Projections

U.S. Small Business Administration: www.sba.gov/blogs/3-essentia...small-business

U.S. Securities and Exchange Commission: https://www.sec.gov/reportspubs/inve...tguidehtm.html

Forbes, 5 Financial Reports You Should Be Running: https://www.forbes.com/sites/sagewor.../#183ae98d6548

Medium, 3 Phases of Financial Indicators for Startups: https://medium.com/@DanielleMorrill/...s-b18ddb97f5f0

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8.1.08: Review Questions

1. What are the different stages in a company’s lifecycle?
2. How do financing requirements change at different stages of a company’s lifecycle?
3. What are the two most common categories of financing available to an entrepreneur?
4. What is the Small Business Administration?
5. What is an SBA loan?
6. What is a charitable organization?
7. What is a sustainable funding strategy?
8. What is social entrepreneurship?
9. What is crowdfunding?
10. What is bartering?
11. What does the term *bootstrapping* mean in terms of startups?
12. What purpose does an accounting system serve?
13. What key terms are used in the accounting equation?
14. How does accounting differ from finance?
15. What are the basic financial statements? What information do they provide?
16. What are projections used for?
17. What is a break-even point?

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SECTION OVERVIEW

8.2: Accounting and Cash Flow

8.2.1: Chapter Introduction

8.2.2: Understanding the Need for Accounting Systems

8.2.3: Financial Accouting Statements

8.2.4: Financial Ratio Analysis

8.2.5: The Three Threads

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8.2.1: Chapter Introduction

Simione Consultants LLC

Health care is the largest single industry in the US economy. Currently, health care represents nearly 17 percent of the gross domestic product, encompassing nearly 600,000 establishments and employing more than 14 million people. The healthcare industry covers an extraordinarily wide range of businesses and operations. It includes large hospitals, diagnostic laboratories, nursing care facilities, and the offices of doctors and dentists. Each establishment has individuals that possess considerable expertise in their respective disciplines. However, they may not possess the knowledge or the expertise that would enable them to manage their establishments in the most efficient manner. That is where firms like Simione Consultants LLC play a vital role.

Simione Consultants LLC represents the evolution of consulting companies that have spun off from many accounting firms. Accountants are no longer merely reconciling accounts or preparing tax returns for their clients. They are now offering a broad range of consulting services. Simione Consultants LLC provides expert assistance to hospital-based and hospital-affiliated home health and hospice agencies, visiting nurse associations, small proprietary agencies, and large national chains. They provide services that one might expect from a firm whose origins were in a standard accounting practice—such as assisting in accounts receivables and cash-flow management. Other accounting services that they provide include financial analysis reports and the preparation of cost reports for the federal government. They can conduct in-depth cost analyses at a detailed and granular level so that clients can improve their operational efficiencies. The compliance division consulting services include working with healthcare attorneys, corporate compliance and audit departments, and government agencies such as the Office of the Inspector General. Its clinical operations division works closely with financial consultants to improve the financial health of its clients.

What makes Simione Consultants LLC distinct is its ability to go beyond these basic accounting tasks and provide vital ancillary support for its clients in this niche market. They are in a position to conduct the valuation of businesses or assist in mergers and acquisitions. They help clients with preparing a prospectus or assisting with negotiations. Their consulting services can advise on how a client can maximize its return on an information management system by identifying system requirements and specifying possible solutions. In addition, the company has developed a software product—“The Financial Monitor”—that provides quarterly home health and hospice reports with multiple valuable benchmarks, including national, state, and profit-status norms, to help their clients and the industry make informed financial decisions.

A measure of how firms such as Simione Consultants LLC have moved beyond balance accounts is the company’s ability to support a client’s marketing function. The firm can help build comprehensive marketing plans and assist clients in developing and improving sales materials and training.

Simione Consultants LLC began its work in the home healthcare industry more than forty years ago with an agency in Hamden, Connecticut. It was the vision of William J. Simione Jr., the founding member, who saw an opportunity. With his brother Robert J. Simione, the managing principal, and a dedicated team of principals, management, and staff, William Simione has helped Simione Consulting LLC become one of the leading home health and hospice consulting companies in the United States with over a thousand clients. Robert Simione says that a company is only as good as the people who work for it, and Simione Consultants LLC has the best home health and hospice consultants in the country.

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8.2.2: Understanding the Need for Accounting Systems

Learning Objectives

- Understand why a basic knowledge of accounting is important for a small business.
- Understand the importance of selecting an accountant to enhance the overall operation of a business.
- Define the two major approaches to accounting systems: cash versus accruals.

Imagine that you invite a friend from China, who is visiting the United States for the first time, to a baseball game. Your friend has never been to a baseball game before and knows nothing of the game's rules. He might notice on the scoreboard listings for runs, hits, and errors. Your friend might also see notations on the number of strikes and balls. He does not know exactly what any of those terms mean, but he notices that some people in the stands applaud when the number of runs increases. Your friend might be amused by seeing individuals periodically running from one base to another; however, without knowing the basic rules of baseball, he cannot possibly understand what is actually occurring. He certainly could not comment on how well the game is going or provide suggestions about what one of the teams should do next. Most Americans would be in the same position if they were watching a cricket match. In both cases, you and your friend are in the same position of someone who wishes to run a business without having a fundamental understanding of accounting systems.

Warren Buffett has said that accounting is, to put it simply, the language of business. Without a fundamental understanding of this language of accounting and its set of rules, you are in the same position as your Chinese friend—you really do not know what is going on with a business. If someone is considering starting a business, he or she should possess some degree of fluency in this language. One does not expect this businessperson to be as knowledgeable as a certified public accountant (CPA) or an expert in tax issues. However, such businesspeople should have a clear expectation that they will be able to look at the key elements of an accounting system and interpret how well their businesses are doing. They should be able to track some of the key tasks and elements associated with a comprehensive accounting system. As we will see later, computerized accounting programs for small businesses have greatly simplified this responsibility.

Accounting is defined by the American Institute of Certified Public Accountants (AICPA) as "the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof." Put more simply, it is essentially an information system. Accounting provides critical information to potential investors and businesses managers. Accounting may, in fact, be one of the oldest information systems known to humans. Some have argued that accounting systems were the impetus for the development of writing systems in Mesopotamia. Archaeologists have discovered clay tokens, dating back 10,000 years ago, which functioned as part of the inventory system measuring agricultural goods, such as grains and domesticated animals. By 3500 BC, these tokens were being stored in containers—known as *bullae*. Notations on the surface of these containers indicated the type and quantity of the tokens held within; for many, this system was the basis of an abstract system of written communication.

Other ancient societies recognized the importance of carefully monitoring and recording economic transactions. The Roman Empire needed to finance its operations and employed the familiar concept of an annual budget to coordinate expenditures and taxation. It had treasury managers, known as *questors*, who were subject to periodic audits. The most famous monograph on accounting dates to Renaissance Italy. Luca Pacioli, a Franciscan friar and polymath, wrote *Summa de Arithmetica, Geometria, Proportioni et Proportionalita* in 1494. Essentially this was a math textbook, but it included a section on double-entry bookkeeping. This approach to accounting had been covered by Beredetto Cotrugli a century earlier. The text was immediately recognized as an important contribution and was one of the first books produced by Gutenberg. On a first reading, Pacioli's coverage appears to be remarkably "modern." It described how merchants should identify their assets and liabilities, note transitions as they occur, and identify them as either debits or credits. He pointed out that the total of debits and credits must be equal, thus his model became the basis of the balance sheet. In the intervening five hundred years, business has essentially adapted Pacioli's approach. Obviously, over the last five centuries, businesses have grown both in size and in complexity, and accounting systems have grown with them. Therefore, it is important for any business regardless of size to be able to "count" on solid accounting information.

The exact nature of accounting support will be greatly determined by the type and size of the small business. The level of accounting support required by the nonemployer business will obviously differ significantly from the level required by a business

generating tens of millions of dollars of revenue and employing hundreds of workers. The level of support will also be influenced by the business owner's familiarity with accounting and the type of accounting information systems that have been determined as appropriate. Regardless of size or type, small businesses should plan on eventually acquiring the talents of an accountant. Preferably, the decision to use an accountant should occur with the creation of the business.

Hiring an accountant or an accounting firm is an important decision for a small business. Employing an accountant does not translate into this individual being a full-time employee of the business. At the start, most small businesses will use the accountant as a consultant or a contract employee. As they grow, some small businesses might benefit from acquiring the services of full-service accounting firm. Although some start-ups, particularly those that might be cash-strapped, use the services of the bookkeeper only, but this is ill-advised. Most small businesses will need the services of a CPA. Another type of accountant a small business might employ is known as an enrolled agent. These are accountants who have passed a tax test from the Internal Revenue Service (IRS).

When looking for an accountant, there are some issues that you should consider. Try to find an accountant who has some working familiarity with a particular type of business or industry. Hopefully, you will be able to find an accountant with whom you have some rapport. This is important because a good accountant is more than simply someone who balances the books. You should consult an accountant before determining what type of accounting system you intend to employ—cash versus accrual. Remember that an accountant will play an important role in assisting you in the creation, purchase, and development of an accounting information system for the business. This system is important in providing the appropriate information to the external community (for this audience the term **financial accounting** is often used)—bankers, angel investors, venture capitalists, and/or the government. The same accounting information system will also be an important component of internal controls (in this case the term **managerial accounting** is used)—the systems and policies by which you make a firm more efficient. In this role, an accountant can help develop appropriate policies with respect to cash control and inventory control. An accountant can play a critical role in developing business plans, particularly with respect to budgets and financial statements. As highlighted earlier, you should consult an accountant before selecting an accounting software package. Quite often, an accountant can be extremely useful in training people to use such a software package.

Video Clip: Why Warren Buffett Said Accounting is the Language of Business

This video introduces the importance of accounting.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Why You Need an Accountant

This video explains why a small business needs the services of a professional accountant.

A YouTube element has been excluded from this version of the text. You can view it online here.

Alternative Approaches to Accounting Systems

The evolution of accounting has led to two major systems: the cash basis model and the accrual basis model. Before describing the two systems, we must identify a very important term—accounting transactions. When in business, we either receive money from a sale or spend money, such as in buying a piece of equipment. We can define these as transactions. The manner in which we record transactions defines the difference between a cash basis accounting system or an accrual accounting system.

In most cases, either system can be used by a business (there are situations under which a cash-based accounting system cannot be used, the details of which are discussed later), but regardless of the system used, a business must clearly specify which method is being employed.

In the **cash-based accounting** system, a transaction is recorded when money is either received or spent. As an example, a business has three sales on June 29 of a particular year. The first sale is for $500, the second is for $1,000, and the third is for $300. However, the three customers use different methods of payment. The first customer pays for the product in cash, the second customer writes a personal check, and the third customer pays by credit card. The second customer's personal check clears on July 5, while the credit card company transfers the $300 into the business's account on July 3. Under the cash basis accounting system, the business would list the first sale of $500 as a June transaction, but it would list the second and third sales (totaling $1,300) as

July transactions. The same logic is used with respect to expenditures. If the same firm purchased a laptop computer in July but did not have to pay for two months, then the transaction would be recorded in September.

Under the **accrual accounting** system, transactions are recorded when they occur. If the aforementioned business was functioning under the accrual basis accounting system, then all three sales (totaling $1,800) would be recorded as June transactions, and the purchase of the laptop would be designated as a July transaction.

Generally, though, with a few exceptions, businesses must use the accrual basis accounting method if they have inventory of any component of items that they sell to the public and if the sales are more than $5 million per year. Other conditions under which the cash basis accounting system may not be used include C corporations, partnerships with at least one C corporation partner, and tax shelters. The major benefit of cash basis accounting is its simplicity. It greatly reduces the demand on bookkeeping. The cash basis system also provides a much more accurate indication of a company's current cash position. This approach may be used to affect taxable income, which can be done by deferring billing so that payments are received in the next year. However, there are drawbacks to the cash basis approach—the most serious being that it may provide a distorted or an inaccurate indication of profitability. The reality is that cash basis accounting systems are really only appropriate for businesses with sales under $1 million and that function basically on a cash basis.

Accrual basis accounting is in conformance with IRS and generally accepted accounting principles (GAAP) regulations. Although more complex and generally requiring greater bookkeeping with a more sophisticated approach to accounting, the accrual basis provides a more accurate indication of the profitability of a business. The major drawback of the accrual basis system comes with respect to understanding the business's cash position. A firm may look profitable under this system, but if customers have not paid for the goods and services, the cash position might be dire. A summary of the pros and cons of the two systems is provided in Figure 8.2.2.1.

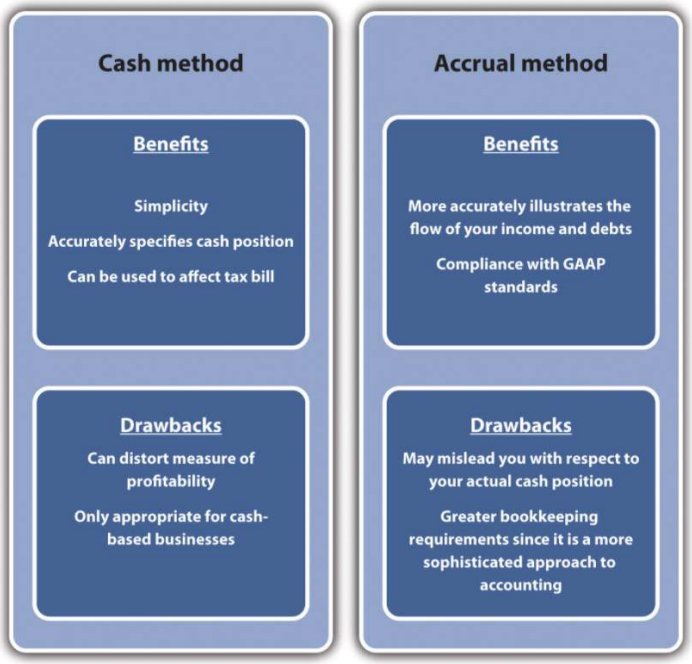


Figure 8.2.2.1: Comparative Accounting Systems (Copyright; author via source)

Video Clip: Accrual Versus Cash-Basis Accounting Video Presentation

A lecture on the two accounting systems.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Accrual Basis versus Cash Basis Accounting Power

A video with voice-over of a PowerPoint presentation.

A YouTube element has been excluded from this version of the text. You can view it online here.

KEY TAKEAWAYS

- Accounting is one of the oldest activities of human civilizations and dates back over five thousand years.
- Small businesses require accounting capabilities, which must be done either in-house or through an external service.
- The selection process for an accounting service should be carefully considered. The evaluation process should consider the following: expertise in a particular type of business or industry, rapport, availability of additional consulting services, and the ability to support computerized accounting systems.
- Accounting systems may be divided into two major types: cash basis and accrual basis.
- Cash basis systems count a transaction when the cash is received. Such systems are used by smaller businesses that have no appreciable inventory.
- Accrual basis systems count transactions when they occur. Although this system may require additional analysis to determine a business's actual cash position, it provides a more accurate measure of profitability.

EXERCISES

1. Identify five local businesses and talk to their owners. Ask them about how they handle their accounting needs. Do they do it *all* themselves or do they use an accountant or an accounting service? If they use an accountant or an accounting service, ask them in what way—merely to prepare taxes or do they draw on them for other advice?
2. Identify five local accountants or accounting firms. Ask them about the services that they provide to small businesses. If possible, try to determine the cost of these services.
3. Ask the five local businesses which system they use—cash or accrual—and why they use it.

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8.2.3: Financial Accouting Statements

Learning Objectives

- Understand what is measured on a balance sheet.
- Understand the term *depreciation*.
- Understand what goes on an income statement.
- Understand what is measured in a cash-flow statement.
- Appreciate the importance of forecasting when developing a cash-flow projection statement.

As discussed earlier, all business plans should contain sets of financial statements. However, even after the initial business plan is created, these financial statements provide critical information that will be required for the successful operation of the business. They not only are necessary for tax purposes but also provide critical insights for managing the firm and addressing issues such as the following:

- Are we profitable?
- Are we operating efficiently?
- Are we too heavily in debt or could we acquire more debt?
- Do we have enough cash to continue operations?
- What is this business worth?

There are three key financial statements: the balance sheet, the income statement, and the cash-flow statement. Every business owner or manager needs to be able to correctly interpret these statements if he or she expects to continue successful operations. It should be pointed out that all three financial statements follow general formats. The degree of detail or in some cases terminology may differ slightly from one business to another; as an example, some firms may wish to have an extensive list of operational expenses on their income statements, while others would group them under broad categories. Likewise, privately-held businesses would not use the term *shareholders' equity* but rather use *owner's equity* in their balance sheet, and they would not list dividends. The aim of this chapter is to provide the reader with a broad overview of accounting concepts as they apply to managing small and mid-sized businesses.

The Balance Sheet Statement

One should think of the **balance sheet** statement as a photograph, taken at a particular point in time, which images the financial position of a firm. The balance sheet is dominated by what is known as the accounting equation. Put simply, the accounting equation separates what is owned from who owns it. Formally, the accounting equation states the following:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Assets are "economic resources that are expected to produce a benefit in the future." **Liabilities** are the amount of money owed to outside claims (i.e., money owed to people outside the business). **Owner's equity**—also known as stockholders' equity—represents the claims on the business by those who own the business. As specified in the accounting equation, the dollar value of assets must equal the dollar value of the business's liabilities plus the owner's equity. Before proceeding with any numerical example, let us define some important terms.

Current assets are assets that will be held for less than one year. They include **cash**, **marketable securities**, **accounts receivables**, **notes receivable**, **prepaid expenses**, and **inventory**. These are listed in a specific order. The order is based on the degree of liquidity of each asset. *Liquidity* measures the ease in which an asset can be converted into cash. Naturally, cash is the most liquid of all assets. All firms should have cash readily available. The exact amount of the desirable amount of cash to be held at hand will be determined by the sales level of the anticipated cash receipts and the cash needs of the business.

Marketable securities are stocks and bonds that a business may hold in the hope that they would provide a greater return to the business rather than just letting cash "sit" in a bank account. Most of these securities can be easily turned into cash—should the need arise.

Accounts receivables represent the amount of money due to a business from prior credit sales. Not all firms operate on a strictly cash sales basis. Many firms will offer customers the opportunity to purchase on a credit basis. As an example, a furniture store sells a bedroom set worth $6,000 to a newlywed couple. The couple puts down $2,500 to fix the sale and then signs a contract to pay the remaining $3,500 within the next year. That $3,500 would be listed as accounts receivable for the furniture firm.

Prepaid expense is an accrual accounting term that represents a payment that is made in advance of their actual occurrence. Insurance would be an example of a prepaid expense because a company is paying premiums to cover damages that might occur in the near future. If a year's worth of rent were paid at one time, it too would be viewed as a prepaid expense.

Inventory is the tangible goods held by a business for the production of goods and services. Inventory can fall into three categories: raw materials, work-in-process (WIP), and finished goods. Raw materials inventory represents items or commodities purchased by a firm to create products and services. WIP inventory represents "partially completed goods, part or subassemblies that are no longer part of the raw materials inventory and not yet finished goods." The valuation of WIP should include the cost of direct material, direct labor, and overhead put into the WIP inventory. Finished inventory represents products that are ready for sale. Generally accepted accounting principles (GAAP) require that a business value its inventory on either the cost price or the market price—whichever is lowest. This inherent conservative approach to valuation is due to the desire to prevent the overestimation of inventory during inflationary periods.

Total current assets are the summation of the aforementioned items and are defined as follows:

Total Current Assets = Cash + Marketable Securities + Accounts Receivable + Prepaid Expenses + Inventory

The next set of items in the asset section of the balance sheet is long-term assets. **Long-term assets** are those assets that will not be turned into cash within the next year. Long-term assets may include a category known as investments. These are items that management holds for investment purposes, and they do not intend to "cash in" within the upcoming year. They might consist of other companies' stock, notes, or bonds. In some cases, they may represent specialized forms—money put away for pension funds. The next major category of long-term assets is fixed assets. **Fixed assets** include plant, equipment, and land. Generally, these are valued at their original cost. The value of these assets will decline over time. As an example, you purchase a new car for $25,000. If you were to sell the same car one, two, or five years later, its value would be less than the original purchase price. This recognition is known as **depreciation**, which is a noncash expense that specifically recognizes that assets decline in value over time. Accumulated depreciation is a running total of all depreciation on assets. Depreciation is also found on the income statement. Its presence in that financial statement enables a business to reduce its taxable income. There are many methods by which you can compute the depreciation value on fixed assets. These methods can be split into two broad categories: straight-line depreciation and accelerated depreciation. Straight-line depreciation is fairly easy to illustrate. In the example of the car, assume you purchased this car for company use. You intend to use it for five years, and at the end of the five years, you plan on scrapping the car and expect that its salvage value will be zero. This is illustrated in Table 8.2.3.1.

Table 8.2.3.1: Depreciation Calculations

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Depreciation	$0	$5,000	$5,000	$5,000	$5,000	$5,000
Accumulated depreciation	$0	$5,000	$10,000	$15,000	$20,000	$25,000
Net asset value	$25,000	$20,000	$15,000	$10,000	$5,000	$0

Because the useful lifetime of the vehicle was five years, the original value of the vehicle was divided by five; therefore, the annual depreciation would equal $5,000 ($25,000/5 = $5,000 per year). The accumulated depreciation simply sums up the prior years' depreciation for that particular asset.

Accelerated depreciation methods attempt to recapture a major portion of the depreciation earlier in the life of an asset. Accelerated depreciation yields tax-saving benefits earlier in the life of any particular fixed asset. The appropriate method of depreciating an asset for tax purposes is dictated by the Internal Revenue Service (IRS). One should look at the IRS publication 946—*How to Depreciate Property*—to get a better understanding of the concept of depreciation and how to properly compute it.

The last category of long-term assets is **intangible assets**—assets that provide economic value to a business but do not have a tangible, physical presence. Intangible assets include items such as patents, franchises, copyrights, and goodwill. Thus the value of long-term assets can be calculated as follows:

Long-term Assets = Investments + Fixed Assets − Accumulated Depreciation + Intangible Assets

The last element on the asset side of the balance sheet is the total assets. This is the summation of current assets and long-term assets.

On the other side of the balance sheet, we have liabilities plus owner's equity. The elements of liabilities consist of current liabilities and long-term liabilities. These represent what a business owes to others. **Current liabilities** are debts and obligations that are to be paid within a year. These include **notes payable**, **accounts payable**, other items payable (e.g., taxes, wages, and rents), dividends payable, and the current portion of long-term debt. In equation form:

Current Liabilities = Notes Payable + Accounts Payable + Other Items Payable + Dividends Payable + the Current Portion of Long-term Debt

Notes payable represents money that is owed and which must be repaid within a year. It is fairly inclusive because it may include lines of credit from banks that have been used, short-term bank loans, mortgage obligations, or payments on specific assets that are due within a year.

Accounts payable are short-term obligations that a business owes to suppliers, vendors, and other creditors. It may consist of all the supplies and materials that were purchased on credit.

Other items payable can include items such as the payroll and tax withholdings owed to employees or the government but which have not as of yet been paid.

Dividends payable is a term that is appropriate for businesses structured as corporations. This category represents the amount that a business plans to pay its shareholders.

The current portion of long-term debt represents how much of the long-term debt must be repaid within the upcoming fiscal year. This would include the portion of the principal that is due in this fiscal year.

The other portion of liabilities is represented by long-term liabilities. These are debts payable over a period greater than one year and include long-term debt, pension fund liability, and long-term lease obligations. In equation form,

Long-term Liabilities = Long-term Debt + Pension Fund Liabilities + Long-term Lease Obligations

Total liabilities is the sum of current liabilities and long-term liabilities.

The other major component of the right-side of the balance sheet is owner's (or stockholders') equity. Owner's equity represents the value of the shareholders' ownership in a business. It is sometimes referred to as net worth. It may be composed of items such as paid in capital and retained earnings. Paid in capital is the amount of money provided by investors through the issuance of common or preferred stock. **Retained earnings** is the cumulative net income that has been reinvested in a business and which has not been paid out to shareholders as dividends.

The entire balance sheet and its calculations are summarized in Figure 8.2.3.1.

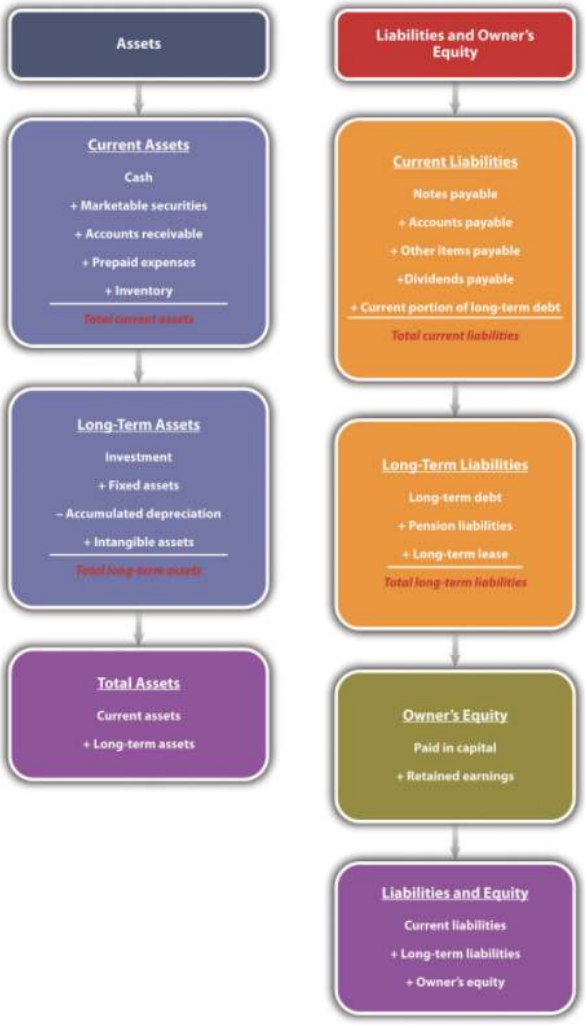


Figure 8.2.3.1: The Balance Sheet

In Table 8.2.3.2, we provide six years' worth of balance sheet statements for a hypothetical small business—Acme Enterprises. It is obviously important to have such information, but what exactly might this tell us in terms of the overall success and operation of the business? We will return to these statements later to show how those questions can be addressed with ratio analysis.

Table 8.2.3.2 Acme Enterprises' Balance Sheet, 2005–2010 ($ Thousands)

	December 31					
Assets	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Cash and marketable securities	$30.0	$32.3	$34.7	$37.3	$40.1	$43.1
Accounts receivable	$100.0	$107.5	$115.6	$124.2	$133.5	$143.6
Inventories	$70.0	$75.3	$80.9	$87.0	$93.5	$100.5
Other current assets	$90.0	$96.8	$104.0	$111.8	$120.2	$129.2
Total current assets	$290.0	$311.8	$335.1	$360.3	$387.3	$416.3
Property, plant, and equipment—gross	$950.0	$1,154.5	$1,387.2	$1,654.6	$1,958.1	$2,306.2
Accumulated depreciation	$600.0	$695.0	$810.5	$949.2	$1,114.6	$1,310.4
Property, plant, and equipment—net	$350.0	$459.5	$576.7	$705.4	$843.5	$995.7
Other noncurrent assets	$160.0	$176.0	$193.6	$213.0	$234.3	$257.7
Total assets	$800.0	$947.3	$1,105.5	$1,278.6	$1,465.1	$1,669.7
Liabilities						
Accounts payable	$91.0	$97.8	$105.2	$113.0	$121.5	$130.6
Short-term debt	$150.0	$177.5	$216.3	$264.2	$328.1	$406.0
Other current liabilities	$110.0	$118.3	$127.1	$136.7	$146.9	$157.9
Total current liabilities	$351.0	$393.6	$448.6	$513.9	$596.5	$694.6
Long-term debt	$211.0	$211.0	$211.0	$211.0	$211.0	$211.0
Deferred income taxes	$50.0	$53.8	$57.8	$62.1	$66.8	$71.8
Other noncurrent liabilities	$76.0	$81.7	$87.8	$94.4	$101.5	$109.1
Total liabilities	$688.0	$740.0	$805.2	$881.4	$975.8	$1,086.5
Paid in capital	$—	$—	$—	$—	$—	$—
Retained earnings	$112.0	$207.3	$300.3	$397.2	$489.3	$583.3

	December 31					
Total owner's equity	$112.0	$207.3	$300.3	$397.2	$489.3	$583.3
Total liabilities + owner's equity	$800.0	$947.3	$1,105.5	$1,278.6	$1,465.1	$1,669.7

Video Clip: Beginner's Guide to Financial Statements: Balance Sheets

An introduction to the balance sheet.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: What is the Balance Sheet?

A voice-over PowerPoint presentation describing the balance sheet. Be aware that this is seven minutes long.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Balance Sheet: How to Explain How a Balance Sheet Works

Another description of the balance sheet.

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The Income Statement

Whereas the balance sheet looks at a firm at a particular point (date) in time, the **income statement** examines the overall profitability of a firm over a particular length or period of time. Normally, there are several time periods that may be used: fiscal year, fiscal quarter, or monthly. The income statement is also known as a *profit and loss statement*. It identifies all sources of revenues generated by a business and all the expenses incurred. The income statement provides the best insight into whether a business is profitable.

The income statement begins by identifying the sales or income for the designated period of time. Sales would be all the revenues derived from all the products and services sold during that time. The term *income* is sometimes used and represents all revenues and additional incomes produced by a business during the designated period. The next item in the income statement is the **cost of goods sold (COGS)**, which is composed of all costs associated with the direct production of goods and services that were sold during the time period. It would include the costs of the raw materials used to produce the goods and those costs associated with production, such as direct labor. With these two values, the first measure of profit—**gross profit**—can be calculated:

$$\text{Gross Profit} = \text{Income} - \text{COGS}$$

The next element in the income statement is **operating expenses**—expenses that are incurred during the normal operation of a business. Operating expenses can be broken down into four broad categories: selling expenses, general and administrative expenses, depreciation, and other overhead expenses. Selling expenses would include all salaries and commissions paid to the business's sales staff. It would also include the cost of promotions, advertising expenses, and other sales expenditures. Promotion costs might consist of costs associated with samples or giveaways. Advertising expenses would include all expenditures for print, radio, television, or Internet ads. Other sales expenditures would include money spent on meals, travel, meetings, or presentations by the sales staff. General and administrative expenses are those associated with the operation of a business beyond COGS and direct-selling expenses. Expenditures in this category would include salaries of office personnel, rent, and utilities. Depreciation was covered in the previous subsection. The balance sheet has a component designated accumulated depreciation. This is the summation of several years' worth of depreciation on assets. In the income statement, depreciation is the value for a particular time period. If you look back in Table 8.2.3.1, the annual depreciation on the vehicle was $5,000. If a business was developing an income statement for one particular year, then the depreciation would be listed as $5,000. It is a noncash expenditure expense. The last component of operating expenses would be other overhead costs—a fairly generic category that may include items such as office supplies, insurance, or a variety of services a business might use. Having identified all the components of operating expenses, one is now in a position to compute a second measure of profitability—**operating profit**, which is sometimes referred to as earnings before interest and taxes (EBIT):

Operating Profit (EBIT) = Gross Profit − Operating Expenses

The next section of the income statement is designated **other revenues and expenses**. This segment would include other nonoperational revenues (such as interest on cash or investments) and interest payments on loans and other debt instruments. When the other revenues and expenses are subtracted from the operating profit, one is left with **earnings before taxes (EBT)**:

EBT = Operating Profit − Other Revenues and Expenses

Taxes are then computed on the EBT and then subtracted. This includes all federal, state, and local tax payments that a business is obligated to pay. This brings us to our last measure of profitability—**net profit**:

Net Profit = EBT − Taxes

If a business does not pay out dividends, the net profit becomes an addition to retained earnings. The format of the income statement is summarized in Figure 8.2.3.2.The income statement is the item that most individuals look at to determine the success of business operations. In Table 8.2.3.3, the income statements for Acme Enterprises are given for the period 2005 to 2010.

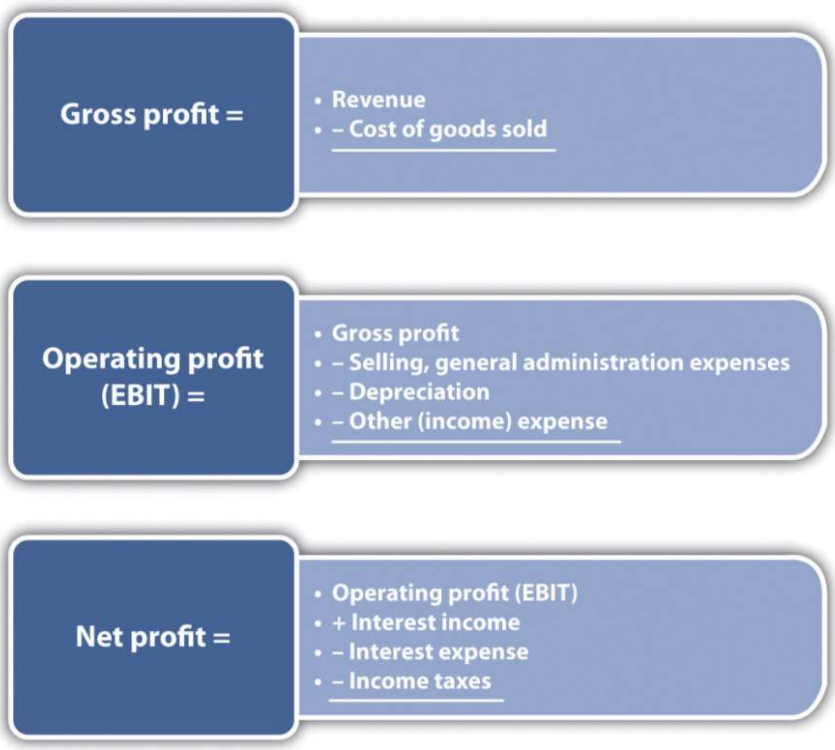


Figure 8.2.3.2: The Income Statement

Table 8.2.3.3: Acme Enterprises' Income Statement, 2005–10 ($ Thousands)

	2005	2006	2007	2008	2009	2010
Sales	$1,000.0	$1,075.0	$1,155.6	$1,242.3	$1,335.5	$1,435.6
COGS	$500.0	$537.5	$566.3	$608.7	$641.0	$689.1
Gross operating profit	$500.0	$537.5	$589.4	$633.6	$694.4	$746.5
Selling and general administrative expenses	$250.0	$268.8	$288.9	$310.6	$333.9	$358.9
Depreciation	$95.0	$115.5	$138.7	$165.5	$195.8	$230.6
Other net (income)/expenses	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
EBIT	$155.0	$153.3	$161.7	$157.5	$164.8	$157.0
Interest income	$2.1	$2.3	$2.4	$2.6	$2.8	$3.0
Interest expense	$10.5	$12.4	$15.1	$18.5	$23.0	$28.4
Pretax income	$146.6	$143.1	$149.0	$141.7	$144.6	$131.6
Income taxes	$51.31	$50.10	$52.16	$49.58	$50.61	$46.06
Net income	$95.29	$93.04	$96.87	$92.08	$93.99	$85.54
Dividends	$—	$—	$—	$—	$—	$—
Addition to retained earnings	$95.29	$93.04	$96.87	$92.08	$93.99	$85.54

Video Clip: What is the Income Statement?

A basic introduction to income statements.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Income Statement

A further description of an income statement.

A YouTube element has been excluded from this version of the text. You can view it online here.

The Cash-Flow Statement

The third component of financial statements is the **cash-flow statement**. There are two types of cash-flow statements—one examines cash flows for a given period (historic), and the other is a projection of future cash flows. The **historic cash-flow statement** is similar to the income statement in that it looks at cash inflows and cash outflows for a business during a specified period of time. Like the income statement, these periods of time can be the fiscal year, the fiscal quarter, or a month. The **cash-flow projections statement** attempts to identify cash flows into a firm and cash flows from a firm for some future period. This projection is extremely important because it may identify future subperiods in which a firm is producing a negative cash flow—where cash outflows exceed cash inflows.

From the standpoint of a small business owner, cash-flow statements provide insight into where cash flows are coming and going. The cash-flow projections statement may be the most important component of all the financial statements. Its importance stems from the fact that the flow of cash into a firm may not be synchronized with its cash outflows. Should there be a significant

mismatch with cash outflows being significantly higher than cash inflows, a business may be in great difficulty with respect to meeting its current obligations, such as payroll, paying suppliers, and meeting short-term creditors. As we will see, cash-flow projection statements require several forecasts. These are discussed later in this section.

At some point, many businesses will experience negative cash flow. In fact, a negative cash flow is quite common in start-up operations and high-growth businesses where there is a pressing need for capital expenditures, research and development expenditures, and other significant cash outflows. One can also see the recurring presence of negative cash flows in businesses with seasonal sales. Negative cash flows can be covered by short-term borrowing. However, this type of borrowing brings up two important issues. First, any type of borrowing raises the overall debt level of a business, which might have an impact on the interest rate on the debt. Second, when a negative cash flow exists either because of an unforeseen exigency or because a business owner has failed to properly conduct a cash-flow projection analysis, a lender might look at a business in a jaundiced manner, which could have long-term consequences for a business.

A careful examination of the cash-flow statement could illustrate a point that has been mentioned several times in this book: there can be a significant difference between positive cash flow and profit. In looking at the income statement, one could find a positive net income (profit) and then examine the cash-flow statement and discover that a business has a significant negative cash flow. The cash-flow statement specifically maps out where cash is flowing into a firm and where it flows out. A properly developed cash-flow statement will show if a business will be generating enough cash to continue operations, whether it has sufficient cash for new investments, and whether it can pay its obligations. As previously stated, many of the uninitiated will look singularly at profits, while those who have greater expertise in business will always believe that cash is king.

As a way of visualization, the cash-flow statement bears some similarity to the bank statement you may receive at the end of the month. A bank statement shows the beginning cash balance, deposits (cash inflows), and checks you have written (cash outflows) for that month. Hopefully, you have a positive cash flow—cash inflows are greater than cash outflows—and you have not bounced any checks. Unlike the bank statement, the cash-flow statement is broken into three major categories: operations, financing, and investing. Cash flow from operations examines the cash inflows from all revenues, plus interest and dividend payments from investments held by a business. It then identifies the cash outflows for paying suppliers, employees, taxes, and other expenses. Cash flow from investing examines the impact of selling or acquiring current and fixed assets. Cash flow from financing examines the impact on the cash position from the changes in the number of shares and changes in the short and long-term debt position of a firm.

Cash inflows from operating activities consist of the following:

- Cash derived from the sale of goods or services
- Cash derived from accounts receivable
- Any cash derived from interest or dividends
- Any other cash derived that is not identified with financing or investments

The cash outflows from operating activities consist of the following:

- Cash outlays for goods purchased in the creation of goods and services
- Cash outlays for payment to suppliers
- Cash outlays to employees
- Cash paid for taxes or interest paid to creditors

Financing focuses on the cash flows associated with debt or equity. Some of the cash inflows associated with financing activities consist of the following:

- Cash from the sale of a company’s stock
- Cash received from borrowing (debt)

Cash outflows associated with financing consist of the following:

- Cash outlays to repay principal on long- and short-term debt
- Cash outlays to repurchase preferred stocks
- Cash outlays to pay for dividends on either common or preferred stock

The third category is investing. The sources of cash flow from investing activities consist of the following:

- Cash received from the sale of assets
- Cash received from the sale of equity investments
- Cash received from collections on a debt instrument

Cash outflows associated with investing activities consist of the following:

- Cash outlays to acquire a debt instrument of another business
- Cash payments to buy equity interest in other businesses
- Cash outlays to purchase a productive asset

A schematic of the cash-flow statement's three areas of analysis is presented in Figure 8.2.3.3.

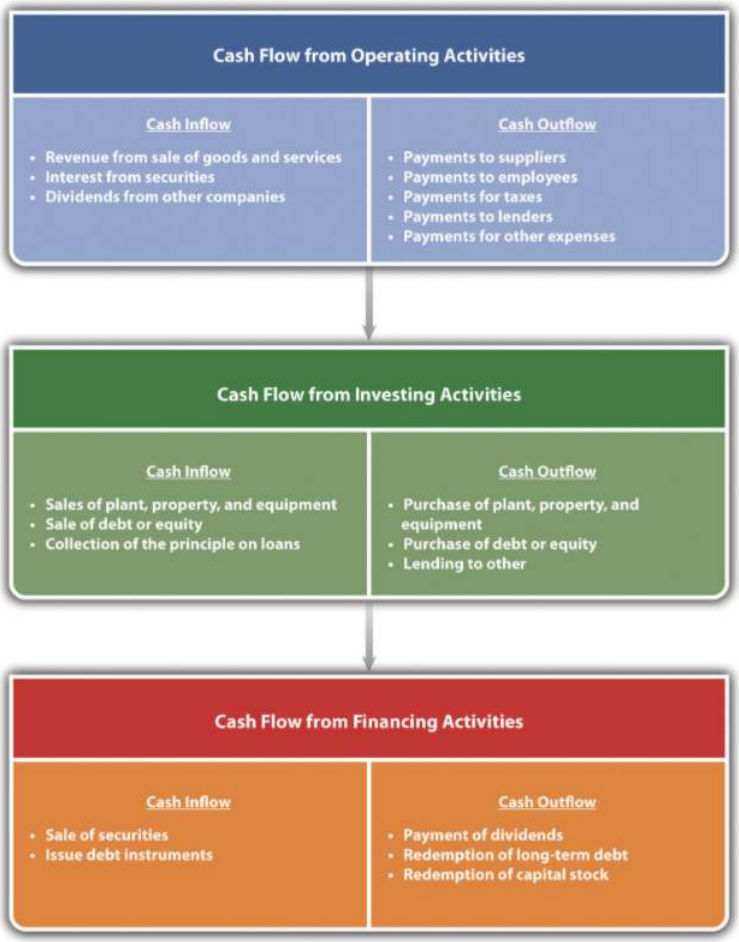


Figure 8.2.3.3: Cash Flow Breakdown

Cash-flow projection statements are about the state of future cash flows, which means they require forecasts. This translates into multiple forecasts—sales forecasts, forecasts of expenses, forecasts for necessary investments, and forecasts for a business's financing requirements.

The most common approach for cash-flow forecasting in small businesses centers on projections of cash receipts and disbursements. These projections are often based on recent past data. We will demonstrate—shortly—this approach through an extensive example. This approach is generally limited to short and midterm forecasts (i.e., three to twelve months). There are other approaches to cash-flow forecasting; however, given the relative complexity of these approaches, they are often used only by larger and more sophisticated businesses. These other approaches include the adjusted net income method, the pro forma balance sheet method, and the accrual reversal method.

The concept of cash-flow projection forecasting can be illustrated by using an example. Alex McLellan runs Soft Serve Services—a business that repairs and services soft-serve ice cream machines. His clients include ice cream parlors, resorts, and outlets at malls. Alex is a former engineer and somewhat methodical in developing his calculations for future budgets. He will be operating on the assumption that his business will be limited to his current locale. Alex has followed the same pattern for forecasting cash flows for years. First, he gathers together from his records his monthly and annual sales for the last five years, which are provided in Table 8.2.3.4.

Table 8.2.3.4: Sales Data for Soft Serve Services

	2006	2007	2008	2009	2010
January	$20,135	$20,562	$21,131	$22,657	$23,602
February	$19,545	$19,739	$19,852	$22,154	$22,307
March	$24,451	$24,360	$24,594	$26,361	$27,590
April	$22,789	$23,374	$24,000	$26,220	$32,968
May	$25,986	$28,531	$27,099	$30,057	$34,834
June	$28,357	$30,468	$32,893	$34,168	$37,078
July	$32,650	$35,307	$36,830	$40,321	$46,899
August	$34,488	$37,480	$40,202	$44,890	$52,042
September	$26,356	$27,909	$29,317	$32,917	$33,309
October	$24,211	$22,795	$23,719	$24,339	$25,691
November	$21,722	$22,272	$22,147	$23,080	$23,466
December	$22,017	$22,454	$28,321	$30,468	$33,583
Annual sales	$302,706	$315,252	$330,105	$357,631	$393,368

Using these data, Alex was able to calculate the growth rate in sales for the last four of the five years. As an example:

Growth Rate 2007 = (Sales 2007 − Sales 2006) / (Sales 2006) = ($315,252 − $302,706) / ($302,706) = ($12,546) / ($302,706) = 4.14 Percent

Although the average of the four annual growth rates was 6.8 percent (the annual growth rates were 4.14 percent in 2007, 4.71 percent in 2008, 8.34 percent in 2009, and 9.99 percent in 2010, thus having an average of 6.8 percent), Alex believes that the last two years were unusually good, and the growth rate for 2011 would be slightly lower at a rate of 6.5 percent. This rate of growth would mean that his estimate for sales in 2011 would be $418,937, which comes from the following:

Annual Sales 2011 = Annual Sales 2010 × (1 + Growth Rate 2011) = $393,368 × (1.065)

He knows from experience that his sales are quite seasonal. Alex believes that there is a high degree of consistency in this seasonality of sales across the years. So he computes (using a spreadsheet program) what percentage of annual sales occurs in each month. This calculation for January 2006 would be given as follows:

Percentage of Annual Sales for January 2006 = (January 2006 Sales) / (Annual Sales 2006) = ($20,135) / ($302,706) = 6.65 Percent

His analysis for each month in each of the five years is provided in Table 8.2.3.4, as are the averages for each month.

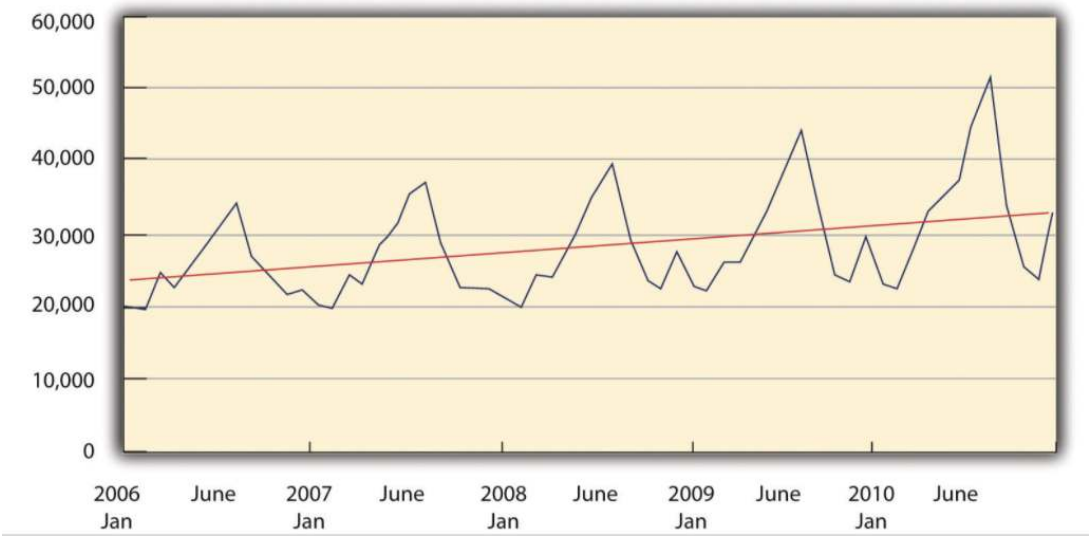


Figure 8.2.3.4: Seasonality in Sales

Table 8.2.3.5: Monthly Sales as a Percentage of Annual Sales

	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)	Average (%)
January	6.65	6.52	6.40	6.34	6.00	6.38
February	6.46	6.26	6.01	6.19	5.67	6.12
March	8.08	7.73	7.45	7.37	7.01	7.53
April	7.53	7.41	7.27	7.33	8.38	7.59
May	8.58	9.05	8.21	8.40	8.86	8.62
June	9.37	9.66	9.96	9.55	9.43	9.60
July	10.79	11.20	11.16	11.27	11.92	11.27
August	11.39	11.89	12.18	12.55	13.23	12.25
September	8.71	8.85	8.88	9.20	8.47	8.82
October	8.00	7.23	7.19	6.81	6.53	7.15
November	7.18	7.06	6.71	6.45	5.97	6.67
December	7.27	7.12	8.58	8.52	8.54	8.01

Alex was the able to estimate sales for January 2011 in the following manner: Because Alex was using spreadsheet software, the monthly averages were computed out to more than two decimal places. This explains why the calculations are not exact. As in the case of January, the actual monthly percentage was closer to 6.3821 percent, which provides the monthly forecast of $26,737.

January 2011 Sales = Annual Sales 2011 × January Percentage = ($418,937) × (6.38 Percent) = $26,737

Using the same approach, he was able to compute forecasted sales for February and March. To maintain sales, Alex offers his customers a rather generous credit policy. He asks them to pay 50 percent of the bill in the month in which the work is done; another 35 percent of the bill in the following month, and the remaining 15 percent of the bill two months after the work has been completed. For Alex to project cash inflows for January, he would need to consider sales from the two prior months—December and November. His projected cash inflows for January would be determined as follows:

November 2010 Sales = $23,466

December 2010 Sales = $33,583

January 2011 Sales = $26,737

Cash Inflow from November 2010 Sales = ($23,466) × 15 Percent = $3,520

Cash Inflow from December 2010 Sales = ($33,583) × 35 Percent = $11,754

Cash Inflow from January 2011 Sales = ($26,737) × 50 Percent = $13,368

Total Cash Inflows From Operations = Sum of Cash Inflows For Three Months = $28,642

Alex then estimates his cash outflows from operations. From past experience, he knows that the purchases of parts and materials run approximately 50 percent of the dollar value of his sales. However, because of delays in acquiring parts and materials, he must order them in advance. He has to anticipate what sales would be the following month and has to place a purchase order predicated on that value. Further, 60 percent of that dollar value is in that month and the remaining 40 percent is in the following month. This can be illustrated for January 2011. To determine the purchases of parts and materials in January, he begins with his forecast for sales in February 2011.

February 2011 Sales = $25,637

Parts and Materials Purchases in January 2011 = 50 Percent of February 2011 Sales = 50 Percent × $25,637 = $12,819.

He is obligated to pay 60 percent of this amount in January 2011 and the remaining 40 percent in February 2011. This also means that his cash outlay in January 2011 must include a payment for 40 percent of December's purchases.

Parts and Materials Purchases in December 2011 = 50 Percent of January 2011 Sales = 50 Percent × $26,737 = $13,369

Parts and Materials Cash Outlay in January 2011 = 60 Percent of Purchases January 2011 + 40 Percent of Purchases December 2010

Parts and Materials Cash Outlay in January 2011 = (60 Percent × $12,819) + (40 Percent × $13,369) = $13,038.

In addition to purchasing parts and materials, Alex has to consider his operational expenses, which include wages, payroll taxes, office supplies, repairs, advertising, and expenses related to automobiles, phone bills, rent, utilities, expenses associated with accounting services, and taxes. These are itemized in Table 8.2.3.6. Adding in these expenses brings his total cash outflow $19,864.

For January 2001, he has no cash inflows or cash outflows with respect to either investment activities or financing activities. This means that his total cash flow for January 2011 represents the difference between cash inflows and outflows for operational activities. His cash flow for January 2011 was a positive value of $8,778. Because he ended December 2010 with a cash position of $3,177, the addition of this $8,778 brings his cash position at the end of January 2011 to $11,955. His bank, with which he has an open line of credit, requires that he maintain a minimum of $2,500 in his cash account each month. Should Alex drop below this amount, his bank will lend him—automatically—up to $5,000.

It is useful to examine the rest of his projections (see Table 8.2.3.6. February 2011 follows much as January 2011. Alex was able to produce a positive net cash flow in February of $5,669, which brought his ending cash position at the end of February 2011 to $17,624.

Unlike the other months of 2011, Alex planned on producing cash flows with respect to investment activities in March 2011. He planned on selling an asset to a friend and anticipated a positive cash flow of $500 from this sale. He also planned on purchasing a used van in March 2011 and estimated that the price would be $21,000. His intention was to pay for the van from his cash account and not take out a car loan. His cash outflows for March 2011 were a negative $16,075. With the bank's requirement of maintaining a $2,500 minimum balance, this meant that Alex activated the automatic borrowing option from his bank to the amount of $950. It required some effort on Alex's part to build the cash-flow spreadsheet, but it enabled him to examine various options, such as the impact of deferring the purchase of the van until May 2011. Although any cash-flow spreadsheet is dependent on the accuracy of forecasts, it is a mechanism by which a small business owner can examine various scenarios and determine the possible impact of those scenarios on his or her overall cash flow.

Table 8.2.3.6: Cash-Flow Projections for the First Quarter of 2011

	November	December	January	February	March
Cash Flow from Operating Activities					
Cash on hand at end of month		$3,177	$11,955	$17,624	$1,550
Cash Inflow from Operations					
Sales	$23,466	$33,583	$26,737	$25,637	$31,537
Cash flow from month of sales			$13,369	$12,818	$15,769
Cash flow from prior month's sales			$11,754	$9,358	$8,973
Cash flow from two month's prior sales			$3,520	$5,037	$4,011
Total cash inflow from operations			$28,642	$27,214	$28,752
Parts Purchases					
Cash outflow for this month's purchases			$7,691	$9,461	$9,533
Cash outflow for prior month's purchases			$5,347	$5,127	$6,307
Gross wages (excludes withdrawals)			$4,000	$4,000	$4,000
Payroll expenses (taxes, etc.)			$150	$150	$150
Outside services			$—	$—	$—
Supplies (office and operating)			$50	$50	$50
Repairs and maintenance			$—	$—	$450
Advertising			$100	$200	$250
Auto, delivery, and travel			$120	$150	$180
Accounting and legal			$200	$200	$200
Rent			$1,650	$1,650	$1,650

	November	December	January	February	March
Telephone			$65	$65	$65
Utilities			$325	$325	$325
Insurance			$166	$166	$166
Taxes (real estate, etc.)			$—	$—	$1,000
Interest			$—		
Other expenses			$—	$—	$—
Total cash outflows from operations			$19,864	$21,544	$24,327
Sale of asset			$—	$—	$500
Sale of debt or equity			$—	$—	$—
Collection of principal on a loan			$—	$—	$—
Total cash flow from investing activities			$—	$—	$500
Purchase of plant, property, and equipment			$—	$—	$21,000
Purchase of debt			$—	$—	$—
Total cash outflows from investing			$—	$—	$21,000
Sales of securities or equity			$—	$—	$—
Issue of debt instruments			$—	$—	$—
Total cash inflow from financing activities			$—	$—	$—
Payment of dividends			$—	$—	$—
Redemption of long-term debt			$—	$—	$—
Total cash outflows from financing			$—	$—	$—
Net cash flow			$8,778	$5,669	$(16,075)
Required cash balance	$2,500	$2,500	$2,500	$2,500	$2,500

	November	December	January	February	March
Required borrowing			$—	$—	$(950)

Video Clip: Cash-Flow Analysis

A discussion of cash flow.

A YouTube element has been excluded from this version of the text. You can view it online here.

KEY TAKEAWAYS

- To truly understand how well a business is doing requires an ability to understand the financial statements of the business.
- The balance sheet shows what a business owns and what claims are on the business.
- The income statement shows how profitable a business is and identifies the expenses of the business.
- Cash flow is the lifeblood of a business's operation.
- Cash-flow projections are vital for any business.

EXERCISES

Edwina Haskell was an accomplished high school student who looked forward to attending Southern New England University (SNEU). SNEU was unique in that it operated on a trimester basis, its policy was to actively foster independent development among the students. Edwina's mother and father each own their own small businesses. Soon after freshman orientation at SNEU, Edwina recognized a need among the students that could be the basis for developing a small business. Freshman students could not bring their cars on the campus. In effect, they were confined to the dorm; if they wished to travel, they had to take school-provided buses that operated on a fixed schedule. Further, the university's cafeteria closed at eight in the evening. Students who wanted to have some food or snacks after 8:00 p.m. had to call local restaurants that delivered. The few restaurants in the neighborhood around SNEU that had delivery services often were late in their deliveries, and hot food, such as pizza, was frequently delivered cold.

Edwina felt that there was a niche market on the campus. She believed that students would be interested in ordering sandwiches, snacks, and sodas from a fellow student provided that the food could be delivered in a timely fashion. After talking with several students in her dorm complex, she believed that offering a package of a sandwich, a soda, and a small snack, such as potato chips, for $5 and a guaranteed delivery of 15 minutes or less would be a winner. Because her dorm complex consisted of four large adjoining buildings that house nearly 1,600 students, she felt that there would be sufficient demand to make the concept profitable. She talked about this concept with her roommates and with her parents. Her roommates were willing to help prepare the sandwiches and deliver them. She planned on paying each of them $250 per trimester for taking orders, making sandwiches, and delivering them. All three roommates, whom she knew from high school, were willing to be paid at the end of the trimester.

Edwina recognized that for this business plan to work, she would have to have a sufficient inventory of cold cuts, lettuce, tomatoes, soda, chips, and condiments to be able to meet student demands. The small refrigerators in the dorm rooms would not be sufficient. After talking to her parents, they were willing to help her set up her business. They would lend her $1,000 to buy a larger refrigerator to place in her dorm room. She did not have to repay this loan until she graduated in four years, but her parents wanted her to appreciate the challenges of operating a small business. They set up several conditions. First, although she did not have to pay back the $1,000 for the refrigerator for four years, she had to pay interest on this "loan." She had to repay 3 percent of this loan each trimester. Further, they reminded her that although she could pay her friends at the end of the semester, she would need funds to buy the cold cuts, bread, rolls, soda, snacks, condiments, and supplies such as foil to wrap the sandwiches, plus plates and paper bags. Although Edwina was putting $500 of her own money into her business, her parents felt that she might need an infusion of cash during the first year (i.e., the first three trimesters). They were willing to operate as her bank—lending her money, if needed, during the trimesters. However, she had to pay the loan(s) back by the end of the year. They also agreed that the loan(s) would be at a rate of 2 percent per trimester.

Within the first three weeks of her first trimester at SNEU, Edwina purchased the $1,000 refrigerator with the money provided by her parents and installed it in her dorm. She also went out and purchased $180 worth of supplies consisting of paper bags;

paper plates; and plastic knives, spoons, and forks. She paid for these supplies out of her original $500 personal investment. She and her roommates would go out once or twice a week, using the SNEU bus system to buy what they thought would be the required amount of cold cuts, bread, rolls, and condiments. The first few weeks' worth of supplies were purchased out of the remainder of the $500. Students paid in cash for the sandwiches. After the first two weeks, Edwina would pay for the food supplies out of the cash from sales.

In the first trimester, Edwina and her roommates sold 640 sandwich packages, generating revenue of $3,200. During this first trimester, she purchased $1,710 worth of food supplies. She used $1,660 to make the 640 sandwich packages. Fortunately, the $50 of supplies were condiments and therefore would last during the two-week break between the trimesters. Only $80 worth of the paper products were used for the 640 sandwich packages. Edwina spent $75 putting up posters and flyers around the campus promoting her new business. She anticipated that the tax rate would be approximately 35 percent of her earnings before taxes. She estimated this number at the end of the first trimester and put that money away so as to be able to pay her tax bill.

During the two weeks off between the first and second trimester, Edwina and her roommates talked about how they could improve business operations. Several students had asked about the possibility of having warm sandwiches. Edwina decided that she would purchase two Panini makers. So at the beginning of the second trimester, she tapped into her parents' line of credit for two Panini grills, which in total cost $150. To make sure that the sandwiches would be delivered warm, she and her roommates spent $100 on insulated wrappings. The $100 came from cash. The second trimester proved to be even more successful. The business sold 808 sandwiches, generating revenue of $4,040. During this second trimester, the business purchased $2,100 worth of food supplies, using $2,020 of that to actually create the 808 sandwich packages. They estimated that during the second trimester, they used $101 worth of supplies in creating the sandwich packages.

There was only a one-week break between the second and third trimesters, and the young women were quite busy in developing ideas on how to further expand the business. One of the first decisions was to raise the semester salary of each roommate to $300 apiece. More and more students had been asking for a greater selection of warm sandwiches. Edwina and her roommates decided to do some cooking in the dorms so as to be able to provide meatball and sausage sandwiches. Edwina once again tapped into her parents' line of credit to purchase $275 worth of cooking supplies. One of the problems they noticed was that sometimes students would place calls to order a sandwich package, but the phones were busy. Edwina hired a fellow student to develop a website where students could place an order and select the time that they would like a sandwich package to be delivered. The cost of creating and operating this website for this third trimester was $300.

This last semester of Edwina's freshman year proved to be the most successful in terms of sales. They were able to fulfill orders for 1,105 sandwich packages, generating revenue of $5,525. Edwina determined that the direct cost of food for these sandwich packages came out to be $2,928.25. The direct cost of paper supplies was $165.75. At the end of her freshman year, Edwina repaid her parents the $425 that came from her credit line that was used to purchase the Panini makers and the cooking utensils.

1. Prepare a beginning balance sheet for the first day of Edwina's business.
2. Prepare income statements for the end of each trimester.
3. Prepare balance sheets for the end of each semester.

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8.2.4: Financial Ratio Analysis

Learning Objectives

- Understand why the numbers found on a balance sheet and an income statement may not be enough to properly evaluate the performance of a business.
- Understand the concept of financial ratios and the different categories of financial ratios.
- Acquire the ability to calculate financial ratios and interpret their meaning.

Managerial accounting focuses on providing information that is useful for the managers of a firm. Financial accounting provides information to interested external constituencies. Both use information derived from financial statements. These numbers, however, may not provide a singular insight into the overall economic effectiveness of any particular business. These numbers must be placed in some form of context. As an example, suppose you are told that a particular business earned $2 million worth of profit last year. Obviously, earning a $2 million profit is better than a $1 million profit and certainly better than a $2 million loss. However, you are still left with the question of exactly how good that $2 million profit is. After all, if you were told that Walmart made only $2 million profit last year, you would likely be concerned with respect to the management capability and performance of Walmart. Making only $2 million profit on revenues in excess of $400 billion worth of sales would not be at all impressive. However, if you were told that a mom-and-pop grocery store made $2 million profit last year based on $4 million of sales, you would be amazed at that mom-and-pop store and hold them in considerable esteem for their management capability.

One way of putting financial data into a comparative context is known as financial ratio analysis. From a financial accounting standpoint, ratio analysis enables external constituencies to evaluate the performance of a firm with respect to other firms in that particular industry. This is sometimes referred to as comparative ratio analysis. From a managerial accounting standpoint, ratio analysis can assist a management team to identify areas that might be of concern. The management team can track the performance on these ratios across time to determine whether the indicators are improving or declining. This is referred to as trend ratio analysis. There are literally scores of financial ratios that can be calculated to evaluate a firm's performance.

Financial ratios can be grouped into five categories: **liquidity ratios**, **financial leverage ratios**, **profitability ratios**, **asset management or efficiency ratios**, and **market value ratios**. Because many small businesses are not publicly held and have no publicly traded stock, market ratios play no role in analyzing a small firm's performance. This section will review some of the most commonly used ratios in each category.

Liquidity ratios provide insight into a firm's ability to meet its short-term debt obligations. It draws information from a business's current assets and current liabilities that are found on the balance sheet. The most commonly used liquidity ratio is the current ratio given by the formula:

$$\text{Current Assets} / \text{Current Liabilities}$$

The normal rule of thumb is that the current ratio should be greater than one if a firm is to remain solvent. The greater this ratio is above one, the greater its ability to meet short-term obligations. As with all ratios, any value needs to be placed in context. This is often done by looking at standard ratio values for the same industry. These ratios are provided by Dun and Bradstreet; these data are also available on websites, such as Bizstats.com.

Another ratio used to evaluate a business's ability to meet in short-term debt obligations is the quick ratio—also known as the acid test. It is a more stringent version of the current ratio that recognizes that inventory is the least liquid of all current assets. A firm might find it impossible to immediately transfer the dollar value of inventory into cash to meet short-term obligations. Thus the quick ratio, in effect, values the inventory dollar value at zero. The quick ratio is given by the following formula:

$$\text{Current Assets} - \text{Inventory} / \text{Current Liabilities}$$

Using the data provided in the balance sheet for Acme Enterprises (see Section 8.2.3), we can compute the current ratio and the quick ratio. The results for Acme Enterprises and its industry's means are provided in Table 8.2.4.1.

Table 8.2.4.1: Liquidity Ratio Results

	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009(%)	2010 (%)
Acme's current ratio	0.83	0.79	0.75	0.70	0.65	0.60
Industry's current ratio	1.15	1.08	1.04	1.02	1.03	1.01
Acme's quick ratio	0.63	0.60	0.57	0.53	0.49	0.45
Industry's quick ratio	1.04	1.02	0.98	0.95	0.94	0.91

One should immediately notice that this business appears to be in serious trouble. None of the current ratios are above of value of 1.0, which indicates that the business would be unable to meet short-term obligations to its creditors should they have to be paid. Acme's current ratios are below the industry's average values; however, it should be noted that the industry's values are quite close to one. Further, the current ratio values for Acme and the industry are declining, but Acme's are declining quite significantly. This indicates the financially precarious position of the firm is growing steadily worse. The quick ratio shows an even direr situation should the firm not be able to sell off its inventory at market value. Acme's quick ratio values are well below the industry's average. Without these two ratios, a quick perusal of the total current assets of Acme Enterprises would result in a false impression that the firm is growing in a healthy fashion and current assets are rising.

Financial leverage ratios provide information on a firm's ability to meet its total and long-term debt obligations. It draws on information from both the balance sheet and the income statement. The first of these ratios—the debt ratio—illustrates the extent to which a business's assets are financed with debt. The formula for the debt ratio is as follows:

Total Debt / Total Assets

A variation on the debt ratio is the ratio of debt to the total owner's equity (the debt-to-equity ratio). As with the other ratios, one cannot target a specific, desirable value for the debt-to-equity ratio. Median values will vary significantly across different industries. The automobile industry, which is rather capital intensive, has debt-to-equity ratios above two. Other industries, such as personal computers, may have debt-to-equity ratios under 0.5. The formula for the debt-to-equity ratio is as follows:

Total Debt / Total Owner's Equity

One can refine this ratio by examining only the long-term portion of total debt to the owner's equity. Comparing these two debt-to-equity ratios gives insight into the extent to which a firm is using long-term debt versus short-term debt. The formula for the long-term debt-to-owner's equity ratio is as follows:

Long-term Debt / Total Owner's Equity

The interest coverage ratio examines the ability of a firm to cover or meet the interest payments that are due in a designated period. The formula for the interest coverage ratio is as follows:

EBIT / Total Interest Charges

The financial leverage ratios for Acme and its industry are provided in Table 8.2.4.2. Interestingly, Acme's debt-to-total-assets ratio has declined over the last six years. Further, its ratio has always been lower than the industry average in every year. This stands in contrast to the liquidity ratios. The business's debt-to-equity ratio has declined precipitously over the last six years and was significantly lower than the industry averages. The same is true for the long-term debt-to-equity ratios. These ratios have declined for several reasons. The total assets of the firm have doubled over the last six years, and equity has grown by a factor of five while the long-term debt has remained constant. It would appear that the firm has been financing its growth with short-term debt and its own profits. However, one should note that the **times interest earned ratio** has declined dramatically, falling to approximately half the level of the industry average in 2010. This indicates that the firm has less ability to meet its debt obligations. In conjunction with the results of the other ratios, one would say that Acme has relied, excessively, on its short-term debt and should take actions to return to a firmer financial footing.

Table 8.2.4.2: Financial Leverage Ratios Results

	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)
Acme's debt-to-total assets ratio	0.86	0.78	0.73	0.69	0.67	0.65
Industry's debt-to-total assets ratio	1.01	0.97	0.95	0.92	0.89	0.86
Acme's debt-to-equity ratio	6.14	3.57	2.68	2.22	1.99	1.86
Industry's debt-to-equity ratio	3.31	3.25	3.67	3.11	2.96	2.65
Acme's long-term debt-to-equity ratio	1.88	1.02	0.70	0.53	0.43	0.36
Industry's long-term debt-to-equity ratio	1.52	1.54	1.42	1.32	1.27	1.12
Acme's times interest earned ratio	14.76	12.34	10.68	8.52	7.17	5.52
Industry's times interest earned ratio	11.55	11.61	10.95	10.65	10.43	10.01

The next grouping of ratios is the profitability ratios. Essentially, these ratios look at the amount of profit that is being generated by each dollar of sales (revenue). Remember, from the review of the income statement, we can identify three different measures of profit: gross profit, operating profit, and net profit. Each measure of profit can be examined with respect to the net sales of a business, and each can give us a different insight into the overall efficiency of a firm in generating profit.

The first profitability ratio examines how much gross profit is generated by each dollar of revenue and is given by the following formula:

$$\text{Gross Profit Margin} = \text{Gross Profit} / \text{Revenue}$$

The next examines operating profit per dollar of sales and is calculated in the following manner:

$$\text{Operating Profit Margin} = \text{Operating Profit} / \text{Revenue}$$

Lastly, the net profit margin is the one that is mostly used to evaluate the overall profitability of a business. It is determined as follows:

$$\text{Net Profit Margin} = \text{Net Profit} / \text{Revenue}$$

The profitability ratios for Acme and its industry are provided in Table 8.2.4.3. Acme has seen a slight increase in its gross profit margin over the last six years, which indicates a reduction in either direct labor or direct materials costs. Acme's gross profit margin is slightly lower, across the six years, than the industry's mean values. Acme's operating profit margins have declined, particularly since 2008. This would indicate, in light of an increasing gross profit margin, that its operating expenses have increased proportionately. Acme's operating profit margins had parity with its industry until 2008. The most troublesome results may be the net profit margins, which experienced a one-third decline over the last six years. Although the industry's net profit margins have declined, they have not done so at the same rate as those for Acme. These results indicate that Acme needs to carefully review its operational expenses with a clear intention to reduce them.

Table 8.2.4.3: Profitability Ratios Results

	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)
Acme's gross profit margin	50.0	50.0	51.0	51.0	52.0	52.0
Industry's gross profit margin	51.2	51.3	51.6	51.5	53.2	53.1
Acme's operating profit margin	15.5	14.3	14.0	12.7	12.3	10.9
Industry's operating profit margin	14.7	14.1	14.2	13.2	13.0	13.2
Acme's net profit margin	9.5	8.7	8.4	7.4	7.0	6.0
Industry's net profit margin	9.2	8.9	8.5	8.4	8.1	7.9

The last category of financial ratios is the asset management or efficiency ratios. These ratios are designed to show how well a business is using its assets. These ratios are extremely important for management to determine its own efficiency. There are many different activity or efficiency ratios. Here we will examine just a few. The sales-to-inventory ratio computes the number of dollars of sales generated by each dollar of inventory. Firms that are able to generate greater sales volume for a given level of inventory are perceived as being more efficient. This ratio is determined as follows:

Sales to Inventory = Sales / Inventory

There are other efficiency ratios that look at how well a business is managing its inventory. Some look at the number of days of inventory on hand; others look at the number of times inventory is turned over during the year. Both can be used to measure the overall efficiency of the inventory policy of a firm. For simplicity's sake, these ratios will not be reviewed in this text.

The sales-to-fixed-asset ratio is another efficiency measure that looks at the number of dollars of sales generated by a business's fixed assets. Again, one is looking for a larger value than the industry average because this would indicate that a business is more efficient in using its fixed assets. This ratio is determined as follows:

Sales to Fixed Assets = Sales / Fixed Assets

Another commonly used efficiency ratio is the days-in-receivables ratio. This ratio shows the average number of days it takes to collect accounts receivables. The desired trend for this ratio is a reduction, indicating that a firm is being paid more quickly by its customers. This ratio is determined as follows:

Days in Receivables = Accounts Receivable / (Sales / 365)

The 365 in the denominator represents the number of days in a year. A summary of the activity ratios for Acme and the industry is provided in Table 8.2.4.4.

Table 8.2.4.4: Efficiency Ratios Results

	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)
Acme's sales to inventory	14.3	14.3	14.3	14.3	14.3	14.3
Industry's sales to inventory	16.2	15.7	15.3	14.9	14.3	13.7
Acme's sales to fixed assets	8.57	7.02	6.01	5.28	4.75	4.33
Industry's sales to fixed assets	7.64	7.12	6.78	6.55	6.71	6.34
Acme's days in receivables	36.5	36.5	36.5	36.5	36.5	36.5
Industry's days in receivables	33.2	34.6	38.2	37.4	33.9	35.1

Almost immediately one should notice several interesting sets of value. Acme's sales-to-inventory ratios for the period 2005 to 2010 and its days in receivables for the same time frame are constant. This is not true for the industry values. This might indicate that Acme has a rigorous policy of tying its inventory level to sales. Likewise, it would appear that Acme has some formal policy to explicitly link accounts receivable to sales volume. Industry values for both ratios fluctuated across the time span; however, it should be noted that the industry's days in receivables fluctuated across a rather narrow band. Acme's sales to fixed assets have been declining from 2005 to 2010. In fact, it has dropped almost in half. This is a sign that Acme's ability to manage its assets vis-à-vis sales has declined significantly and should be a source of considerable worry for the management team.

Financial ratios serve an extremely useful purpose for small business owners who are attempting to identify trends in their own operations and see how well their business's stand up against its competitors. As such, owners should periodically review their financial ratios to get a better understanding of the current position of their firms.

Video Clip: Debt Management

Basic coverage for calculating debt ratios.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Profitability

Basic coverage for calculating profitability ratios.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Asset Management

Basic coverage for calculating asset management ratios.

A YouTube element has been excluded from this version of the text. You can view it online here.

KEY TAKEAWAYS

- Financial ratios enable external constituencies to evaluate the performance of a firm with respect to other firms in a particular industry.
- Ratio analysis can help a management team identify areas that might be of concern.
- The management team can track the performance on these ratios across time to determine whether the indicators are improving or declining.
- Financial ratios can be grouped into five categories: liquidity ratios, financial leverage ratios, asset management or efficiency ratios, profitability ratios, and market value ratios.

EXERCISES

1. In the Appendix, you will find the income statements and balance sheets for Frank's All-American BarBeQue for the years 2006 to 2010. Compute some of the key financial ratios for this business and discuss the meanings of any trends.
2. Locate the average values of these values for the restaurant industry and comment on how well or poorly Frank's All-American BarBeQue appears to be doing with respect to the industry.
3. Frank's business plan in the Appendix provides projected income statements and balance sheets for a five-year forecast horizon. Compute the same ratios as in Exercise 1 and comment on your results.

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8.2.5: The Three Threads

Learning Objectives

- To understand that a functioning accounting system can provide customer value through accurate billings and records.
- To understand that there are several techniques that can help a small business maintain a positive cash flow.
- To appreciate that small businesses can use sophisticated, low-cost computer accounting systems to manage their accounting and operational operations.

Customer Value

One might find at first consideration a tenuous link between a business's accounting system and the concept of customer value. However, if looked at from the customer's perspective, a business that provides accurate and prompt billings is a business that can control its costs, which can result in lower prices. A business that improves its overall efficiency because it can accurately monitor and track its operations provides far greater value than a business with a haphazard approach to accounting controls.

The ability to tailor a business's operations to better meet customer needs is the key to providing value. As a business acquires a better appreciation of its capabilities, it can then make improvements that will better meet customer needs and outperform competitors.

As a business grows more confident in its ability to handle accounting issues, it may wish to look at more sophisticated techniques that can better serve the business and the customer. As Andrew Hereth puts it, "An accounting process needs to be established that accounts for the cost of each customer, for each market and for each channel."

Cash-Flow Implications

Creating a positive cash flow or at least reducing a negative cash flow should be of central interest to all small businesses. Unlike the example of Alex's Soft Serve Services, not all small businesses can anticipate that they will be able to cover a negative cash flow simply by borrowing. That means that businesses must be much more proactive in attempting to eliminate or reduce negative cash flows. Therefore it is important to examine some ways in which a small business can increase its cash inflows.

- **Restrict credit and credit terms.** Many small businesses, but not all, offer credit terms and policies for current and potential customers. The easier the credit, the more likely a business will be able to generate a sale; however, easy credit terms generally mean that it will take a longer period of time for the business to receive the total cash payment from a sale. Thus many businesses accept only cash or debit and credit cards. Restricting the credit terms may simply mean that credit is provided only to particular customers or the terms of the credit are tightened—for example, 60 percent of the sale price is due the day of the sale, and the remaining 40 percent would be due in thirty days.
- **Conduct credit checks.** Businesses that plan to offer credit to customers, particularly customers who will be making large purchases, may find that it pays to spend money to conduct a credit check on these customers. Again, the use of credit checks is very much a function of the type and size of the business and the potential sales that may be involved.
- **Make credit terms explicit.** For businesses that provide credit to their customers, it is critical to make sure the customer has an explicit idea of what the exact credit terms are. In the long run, it will pay to clearly indicate on the invoice the exact payment schedule.
- **Provide incentives to expedite customer payment.** It is often worth to knock off several percentage points on a sale to speed up a customer's payment. The exact size of the discount will have to be determined by the business owner.
- **Request partial payment in advance.** When providing credit terms, small businesses should consider the requirement of a deposit or a retainer up front. Hopefully, this should not deter many customers from purchasing particularly high-priced items. The request for payment in advance assures that a business will receive some cash inflow even if the customer defaults.

One of the best ways to maintain a positive cash flow is to reduce the size of the negative cash flow, which can be done by conducting cash-flow analyses on a regular basis. Throughout this chapter, the time frame most commonly used has been the fiscal year or a fiscal month. In the case of rigorously monitoring cash flow, it is strongly suggested that one consider using even smaller time units, namely a weekly analysis or even a daily analysis.

Digital Technology and E-Environment Implications

Computer-based accounting systems have much to offer the owner of a small business. Most small businesses would find that a computerized accounting system has the following advantages over a manual system:

- **Accuracy.** In computerized systems, data entry can be structured so as to preclude the input of wrong information. Further, transactions are entered only once in computerized systems, whereas they may require several entries in a manual system.
- **Speed.** Data entry and data retrieval can occur on a real-time basis. Calculations are done instantly in a computerized system. For businesses with multiple locations, data can be instantly coordinated rather than waiting for the collection of data from diverse locations as would occur with manual systems.
- **Report generation.** Computerized systems can provide real-time generation of a variety of reports that can enable owners or operators to improve their decision making.
- **Cost reduction.** Although small businesses may be required to expend money on the initial purchase (and maintenance) of computerized accounting system, these systems often provide significant savings in terms of reducing the amount of time required for bookkeepers and accountants to track businesses records.
- **Backup.** The records in a computerized system can be backed up at a variety of locations. This minimizes the chance that all records would be destroyed in some form of accident, such as a fire or a flood, as might be the case with paper records in a manual system.

Computer-based accounting packages that have been designed for small to midsize businesses have been available for more than a quarter of a century. Many of the packages that existed twenty-five years ago are no longer available. Some have argued that a natural selection process exists for computerized accounting system so that today's survivors represent the best qualities required of such systems. In recent years, a whole new category of accounting software has been developed—cloud-based software. This software resides on the web and does not require a software package to be downloaded on small business owner's computer. Such programs are accessible from any computer.

Selecting a new computer accounting system or changing from a manual system to a computer-based system is a major step for any small business. It should be conducted with careful consideration and treated as a major project. Prior to starting the project, it is highly advisable to sit down with one's accountant and consider the options. Some of the first steps in starting this project involve specifying the budget and the required attributes of the software package. In developing the budget, one should consider the initial acquisition price of the software, training costs, and maintenance costs. If one is planning to move from one computerized accounting system to another, the cost of transferring operations should also be considered in the overall budgeting process. With regard to the initial purchase price, these packages can range from being free to costing thousands of dollars depending on the number of modules required. Some systems use a fee structure that is based on the number of users. This would allow a business owner to get some sense of the look and the feel of the software package.

The second initial phase of the acquisition process centers on identifying what is needed in the accounting package. This relates to the elements (support services) or modules that are absolutely required. One should also identify what modules might be of benefit at some point in the future. To assist an owner in identifying what modules are required or may be required in the future, the information that flows into the accounting system must be specified. In another chapter, we refer to the idea of accounting transactions, which fall into several categories. A business needs to identify all the required categories, particularly if it is transitioning from a manual system to a computerized system. A business also needs to identify the accounting reports that are required throughout the business. It is important to consider if the software is compatible with e-business, e-commerce, and Internet capabilities.

Another issue is to consider how many people will have to access the system throughout the entire business. This number will have a dramatic impact on the training requirements. Recognize that the business will have to provide manuals that must be accessible to all who will be using the accounting system. This also brings up the issue of the necessity of employee training programs. Consider the relative ease of use of any computerized accounting system—not only for yourself but also for the employees. This is where an understanding of the learning curve of using the system will be extremely important. Again, a business's accountant can play a critical role not only in determining the selection of the system but also in developing training programs for the employees and showing them how to use the system. Having generated this list of the required components of the accounting system, one should identify competing software products (along with their costs) and prioritize them, as shown in Figure 8.2.5.1. In addition to consulting with an accountant, a business owner should review the various accounting software packages by talking to other

business owners, reading evaluations in the business and computer press, and exploring software packages on a trial basis. Many accounting software packages allow users to try out the system with no initial charge. After a fixed period of time, usually thirty days, the program becomes inoperative. This allows you to become familiar with the look and the feel of the software.

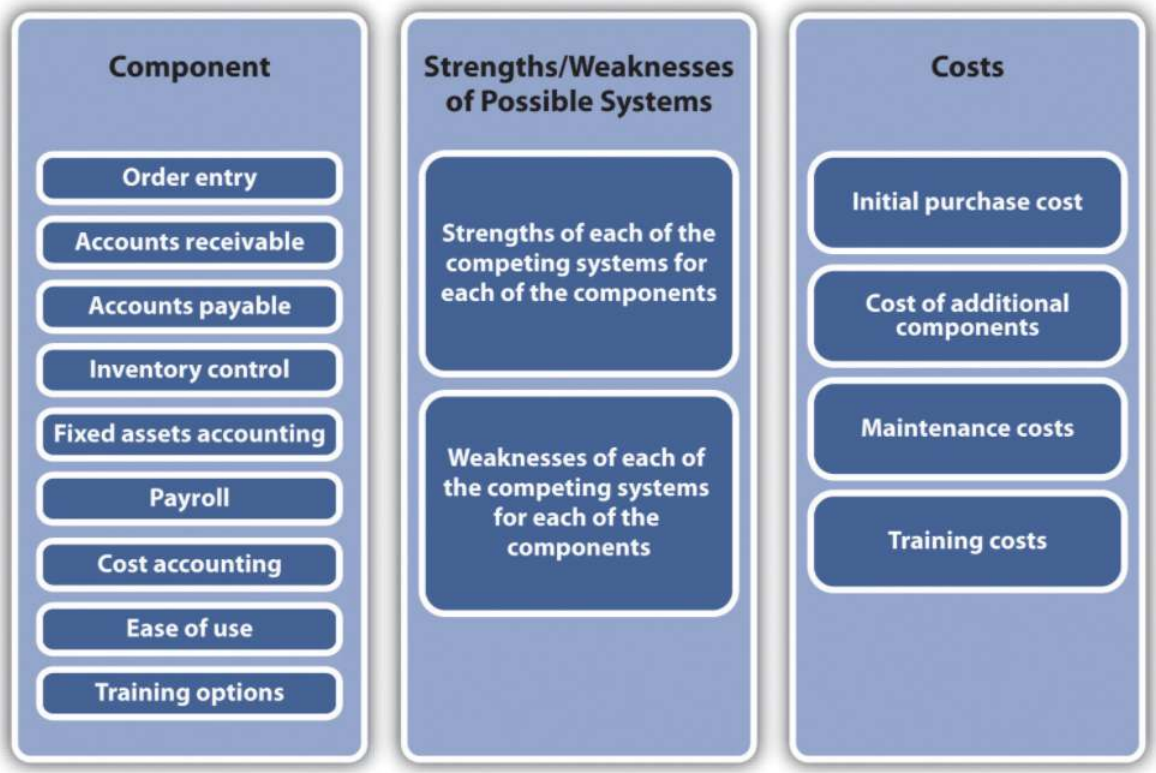


Figure 8.2.5.1: Evaluation of Computer Accounting Systems

The third preliminary step is the creation of a timeline that would determine when you must successfully implement the accounting package into the actual operations of the business. This timeline should consider the time required to conduct test runs of the software. Tests should be conducted with only one or two modules. They should be operated for a sufficient period of time (at least a month) to examine if the system works as well as the manual system or the current computerized system. A timeline should also be created for training the personnel who will be using the software.

Moving to a computerized accounting system or a new system means that you should be ready for any disaster. To prepare for such disasters, there should be a formal policy of backing up all data on a regular basis. The backed up data should be at another locale other than the main storage site. Portable hard drives for off-site data storage site serve this purpose well. Some software packages perform their own backup procedures.

Several factors may need to be considered when examining accounting software for small businesses, including the following: will the software run on computers that a business currently uses, how often should the company provide updates of the software, and are there specific versions of the accounting software for the industry in which a business operates. Small businesses should also consider cloud computing options with regard to accounting software. **Cloud computing** refers to the fact that programs and data are stored off-site at another location. This means that accounting transactions can be entered from any computer, in some cases from smartphones, and are accessible anywhere in the world. Although for start-up businesses and the very smallest of businesses the adoption of a computerized accounting system appears to be a daunting task, in the long run, it is a key element for the long-term survival of the business.

Video Clip: Evaluating Accounting Software

This video discusses ways to determine what software is best.

A YouTube element has been excluded from this version of the text. You can view it online here.

Explore this link as well.

KEY TAKEAWAYS

- Good accounting systems can help a firm provide value to its customers through better billing and increased efficiency.
- Small businesses can be proactive in preserving cash flow through a variety of simple actions.
- Small businesses today can acquire very powerful computer accounting software packages. These packages are affordable and relatively easy to use.

EXERCISES

1. Besides the suggestions provided, what other approaches might a small business use to preserve cash flow?
2. Select five or six computerized accounting packages (including one of the cloud variety) that might be used by a start-up restaurant, and prepare a rigorous analysis of which should be selected and why.

Disaster Watch

Sales and cash-flow forecasting can often prove to be a significant challenge to small business owners. Assumptions have to be made, forecasting models must be selected, and calculations have to be made. In many cases, the forecasts will not be exact. This can be profoundly frustrating. Yet one of the great benefits of forecasting is that it may force a small business owner to think about what the future may hold. However, neither small businesses nor large businesses can predict or plan for all events. Certain events just happen. Given this element of unpredictable chance, businesses should think about how they might protect and conserve their cash flow should the “unthinkable” occur.

Yankee Gas had a project that involved installing a pipeline from Waterbury, Connecticut, to Wallingford, Connecticut. The original intent according to Yankee Gas was that all work on the pipeline would occur during the night to minimize customer disruptions. Or at least, this was what the storeowners along the line of the work were told. During one phase of the project, the company altered the schedule and began working during daytime hours. Installation involved digging a trench into which the pipeline was laid. This produced a major disruption that required that traffic be diverted away from several businesses’ main entrances and their parking lots. Multiple businesses found their customers had to be “forceful” with the local police to enter areas near the businesses. One of the businesses was a deli that focused on preparing fresh food on a daily basis. Food that was not sold during the day had to be discarded that night. This occurred during the summer months, which were the best times for this deli. A local gas station saw sales drop so precipitously that the owner was unable to meet the rent.

One of the responses on the part of many of the business owners was to seek compensation. Unfortunately, they found that no one was willing to accept responsibility for the detour policy. As an owner of a travel agency put it, “The town said it was the state, the state said it was the (local) police and the police said it was Yankee Gas.” While the owners await the resolution of responsibility, they have to consider the possibility of more street work during the following summer.

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SECTION OVERVIEW

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8.3.1: Introduction

Learning Objectives

After reading this chapter, you should be able to answer these questions:

- Why are financial reports and accounting information important, and who uses them?
- What are the differences between public and private accountants, and how has federal legislation affected their work?
- What are the six steps in the accounting cycle?
- In what terms does the balance sheet describe the financial condition of an organization?
- How does the income statement report a firm's profitability?
- Why is the statement of cash flows an important source of information?
- How can ratio analysis be used to identify a firm's financial strengths and weaknesses?
- What major trends affect the accounting industry today?

EXPLORING BUSINESS CAREERS

Theresa Lee: Future Glory

Theresa Lee always knew she would start her own business; it was just a matter of time. In 2013, after working as a designer in the Bay Area for more than a decade, Lee cofounded Future Glory, which specializes in handmade leather bags and accessories, now made in a small studio in the Dogpatch neighborhood of San Francisco.

Lee would be the first to tell you that she is a creative person and not so great with numbers and other business details. But the business details, including financial statements and cash flow, are key to any company. That's where accounting software like QuickBooks Online comes in handy. QuickBooks is a global online accounting program that has helped tech-savvy entrepreneurs take the worry out of crunching the numbers that can make or break their business ventures.

Intuit, the global leader in accounting software, has revolutionized the approach taken by small businesses with its products, including QuickBooks and TurboTax, programs that can be used by new businesses, independent contractors, product sellers, accountants, and other types of businesses. The company estimates more than two million global customers are currently using the online version of QuickBooks. Intuit provides online support that includes expert help, a resource blog, accounting advice, and other features utilized by QuickBooks users and those wanting more information about how to track typical business accounting functions.

As Lee points out, using a cloud-based accounting program has helped her gain control over company finances and provided insight into key business components such as profit and loss, cost of goods sold, and labor. In addition, QuickBooks' ability to work with other apps has helped her manage e-commerce sales efficiently. Lee uses Shopify as an e-commerce platform and PayPal as a payment system. By using a version of these apps designed to work with QuickBooks, Lee can import sales data (line items, fees, and taxes) as well as customer information into the accounting program. In addition, Shopify e-commerce data automatically syncs with QuickBooks, allowing her to keep bookkeeping activities to a minimum and giving her more time to focus on designing and creating new products and fulfilling the social goals of her business.

According to Lee, a significant part of her operation is dedicated to providing training and jobs to members of the local community. In addition, Future Glory supports various social causes, donating a portion of revenue to various organizations that assistant women and children in need.

Keeping a close eye on financial and accounting information is an important part of any business, whether it's a startup or a global conglomerate. The continuing revolution in technology has enabled bookkeeping and accounting activities to be done more efficiently while giving business owners, particularly small businesses like Future Glory, the time to spend expanding their business and giving back to their local communities.

Financial information is central to every organization. To operate effectively, businesses must have a way to track income, expenses, assets, and liabilities in an organized manner. Financial information is also essential for decision-making. Managers prepare financial reports using accounting, a set of procedures and guidelines for companies to follow when preparing financial

reports. Unless you understand basic accounting concepts, you will not be able to “speak” the standard financial language of businesses. This module examines the role of accounting in business, how accounting contributes to a company’s overall success, the three primary financial statements, and careers in accounting.

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8.3.2: Accounting - More than Numbers

Why Are Financial Reports and Accounting Information Important, and Who Uses Them?

Prior to 2001, accounting topics rarely made the news. That changed when Enron Corp.'s manipulation of accounting rules to improve its financial statements hit the front pages of newspapers. The company filed bankruptcy in 2001, and its former top executives were charged with multiple counts of conspiracy and fraud. Arthur Andersen, Enron's accounting firm, was indicted and convicted of obstruction of justice, and in 2002, the once-respected firm went out of business. Soon financial abuses at other companies—among them Tyco, Adelphia, WorldCom, and more recently Madoff Investment Securities—surfaced. Top executives at these and other companies were accused of knowingly flouting accepted accounting standards to inflate current profits and increase their compensation. Many were subsequently convicted:

- Investment securities broker Bernard Madoff and his accountant bilked investors out of more than $65 billion; Madoff is currently serving a 150-year prison term.
- Andrew Fastow, Enron's former chief financial officer, and Ben Glisan Jr., its former treasurer, pleaded guilty and received prison terms of 10 and five years, respectively. The company's former chairman, Ken Lay, and CEO, Jeffrey Skilling, were convicted of multiple charges.
- Bernard Ebbers, WorldCom's CEO, was sentenced to 25 years in prison for conspiracy, securities fraud, and filing false reports with regulatory agencies—crimes that totaled $11 billion in accounting fraud.
- Tyco's CEO L. Dennis Kozlowski was fined $70 million and sentenced to 8 to 25 years.

These and other cases raised critical concerns about the independence of those who audit a company's financial statements, questions of integrity and public trust, and issues with current financial reporting standards. Investors suffered as a result because the crisis in confidence sent stock prices tumbling, and companies lost billions in value.

So it's no surprise that more people are paying attention to accounting topics. We now recognize that accounting is the backbone of any business, providing a framework to understand the firm's financial condition. Reading about accounting irregularities, fraud, audit (financial statement review) shortcomings, out-of-control business executives, and bankruptcies, we have become very aware of the importance of accurate financial information and sound financial procedures.

All of us—whether we are self-employed, work for a local small business or a multinational Fortune 100 firm, or are not currently in the workforce—benefit from knowing the basics of accounting and financial statements. We can use this information to educate ourselves about companies before interviewing for a job or buying a company's stock or bonds. Employees at all levels of an organization use accounting information to monitor operations. They also must decide which financial information is important for their company or business unit, what those numbers mean, and how to use them to make decisions.



Figure 8.3.2.1: This advertisement by the U.S. Marshals Service underscores the greed and financial abuse caused by Bernard Madoff, as his personal belongings were seized by the government and auctioned off to help pay for the $65 billion lost by individuals who invested in his financial securities firm. Madoff is serving a jail term of 150 years for his fraudulent actions. *What should be the lessons learned by executives and accounting professionals about Madoff's behavior?* (Credit: P K /Flickr/ Attribution 2.0 Generic (CC BY 2.0))

This chapter starts by discussing why accounting is important for businesses and for users of financial information. Then it provides a brief overview of the accounting profession and the post-Enron regulatory environment. Next it presents an overview of basic accounting procedures, followed by a description of the three main financial statements—the balance sheet, the income statement, and the statement of cash flows. Using these statements, we then demonstrate how ratio analysis of financial statements can provide valuable information about a company's financial condition. Finally, the chapter explores current trends affecting the accounting profession.

Accounting Basics

Accounting is the process of collecting, recording, classifying, summarizing, reporting, and analyzing financial activities. It results in reports that describe the financial condition of an organization. All types of organizations—businesses, hospitals, schools, government agencies, and civic groups—use accounting procedures. Accounting provides a framework for looking at past performance, current financial health, and possible future performance. It also provides a framework for comparing the financial positions and financial performances of different firms. Understanding how to prepare and interpret financial reports will enable you to evaluate two companies and choose the one that is more likely to be a good investment.

The accounting system shown in Figure 8.3.2.2 converts the details of financial transactions (sales, payments, purchases, and so on) into a form that people can use to evaluate the firm and make decisions. Data become information, which in turn becomes reports. These reports describe a firm's financial position at one point in time and its financial performance during a specified period. Financial reports include *financial statements*, such as balance sheets and income statements, and special reports, such as sales and expense breakdowns by product line.



Figure 8.3.2.2: The Accounting System (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Who Uses Financial Reports?

The accounting system generates two types of financial reports, as shown in Figure 8.3.2.3: internal and external. Internal reports are used within the organization. As the term implies, **managerial accounting** provides financial information that managers inside the organization can use to evaluate and make decisions about current and future operations. For instance, the sales reports prepared by managerial accountants show how well marketing strategies are working, as well as the number of units sold in a specific period of time. This information can be used by a variety of managers within the company in operations as well as in production or manufacturing to plan future work based on current financial data. Production cost reports can help departments track and control costs, as well as zero in on the amount of labor needed to produce goods or services. In addition, managers may prepare very detailed financial reports for their own use and provide summary reports to top management, providing key executives with a "snapshot" of business operations in a specific timeframe.

Financial accounting focuses on preparing external financial reports that are used by outsiders; that is, people who have an interest in the business but are not part of the company's management. Although they provide useful information for managers, these reports are used primarily by lenders, suppliers, investors, government agencies, and others to assess the financial strength of a business.

To ensure accuracy and consistency in the way financial information is reported, accountants in the United States follow **generally accepted accounting principles (GAAP)** when preparing financial statements. The **Financial Accounting Standards Board (FASB)** is a private organization that is responsible for establishing financial accounting standards used in the United States.

Currently there are no international accounting standards. Because accounting practices vary from country to country, a multinational company must make sure that its financial statements conform to both its own country's accounting standards and those of the parent company's country. Often another country's standards are quite different from U.S. GAAP. In the past, the U.S. Financial Accounting Standards Board and the International Accounting Standards Board (IASB) worked together to develop global accounting standards that would make it easier to compare financial statements of foreign-based companies. However, as of this writing, the two organizations have not agreed on a global set of accounting standards.

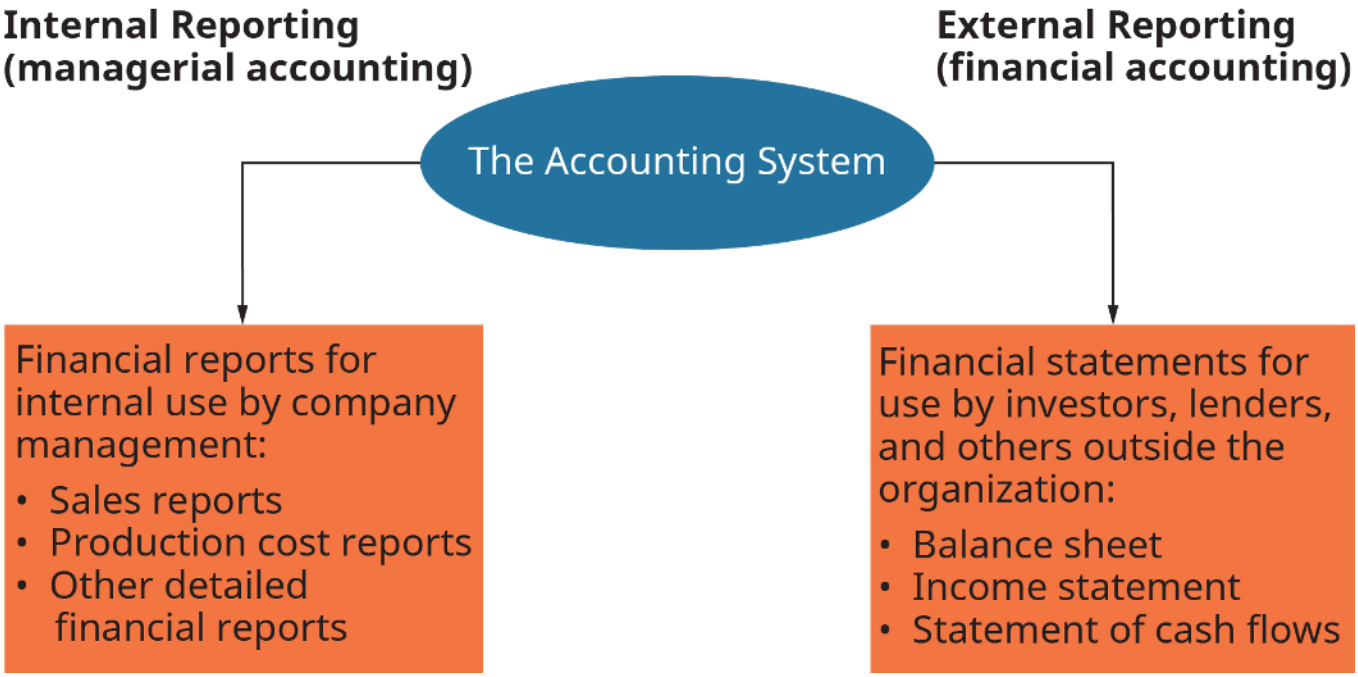


Figure 8.3.2.3: Reports Provided by the Accounting System (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

EXPANDING AROUND THE GLOBE

Global Accounting Standards Unlikely to Happen

Imagine being a CFO of a major multinational company with significant operations in 10 other countries. Because the accounting rules in those countries don't conform to GAAP, your staff has to prepare nine sets of financial reports that comply with the host country's rules—and also translate the figures to GAAP for consolidation into the parent company's statements in the United States. It's a massive undertaking for anyone.

The U.S. FASB and the IASB have tried to make this task easier, but progress has been slow. These groups hoped to develop international accounting standards that remove disparities between national and international standards, improve the quality of financial information worldwide, and simplify comparisons of financial statements across borders for both corporations and investors. Unfortunately, it looks like this goal of convergence is slipping away.

More than a decade ago, the FASB and the IASB jointly published a memorandum of understanding (MOU) reaffirming the two organizations' desire to create uniform global accounting standards. "This document underscores our strong commitment to continue to work together with the IASB to bring about a common set of accounting standards that will enhance the quality, comparability, and consistency of global financial reporting, enabling the world's capital markets to operate more effectively," said Robert Herz, FASB's former chairman. Sir David Tweedie, then chairman of the IASB, agreed: "The pragmatic approach described in the MOU enables us to provide much-needed stability for companies using IFRS [the IASB's International Financial Reporting Standards] in the near term," he commented. (About 150 countries worldwide currently use IFRS.)

As they worked toward convergence, the board members decided to develop a new set of common standards rather than try to reconcile the two standards. These new standards had to be better than existing ones, not simply eliminate differences. Unfortunately, merging GAAP and IFRS into a consistent set of international accounting standards has proven to be very difficult because of different approaches used in the two sets. For example, because of frequent litigation surrounding financial information in the United States, preparers of financial statements demand very detailed rules in all areas of accounting, in contrast to the IASB's approach of setting accounting principles and leaving preparers to apply them to individual situations they encounter. In addition, many companies doing business in the United States fear that moving toward global accounting standards would be very costly and time-consuming in terms of changing accounting software, employee and vendor training, and other business-related practices.

For now, the two organizations agree to disagree on when and if they can “converge” GAAP and IFRS into a global set of standards. However, they continue to keep each other informed about upcoming changes in standards that may impact accounting practices worldwide.

Critical Thinking Questions

1. Is it important to have a single set of international accounting standards for at least publicly owned companies? Defend your answer.
2. Do you think the two organizations will ever come close to uniform global accounting standards? Use a search engine and the archives of *CFO* magazine, **http://www.cfo.com**, to research this topic, and summarize your findings.

Financial statements are the chief element of the **annual report**, a yearly document that describes a firm’s financial status. Annual reports usually discuss the firm’s activities during the past year and its prospects for the future. Three primary financial statements included in the annual report are discussed and shown later in this chapter:

- The balance sheet
- The income statement
- The statement of cash flows

CONCEPT CHECK

1. Explain who uses financial information.
2. Differentiate between financial accounting and managerial accounting.
3. How do GAAP, the FASB, and the IASB influence the accounting industry?

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8.3.3: The Accounting Profession

What are the Differences Between Public and Private Accountants, and How Has Federal Legislation Affected Their Work?

When you think of accountants, do you picture someone who works in a back room, hunched over a desk, wearing a green eye shade and scrutinizing pages and pages of numbers? Although today's accountants still must love working with numbers, they now work closely with their clients to not only prepare financial reports but also help them develop good financial practices. Advances in technology have taken the tedium out of the number-crunching and data-gathering parts of the job and now offer powerful analytical tools as well. Therefore, accountants must keep up with information technology trends. The accounting profession has grown due to the increased complexity, size, and number of businesses and the frequent changes in the tax laws. Accounting is now a $95 billion-plus industry. The more than 1.4 million accountants in the United States are classified as either public accountants or private (corporate) accountants. They work in public accounting firms, private industry, education, and government, and about 10 percent are self-employed. The job outlook for accountants over the next decade is positive; the Bureau of Labor Statistics projects that accounting and auditing jobs will increase 11 percent faster than many other industries in the U.S. economy.

Public Accountants

Independent accountants who serve organizations and individuals on a fee basis are called **public accountants**. Public accountants offer a wide range of services, including preparation of financial statements and tax returns, independent auditing of financial records and accounting methods, and management consulting. **Auditing**, the process of reviewing the records used to prepare financial statements, is an important responsibility of public accountants. They issue a formal *auditor's opinion* indicating whether the statements have been prepared in accordance with accepted accounting rules. This written opinion is an important part of a company's annual report.

The largest public accounting firms, called the Big Four, operate worldwide and offer a variety of business consulting services in addition to accounting services. In order of size, they are Deloitte, PwC (PricewaterhouseCoopers), EY (Ernst & Young), and KPMG International. A former member of this group, Arthur Andersen, disbanded in 2002 as a result of the Enron scandal.

To become a **certified public accountant (CPA)**, an accountant must complete an approved bachelor's degree program and pass a test prepared by the American Institute of CPAs (AICPA). Each state also has requirements for CPAs, such as several years' on-the-job experience and continuing education. Only CPAs can issue the auditor's opinion on a firm's financial statements. Most CPAs first work for public accounting firms and later may become private accountants or financial managers. Of the more than 418,000 accountants who belong to the AICPA, 47 percent work in public accounting firms and 39 percent in business and industry.

Private Accountants

Accountants employed to serve one particular organization are **private accountants**. Their activities include preparing financial statements, auditing company records to be sure employees follow accounting policies and procedures, developing accounting systems, preparing tax returns, and providing financial information for management decision-making. Whereas some private accountants hold the CPA designation, managerial accountants also have a professional certification program. Requirements to become a **certified management accountant (CMA)** include passing an examination.

Reshaping the Accounting Environment

Although our attention was focused on big-name accounting scandals in the late 1990s and early 2000s, an epidemic of accounting irregularities was also taking place in the wider corporate arena. The number of companies restating annual financial statements grew at an alarming rate, tripling from 1997 to 2002. In the wake of the numerous corporate financial scandals, Congress and the accounting profession took major steps to prevent future accounting irregularities. These measures targeted the basic ways, cited by a report from the AICPA, that companies massaged financial reports through creative, aggressive, or inappropriate accounting techniques, including:

- Committing fraudulent financial reporting
- Stretching accounting rules to significantly enhance financial results
- Following appropriate accounting rules but using loopholes to manage financial results

Why did companies willfully push accounting to the edge—and over it—to artificially pump up revenues and profits? Looking at the companies involved in the scandals, some basic similarities have emerged:

- A company culture of arrogance and above-average tolerance for risk
- Interpretation of accounting policies to their advantage and manipulation of the rules to get to a predetermined result and conceal negative financial information
- Compensation packages tied to financial or operating targets, making executives and managers greedy and pressuring them to find sometimes-questionable ways to meet what may have been overly optimistic goals
- Ineffective checks and balances, such as audit committees, boards of directors, and financial control procedures, that were not independent from management
- Centralized financial reporting that was tightly controlled by top management, increasing the opportunity for fraud
- Financial performance benchmarks that were often out of line with the companies' industry
- Complicated business structures that clouded how the company made its profits
- Cash flow from operations that seemed out of line with reported earnings
- Acquisitions made quickly, often to show growth rather than for sound business reasons; management focused more on buying new companies than making the existing operations more profitable

Companies focused on making themselves look good in the short term, doing whatever was necessary to top past performance and to meet the expectations of investment analysts, who project earnings, and investors, who panic when a company misses the analysts' forecasts. Executives who benefited when stock prices rose had no incentive to question the earnings increases that led to the price gains.

These number games raised serious concerns about the quality of earnings and questions about the validity of financial reports. Investors discovered to their dismay that they could neither assume that auditors were adequately monitoring their clients' accounting methods nor depend on the integrity of published financial information.

Better Numbers Ahead

Over the past 15 years, a number of accounting reforms have been put in place to set better standards for accounting, auditing, and financial reporting. Investors, now aware of the possibility of various accounting shenanigans, are avoiding companies that use complicated financial structures and off-the-books financing.

In 2002, the **Sarbanes-Oxley Act** (commonly referred to as SOX) went into effect. This law, one of the most extensive pieces of business legislation passed by Congress, was designed to address the investing public's lack of trust in corporate America. It redefines the public corporation–auditor relationship and restricts the types of services auditors can provide to clients. The Act clarifies auditor-independence issues, places increased accountability on a company's senior executives and management, strengthens disclosure of insider transactions (an employee selling stock based on information not known by the public), and prohibits loans to executives.

An independent five-member Public Company Accounting Oversight Board (PCAOB) was given the authority to set and amend auditing, quality control, ethics, independence, and other standards for audit reports. The Act specifies that all PCAOB members be financially literate. Two members must have their CPA designation, and the other three cannot be or have been CPAs. Appointed and overseen by the Securities and Exchange Commission (SEC), the PCAOB can also inspect accounting firms; investigate breaches of securities law, standards, competency, and conduct; and take disciplinary action. The corporate Board registers public accounting firms, as the Act now requires. Altering or destroying key audit documents now carries felony charges and increased penalties.

Other key provisions of the Act cover the following areas:

- *Auditing standards:* The Board must include in its standards several requirements, such as maintaining audit work papers and other documentation for audit reports for seven years, the review and approval of audit reports by a second partner, and audit standards for quality control and review of internal control procedures.
- *Financial disclosure:* Companies must clearly disclose all transactions that may have a material current or future effect on their financial condition, including those that are off the books or with unconsolidated entities (related companies whose results the company is not required to combine with its own financial statements under current accounting rules). Management and major

stockholders must disclose transactions such as sales of company stock within two days of the transaction. The company must disclose its code of ethics for senior financial executives. Any significant changes in a company's operations or financial condition must be disclosed "on a rapid and current basis."

- *Financial statement certification:* Chief executive officers and chief financial officers must certify company financial statements, with severe criminal and civil penalties for false certification. If securities fraud results in restatement of financial reports, these executives will lose any stock-related profits and bonuses they received prior to the restatement.
- *Internal controls:* Each company must have appropriate internal control procedures in place for financial reporting, and its annual report must include a report on implementation of those controls to assure the integrity of financial reports.
- *Consulting work:* The Act restricts the non-auditing work auditors may perform for a client. In the past, the large accounting firms had expanded their role to include a wide range of advisory services that went beyond their traditional task of validating a company's financial information. Conflicts of interest arose when the same firm earned lucrative fees for both audit and consulting work for the same client.

Other regulatory organizations also took steps to prevent future abuses. In September 2002, the AICPA Auditing Standards Board(ASB) issued expanded guidelines to help auditors uncover fraud while conducting audits. The New York Stock Exchange stiffened its listing requirements so that the majority of directors at listed companies must be independent and not employees of the corporation. Nor can auditors serve on clients' boards for five years. Companies listed in the Nasdaq marketplace cannot hire former auditors at any level for three years.

In response to the passage of Sarbanes-Oxley and other regulations, companies implemented new control measures and improved existing ones. The burdens in both cost and time have been considerable. Many companies had to redesign and restructure financial systems to improve efficiency. Some finance executives believe that their investment in increased controls has improved shareholder perceptions of their company's ethics. Others, however, reported that costs depressed earnings and negatively affected stock prices. Despite the changes and costs associated with SOX compliance, 15 years after the law's implementation, many business executives believe that the process has helped them fine-tune financial activities and reporting while addressing dynamic changes in the market and other economic challenges.

CONCEPT CHECK

1. Compare the responsibilities of public and private accountants. How are they certified?
2. Summarize the major changes affecting accounting and corporate reporting and the reasons for them.

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8.3.4: Basic Accounting Procedures

What are the Six Steps in the Accounting Cycle?

Using generally accepted accounting principles, accountants record and report financial data in similar ways for all firms. They report their findings in financial statements that summarize a company's business transactions over a specified time period. As mentioned earlier, the three major financial statements are the balance sheet, income statement, and statement of cash flows.

People sometimes confuse accounting with bookkeeping. Accounting is a much broader concept. Bookkeeping, the system used to record a firm's financial transactions, is a routine, clerical process. Accountants take bookkeepers' transactions, classify and summarize the financial information, and then prepare and analyze financial reports. Accountants also develop and manage financial systems and help plan the firm's financial strategy.

The Accounting Equation

The accounting procedures used today are based on those developed in the late 15th century by an Italian monk, Brother Luca Pacioli. He defined the three main accounting elements as assets, liabilities, and owners' equity. **Assets** are things of value owned by a firm. They may be *tangible*, such as cash, equipment, and buildings, or *intangible*, such as a patent or trademarked name. **Liabilities**—also called *debts*—are what a firm owes to its creditors. **Owners' equity** is the total amount of investment in the firm minus any liabilities. Another term for owners' equity is *net worth*.

The relationship among these three elements is expressed in the accounting equation:

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$$

The accounting equation must always be in balance (that is, the total of the elements on one side of the equals sign must equal the total on the other side).

Suppose you start a coffee shop and put $10,000 in cash into the business. At that point, the business has assets of $10,000 and no liabilities. This would be the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

$$\$10{,}000 = \$0 + \$10{,}000$$

The liabilities are zero and owners' equity (the amount of your investment in the business) is $10,000. The equation balances.

To keep the accounting equation in balance, every transaction must be recorded as two entries. As each transaction is recorded, there is an equal and opposite event so that two accounts or records are changed. This method is called **double-entry bookkeeping**.

Suppose that after starting your business with $10,000 cash, you borrow another $10,000 from the bank. The accounting equation will change as follows:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$

$$\$10{,}000 = \$0 + \$10{,}000 \text{ — Initial Equation}$$

$$\$10{,}000 = \$10{,}000 + \$0 \text{ — Borrowing Transaction}$$

$$\$20{,}000 = \$10{,}000 + \$10{,}000 \text{ — Equation After Borrowing}$$

Now you have $20,000 in assets—your $10,000 in cash and the $10,000 loan proceeds from the bank. The bank loan is also recorded as a liability of $10,000 because it's a debt you must repay. Making two entries keeps the equation in balance.

The Accounting Cycle

The *accounting cycle* refers to the process of generating financial statements, beginning with a business transaction and ending with the preparation of the report. Figure 8.3.4.1 shows the six steps in the accounting cycle. The first step in the cycle is to analyze the data collected from many sources. All transactions that have a financial impact on the firm—sales, payments to employees and suppliers, interest and tax payments, purchases of inventory, and the like—must be documented. The accountant must review the documents to make sure they're complete.

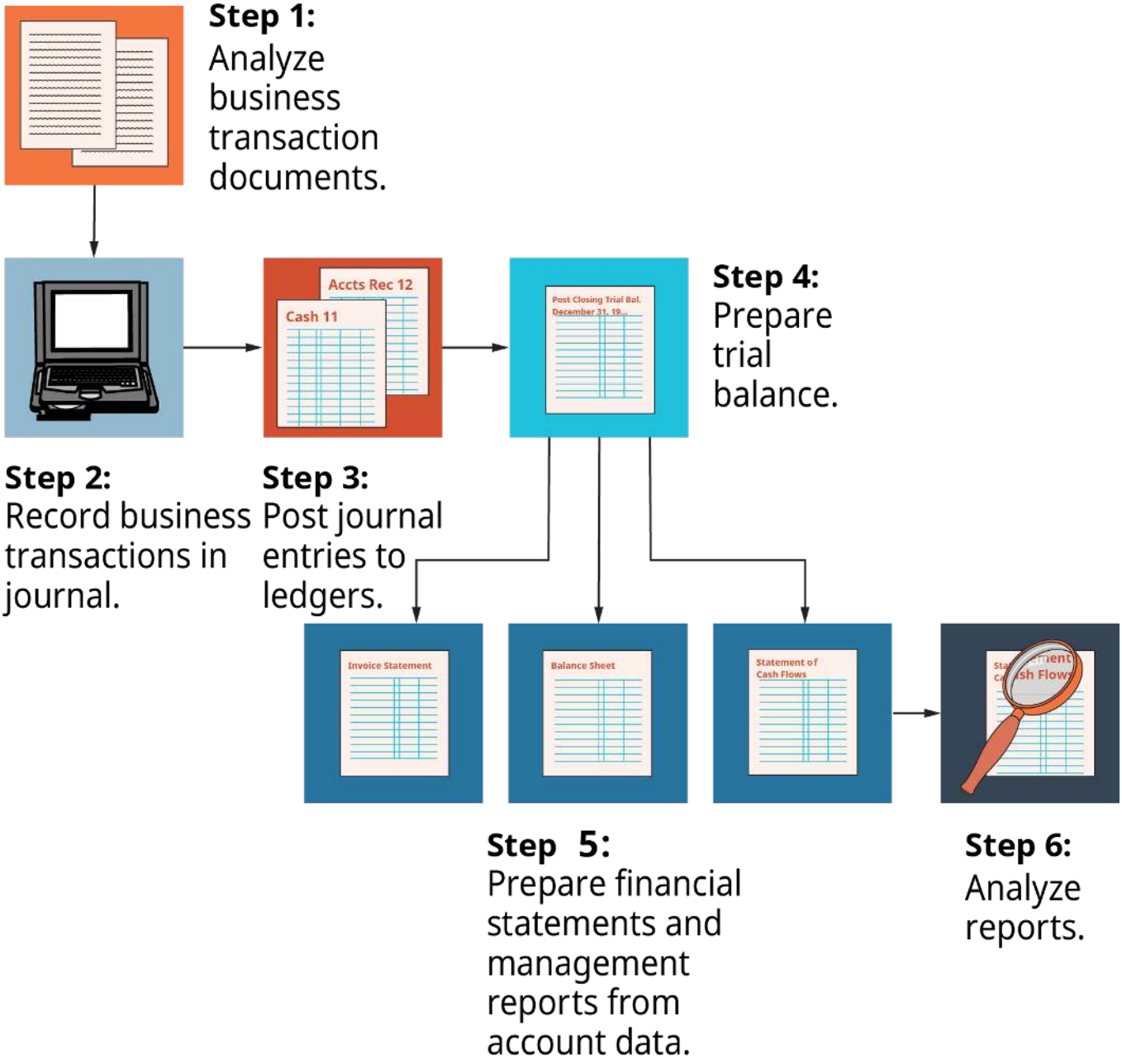


Figure 8.3.4.1: The Accounting Cycle (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Next, each transaction is recorded in a *journal*, a listing of financial transactions in chronological order. The journal entries are then recorded in *ledgers*, which show increases and decreases in specific asset, liability, and owners' equity accounts. The ledger totals for each account are summarized in a *trial balance*, which is used to confirm the accuracy of the figures. These values are used to prepare financial statements and management reports. Finally, individuals analyze these reports and make decisions based on the information in them.

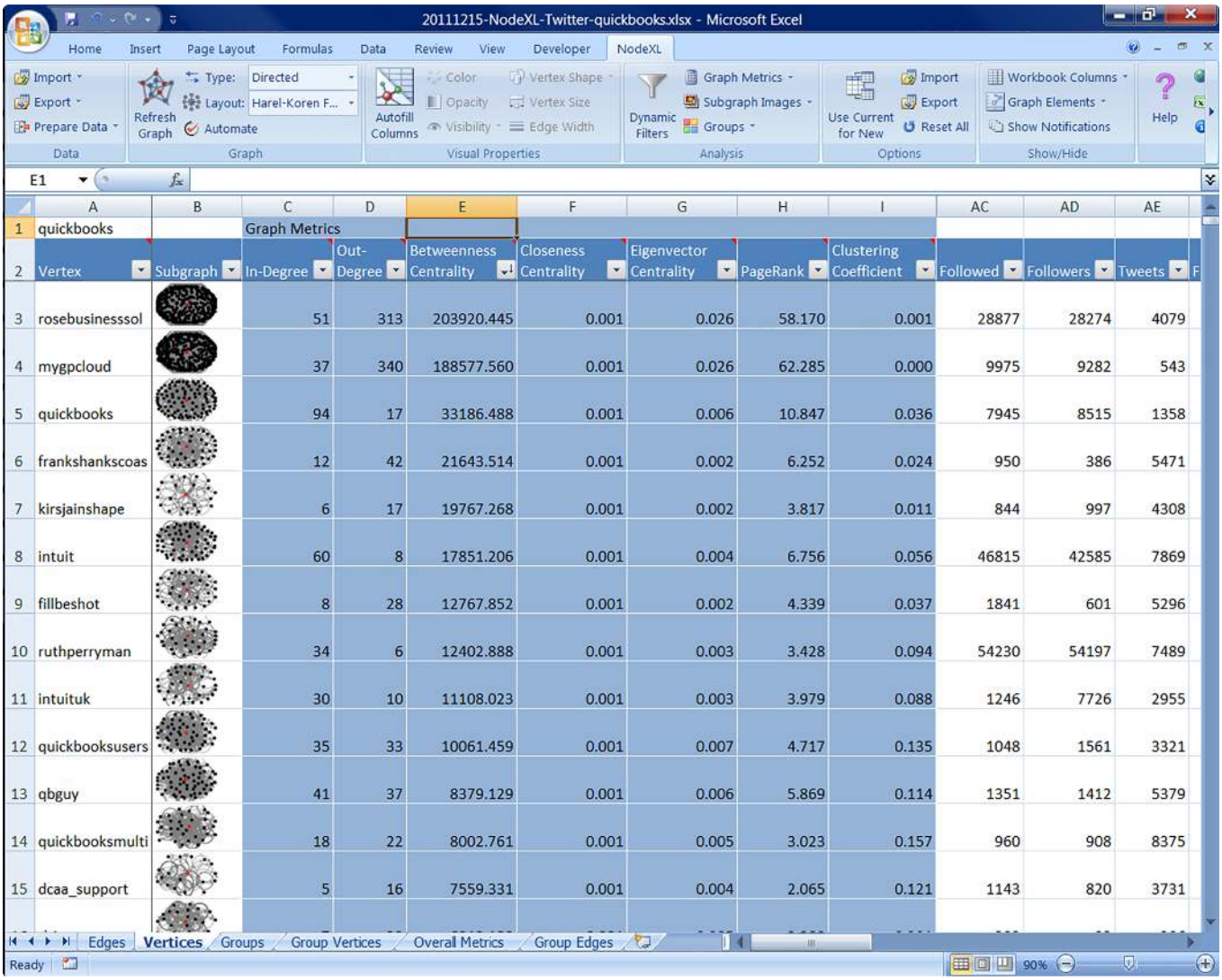


Figure 8.3.4.2: QuickBooks is a well-known software developer that provides business-management solutions to businesses of different sizes. The company's accounting software tools benefit professionals by automating a broad range of accounting and other business tasks. QuickBooks has become standard in the accounting and business fields, assisting in managerial decision-making and streamlining bookkeeping and accounting processes. *What accounting functions are typically incorporated into basic accounting software programs?* (Credit: Marc Smith/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Technological Advances

Over the past decade, technology has had a significant impact on the accounting industry. Computerized and online accounting programs now do many different things to make business operations and financial reporting more efficient. For example, most accounting packages offer basic modules that handle general ledger, sales order, accounts receivable, purchase order, accounts payable, and inventory control functions. Tax programs use accounting data to prepare tax returns and tax plans. Point-of-sale terminals used by many retail firms automatically record sales and do some of the bookkeeping. The Big Four and many other large public accounting firms develop accounting software for themselves and for clients.

Accounting and financial applications typically represent one of the largest portions of a company's software budget. Accounting software ranges from off-the-shelf programs for small businesses to full-scale customized enterprise resource planning systems for major corporations. Although these technological advances in accounting applications have made the financial aspects of running a small business much easier, entrepreneurs and other small-business owners should take to time to understand underlying accounting principles, which play an important role in evaluating just how financially sound a business enterprise really is.

MANAGING CHANGE

Data Analytics Become Effective CPA Tool

Knowledge is power, and understanding what your customers want and how your company can provide it often differentiates you from the competition. As the accounting field continues to take advantage of technological advances, it is important that data analytics become a key element of any accounting professional's toolbox.

Historically described as "paper pushers" who track financial information, today's accountants need to learn about big data and data analytics as part of their continuing education. Not long ago, an accountant's work finished when business financial statements were finalized and tax forms were ready to be filed with federal, state, and local governing bodies. Not anymore. With the revolution of computer technology, automation, and data collection from a myriad of sources, accountants can use data analytics to provide a clearer picture of the overall business environment for their companies and clients on an ongoing basis.

Data analytics can be defined as the process of examining numerous data sets (sometimes called big data) to draw conclusions about the information they contain, with the assistance of specialized systems and software. Using data analytics effectively can help businesses increase revenue, expand operations, maximize customer service, and more. Accountants can use data analytics to make more accurate and detailed forecasts; help companies link diverse financial and nonfinancial data sets, which provides a more comprehensive reporting of their overall performance to shareholders and others; assess and manage risk across the entire organization; and identify possible fraud.

Data analytics can also improve and enhance the auditing process because more information will now be collected, which allows for analysis of *full* data sets in situations where only samples were audited previously. In addition, continuous monitoring will be easier to accomplish using data sets that are comprehensive.

Accounting professionals who can adapt to quickly changing technology such as data analytics will not only expand the scope of their expertise but also provide financial guidance that will give their companies and clients a strong strategic advantage over competitors.

Critical Thinking Questions

1. How can accountants use data analytics to enhance the services they provide to their clients?
2. Is the seismic shift in technology a good thing for professional accountants? Explain your reasoning.

CONCEPT CHECK

1. Explain the accounting equation.
2. Describe the six-step accounting cycle.
3. What role do computers and other technology play in accounting?

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8.3.5: The Balance Sheet

In What Terms Does the Balance Sheet Describe the Financial Condition of an Organization?

The **balance sheet**, one of three financial statements generated from the accounting system, summarizes a firm's financial position at a specific point in time. It reports the resources of a company (assets), the company's obligations (liabilities), and the difference between what is owned (assets) and what is owed (liabilities), or owners' equity.

The assets are listed in order of their **liquidity**, the speed with which they can be converted to cash. The most liquid assets come first, and the least liquid are last. Because cash is the most liquid asset, it is listed first. Buildings, on the other hand, have to be sold to be converted to cash, so they are listed after cash. Liabilities are arranged similarly: liabilities due in the short term are listed before those due in the long term.

The balance sheet as of December 31, 2018, for Delicious Desserts, Inc., a fictitious bakery, is illustrated in the table below. The basic accounting equation is reflected in the three totals highlighted on the balance sheet: assets of $148,900 equal the sum of liabilities and owners' equity ($70,150 + $78,750). The three main categories of accounts on the balance sheet are explained below.

Balance Sheet as of December 31, 2018 for Delicious Desserts, Inc.			
Assets			
Current assets: Cash Marketable securities Accounts receivable Less: Allowance for doubtful accounts Notes receivable Inventory Total current assets	 $45,000 1,300	 $15,000 4,500 43,700 5,000 15,000	 83,200
Fixed assets: Bakery equipment Less: Accumulated depreciation Furniture and fixtures Less: Accumulated depreciation Total fixed assets Intangible assets: Trademark Goodwill Total intangible assets Total assets	 $56,000 16,000 $18,450 4,250	 $40,000 14,200 $4,500 7,000	 54,200 11,500 $148,900
Liabilities and owners' equity			
Current liabilities: Accounts payable Notes payable Accrued expenses Income taxes payable Current portion of long-term debt Total current liabilities	 $30,650 15,000 4,500 5,000 5,000	 $60,150	
Long-term liabilities: Bank loan for bakery equipment Total long-term liabilities Total liabilities	 $10,000	 10,000	 $ 70,150
Owners' equity: Common stock (10,000 shares outstanding) Retained earnings Total owners' equity Total liabilities and owners' equity	 	 $30,000 48,750	 78,750 $148,900

Assets

Assets can be divided into three broad categories: current assets, fixed assets, and intangible assets. **Current assets** are assets that can or will be converted to cash within the next 12 months. They are important because they provide the funds used to pay the firm's current bills. They also represent the amount of money the firm can quickly raise. Current assets include:

- *Cash:* Funds on hand or in a bank
- *Marketable securities:* Temporary investments of excess cash that can readily be converted to cash
- *Accounts receivable:* Amounts owed to the firm by customers who bought goods or services on credit
- *Notes receivable:* Amounts owed to the firm by customers or others to whom it lent money
- *Inventory:* Stock of goods being held for production or for sale to customers

Fixed assets are long-term assets used by the firm for more than a year. They tend to be used in production and include land, buildings, machinery, equipment, furniture, and fixtures. Except for land, fixed assets wear out and become outdated over time. Thus, they decrease in value every year. This declining value is accounted for through depreciation. **Depreciation** is the allocation of the asset's original cost to the years in which it is expected to produce revenues. A portion of the cost of a depreciable asset—a building or piece of equipment, for instance—is charged to each of the years in which it is expected to provide benefits. This practice helps match the asset's cost against the revenues it provides. Because it is impossible to know exactly how long an asset will last, estimates are used. They are based on past experience with similar items or IRS guidelines for assets of that type. Notice that, through 2018, Delicious Desserts has taken a total of $16,000 in depreciation on its bakery equipment.

Intangible assets are long-term assets with no physical existence. Common examples are patents, copyrights, trademarks, and goodwill. *Patents* and *copyrights* shield the firm from direct competition, so their benefits are more protective than productive. For instance, no one can use more than a small amount of copyrighted material without permission from the copyright holder. *Trademarks* are registered names that can be sold or licensed to others. One of Delicious Desserts' intangible assets is a trademark valued at $4,500. *Goodwill* occurs when a company pays more for an acquired firm than the value of its tangible assets. Delicious Desserts' other tangible asset is goodwill of $7,000.

Liabilities

Liabilities are the amounts a firm owes to creditors. Those liabilities coming due sooner—current liabilities—are listed first on the balance sheet, followed by long-term liabilities.

Current liabilities are those due within a year of the date of the balance sheet. These short-term claims may strain the firm's current assets because they must be paid in the near future. Current liabilities include:

- *Accounts payable:* Amounts the firm owes for credit purchases due within a year. This account is the liability counterpart of accounts receivable.
- *Notes payable:* Short-term loans from banks, suppliers, or others that must be repaid within a year. For example, Delicious Desserts has a six-month, $15,000 loan from its bank that is a note payable.
- *Accrued expenses:* Expenses, typically for wages and taxes, that have accumulated and must be paid at a specified future date within the year although the firm has not received a bill
- *Income taxes payable:* Taxes owed for the current operating period but not yet paid. Taxes are often shown separately when they are a large amount.
- *Current portion of long-term debt:* Any repayment on long-term debt due within the year. Delicious Desserts is scheduled to repay $5,000 on its equipment loan in the coming year.

Long-term liabilities come due more than one year after the date of the balance sheet. They include bank loans (such as Delicious Desserts' $10,000 loan for bakery equipment), mortgages on buildings, and the company's bonds sold to others.

Owners' Equity

Owners' equity is the owners' total investment in the business after all liabilities have been paid. For sole proprietorships and partnerships, amounts put in by the owners are recorded as capital. In a corporation, the owners provide capital by buying the firm's common stock. For Delicious Desserts, the total common stock investment is $30,000. **Retained earnings** are the amounts left

over from profitable operations since the firm's beginning. They are total profits minus all dividends (distributions of profits) paid to stockholders. Delicious Desserts has $48,750 in retained earnings.

CONCEPT CHECK

1. What is a balance sheet?
2. What are the three main categories of accounts on the balance sheet, and how do they relate to the accounting equation?
3. How do retained earnings relate to owners' equity?

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8.3.6: The Income Statement

How Does the Income Statement Report a Firm's Profitability?

The balance sheet shows the firm's financial position at a certain point in time. The **income statement** summarizes the firm's revenues and expenses and shows its total profit or loss over a period of time. Most companies prepare monthly income statements for management and quarterly and annual statements for use by investors, creditors, and other outsiders. The primary elements of the income statement are revenues, expenses, and net income (or net loss). The income statement for Delicious Desserts for the year ended December 31, 2018, is shown in the table below.

Income Statement for Delicious Desserts, Inc. for the Year Ending December 31, 2018			
Revenues			
Gross sales		$275,000	
Less: Sales discounts		2,500	
Less: Returns and allowances		2,000	
Net sales			$270,500
Cost of Goods Sold			
Beginning inventory, January 1		$ 18,000	
Cost of goods manufactured		109,500	
Total cost of goods available for sale		$127,500	
Less: Ending inventory December 31		15,000	
Cost of goods sold			112,500
Gross profit			**$158,000**
Operating Expenses			
Selling expenses			
Sales salaries	$31,000		
Advertising	16,000		
Other selling expenses	18,000		
Total selling expenses		$ 65,000	
General and administrative expenses			
Professional and office salaries	$20,500		
Utilities	5,000		
Office supplies	1,500		
Interest	3,600		
Insurance	2,500		
Rent	17,000		
Total general and administrative expenses		50,100	
Total operating expenses			115,100
Net profit before taxes			**$ 42,900**
Less: Income taxes			10,725
Net profit			**$ 32,175**

Revenues

Revenues are the dollar amount of sales plus any other income received from sources such as interest, dividends, and rents. The revenues of Delicious Desserts arise from sales of its bakery products. Revenues are determined starting with **gross sales**, the total dollar amount of a company's sales. Delicious Desserts had two deductions from gross sales. *Sales discounts* are price reductions given to customers that pay their bills early. For example, Delicious Desserts gives sales discounts to restaurants that buy in bulk and pay at delivery. *Returns and allowances* is the dollar amount of merchandise returned by customers because they didn't like a product or because it was damaged or defective. **Net sales** is the amount left after deducting sales discounts and returns and allowances from gross sales. Delicious Desserts' gross sales were reduced by $4,500, leaving net sales of $270,500.

Expenses

Expenses are the costs of generating revenues. Two types are recorded on the income statement: cost of goods sold and operating expenses.

The **cost of goods sold** is the total expense of buying or producing the firm's goods or services. For manufacturers, cost of goods sold includes all costs directly related to production: purchases of raw materials and parts, labor, and factory overhead (utilities, factory maintenance, machinery repair). For wholesalers and retailers, it is the cost of goods bought for resale. For all sellers, cost of goods sold includes all the expenses of preparing the goods for sale, such as shipping and packaging.

Delicious Desserts' cost of goods sold is based on the value of inventory on hand at the beginning of the accounting period, $18,000. During the year, the company spent $109,500 to produce its baked goods. This figure includes the cost of raw materials, labor costs for bakery workers, and the cost of operating the bakery area. Adding the cost of goods manufactured to the value of beginning inventory, we get the total cost of goods available for sale, $127,500. To determine the cost of goods sold for the year, we subtract the cost of inventory at the end of the period:

$$\$127,500 - \$15,000 = \$112,500$$

The amount a company earns after paying to produce or buy its products but before deducting operating expenses is the **gross profit**. It is the difference between net sales and cost of goods sold. Because service firms do not produce goods, their gross profit equals net sales. Gross profit is a critical number for a company because it is the source of funds to cover all the firm's other expenses.

The other major expense category is **operating expenses**. These are the expenses of running the business that are not related directly to producing or buying its products. The two main types of operating expenses are selling expenses and general and administrative expenses. *Selling expenses* are those related to marketing and distributing the company's products. They include salaries and commissions paid to salespeople and the costs of advertising, sales supplies, delivery, and other items that can be linked to sales activity, such as insurance, telephone and other utilities, and postage. *General and administrative expenses* are the business expenses that cannot be linked to either cost of goods sold or sales. Examples of general and administrative expenses are salaries of top managers and office support staff; utilities; office supplies; interest expense; fees for accounting, consulting, and legal services; insurance; and rent. Delicious Desserts' operating expenses totaled $115,100.

Net Profit or Loss

The final figure—or bottom line—on an income statement is the **net profit** (or **net income**) or **net loss**. It is calculated by subtracting all expenses from revenues. If revenues are more than expenses, the result is a net profit. If expenses exceed revenues, a net loss results.

Several steps are involved in finding net profit or loss. First, cost of goods sold is deducted from net sales to get the gross profit. Then total operating expenses are subtracted from gross profit to get the net profit before taxes. Finally, income taxes are deducted to get the net profit. As shown in the table above, Delicious Desserts earned a net profit of $32,175 in 2018.

It is very important to recognize that profit does not represent cash. The income statement is a summary of the firm's operating results during some time period. It does not present the firm's actual cash flows during the period. Those are summarized in the statement of cash flows, which is discussed briefly in the next section.

CONCEPT CHECK

1. What is an income statement? How does it differ from the balance sheet?
2. Describe the key parts of the income statement. Distinguish between gross sales and net sales.
3. How is net profit or loss calculated?

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8.3.7: The Statement of Cash Flows

Why is the Statement of Cash Flows an Important Source of Information?

Net profit or loss is one measure of a company's financial performance. However, creditors and investors are also keenly interested in how much cash a business generates and how it is used. The **statement of cash flows**, a summary of the money flowing into and out of a firm, is the financial statement used to assess the sources and uses of cash during a certain period, typically one year. All publicly traded firms must include a statement of cash flows in their financial reports to shareholders. The statement of cash flows tracks the firm's cash receipts and cash payments. It gives financial managers and analysts a way to identify cash flow problems and assess the firm's financial viability.



Figure 8.3.7.1: Coinstar is a cash cow—literally. The company established a niche counting loose change at the exits of supermarkets and other retailers everywhere. For a small fee, Coinstar's coin-counting machines turn penny jars and piggy banks into cash vouchers, a no-fee eGift card, or a charity donation. Recently Coinstar's parent company, Outerwall, was acquired by a private equity firm in a $1.6 billion deal to take the holding company private. *What does the statement of cash flows indicate about a company's financial status?* (Credit: Mike Mozart/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Using income statement and balance sheet data, the statement of cash flows divides the firm's cash flows into three groups:

- *Cash flow from operating activities:* Those related to the production of the firm's goods or services
- *Cash flow from investment activities:* Those related to the purchase and sale of fixed assets
- *Cash flow from financing activities:* Those related to debt and equity financing

Delicious Desserts' statement of cash flows for 2018 is presented in the table below. It shows that the company's cash and marketable securities have increased over the last year. And during the year the company generated enough cash flow to increase

inventory and fixed assets and to reduce accounts payable, accruals, notes payable, and long-term debt.

Statement of Cash Flows for Delicious Desserts, Inc. for 2018		
Cash Flow from Operating Activities		
Net profit after taxes	$27,175	
Depreciation	1,500	
Decrease in accounts receivable	3,140	
Increase in inventory	(4,500)	
Decrease in accounts payable	(2,065)	
Decrease in accruals	(1,035)	
Cash provided by operating activities		$24,215
Cash Flow from Investment Activities		
Increase in gross fixed assets	($ 5,000)	
Cash used in investment activities		($5,000)
Cash Flow from Financing Activities		
Decrease in notes payable	($ 3,000)	
Decrease in long-term debt	(1,000)	
Cash used by financing activities		($4,000)
Net increase in cash and marketable securities		**$15,215**

CONCEPT CHECK

1. What is the purpose of the statement of cash flows?
2. Why has cash flow become such an important measure of a firm's financial condition?
3. What situations can you cite from the chapter that support your answer?

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8.3.8: Analyzing Financial Statements

How Can Ratio Analysis Be Used To Identify a Firm's Financial Strengths and Weaknesses?

Individually, the balance sheet, income statement, and statement of cash flows provide insight into the firm's operations, profitability, and overall financial condition. By studying the relationships among the financial statements, however, one can gain even more insight into a firm's financial condition and performance. A good way to think about analyzing financial statements is to compare it a fitness trainer putting clients through various well-established assessments and metrics to determine whether a specialized fitness program is paying dividends for the person in terms of better strength, endurance, and overall health. Financial statements at any given time can provide a snapshot of a company's overall health. Company management must use certain standards and measurements to determine whether they need to implement additional strategies to keep the company fit and making a profit.

Ratio analysis involves calculating and interpreting financial ratios using data taken from the firm's financial statements in order to assess its condition and performance. A financial ratio states the relationship between financial data on a percentage basis. For instance, current assets might be viewed relative to current liabilities or sales relative to assets. The ratios can then be compared over time, typically three to five years. A firm's ratios can also be compared to industry averages or to those of another company in the same industry. Period-to-period and industry ratios provide a meaningful basis for comparison, so that we can answer questions such as, "Is this particular ratio good or bad?"

It's important to remember that ratio analysis is based on historical data and may not indicate future financial performance. Ratio analysis merely highlights potential problems; it does not prove that they exist. However, ratios can help managers monitor the firm's performance from period to period to understand operations better and identify trouble spots.

Ratios are also important to a firm's present and prospective creditors (lenders), who want to see if the firm can repay what it borrows and assess the firm's financial health. Often loan agreements require firms to maintain minimum levels of specific ratios. Both present and prospective shareholders use ratio analysis to look at the company's historical performance and trends over time.

Ratios can be classified by what they measure: liquidity, profitability, activity, and debt. Using Delicious Desserts' 2018 balance sheet and income statement, we can calculate and interpret the key ratios in each group. The table below summarizes the calculations of these ratios for Delicious Desserts. We'll now discuss how to calculate the ratios and, more important, how to interpret the ratio value.

Liquidity Ratios

Liquidity ratios measure the firm's ability to pay its short-term debts as they come due. These ratios are of special interest to the firm's creditors. The three main measures of liquidity are the current ratio, the acid-test (quick) ratio, and net working capital.

The **current ratio** is the ratio of total current assets to total current liabilities. Traditionally, a current ratio of 2 ($2 of current assets for every $1 of current liabilities) has been considered good. Whether it is sufficient depends on the industry in which the firm operates. Public utilities, which have a very steady cash flow, operate quite well with a current ratio well below 2. A current ratio of 2 might not be adequate for manufacturers and merchandisers that carry high inventories and have lots of receivables. The current ratio for Delicious Desserts for 2018 is 1.4. This means little without a basis for comparison. If the analyst found that the industry average for small bakeries was 2.4, Delicious Desserts would appear to have low liquidity.

The **acid-test (quick) ratio** is like the current ratio except that it excludes inventory, which is the least-liquid current asset. The acid-test ratio is used to measure the firm's ability to pay its current liabilities without selling inventory. The name *acid-test* implies that this ratio is a crucial test of the firm's liquidity. An acid-test ratio of at least 1 is preferred. But again, what is an acceptable value varies by industry. The acid-test ratio is a good measure of liquidity when inventory cannot easily be converted to cash (for instance, if it consists of very specialized goods with a limited market). If inventory is liquid, the current ratio is better. Delicious Desserts' acid-test ratio for 2018 is 1.1. Because the bakery's products are perishable, it does not carry large inventories. Thus, the values of its acid-test and current ratios are fairly close. At a manufacturing company, however, inventory typically makes up a large portion of current assets, so the acid-test ratio will be lower than the current ratio.

Ratio Analysis for Delicious Desserts at Year-End 2018			
Ratio	Formula	Calculation	Result
Liquidity Ratios			
Current ratio	Total current assets / Total current liabilities	$83,200 / $60,150	1.4
Acid-test (quick) ratio	Total current assets–inventory / Total current liabilities	($83,200 − $15,000) / $60,150	1.1
Net working capital	Total current assets – Total current liabilities	$83,200 − $60,150	$23,050
Profitability Ratios			
Net profit margin	Net profit / Net sales	$32,175 / $270,500	11.9%
Return on equity	Net profit / Total owners' equity	$32,175 / $78,750	40.9%
Earnings per share	Net profit / Number of shares of common stock outstanding	$32,175 / 10,000	$3.22
Activity Ratio			
Inventory turnover	Cost of goods sold / Average inventory		
	Cost of goods sold / ((Beginning inventory + Ending inventory) / 2)	$112,500 / (($18,000 + $15,000) / 2)	
		$112,500 / $16,500	6.8 times
Debt Ratio			
Debt-to-equity ratio	Total liabilities / Owners' equity	$70,150 / $78,750	89.1%

Net working capital, though not really a ratio, is often used to measure a firm's overall liquidity. It is calculated by subtracting total current liabilities from total current assets. Delicious Desserts' net working capital for 2018 is $23,050. Comparisons of net working capital over time often help in assessing a firm's liquidity.

Profitability Ratios

To measure profitability, a firm's profits can be related to its sales, equity, or stock value. **Profitability ratios** measure how well the firm is using its resources to generate profit and how efficiently it is being managed. The main profitability ratios are net profit margin, return on equity, and earnings per share.

The ratio of net profit to net sales is the **net profit margin**, also called *return on sales*. It measures the percentage of each sales dollar remaining after all expenses, including taxes, have been deducted. Higher net profit margins are better than lower ones. The net profit margin is often used to measure the firm's earning power. "Good" net profit margins differ quite a bit from industry to industry. A grocery store usually has a very low net profit margin, perhaps below 1 percent, whereas a jewelry store's net profit margin would probably exceed 10 percent. Delicious Desserts' net profit margin for 2018 is 11.9 percent. In other words, Delicious Desserts is earning 11.9 cents on each dollar of sales.



Figure 8.3.8.1: For giant retailers such as Macy's, the high expense of operating a brick-and-mortar store counters the elevated markup on merchandise, resulting in slim profit margins. Because competition forces marketers to keep prices low, it is often a retailer's cost-cutting strategy, not initial markup or sales volume, that determines whether a business will be profitable. *What expenses other than payroll and the cost of merchandise affect a retailer's net profit margin?* (Credit: Mike Mozart/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

The ratio of net profit to total owners' equity is called **return on equity (ROE)**. It measures the return that owners receive on their investment in the firm, a major reason for investing in a company's stock. Delicious Desserts has a 40.9 percent ROE for 2018. On the surface, a 40.9 percent ROE seems quite good. But the level of risk in the business and the ROE of other firms in the same industry must also be considered. The higher the risk, the greater the ROE investors look for. A firm's ROE can also be compared to past values to see how the company is performing over time.

Earnings per share (EPS) is the ratio of net profit to the number of shares of common stock outstanding. It measures the number of dollars earned by each share of stock. EPS values are closely watched by investors and are considered an important sign of success. EPS also indicates a firm's ability to pay dividends. Note that EPS is the dollar amount earned by each share, not the actual amount given to stockholders in the form of dividends. Some earnings may be put back into the firm. Delicious Desserts' EPS for 2018 is $3.22.

Activity Ratios

Activity ratios measure how well a firm uses its assets. They reflect the speed with which resources are converted to cash or sales. A frequently used activity ratio is inventory turnover. The **inventory turnover ratio** measures the speed with which inventory moves through the firm and is turned into sales. It is calculated by dividing cost of goods sold by the average inventory. (Average inventory is estimated by adding the beginning and ending inventories for the year and dividing by 2.) Based on its 2018 financial data, Delicious Desserts' inventory, on average, is turned into sales 6.8 times each year, or about once every 54 days (365 days ÷

6.8). The acceptable turnover ratio depends on the line of business. A grocery store would have a high turnover ratio, maybe 20 times a year, whereas the turnover for a heavy equipment manufacturer might be only three times a year.

Debt Ratios

Debt ratios measure the degree and effect of the firm's use of borrowed funds (debt) to finance its operations. These ratios are especially important to lenders and investors. They want to make sure the firm has a healthy mix of debt and equity. If the firm relies too much on debt, it may have trouble meeting interest payments and repaying loans. The most important debt ratio is the debt-to-equity ratio.

The **debt-to-equity ratio** measures the relationship between the amount of debt financing (borrowing) and the amount of equity financing (owners' funds). It is calculated by dividing total liabilities by owners' equity. In general, the lower the ratio, the better. But it is important to assess the debt-to-equity ratio against both past values and industry averages. Delicious Desserts' ratio for 2018 is 89.1 percent. The ratio indicates that the company has 89 cents of debt for every dollar the owners have provided. A ratio above 100 percent means the firm has more debt than equity. In such a case, the lenders are providing more financing than the owners.

CONCEPT CHECK

1. How can ratio analysis be used to interpret financial statements?
2. Name the main liquidity and profitability ratios, and explain what they indicate.
3. What kinds of information do activity ratios give? Why are debt ratios of concern to lenders and investors?

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8.3.9: Trends in Accounting

What Major Trends Affect the Accounting Industry Today?

The post-SOX business environment has brought many changes to the accounting profession. When the public accounting industry could no longer regulate itself back in the late 1990s and early 2000s, it became subject to formal regulation for the first time. This regulatory environment set higher standards for audit procedures, which actually helped public companies fine-tune their financial reporting procedures, despite the added costs and labor hours needed to comply with SOX. Once again the core auditing business, rather than financial advisory and management consulting services, became the primary focus of public accounting firms. The relationship between accountants and their clients has also changed, and the role of chief audit executive has taken on more visibility in many large organizations. In addition, the FASB has made slow but steady progress in making changes related to GAAP, including a separate decision-making framework for users and preparers of private company financial statements. There are several other important trends that may affect the accounting industry over the next several years, including cloud computing services, automation, and staffing challenges.

Cloud-Based Services

The internet and cloud technology continue to disrupt many industries, including accounting, and clients expect their accountants to be up to speed on how financial data and other accounting information can be entered, accessed, and discussed in a very short period of time. For the most part, gone are the days when accountants and their support staff spend hours manually inputting data that gets “re-hydrated” into standardized accounting and financial statements, and reams of paper generate a company’s weekly, monthly, or yearly reports.

According to recent research, cloud-based accounting firms add five times more clients than traditional accounting firms because businesses expect their accountants to be able to use technology to create the company’s financial picture in real time, while assisting them in decision-making about where to go next in terms of profitability, sales, expansion, etc. In addition, it is estimated that more than 90 percent of small and medium-sized companies use cloud-based accounting software, which helps them synthesize the information they collect for their many important financial statements. This use of computerized accounting programs offers many opportunities to accountants to shift their focus when it comes to attracting and retaining business clients.

Automation

In addition to cloud-based services, automation will continue to play an important role in the accounting industry, particularly in auditing services, where the manual gathering and inputting of information can be an inefficient and sometimes inaccurate process. Being able to automate this process will help generate complete sets of data that will improve the overall details of the auditing process. In addition, accountants who can use a client’s data files from their business operations and import this information into a tax or accounting software package will streamline the overall accounting process and lessen the tedious work of data entry.

Staffing Challenges

As these and other disruptive technologies change the focus of accounting work, the challenge of hiring the right staff to use these new tools intensifies. With accounting processes becoming automated and less time-intensive, some accounting firms are becoming more connected to their clients and increasing their advisory services when it comes to daily business operations. This change in approach will likely have an impact on the type of experienced employees accountants hire in the future. In addition, because most services are now cloud-based and financial data is available rather quickly, businesses are apt to change accounting firms faster than in the past if they are unsatisfied with the services they receive. Accountants have a great opportunity to expand their business portfolios and increase their client list by leveraging technology as part of their overall corporate strategies.

MANAGING CHANGE

Attracting and Retaining Millennial CPAs

Much has been written about millennials, the population segment born between 1980 and 2000. As the older baby boomer generation continues to retire, millennials now make up the largest group in the U.S. labor force. This group will continue to shape the workplace over the next few decades.

Businesses and other organizations cannot ignore this group and their expectations about employment. To be successful, today's accounting firms—whether Big 4 firms or small and mid-sized businesses—need to understand what makes millennials tick, what is important to them, what makes them look for new opportunities both within and outside the organization—and how to retain them.

Global accounting services company PwC recently partnered with several other institutions to conduct a two-year generational study about the attitudes of millennial employees. Key findings suggest that millennials want flexibility in their work lives that leads to an enjoyable work-life balance, appreciation for the work they accomplish, challenges that will help them grow in their careers, and continued support from employers. As a result of this study, PwC made several changes to its own work environment to attract and retain millennial workers, including flexible schedules, relaxed dress codes, greater communication at all levels of the company, and a renewed commitment to transparency within the organization.

PwC is not alone in shifting its organizational culture to address some of the issues millennials say are important factors for them within the work environment. For example, Baker Tilly, another top accounting firm, recognizes that more than half its workforce consists of millennials who have helped shape the company's approach to work. The themes of flexibility and trust permeate the company's culture, which reinforces employees' motivation to be engaged in work that is meaningful, satisfying, and helps them develop as individuals.

Here are some other strategies accounting firms might employ to keep their 30-something employees from jumping ship:

- *Initiate onboarding activities quickly:* Although training accounting professionals takes time, companies should engage and train new employees quickly to immerse them in organizational culture and assign them work they view as meaningful.
- *Assign mentors from the start:* Millennials want to know their work makes a difference, so what better way to get them involved right from the start than to make sure they are connected to mentors who can guide their work and career path.
- *Support a flexible approach to work:* Some millennials are in the prime of their career, and many may also be juggling a family life that requires a lot of their time. Companies need to remember that millennials like being productive, although they may not think a long workday equates to a productive one. The use of cloud-based technology encourages employees to do their work in a productive atmosphere that may not take place in the office.

Recognizing generational traits of millennials not only demonstrates commitment on the part of the company, but also helps keep these employees engaged and involved in their work.

Critical Thinking Questions

1. Do you think a shift in thinking when it comes to managing millennials is a smart strategy? Why or why not?
2. Will accounting firms be required to rethink their billing strategies to address millennials' insistence on a more flexible approach to work? Explain your reasoning.

CONCEPT CHECK

1. How has the relationship between public accounting firms and their clients changed since SOX became law?
2. Describe how cloud computing and automation are changing the accounting industry.
3. What are some of the challenges encountered by accounting firms when introducing new technologies into their workflow process?

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SECTION OVERVIEW

4: Customer-Focused Marketing Strategies

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9.1.2: Entrepreneurial Marketing and the Marketing Mix

9.1.3: Market Research, Market Opportunity Recognition, and Target Market

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9.1.5: Entrepreneurial Branding

9.1.6: Marketing Strategy and the Marketing Plan

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9.1.1: Introduction

Birchbox

Birchbox founders Katia Beauchamp and Hayley Barna loved shopping for beauty products but found the experience expensive and frustrating. So many brands making so many claims—how could anyone find the best beauty buys without wasting money on products they might not need? There had to be an efficient and cost-effective solution to this problem.

Their solution was to start Birchbox: an easy and affordable way to shop online for the best and newest beauty products by trying out samples first. Their entrepreneurial concept requires customers to share lifestyle and grooming preferences with Birchbox via an online form. The company then sends a personalized box of beauty product samples from brand partners along with information about each product. If customers like the offerings, they can purchase the full-size merchandise from big cosmetic manufacturers through Birchbox with a few clicks. Birchbox was a success from the start. Beauchamp and Barna were able to create relationships with cosmetic brands, fund their website, and hire the necessary workforce. However, they did not turn a profit until a few years later.



Figure 9.1.1.1: Birchbox founders Katia Beauchamp and Hayley Barna have disrupted the beauty and fashion retail industries with their monthly cosmetics sample boxes. (credit: modification of “487908877AP00050_TechCrunch” by TechCrunch/Flickr, CC BY 2.0)

While Birchbox was initially an innovator and disruptor within the cosmetics and beauty supply market by supplying products in a new and different way, competition increased as retailers like Macy’s, Target, and Walmart started to offer similar services to customers worldwide. Birchbox was valued at $485 million in 2014, but stiff competition plus the high costs of operations and customer acquisition pressured the new company. In 2016, Birchbox aggressively cut costs in marketing, logistics, production, and staffing, and invested in mobile platforms that allowed the company to secure their competitive advantage, resulting in the company turning a profit for the first time in 2017. Birchbox has continued to expand its business, thanks to the founders’ ability to distinguish their brand from competitors by collecting customer information to customize experiences and by providing the experience through platforms that reach a vast number of customers online.

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9.1.2: Entrepreneurial Marketing and the Marketing Mix

Learning Objectives

By the end of this section, you will be able to:

- Distinguish between traditional marketing and entrepreneurial marketing
- Describe the seven elements of the marketing mix

Being a successful entrepreneur often means being able to balance the many different aspects of a business, such as financing, accounting, and management. One of the most important of those aspects is marketing. After all, if no one hears about the new product, how can it be successful? According to marketing research company CB Insights, in a survey of 101 companies that failed, 14 percent of them failed due to poor marketing. **Marketing** is an umbrella term given to those activities that companies use to identify consumers and convert them into buyers for the purposes of achieving a profit. No matter the size of the enterprise, marketing lays the foundation for how a company reaches and serves its target customers. Whether it's a global brand such as PepsiCo or Apple, a small- to mid-size company such as Birchbox, or a small restaurant or local gym, marketing refers to the core strategies companies use to reach and sell to customers. As you might expect, the way entrepreneurs market their new product is somewhat different from how a large company markets an established brand.

Traditional Marketing

Traditional marketing for large businesses such as Coca-Cola, Disney, and Dell tends to focus on managing and growing existing programs and brands. Companies like these enjoy greater resources such as substantial financial support and large numbers of marketing professionals to steer their efforts. However, marketing for small- and medium-sized businesses (those with 500 or fewer employees and less than $7.5 million of yearly receipts, as defined by the Small Business Administration)[3] is different because financial resources are limited, and it is often the entrepreneur alone who is in charge of marketing efforts. If they do have funds for marketing expenses, they might use a small agency on a fee-for-project basis.

As you have learned in previous chapters, small start-ups are usually tight on resources, so they need to augment their resources through creativity and hard work. While having limited resources creates obvious challenges, being small also has its advantages. For example, it allows new companies to be more flexible, agile, and creative than their established competition. These qualities can allow new companies to disrupt their industries and become major global players by employing entrepreneurial marketing practices.

Entrepreneurial Marketing

On a basic level, **entrepreneurial marketing** is a set of unconventional practices that can help start-ups and younger firms emerge and have an edge in competitive markets. The main difference between these and traditional approaches is that entrepreneurial marketing tends to focus on satisfying the customer and building trust by providing innovative products and services that disrupt or appeal to a specific market. Table 9.1.2.1 provides an overview of differences between traditional and entrepreneurial marketing.

Table 9.1.2.1: Traditional versus Entrepreneurial Marketing

Traditional Marketing	Entrepreneurial Marketing
Greater amount of resources	Few to no resources; founder drives efforts (sweat equity)
Management of an established brand, reminder advertising	Must be ingenious, energetic, and persistent to develop story and brand; leads to trust
Financial and market share goals	Satisfaction and awareness goals
Manage existing customers	Capture first customers; develop a client base and long-term relationships
Manage existing products, promotion, pricing, placement, people, physical environment, and process (the “7 Ps”)	Develop new products, price points, channels (placement), communication, process, training, and design
Continue doing what works	Trial and error; market pilots
Communication with customers standardized, one-directional; more difficult to create one-on-one relationships	Communication with customers is more fluid and spontaneous; two-way relationships

As the table shows, entrepreneurial marketing emphasizes flexibility and innovation as a way to stake a claim within competitive markets. For example, consider how Drybar founder Alli Webb used her understanding of market needs to create a niche within the traditional hairstyling industry. A hairstylist by trade, Webb spent five years as a stay-at-home parent, drying hair for friends and family members at their homes to make extra cash. During this time, she realized there was a market need for “just” blowouts, or professional hair drying and styling.

Seeing this need, Webb developed a business model that would offer women a way to get a blowout without having to also get a cut or color. Webb didn’t invent the blowout; she just reinvented the space to do it, focusing on that sole aspect of hair styling, and offering the service in trendy settings (Figure 9.1.2.1). By being flexible and innovative through a new space to provide this service, Drybar was able to carve a niche in the hairstyle industry. In business since 2008, Drybar is still expanding. Webb expected to open at least 20 new locations in 2019.



Figure 9.1.2.1: Simple innovative ideas such as Drybar can carve new market niches that weren’t served before. Drybar has now grown to over 100 locations across the US. (credit: work by ralph and jenny/Flickr, CC BY 2.0)

Marketing Mix

One of the biggest misconceptions people have about marketing is that it is all about promotion, or how a company sells or advertises something. But the truth is, promotion is just one facet of the **marketing mix**, which describes the basic set of strategies and approaches that marketers use to identify and reach their target market. A **target market** is the specific group of consumers for which a company seeks to provide a good or service.

One common way of understanding and remembering the components of the marketing mix for products and services is by thinking in terms of the “7 Ps.” While each of these can be part of a company’s marketing mix, the first four relate more to

products: product, pricing, promotion, and place (and traditionally have been called “the 4 Ps of marketing”). The remaining three relate more to services: physical environment, process, and people. While the 7 Ps are conceptually the same for all businesses, how a company addresses each “P” will be specific to that company’s needs and goals.

For a better understanding of the marketing mix, look at how Figure 9.1.2.2 breaks down the 7 Ps into their related activities.

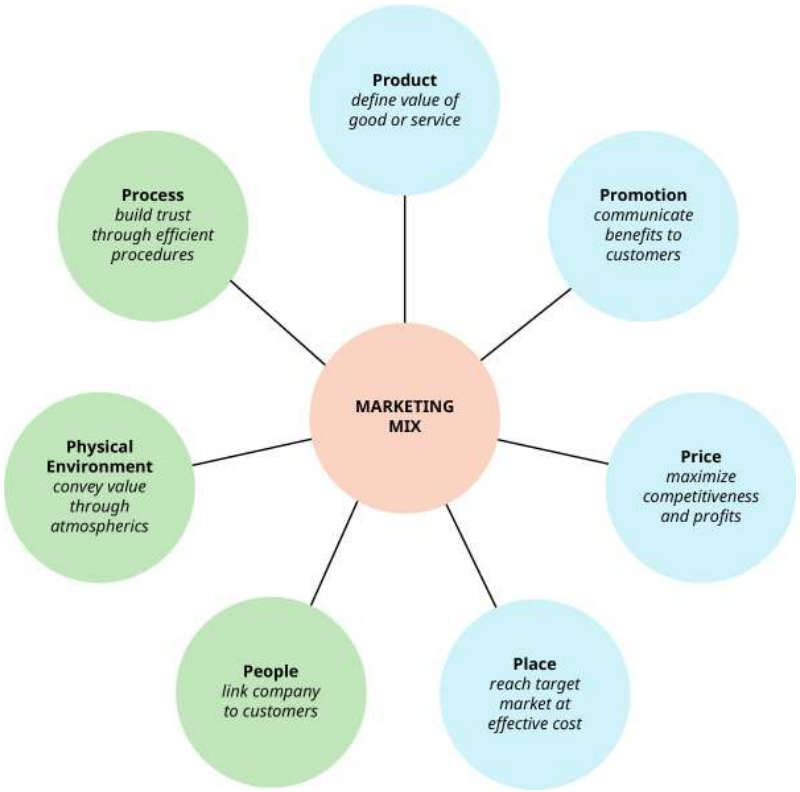


Figure 9.1.2.2: Each P of the marketing mix should work with the other Ps to create value for a business and its customers. *Product*, *promotion*, *price*, and *place* relate more to goods, while the *people*, *physical environment*, and *process* relate more to services. (CC BY 4.0; Rice University & OpenStax)

Product

Within the marketing mix, **product** refers to a good or service that creates value by fulfilling a customer need or desire. Goods are tangible products that can be touched, smelled, heard, and seen, such as a pair of tennis shoes, a granola bar, or a bottle of shampoo. In contrast, services are intangible products. They usually entail paying an expert to do something for you, such as car repair or house cleaning.

Companies can bundle both goods and services together to create extra value for their customers. Birchbox, for example, provides goods (product samples) and services (customized product recommendations) to satisfy their customers’ desire to be able to buy beauty products in a hassle-free manner. The value Birchbox provides to customers relies on their ability to do both. In the United States, service-oriented businesses are increasingly playing a larger role in our local and national economies.

For start-ups, defining the value of the products they are going to offer is an important step toward identifying their competitive advantage within a marketplace. On a basic level, if you don’t know what benefit your product provides or what need it fulfills, neither will your customers. Kevin Plank, founder of Under Armour, knew that the value of his product would benefit many athletes who were tired of having to frequently change their wet sportswear. As a former football player, he had spent many hours training and enduring drenched practices, and wondered how he could alleviate this problem that companies didn’t address well with cotton sportswear. After college, he decided to take his idea to the next level and started a company making athletic wear that had special microfibers that kept athletes dry throughout practice and games. He then embarked on a trip to try to sell his value proposition to college football teams on the east coast. Nearing the end of 1996, he landed his first sale of shirts to Georgia Tech, which totaled $17,000—and the rest is history. Under Armour became a strong competitor to Nike and Adidas by providing a new type of athletic wear that has revolutionized performance by keeping athletes dry.

In contrast, Jawbone, the company that manufactured Bluetooth speakers and other hardware, has gone out of business because it changed its focus from audio to health devices, which placed it directly in competition with FitBit and similar hardware companies. Product failures, among other problems, caused this tech company to flop.[7] The company is now working on reinventing itself and will use artificial intelligence and sensor hardware to provide customers information about their health through a subscription. The wearable sensors will record vital customer information that will be tracked on an online platform that will then provide suggestions for medical action.[8] The company's redesign is not yet complete, so it is not officially in business again yet.

Promotion

Communicating a product's benefits to customers is a significant aspect of any marketing mix. Even if a product is the best in its class, a company must communicate this value to customers, or it will fail. This is what **promotion** does: It is the process of communicating value to customers in a way that encourages them to purchase the good or service. Promotions must have a goal, a budget, a strategy, and an outcome to measure. Companies must use their promotional budget wisely to create the best results, which can include sales, profit, and awareness through the use of a cohesive message throughout the campaign.

Some typical forms of promotion are advertising, social media, public relations, direct mail, sales promotions, and personal selling.

Advertising is a form of mass communication that allows companies to reach a broad audience through TV, radio, newspaper, Internet, magazines, and outdoor ads. Many of these media can be quite expensive for small companies, forcing them to choose one strategy, or to opt for other less expensive tactics such as guerrilla marketing or viral marketing. As Table 9.1.2.2 shows, the advantages of advertising include reaching a mass audience and increasing sales, but on the downside, the cost may be too much to bear, and the company might face a difficult time reaching the right target. As we move from advertising to social media, we can see that social media allows for more accurate targeting and better metrics to assess results.

Social media is a must-use tool for entrepreneurs to connect with consumers, especially younger demographics. Many customers can be found online in one social media platform or another. The goal is to find the customers who fit your target market. The benefits of social media include targeting customers more accurately using the platform of their choice and being able to communicate directly with them. These platforms include networking sites such as Facebook, Twitter, and LinkedIn; photo and video sites such as Snapchat, Instagram, and Pinterest; blogs; and news sites. A business must find the time to connect with its customers wherever they are. As a budding entrepreneur, the best way you can start connecting with them is by identifying your target customers and by figuring out what kind of social media they frequent. You can ask your current customers about their social media habits; you can look up reports about the types of social media your customers frequent; or you can use special software that tracks conversations on social media that pertain to your business and industry.

For example, you may find out that your young customers hang out mostly on Twitter and Instagram, and not so much on Facebook. You could benefit from focusing on only those two platforms and finding out about their conversations. You may want to search hashtags and stories that pertain to your type of business so you can join their conversation. You could then set up your profile, write relevant content and hashtags that make sense to your consumer, and request to follow influencers who can help you create awareness of your business and product. Once you have a profile set up, there are many ways you can create campaigns: contests, discounts, or by simply providing useful content that your customer appreciates. The goal is to be part of the conversation and not sound like you are selling something.

In addition to posting good content and reaching out to influencers, you may also benefit from buying ads that can be geographically targeted to your customer and that are more affordable and effective because you're directly targeting someone who is specifically interested in your product. The disadvantages of targeting social media include the time and skills required to engage with customers, and the need for consistently fresh content. Many start-ups believe that having a Facebook page will be enough to reach their customers, but their customers may spend more time on other social media platforms. The time and effort required to find the right platform, develop good content, and connect with customers on a daily basis is worth it.

Public relations are the efforts and tools companies use to connect and develop goodwill with their constituents. Constituents can include customers, investors, employees, business partners, government entities, and the community at large. The goal is to highlight the company in a positive light by contributing as a community player. Tools can include newsletters, press conferences, community service, events, sponsorships, press releases, articles, and stories that help entrepreneurs create a positive image about their company and get its name out there. If participating in an event, for example, the sponsor will display the logo and name of the company in a place where everyone can see it. This shows the company as a supporter of the community and as a provider of

not just products and services, but of intangible contributions, such as supporting the dreams of the event participants. The goal is not to make a sale at that point, but to impact the community and create positive relationships in general because it's the right thing to do—it may positively influence the consumer when they make a purchase in the future.

Direct mail, which is a way to connect to consumers via email or through printed, mailed pieces, is also a necessary tool to keep in touch with customers, especially when creating long-term relationships. The advantage of this strategy lies in connecting to a customer who is already interested in your product and would like to receive news and promotions from you; however, the disadvantage is that it usually takes time to create these lists because it involves collecting information about customers during events, through online requests, or at the cash register. It also can be expensive to send out pieces of mail that might end up in the trash.

Sales promotions are incentives that attract attention and push the customer to take action. These incentives include discounts, samples, rebates, rewards programs, gifts, and premiums. Sales promotions can attract new customers, but it may also reduce profits because coupons and discounts are offered for trying a product.

Personal selling is a tool that uses face-to-face interactions to communicate and influence a customer to make a purchase. It is especially suited for luxury goods. Usually, higher-priced products will need a longer selling process, and sales personnel will need more training on the product to learn about its unique qualities. This is one of the most expensive ways to reach and retain customers, but it can be worth the investment.

Overall, a good entrepreneur must find the right mix of marketing communications to reach customers. This will vary depending on the start-up's budget, goals, and strategies. Table 9.1.2.2 identifies the advantages and disadvantages of each, as they relate to small and new businesses.

Table 9.1.2.2: Advantages and Disadvantages of Promotion Types

Promotion Type	Examples	Advantages	Disadvantages
Advertising	• TV ads • Radio spots • Newspaper and magazine spreads • Internet ads • Billboards	• Can reach a mass audience • Great for creating brand recognition • Increased sales	• Can be expensive • Access can be limited • Some targeting is possible, but it is impossible to fully control who sees the ad
Public Relations	• Sponsoring community events • Charitable and civic involvement • Scholarships and grants • Press conferences	• Develops positive brand recognition • Creates goodwill toward company and brand within the community	• Big events and public relations campaigns can be resource intensive • Not focused on generating sales
Social Media	• Social networking sites such as Snapchat, Twitter, and Facebook • Blogs and vlogs • Influencers (industry experts who act as advocates)	• Pervasive and inexpensive access to massive audiences • Target markets are highly customizable based on available data • Easy access to young people • Can be used to create goodwill and a loyal fan base	• Many companies use social media, so it is hard to stand out from the crowd • Can be time-consuming • Success requires dedicated personnel with special expertise • It is often difficult to track conversion (customers taking a desired action, such as a purchase) and sales numbers • Requires the creation of unique/engaging content
Direct Mail	• Mailed letters, marketing flyers, postcards, and coupons • Email newsletters	• Subscribers are already interested in your product and thus more likely to convert to paying customers • Keeps already interested consumers up-to-date on product news, sales, product releases • Can target market based on location, average income, and other census-derived information	• Building an email list of interested customers can take time • Direct mail campaigns can be expensive • Results cannot be precisely tracked • Consumers often discard physical and digital “junk mail” without looking at it
Sales Promotions	• Sales • Limited-time offers • Coupons • Free samples • Rewards programs	• Incentivizes buying and encourages consumers to take action • Appeals to consumers’ desire to “get a deal” • A good way to attract new and reluctant buyers	• Reduces profits in exchange for promotion • The promise of future sales and discounts can discourage regular buying
Personal Selling	• Sales meetings between a salesperson and a potential customer	• Personalizes the relationship between the business and the customer	• Can be resource intensive • Requires salespeople who are well-trained and

Promotion Type	Examples	Advantages	Disadvantages
		• Effective salespeople can convert reluctant parties into paying customers • Salespeople can customize purchase options for each buyer	effective • Consumers are turned off by sales tactics they perceive as aggressive • Requires constant lead generation

Price

One of the most important and challenging elements of the marketing mix is pricing. **Price** is the value that must be exchanged for a customer to receive a product or service. This is usually monetary and has a direct impact on sales. Many entrepreneurs are intimidated by financials and the prospect of using statements and other information to make projections. Correctly pricing your product enables your company to be competitive while maximizing your product's profit potential.

Here are several methods that entrepreneurs can use to effectively price products:

Cost-led pricing is the easiest way to price a product. This involves taking the cost of making the product and creating a **profit margin**, which is how much profit your business stands to make after costs have been deducted. For example, if you add the direct costs for materials and labor to the indirect costs of salaries, marketing, rent, and utilities, you determine that your product costs $5 to make. Adding, say, a 30 percent profit margin would give you a sales price of $6.50. The percentage added depends on the business's goals. This type of pricing is helpful when start-ups do not have much information about their target market and need more time to define their value proposition and business identity.

Another way to price a product or service is to consider what the competition is charging and determine whether to go above, below, or match their prices. If going above, or using **premium pricing** (also called perceived value pricing), you need a clear reason why customers would want to spend more on your product. While using **penetration pricing**, or pricing below competitors, can give you a competitive advantage, it may also lead to "price wars" in which competitors keep dropping prices in an attempt to beat each other. Obviously, the disadvantage is diminished profits for all. While pricing the same as your competitors seems like a logical choice, if your product offers no added value, this strategy is unlikely to entice customers to switch to your brand.

LINK TO LEARNING

Warby Parker is an example of a company that prices its eyeglasses below competition prices. Dave Gilboa and Neil Blumenthal started the online company in 2008 with the intention of providing attractive and trendy $95 eyeglasses for everyone. This was a departure from competition, which usually priced eyeglasses at hundreds of dollars. Listen to the interview with Warby Parker founders Dave Gilboa and Neil Blumenthal to learn more about their venture and its pricing strategy.

Customer-led pricing is just as described: pricing led by the customer. You ask what the consumer is willing to pay and charge that. You can find this by doing research and asking customers what they would be willing to pay for a product. Many technology products are priced that way. Companies survey customers about what they are willing to pay, and they create products that deliver the value at the market price.

Loss leader pricing uses a below-standard price to attract business in the hope that customers will stay and shop for other, more profitable products. It is called a loss leader because companies lose money on the lower-priced product. Grocery store ads usually contain several loss leaders that are designed to lure you into their store in the hopes that you do the rest of your food shopping there.

Introductory offers use lower initial prices to attract new customers and build a customer base before prices return to "normal." This method is a form of penetration pricing, as its goal is to help new products penetrate markets with established competitors and brands. Many subscription-based products such as gyms are introduced this way to gain market share and revenue.

In contrast, **skimming** is a pricing strategy that leverages the newness of a product to justify the highest price possible in order to "skim" the most profits off the top, meaning in the first phase of sales. As time passes, the price is lowered to accommodate for

more price-sensitive customers. Apple often introduces its products with this particular method, charging the highest price for them until it has exhausted the market willing to buy at that price and when newer and more technologically advanced products are introduced. Then, Apple slowly lowers its pricing.

In **bundling**, a discount price is set for a bundle of products to encourage customers to buy in bulk. While they pay more than if they were buying just one good or service, they do so because the overall price for a bundle reduces the individual price of that product, giving them a better deal than if they were to purchase items separately. An example of this strategy is used by DirectTV, which bundles its phone, Internet, and satellite services for a monthly fee. If a customer were to purchase these services separately, they would be more expensive. The benefits of bundling include gaining more revenue per customer, as they would not have paid for some services separately, and making the order-taking task simpler. Take fast-food chains, for example. Instead of asking the customer to list everything separately from the menu, they give you the name or number of the bundle. They make more profit by including the drink and sides to the main entrée, and the customer saves money and time ordering.

The **odd numbers strategy** is a psychological pricing strategy often used in conjunction with other pricing methods to make a product's price point more attractive to consumers. Using odd numbers takes advantage of the idea that such numbers have a positive psychological effect on customers. For example, instead of pricing something at $20, the price would be set at $19.99, which consumers perceive as closer to 19 than 20.

LINK TO LEARNING

Explore the five strategies of psychological pricing in an article published in *Entrepreneur* magazine.

While pricing must be established when starting a new business, pricing strategies should be reviewed on an ongoing basis. These occasions in particular merit consideration:

- When adding a new product or service to your offerings
- When demand shifts (due to market, consumer, or other factors)
- When entering a new market
- When competitors are making changes
- When your costs are changing
- When adjusting products/services or strategies

Place

Place refers to the channels or locations—physical or digital—where customers can purchase your products; it is sometimes called *distribution*. For the entrepreneur, the choice of place lies in figuring out which channels will create the most profit. In other words, which channels will reach the majority of the target market at the most efficient cost. Choosing the right distribution channels is one way to create a competitive advantage and generate more success for your business. Certain channels have specific capabilities such as reaching more customers, providing promotions, and providing credit.

As Figure 9.1.2.3 shows, distribution channels fall into two main groups: direct and indirect. Direct channels, such as physical or online storefronts, require no intermediaries and allow you to sell directly to consumers. For example, if you own a bakery, you would likely have a retail storefront that sells directly to consumers.

Indirect channels require intermediaries such as distributors or sales agents to sell your products to the end customer or to other physical or online retail outlets. Indirect channels often have more than one intermediary. For example, to acquire more customers than you could reach on your own, your bakery would use indirect channels such as wholesalers or agents to get your products into local markets and grocery stores across the country. These companies would also help with logistics, which include transportation, warehousing, and handling of products.

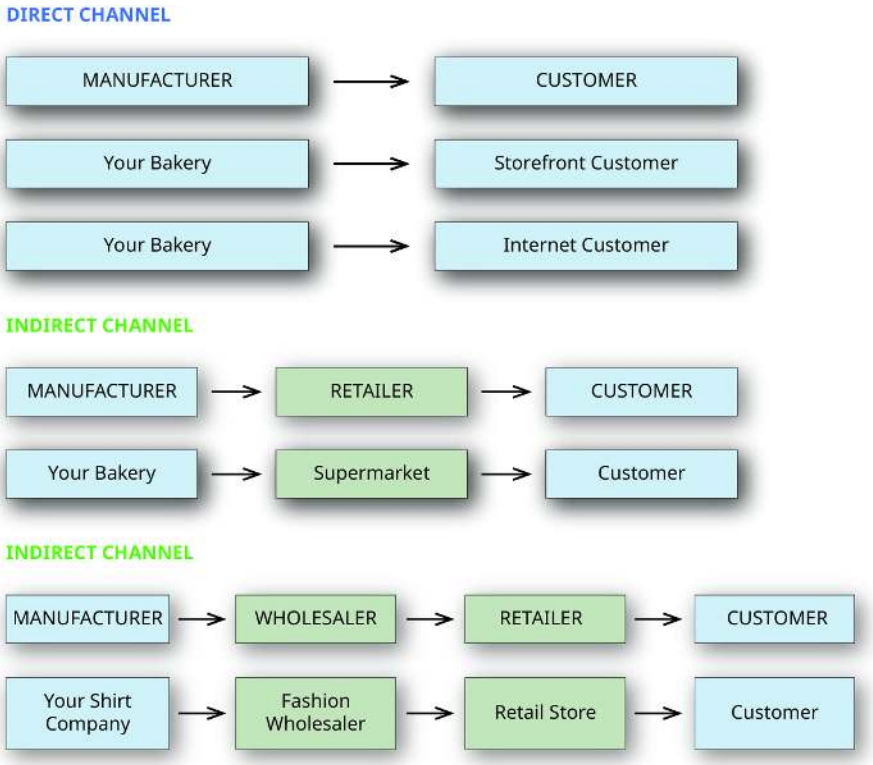


Figure 9.1.2.3: The "P" of "Place" may include distribution through direct or indirect channels. (CC BY 4.0; Rice University & OpenStax)

Taking advantage of multiple distribution channels is one strategy companies use to expand their brand and grow their profits. This can include having a physical storefront, developing an e-commerce website to sell goods online, and distributing goods through wholesalers and retailers. Including multiple touchpoints with the customer can increase the likelihood that they will choose your product.

The longer your distribution channels, the longer it takes for your product to reach the end consumer, and the less control you have over the product and the price. As an entrepreneur, you must decide which channels best fit your product and pricing requirements.

Additional Ps for Services

As you have learned, products include services as well. These include legal, accounting, consulting, medical, entertainment, advertising, banking, and other professional services. When providing services, three additional Ps should be considered in the marketing mix.

People

People, or a company's human resources, will always be a key factor in any successful business. In a service-oriented business, the people who interact with customers are especially important. Because the service *is* the product, they are the face of the brand and a direct link between the company and the customer.

When an employee delivers an acceptable or outstanding service, customers are encouraged to return to purchase the service again and also share their positive experience with others. When customers go into a jewelry store and receive good service from the salespeople, they will likely let their friends and family know about the positive experience through a personal referral or on social media.

When service is poor, customers don't return. If customers have a bad experience at a restaurant, it is likely they will not patronize the establishment any longer and will probably share a negative review online. Sometimes, poor service has to do with factors other than employees, but as online review sites such as Yelp become more common, poor customer service reviews can have a crippling effect on a brand, especially for start-ups trying to break into a market. It is important to hire experienced people and have a good training system in place with rewards that will help employees deliver the best service to customers. Companies should take into

consideration that no matter the size of a business, they must market not only to their customers but also to their employees, as they are the face of the company and the ones who interact with customers. Employees can make or break the brand.

Physical Environment

The **physical environment** where a service is provided is an important part of the marketing mix. It can influence the company's image and convey a lot of information about the quality of a product, service, company, or brand. The old adage that you "get only one chance to make a first impression" is especially true for new businesses. Tangible cues—décor, smell, music, temperature, colors—send an immediate message to customers about quality and professionalism.

For example, if you walked into two dentists' offices (remember, they are also entrepreneurs), and one office smelled and looked clean, and one did not, which one would you choose? The same goes for restaurants, retail stores, and any other physical environment. Since a service cannot be inspected before it is received, these cues help customers make their decisions.

Process

Process is the chain of procedures or activities required to provide a service to the customer. It is all of the activities that take place between the service provider and the customer, from beginning to end.

In the case of a doctor's office, this would include making the appointment, filling out paperwork, waiting to be seen, seeing the doctor, and paying. Because processes can be long and involved, they need to be designed to flow as efficiently and logically as possible. In the case of services that are provided online, process includes the website's design and functionality, and all of the steps customers take from browsing through check out. A strong website design helps the entrepreneur say what the company is about, what it does and for whom, and what actions the customer can take. Actions can range from clicking for more information, the ability to purchase a product, or checking whether there is availability for a service and being able to book it or make an appointment. An example of a great website is Airbnb's website whose design is focused, inspiring, and to the point. What do you think is its main call to action?

ARE YOU READY?

Determining the Marketing Mix

Imagine that you are opening a new yoga studio in a local area. Based on your research, you found that certain styles of yoga are not taught by local studios but are increasingly being sought by women aged twenty-five years and older. Your task is to create a marketing mix that focuses on this market and has a clear competitive advantage over other studios. Develop a marketing mix that includes all 7Ps and define them as they relate to your business.

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9.1.3: Market Research, Market Opportunity Recognition, and Target Market

Learning Objectives

By the end of this section, you will be able to:

- Distinguish between primary and secondary market research
- Define a research goal and the importance of research design
- Understand how to choose a sample, and collect and analyze data
- Identify common sources for secondary market research
- Understand how to identify the target market within the total available market and serviceable available market

Now you know the components of the marketing mix. But, as an entrepreneur, before you can make decisions about them, you need to roll up your sleeves and do some research. This research is market-focused, and it's done after the entrepreneur has decided to move forward and start the enterprise or launch the product. Essentially, it is about the product, not the entrepreneur's readiness.

Market research is essential during the planning phases of any start-up; otherwise, you're shooting in the dark. On a basic level, **market research** is the collection and analysis of data related to a business's target market. Market research can entail everything from information on competitors' products to the interpretation of demographic data related to potential customers.

The main purpose of market research is to gain an understanding of customer needs and wants in an effort to reveal potential business opportunities. When you have a clear picture of what your target market is and what it wants, you can more effectively design your marketing mix to engage that demographic.

Imagine that you are creating a cosmetic line that is organic, contains vitamins and minerals, and is easy to apply. Your target market is women who are interested in high-quality beauty products that are not harmful to themselves or the environment. But after conducting extensive market research, you learn that women aged eighteen to forty-five years tend to be interested in the benefits your product line provides, but that women over fifty years of age are not. In light of these findings, you can either adjust your line's benefits to serve the market you initially wanted to serve (all women), or you can cater to the needs of a smaller audience (eighteen to forty-five-year-old women).

A good exercise for better understanding your target market is to detail the everyday life of your ideal customer. You can do this by describing in detail a set of possible customers who would buy your product. Details could include demographic information such as gender, age, income, education, ethnicity, social class, location, and life cycle. Other information that would be helpful would include psychographics (activities, hobbies, interests, and lifestyles) as well as behavior (how often they use a product or how they feel about it). The better you know your ideal customer, the better you can focus on capturing their attention by matching their preferences with your offerings.

Market research also helps you understand who your competitors are and how they serve the target market you want to engage. The more you know about your competition, the easier it will be to determine and differentiate your offerings. Let's dive into how marketers gather all of these data and the value the data provide to entrepreneurs.

Primary Market Research

Primary research entails collecting new data for the purpose of answering a specific question or set of questions. While conducting your own research can be resource intense, it is also the best way to get answers specific to your business and products, especially if you want to penetrate niche markets that have not been studied. It also allows you to get specific. By asking the right questions, you can determine people's feelings and attitudes toward your brand, whether they like your product design, whether they value its proposed benefits, and whether they think it is priced fairly. Figure 9.1.3.1 shows the steps common in conducting primary market research.

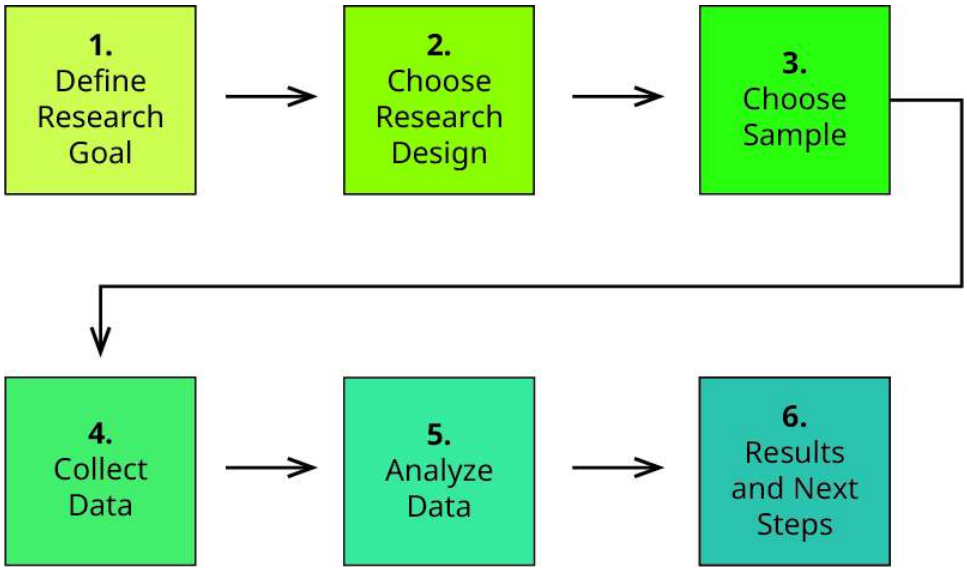


Figure 9.1.3.1: There are six steps in primary market research. (CC BY 4.0; Rice University & OpenStax)

Define the Research Goal

You should start by defining the goal of your research project. What are you trying to find out? Do you want to know more about your target market, their preferences, lifestyle choices, and culture, or do you want to know more about your competitors and why your target market buys from them? What are your criteria for validation of the research goal or goals?

The more time you take to clarify your research questions, the more likely you will be to achieve your research goals. If you can't figure out exactly what you're looking for, that's okay. Exploratory research using a focus group can help you decide what kind of research questions to ask. A **focus group** is a gathering of people, typically six to twelve participants, who come together to discuss a topic presented by a moderator, who usually poses questions and collects qualitative data that can be used to answer questions or define research further.

For example, a manufacturer of water bottles might know there is a problem with their products as sales have been declining over time. The company doesn't know exactly why or where to start, so it would use a focus group to better define the research goal or problem. Using focus groups, they might find out that they are targeting the wrong segment or that there is a need for better water bottle designs. Talking to the focus group can uncover possible research questions to undertake.

Merkadoteknia Research and Consulting is a Hispanic-owned company that conducts research for different industries that cater to Hispanic consumers. This company helps fast-food companies, retailers, and pharmaceutical companies, among others, conduct focus groups and gather insights about specific groups of people that may have different cultural backgrounds. These companies may not know exactly how to start researching their target market, so they use Merkadoktenia Research and Consulting to learn more through the use of focus groups. This approach helps better define the research goal or problem.

Determine Research Design

The next step is to determine which research techniques will most effectively help you answer your questions. Considering what you want to learn and determining what your budget is will help you decide if qualitative or quantitative research best suits your needs. Well-designed research projects often use some combination of both.

Qualitative research uses open-ended techniques such as observation, focus groups, and interviews to gain an understanding of customers' basic reasons, opinions, and motivations. Simply observing potential customers, whether at a store or in daily activities, and noting their behaviors are a simple, effective form of ethnographic research that can help you better understand the lifestyles and habits of potential customers. **Ethnographic research** includes the personal observations of the subject by being immersed in the subject's environment. Research like this helps companies see how people use their product over the course of a day.

For example, if you manufactured a water bottle and wanted to design a "better" water bottle, you could watch how people use their water bottles while working, exercising, during their commute, and so on to better understand their needs and habits. This "ethnographic" research can often uncover latent, or unstated, needs that you can use to build your concept. Unstated needs refer to

those that are expected from a company, such as a certain level of quality or good customer service. These are default expectations that a customer has based on their experience with products in general.

Employing a mystery shopper, or pretending to be one yourself, is another way to learn how customers and employees act within a specific retail environment. A mystery shopper is a person who has been hired by the company or a third party to pose as a real shopper and has gone undercover with a specific goal of testing certain aspects of a business. This can take the form of purchasing a product, browsing and asking questions of an employee, interacting with other customers, or simply observing what is happening inside the store. After the experience, this person will provide feedback to the company.

Focus groups and one-on-one interviews can be useful to obtain more thoughtful answers and explore debatable topics. Both are good methods for digging deeper into the specific motivations and concerns of people, especially as they pertain to personal, privately held beliefs. This research is useful when trying to develop a more novel product, but you must do your best to eliminate "support bias" in that the panelists might seem favorable to new concepts to please or accommodate the moderator. For one-on-one interviews, it is important to develop a thorough interview or discussion guide, so other team members can also conduct the interviews. By doing this, you will ensure a consistent approach to asking key questions and documenting responses to help guide the next step of the development of your product.

Quantitative research focuses on the generation of numerical data that can be turned into usable statistics. This kind of research most often takes the form of surveys or questionnaires that pose multiple-choice questions with predefined answers. While these surveys do not allow for much free expression on the part of the participant, the focused nature of the answers means marketers can identify trends, such as which social media platforms are preferred by customers or potential customers. For example, the researcher may very well find that Instagram is the most used social media app because of its ease of use and its ability to incite emotional responses to pictures.

Sample survey questions can be anything from "How many times have you gone to the corner store this week?" to "Which age range do you belong in?" This kind of approach is an efficient way to collect a lot of data because once the survey is written, it can be distributed in person or online to as many participants as you like. Typically, the more people you survey, the more accurately your data will reflect the demographic you are examining.

Another way to generate quantitative results is through **causal research** and test marketing. In both cases, you present participants with a cause and record the effect. An example of this might be a taste test in which people's reactions to and preferences for different juice flavors are recorded. Given the limited resources of many start-ups, test marketing is a great way to make sure your product works before you start investing in its distribution.

An even more sophisticated—and expensive—method is **conjoint analysis**, in which respondents must rank, choose, or a rate a number of "conjoint," or linked, features or benefits. This real-life scenario approach will give you very useful results from potential buyers, often with features or benefits ranked relative to perceived value or importance.

For instance, let's say your company is trying to create a reusable water bottle to compete in a crowded marketplace. If you were to use conjoint analysis, you would create a survey that lists the water bottle attributes and prices to show consumers different choices. For example, customers could be given a set of very similar water bottles, each with a set of features the company would like to test. Features can include a locking lid so the water doesn't leak, different bottle shapes for easier hold and water retrieval, and different colors and sizes. Each of the choices could have its own price point and the customer can choose, rank, or rate each of the choices based on those attributes and prices. Each of the choices could be described on a survey with words or pictures, and it would ask customers to choose their favorite or rank all of the choices. After collecting information and data from many consumers, researchers would use statistical analysis by applying linear regression (a predictive tool that measures the causality of one marketing variable on another) or other techniques to determine which attributes of a water bottle are more important to the customer and what price they would be willing to pay. Based on this knowledge, the company would create a product that could possibly beat the competition.

Choose a Sample

Next, researchers need to determine the sampling method. In terms of research, your **sample** refers to who you will survey and how many people you will include. In most cases, you will want a sample that reflects your target market, especially if you are trying to

figure out your ideal customer's interests and how to get them to buy your product. Untargeted samples can be useful when trying to figure out who your target market might be, but they aren't an efficient way to get to know your ideal customer.

Generally speaking, larger samples provide more accurate data, although researchers should not feel like they need to survey everyone in a market. For example, if you have a list of 5,000 contacts, you might choose to contact 500 people who would be representative of the total group of contacts. Surveying all of your population could be time consuming and expensive, so choosing a subset of the right people can yield good results. The sample must be large enough to be statistically significant, meaning that the relationship between variables is not a result of chance. The sample can then show the researcher an accurate depiction of a specific phenomenon.

For example, you can test whether men and women actually have different or similar tastes in water bottle attributes. In this case, the significance rests on the gender of the potential customer. If your sample is large enough (say 500 out of 5,000), and you find that men look for different attributes than women do, it is unlikely that the differences found were by chance. The cause of the differences would be the gender.

Therefore, keep in mind that errors of reliability and validity can arise if your sample is not thoughtfully selected. Statistical significance is then important in measuring reliability because it means that there is an actual difference in what is being measured. If there is a difference between men's and women's responses in our water bottle example, checking the significance will determine whether the differences really matter or if they are due to chance. Significance is measured by looking at the probability value, or *P* value, of the result. If it is 5 percent or less, it is usually considered a significant difference that is not due to chance, and the researcher can determine that the answers are indeed different between the two genders. Validity, on the other hand, means that the item that is being measured is relevant to the research. This means that the questions that are being asked will actually answer your research objective.

While random samples can be useful for some types of research projects, many researchers intentionally choose their sample participants based on economic and ethnographic factors to make sure they accurately reflect the nature of the demographic they seek to understand.

Collect Data

Once you've identified your research goals, chosen your design, and determined your sample, you are ready to start collecting data. The data may be collected through observation and taking notes. For example, if you are trying to figure out if your store layout is yielding the most productive sales, you can observe traffic flow and note what people look at and what they actually purchase. Then, you may change the merchandise layout, or the aisle size or space, to see whether people peruse other merchandise that they hadn't seen before. Based on your observations and sales data, you can determine the best flow for your floor.

Interviews can also help secure open-ended answers. You might interview potential customers on what they think is the best way to communicate with them and what they like about certain competitors' products. This can help you obtain additional options that you may not have thought to add on a survey, which is another way to get aggregate data.

Surveys can be done by hand or through online tools such as Survey Monkey or Qualtrics. Surveys are very helpful because you can ask question to current or potential customers about your product, competitors' products, customer service, and any other information you may seek to create or improve your business. They are an easy way to collect large amounts of data from many customers, and they allow you to calculate responses. Online tools are particularly useful in providing repositories of data that can be later exported to other analytical tools such as Excel or SPSS.

Regardless of what research technique you use, be on the lookout for data collection errors. Recording the wrong answers, failing to convey the right instructions to participants, or having to translate on the fly can all create biases that skew the answers and give you inaccurate results.

Analyze Data

Once you collect your data, the next step is to make sense of it. How you analyze the data depends largely on what you want to get out of it. Typically, you will be looking for patterns and trends among the answers. Data analysis is a field unto itself, and when complex analysis is required, seeking the assistance of experts is often worth the extra cost. You can find experts within research marketing firms that specialize in collecting and analyzing data for businesses, such as Merkadoteknia Research and Consulting. These can be found online or through local business organizations, such as chambers of commerce.

Results and Next Steps

At this stage, the entrepreneur seeks to reconcile the results of his or her examination with the goals of their research. For example, if you were doing exploratory research about a potential product you wanted to bring to market, now would be the time to ask questions such as whether the research suggests market potential. Similarly, if the goal was to figure out what customers like about competing products, now would be the time to list those results and determine whether they are worth incorporating into your product. Regardless, it is important to be open to what the data say, even if they indicates results that are contrary to what you were hoping for. Research should be an opportunity for growth and a roadmap for the refinement of your idea.

Secondary Market Research

Secondary research is research that uses existing data that has been collected by another entity. Oftentimes, these data are collected by governmental agencies to answer a wide range of questions or issues that are common to many organizations and people. Secondary research often answers more general questions that an entrepreneur may have, such as population information, average purchases, or trends. If there is a specific question that cannot be answered, such as how many people would be interested in a new product with certain attributes, then primary research will have to answer that. While some of this kind of research must be purchased, much of it is free to the public and a good option for entrepreneurs with limited financial resources. Some commonly used sources for free data include the US Census Bureau, Fact Finder, Pew Research Center, Current Population Survey, the Small Business Administration (SBA), and the Texas State Data Center.

Other useful resources are trade organizations that provide information about specific industries, as well as newspapers, magazines, journals, chambers of commerce, and other organizations that collect local, state, national, and international data. Resources such as these can provide information about everything from population size to community demographics and spending habits. Table 9.1.3.1 lists several free databases that are rich sources of information.

Table 9.1.3.1: Databases for Secondary Research

Database	Information	URL Address
Census Bureau	Economic, demographic, geographic, and social data	https://www.census.gov/
Fact Finder	Economic, population, and geographic data	https://factfinder.census.gov/
American Community Survey	Updated census data	https://www.census.gov/programs-surveys/acs/
Pew Research Center	Fact tank that surveys trends, issues, attitudes, and demographics	http://www.pewresearch.org
Pew Hispanic Center	Surveys on Hispanic trends, demographics, and issues	http://www.pewhispanic.org/
Current Population Survey	Monthly survey of US households on labor data	http://www.bls.gov/cps/home.htm
Texas State Data Center	State demographic data	http://txsdc.utsa.edu/
IBISWorld	US industry trends	http://www.ibisworld.com
Mergent Online	US businesses data	http://www.mergentonline.com/
Demographics Now	US demographic and business data	http://www.demographicsnow.com/

While free sources can provide a lot of information, their research tends to be less specific than that by sources that charge for their data. Companies such as Nielsen/Arbitron, Simmons, and Geoscape can provide more detailed information about specific behaviors on media use, lifestyle choices, specific product consumption, geographic segmentation data, and others. Table 9.1.3.2 lists some sources for this research.

Table 9.1.3.2: Syndicated Sites for Secondary Research

Site	Information	URL Address
Nielsen PRIZM	Geodemographic segmenting	segmentationsolutionsdev.nie...BCode%2B Lookup
Nielsen TV ratings	TV ratings, media, research	http://www.nielsen.com/us/en/insights.html
Nielsen Audio	Audio ratings, media, and research	http://www.nielsen.com/us/en/solutio...ies/audio.html
Experian Simmons	Consumer research, trends, and insights	http://www.experian.com/
Scarborough	Consumer research, trends, and insights	http://www.scarborough.com/
Geoscape	Multicultural consumer research	geoscape.com/

In the end, there is no perfect way to conduct research. It all depends on what you are trying to find out and what the best approach is to do that. If you are just starting out, you may want to maximize secondary research because it is free. You can also try primary data collection by speaking to friends, family, and others you encounter in your local and online communities. If you are working at a university, you will likely have access to free market research reports (marketresearch.com, Frost & Sullivan, etc.).

ARE YOU READY?

Researching Your Market

Pretend you are an entrepreneur who would like to create a new, educational toy for toddlers to develop their motor skills that uses figures, shapes, or blocks. While in college, you worked in the children's section at a well-known retailer. From this experience, you learned that there might be a need for educational toys within the market that isn't being addressed, but you aren't exactly sure how to exploit it.

- Using the market research process, develop a research plan that will help you determine the viability of your idea.

Market Opportunity Recognition and Validation

One common goal of market research is the identification of a **market opportunity**, or an unmet need within a target demographic that might be fulfilled by an existing or new product. Looking for gaps or unmet needs within a marketplace is one way to identify market opportunities for both goods and services. For new products, this entails looking at the needs of a demographic, identifying which of those are not being met, and determining what kind of product could fulfill it. Based on our earlier discussion on secondary research, there are many places where data can be found online or offline to determine these needs.

Similarly, you might identify common local, national, or global problems through observation and directly interacting with potential customers, and try to create services that would solve them. Social, economic, technological, and regulatory changes all have the potential to create market opportunities.

When inventor David Dodgen saw the suffering that Hurricane Katrina had left behind, he saw an unmet need that this event had created. By witnessing the disasters, he realized that when hurricanes or other disastrous events strike, they can contaminate the water supply in a region or city, or prevent access to clean water. As a result, he created the AquaPodkit, a plastic container that can temporarily store fresh water for weeks at a time in the event of an emergency. The Federal Emergency Management Agency (FEMA) recommends that people fill their tub if they feel that there may be a chance that water will be scarce. Oftentimes, tubs can be dirty, and people may not have the time to clean them. With this in mind, Dodgen developed a plastic lining, or bathtub bladder, which is manufactured in the United States and is safe to drink from, together with a pump that helps seal and open the plastic when the water is needed. This kit can hold up to 100 gallons of fresh water in the tub and has proven successful; it has also been featured by CNBC, *Entrepreneur*, and the *New York Times*.

LINK TO LEARNING

View this video about the AquaPodkit to learn more. Dodgen also created smaller bags and pumps that can be stored anywhere, not just in the tub.

WHAT CAN YOU DO?

Climate Change

Background: Earth's climate change is a topic of discussion with great importance these days. For many hundreds of thousands of years, Earth's temperature changes were attributed to tilts on its axis that allowed for more or less energy to enter our atmosphere. Recently, Earth's climate has experienced a dramatic increase in temperature, and most scientists around the world agree that it is attributed to human activities that emit carbon dioxide into the atmosphere.

Greenhouse emissions have increased the temperature of Earth to the point that glaciers in Antarctica and Greenland are now disappearing ten times faster than on a normal ice age recovery session, not to mention the many weather catastrophes that are seen around the world.[9] These changes in temperature have caused ice sheets to melt, snow caps to retreat, oceans to warm and become more acidic, water levels to rise, and severe weather to increase.

As harmful as it sounds, there is still time to change the negative effects of global warming. This can present some opportunities for social entrepreneurs who care about Earth's environment and business.

Your task: As a social entrepreneur, determine one or two opportunities for a business you could develop and test for market validity.

- What kind of opportunities are there to create positive change?
- How can you validate your assumptions?
- How would you test unmet needs?
- What kind of research would you conduct? Why?

Sometimes unmet needs are not uncovered immediately. One way to better understand a market's opportunities is to conduct a **market analysis**, which is an analysis of the overall interest in the product or service within the industry by its target market to determine its viability and profit potential. **Validation**, not to be confused with *validity*, is the act of verifying that a specific product is needed in a target market. This can be done by conducting formal or informal interviews or surveys with potential customers to gather their feedback. Dropbox is an example of a company that conducted validation over and over until they created a product that could work with a mainstream audience.

In addition to identifying competition and determining growth and profit potential, a good market analysis will identify the **total available market (TAM)** for a specific product, which is the total perceived demand for a product or service within the marketplace. It will also identify the **serviceable available market (SAM)**, which is the portion of the market that your business can serve based on your products, services, and location.

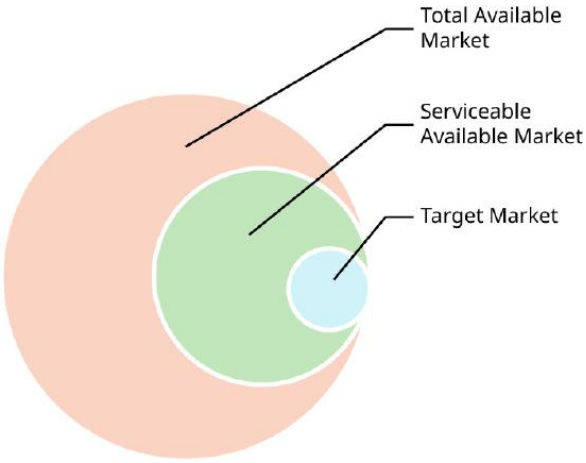


Figure 9.1.3.2: Entrepreneurs must focus on the target market within the TAM and the SAM and allocate resources to attract customers who can be satisfied by the value proposition. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license

To calculate this, let's go to our water bottle example. Let's say that you are trying to figure out what your target market is based on this concept. To calculate the TAM, you would look at the whole industry and determine the total number of customers available for water bottles or total revenue available. To find the number, you can look up the industry numbers for the category on databases such as IBISWorld, mentioned earlier, or any other data available through the World Bank or World Factbook to see the potential number of customers or revenue. This is called the top-down approach, as you are looking at macroeconomic factors to determine an industry's potential.

Another way to calculate the TAM would be by using the bottom-up approach, which involves counting local market sizes and figuring out the competitors' number of customers. After collecting this information, then all the local markets would be added up and multiplied by the average amount they spend on the product per year. Since your company cannot service all markets, the next step is to figure out the SAM. You could estimate the number of customers you can service by splitting the market into those you can service given your product characteristics and geographic, demographic, and cultural factors, among others.

Finally, considering the constraints of the company and strength of the competition, you would determine your focused target market to avoid wasting valuable resources marketing to people who are generally not interested in buying your product.

As an entrepreneur, you want to segment the market and figure out if there are possible pockets of people that you can serve. Segmenting, targeting, and positioning (STP) will help you figure out who is your best customer and will allow you to allocate your resources so that you can more effectively serve that customer. Let's look at these processes now.

Segmenting means that you separate the total population by homogeneous groups of people that have similar tastes, backgrounds, lifestyles, demographics, and even culture. You may segment along lines such as age ranges, gender, ethnicity, line of work, earnings, or activities. There are many ways to separate these groups to choose the right one for your business.

The next step is **targeting**. You select a target based on their ability and willingness to buy. As stated earlier, a target market serves to specify which group of the total market you will serve and how you will position yourself to distinguish your company or product from your competitor.

Positioning (value proposition) is a statement of how you want the customer to perceive your company, good, or service. For example, ModCloth is an online indie retailer that sells vintage, or vintage-looking, trendy, fun clothing that appeals to the global consumer who wants to be stylish. Another example is Wag! which positions itself as the app that lets the pet owner look for a walker on demand. Kind of like the Uber for dogs who want a walk when their owners can't take them!

ENTREPRENEUR IN ACTION

Wag! Dog-Walking App



Figure 9.1.3.3: The Wag! app allows busy people to choose from prescreened dog walkers so their furry friends will be well-taken care of while they're at work. (credit: modification of "A woman with her dog@Takayama" by JAR/Wikimedia Commons, CC BY 2.0)

As a dog owner, Wag! CEO and co-founder Joshua Viner struggled to find the time to walk his beloved dog after a long day at work. He knew it was unfair to keep her cooped up all day. He even considered finding her a new home. This canine conundrum led him to create Wag! in 2015 as a way to help people like him who loved their dogs but didn't always have the time to make sure they were properly exercised.

To start, Viner got together with Jason Meltzer, who, like himself, had experience creating consumer tech companies. Meltzer was the founder of pet services company Surfdog LA, which already had a proven track record of success. Together, they developed an app and website with the goal of making dog ownership easy and guilt free. Wag! gave customers access to trusted, prescreened walkers who could take their dogs out on short notice without them having to be present. Customers could even see their dog being walked via the app.

Since its inception, Wag! has been growing and entering new markets at a steady pace. After launching its service in Los Angeles and San Francisco in 2015, it continues to add cities across the United States.

Because the app's dog-walkers have access to their client's houses, one of the challenges Wag! faced was making sure customers trusted them and their dog walkers. Another challenge was the safety of the dog itself. What happens if a dog gets hurt or lost? It wouldn't take much for issues like these to turn into major problems.

- Describe the target market for this service.
- Are there other potential customers who can be a good target for this service?
- How can Viner position his business to assure pet owners that their dogs will be well taken care of?

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9.1.4: Marketing Techniques and Tools for Entrepreneurs

Learning Objectives

By the end of this section, you will be able to:

- Describe effective entrepreneurial marketing techniques (guerilla, relationship, expeditionary, real-time, viral, digital, word-of-mouth)
- Discuss the pros and cons of these marketing techniques

One of the hardest facts for entrepreneurs to absorb when starting a new business is that financial and human resources are limited. Fortunately, there are many marketing techniques available to entrepreneurs that require little more than a good dose of "sweat equity."

Guerilla Marketing

Coined by business writer and strategist Jay Conrad Levinson in 1984, **guerrilla marketing** refers to creative approaches to marketing that seek to gain maximum exposure through unconventional means. Guerilla marketing often means staging some sort of event or interaction that is designed to attract attention to a brand or product. The goal is to intrigue consumers by standing out from normal sales messages and the thousands of advertisements they are exposed to every day. These approaches usually have a component that encourages potential customers to interact with a company or product in a fun way.

Dennis Crowley, a serendipitous entrepreneur who taught himself to code and who was laid off by Google while working on his social networking site Dodgeball, was able to create and grow Foursquare through the use of guerrilla marketing techniques. Foursquare, the search and discover nearby businesses app, used this technique at the Austin, Texas-based South by Southwest film and music festival. The idea was to set a real game of foursquare in front of the convention hall that also raised awareness for the app. The games were an instant success and attracted thousands of participants who played all day long. If someone didn't know what the game was, a marketing team of 11 people helped them find it on their phones. Their efforts resulted in 100,000 views for the app that that day alone. All of this was achieved for the cost of a box of chalk and two rubber balls. Although the company had plenty of investments to sustain its operations, guerrilla marketing was a clever and helpful way to get users to test it and enjoy it.



Figure 9.1.4.1: Foursquare's guerilla marketing idea generated 100,000 new views for the app at the South by Southwest film and music festival in Austin, Texas. (credit: work by betsyweber/Flickr, CC BY 2.0)

Another example of guerrilla marketing that has been prominent over the last few years is flash mobs. A flash mob is a gathering of people at a public place to perform an act, be it a dance, entertainment, political stance, or some sort of artistic expression that conveys a message to the public for a brief period of time. This is organized through social media calls or emails to gather enough people to perform them. Flash mobs have been effectively used by companies to create awareness and reminders about their brands.

LINK TO LEARNING

You can watch videos of some of the best choreographed flash mobs in business.

Relationship Marketing

One of the main differences between start-up companies and established brands is the need for start-ups to nurture and maintain relationships with new customers. One way to accomplish this is through **relationship marketing**, which seeks to create customer loyalty through personal interactions and long-term engagement strategies. A small company can try to have a closer relationship with clients by writing personal notes by hand or sending an email thanking them for their business, by acknowledging their presence by their first or last name when they come into the establishment, by offering beverages, and by offering other personalized services.

An example of successful relationship marketing from a larger company comes from MooseJaw, a retailer specializing in outdoor clothing for hiking and snowboarding. At one point, a MooseJaw customer returned a piece of clothing that he had bought as a gift for his girlfriend. In his explanation for the return, he wrote, “Girlfriend dumped me.” Seeing this as an opportunity to engage with a customer, the company decided to send the man a care package.

A few weeks later, the man received a surprise shipment with a note saying they were sorry his girlfriend broke up with him so they decided to give him a gift. The box contained shirts, stickers, and other goodies. There was also a card with notes from MooseJaw’s employees. MooseJaw’s efforts were rewarded when the situation went viral on social media, which generated more exposure and support for the company.

Another way companies maintain relationships with their customers is through regular email newsletters. By using sales history and other market data, companies are able to customize the content of these usually free newsletters to the needs, concerns, and desires of their target market. This allows them to stay connected to their customers while developing strong connections and brand loyalty. Start-up companies can take advantage of the free and affordable options offered by such newsletter management software companies as MailChimp, Constant Contact, Mad Mimi, Marketo, Insightly, Slack, and Salesforce.

Expeditionary Marketing

One of the toughest aspects of entrepreneurship is to stay in business and grow in a highly competitive landscape. Businesses are born every day with the goal of making a name for themselves by providing better goods and services. One way that companies big and small can stay relevant is through expeditionary marketing.

Expeditionary marketing refers to strategies that are aimed at moving established companies and their products into new markets and territories. As the name implies, there is an element of risk and discovery involved in expeditionary marketing strategies as they help a company grow into new areas. Determining where and how to effectively enter these new markets often begins with an analysis of a company’s current market and its financial and human resources. Entrepreneurs will choose new markets based on where those resources might be able to fulfill an unmet need. Many small businesses need to leverage their gains as they move into new waters and perhaps more competitive landscapes. Having awareness of changes can foster planning and look for new ways to expand.

This type of marketing is very similar to entrepreneurial marketing, and the terms are often used interchangeably, except that expeditionary marketing involves existing companies continuing to innovate whereas entrepreneurial marketing also involves new companies. Companies that have succeeded in taking their businesses into new markets and consistently pivoting to create new products for current and new markets can be thought of as entrepreneurial companies. Big companies, such as Apple, Google, and Dropbox, have consistently developed products and entered new markets to keep abreast of the competition. Companies that did this while small, like Birchbox, also use this method to grow and fight off competitors.

Real-Time Marketing

Real-time marketing attempts to turn immediately available sales data (often collected from social media, websites, point-of-sale systems, and the like) into actionable and timely strategies that target the shifting landscape of consumer tastes and trends. Some of the tools entrepreneurs can use to secure information include analytics from Facebook, Twitter, and Google, as well as internal sales data. The information can include preferences for one brand over another, lifestyles, behavior, purchase frequency, and dollar

amount spent. This helps entrepreneurs set up strategies that focus on providing the customer what it needs in today's instant gratification society.

For example, a company such as Birchbox creates a post on Facebook or Twitter regarding a new promotion. It can then confirm the number of "clicks" the post gets and determine the depth of engagement for each of the posts. Clicks can be likes, shares, comments, and purchases that can be tracked immediately, minute by minute, hour by hour, or day by day, depending on the length of the promotion. Real time allows the marketer to assess the action followers take immediately after this happens. Success will depend on the goal that was set by the company. For example, if for one of their promotions, Birchbox expects 1,000 likes, 100 shares, and 30 conversions or purchases per day, it will be very easy to track whether the company is accomplishing its goal just by looking at the results every hour. This makes it very easy to gauge and to change. If a post is not getting the desired results in likes, shares, comments, or conversions in the desired timeframe, then the company can make changes to the communication sent to provide a different incentive, such as providing a deeper discount, or using different language, a new picture, and a better call to action. In addition, real-time tracking also allows for the company to answer tweets and comments from its followers immediately. This enables direct communication from customer to company without any interference or time constraints.

Viral Marketing

Viral marketing is a technique that uses engaging content in the hopes that viewers will share it on their personal and social media networks. Successful content then spreads like a virus, creating exponential exposure to a company's message.

The most important element of any viral marketing campaign is developing content that is not only engaging but that people also feel must be shared. Generally speaking, viral content is not "salesy" in nature; rather, it tends to be subtle about its presentation of branded items. In this way, the product or brand reaps the indirect exposure that comes with being part of content that people want to consume. A very successful campaign that included viral marketing is the Dove Real Beauty Sketches campaign where a real-life forensic artist sketches women's faces based on their own descriptions and sketches them again through other people's descriptions of their faces. When these sketches were revealed to the women who were asked to participate, they saw how much kinder and more beautiful other people had described them. This video never mentioned any Dove product at all. The result of this campaign was astounding, as it had more than 140 million views worldwide, becoming the best viral video of 2013 by connecting to the customer in an emotional way that was sincere and warm. This campaign also enabled the company to track results in real time and answer comments from viewers in a timely manner, while enhancing brand awareness.

Another example of an effective viral campaign is that of Dollar Shave Club which has garnered more than 26 million views on YouTube in response to the low budget and entertaining video by the owner of the company. Founded in 2011 in California with the goal of providing low-cost razors to men every month through a membership, the company has been so successful that it has since been acquired by Unilever.

The benefit of this kind of marketing is that it can lead to massive exposure for little or no effort or investment once the content is developed. The challenge, though, is that it is difficult to predict what will be successful viral content. Viral marketers often create a lot of content that does not go viral before finding content that does.

Digital Marketing

Digital marketing refers collectively to all digital (online) marketing efforts, which can include social media, email communications, websites, blogs and vlogs, and search engine optimization (SEO). This is an important area for entrepreneurs to explore because learning how to leverage digital channels and online analytics is key to remaining competitive in this technological era.

Digital ad spending has outpaced television ad spending in recent years. Digital ads include display ads, search ads, and social media ads. These can be very successful at targeting specific people in your target market and are usually more affordable than a TV ad. They are cheaper to make and to place than TV ads, which can cost millions of dollars for production and air time to reach a wide number of people. Digital ads are important for entrepreneurs because they are an effective way to redirect traffic to their websites and gain conversions on a budget. It does not matter how big your budget is. These ads can be strategically bought to be as cost effective as possible. They can range from a few dollars to millions of dollars, depending on your resources. Display ads are those that resemble banners and showcase a product or company on a website in a noticeable way. They come in various sizes, and the entrepreneur may buy them on third-party websites or search engines that provide space for ads. These ads are usually paid

using a pay-per-click model, which means that you only pay for the times that someone clicks on your ad, or you can pay for impressions, which means that you only pay for the number of times the ad appears on readers' screens.

Search ads, conversely, are those text ads you see while you are looking for something on a search engine, whether it's on your laptop, tablet, or mobile device. Google, Bing, and Yahoo! are the three biggest search engines in the United States that provide businesses the ability to create targeted ads to reach customers who are looking for something in particular. These ads are created using keywords that are strategically chosen to target people typing those specific words in the search engine and are paid through a bid system that allows the business to specify how much they will pay for an ad to be displayed in a better position on the engine's display pages. Google Ads and Google Analytics are tools that allow a digital marketer to search for popular keywords and create ads based on these terms to target the right consumer. These tools are so well designed and complex that it takes some time to get acquainted with all of their features and capabilities. Their main features, however, are to look for the right keywords, create the ad campaigns, and track their success.

Go to your favorite search engine and try to search for something. What kind of ads do you see on your screen? Someone on the other side has created these ads to connect with you. Did they do a good job?

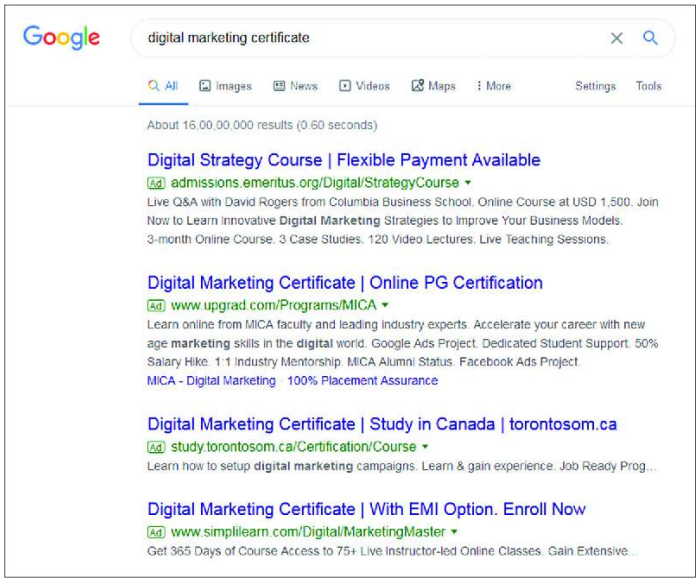


Figure 9.1.4.2: The Google Ads tool is effective for reaching targeted audiences searching online for specific products.

Social media platforms also have the capability for users to create similar ads on their systems to target people based on their behavior, likes, profiles, and searches for products online. Their popularity has increased as more people join the platforms and more information is gathered from them.

ARE YOU READY?

Solar Panels Are Hot

During the last ten years, solar panels have increased in popularity, as they are a great alternative to fossil fuels. Solar panels enable homes and organizations to transition from electricity generated from fossil fuels to clean energy. Given the current climate state and changes in the energy industry, solar panels have become an excellent way to save money on electricity over the long run, a great way to receive tax credits, an incentive to add equity to homes and buildings, and a help to the environment. The cost of installing such technology has decreased over the years thanks to the new technology available, the increase in competition, and the overall increase in demand of the product. Consumers can install the cells on their roofs at a more affordable price.

Given the recent trends and interest you have in helping the environment, you've decided to get a part-time job at a new local solar panel company. This company has a very small market share (less than 1 percent), or percentage of customers, compared to the rest of its competitors. Their goal is to increase that percentage to 2 percent of total customers by the end of the year. To reach that, they have hired you as their marketing coordinator.

As part of your job, you decide to create a plan for a promotion to reach a targeted number of people. This promotion must be conducted online and on a budget. On your first few days on the job, you research the various types of ads that could most effectively reach the most people looking for solar panels. Once your research is over, you come back to the owner and help her decide which ads to use. Focus on the following three areas and provide your advice to the owner.

- What are the best types of ads and platforms for this type of company?
- What is the average price per ad clicked or seen?
- What are five to ten common keywords that can be used in the ads?

Blogging has become an important tool for business owners. It allows them to share information about their companies, products, and their experiences in written or video form. Blogging enables entrepreneurs to create a name for themselves, especially when the content is useful and people are interested in what the blogger has to say. Strategies that help entrepreneurs include making the time to blog, having a specific niche, choosing interesting topics that matter to the blogger and the audience, and using other branding and SEO techniques that help the blog become more visible.

Content marketing is an important topic for digital marketing, as content has become more important in recent years. Content can be displayed as a story, a blog, a website, social media posts, a newsletter, an article, videos, or anything else that has the ability to convey a message to the consumer. This is a valuable tool to distribute content that is useful, which can engage the target audience and entice them to take some sort of action. The entrepreneur must take the time to create useful content to connect with current and potential customers online. Entrepreneurs can also tap influencer marketers to disseminate information about their brands. This includes tapping into social media celebrities, who usually have millions of followers on YouTube, Facebook, Instagram, or similar platforms. This has been one of the biggest recent trends in marketing. When working with influencers, it's important that they disclose that they receive compensation for any product or service they are talking about to avoid legal risks.

Email marketing is a form of direct mail that connects to consumers in a personal way. Emails can contain useful content for consumers, promotions, and tips that entice them to try or be aware of a product. Many email marketing platforms offer services at an affordable price, including Constant Contact, Mad Mimi, Mail Chimp, and Drip. All of these platforms allow the entrepreneur to upload a list of customers or potential customers and create email marketing campaigns that are tailored to each target market. These platforms also offer useful metrics, such as open rates, click-through rates, time spent viewing the message, and conversion rates, which can measure the effectiveness of a campaign.

Word-of-Mouth Marketing

Word-of-mouth (WOM) marketing occurs when a satisfied customer tells others about their positive experience with a good or service. Although similar to viral marketing, WOM does not involve active participation from the marketer and almost exclusively involves only customers, whereas viral marketing attempts to build awareness and buzz mostly via videos or email.

When consumers are very happy with their purchases, they will let people know, whether it is in person or on social media. The company has less control over this type of marketing because it happens organically. While effective WOM marketing can have a huge impact on a brand's sales and visibility, creating WOM is tricky—people have to want to talk about your product.

One way to encourage WOM is to ask satisfied customers to help you spread the word by talking to their circle of friends and family, or by sharing comments online on the website, through portals, or through social media. Companies often include call-to-action cards in their shipments that direct customers to post reviews on their website, the website where they purchased the item (Ebay and Amazon), or on public review sites such as Yelp.

Entrepreneurs who do this need to make sure they monitor what is being said about their businesses so that poor reviews don't undermine their marketing efforts. Many of these sites allow businesses to address and resolve bad reviews, which is a good way to turn a potentially damaging situation into one that creates goodwill and positive brand recognition.

Lululemon is a yoga and athletic wear company that knows well about customer reviews. On its site, customers have the opportunity to leave comments about each of the garments regarding the size, fit, quality, and ease of use. Although the quality of Lululemon garments is high, some customers still have negative experiences and don't hesitate to share their comments on the site. The company responds with an apology for the negative experience and redirects the unsatisfied consumer to an email so they can

move the conversation off the site. This allows the company to make amends with the customer and hopefully remove the negative comments if the issue can be resolved.

Table 9.1.4.1 summarizes entrepreneurial marketing techniques.

Table 9.1.4.1: Entrepreneurial Marketing Techniques

Marketing Technique	Description	Example
Guerilla marketing	Aims to gain maximum exposure through unconventional means	Events, such as flash mobs
Relationship marketing	Creates customer loyalty through personal interaction	Personalized communication to individual customer
Expeditionary marketing	Strives to move established companies and products into new markets	Pivots that create new products or attract new markets
Real-time marketing	Seeks to turn immediately available sales data into actionable and timely strategies that target the shifting landscape of consumer tastes and trends	Analyzing clicks or “likes” and modifying posts/offerings in response
Viral marketing	Uses engaging content in the hopes that viewers will share it on personal and social media networks	Subtle branding embedded in stories users want to share
Digital marketing	Uses online marketing strategies	Online ads and use of search engine optimization (SEO)
Word-of-mouth (WOM) marketing	Relies on satisfied customers telling others about their positive experience	Online customer reviews

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9.1.5: Entrepreneurial Branding

Learning Objectives

By the end of this section, you will be able to:

- Understand the importance of customer-focused branding
- Explain the steps in defining and developing a brand
- Describe the benefits of brand advocacy

In a business context, the word brand has multiple meanings. First, a *brand name* is the name of a product or service offered by a company. For example, Coca-Cola and Goodyear are brand names. But the **brand** also means the image a company promotes and the connotations it fosters of itself and its products. For example, the Coca-Cola brand might be seen as refreshing, youthful, and quintessentially American. The Goodyear tire brand might be seen as performance-driven, affordable, and reliable. A logo, advertising messages, public perception, celebrity endorsements, promotional strategies, and other factors all play a part in promoting a company's particular brand.

Branding is often less about a product's actual benefits or value, and more about how it positions itself within its target market and connects with its loyal customers. Establishing a brand at a company's inception is more challenging than managing a brand that has been present for many years. In the case of a start-up, the initiatives undertaken must be customer centric and should speak directly to the heart of the consumer. These must have a trustworthy and emotional appeal to create a bond with the customer. Let's delve deeper into this.

Customer-Focused Branding

The image a company conveys to its customers is managed through what is called **brand strategy**, which can include advertising, public relations, customer service, and sales promotions.

One common branding strategy is the use of **taglines**, which are short and catchy positioning statements that quickly communicate some core aspect of the brand to the consumer. Taglines can be a powerful tool, and in some cases can become as recognizable as the brand names themselves. Consider the list of taglines from recent start-ups in Table 9.1.5.1. Do they do a good job of communicating the key attributes or benefits of the brand name they are linked to?

Table 9.1.5.1: Taglines of New Companies

New Companies	Tagline
Hello Fresh	Simply Delicious Meals
Airbnb	Belong Anywhere
Uber	Get There
BirchBox	Open to Beautiful
Snapchat	Life Is More Fun When You Live in the Moment
LuminAID	Makers of Brilliant Things
Uptown Cheapskate	Buy. Sell. Trade.

Consider the taglines shown in Table 9.1.5.2. They have been around for a long time, and most customers are familiar with them. Why do you think these taglines have endured over time?

Table 9.1.5.2: Taglines of Established Companies

Mature Companies	Taglines That Have Endured Time
Nike	Just Do It
Apple	Think Different
Subway	Eat Fresh
Walmart	Save Money, Live Better
State Farm	Like a Good Neighbor, State Farm Is There
Master Card	There are some things money can't buy. For everything else, there is Mastercard.
Maybelline	Maybe She's Born With It, Maybe It's Maybelline.
Red Bull	Red Bull Gives You Wings
General Electric	Imagination at Work

Consider, also, how jingles can have a powerful effect on people's recollection of a message. A **jingle** is a very short song or sound that brands a product or company and helps promote it. These tunes are very easy to remember, bold, and fun. Jingles are similar to taglines in that they feature a sound that is catchy and easy to understand by the recipient. Which jingle do you remember off the top of your head?

LINK TO LEARNING

Taglines are not just visual. They can also employ sound. Consider the "Intel Inside" riff or the three notes of NBC's network chime. Sound plays a big role in brand recognition. And jingles are sure bets that entertain as well as forge a connection to a brand. Check out this website for a history lesson in some of the most famous radio and TV commercial jingles of all time.

Other components in a brand include the website, social media, customer service, and packaging. These are important components of a branding strategy that use technology to convey the message. A website allows a company to create an image of its business pages that are linked to each other. These pages convey branding information about a company that sends a message to the consumer through the use of the business logo, colors, copy, ease of use, product information, and e-commerce capabilities. The LuminAID website conveys an image and at the same time has important calls to action and serves as an example of successful branding. This site uses colors, images, and fonts that create a specific image of modern lighting that entices customers to purchase the products and other stakeholders to give light to people who need it.

In addition to the ability of a business's website to convey the company's story, social media platforms reinforce the connection to the consumer. Social media platforms such as Facebook, Twitter, Instagram, and YouTube allow companies to invite customers to join the conversation by posting pictures of their use of products, making recommendations, participating in contests and giveaways, and obtaining coupons and other perks. Entrepreneurs have these tools at their disposal to continue creating the image of the business that perhaps got started as a brick-and-mortar business. Today, tools such as Wix, an easy, online website builder, can be used to develop this branding. Entrepreneurs with larger budgets can hire a website designer to create and help promote the site.

Customer service is another tool that can create a strong company image. Training salespeople and cashiers to be courteous, resourceful, and knowledgeable creates an image in the customer's mind about the product and the business. Wearing uniforms can also create a positive image. Customer service is particularly helpful when dealing with services because it gives some tangibility to the product that the customer cannot see. For example, a hairstylist cannot provide a tangible depiction of how a haircut might look on a customer, but his or her demeanor, attire, and hair, can give the customer clues as to what treatment and results he or she can expect. Packaging is an important component of branding. The design of the package, the color, the information that is conveyed on the package, and the practicality of the package all create an image of what is to be expected from the product.

Method, an environmentally conscious and customer-focused brand of cleaning products, is an example of a company that distinguished itself from the competition by employing effective branding strategies. By using recycled, environmentally friendly packaging and promoting their commitment to using plant-based, nontoxic chemicals, the company was able to attract the attention of, and eventually place their products in, Target stores nationwide.

First, Method convinced Target to use their products to clean their own stores; after a successful test, they convinced the company to carry its line, which includes soaps, detergents, and cleaners. Its quirky brand message helped land the account, as Target is a progressive and innovative retailer. The brand message that Method conveyed to them was that everything inside the cleaning bottles was plant-based, and no harsh chemicals were used in creating the product. The products were either as or more effective than leading brands. In this case, the brand message conveyed the mission of the company in all of its products by integrating all the aspects together in a simple manner through the use of clear bottles, quirky fonts, and (nontoxic) colored liquid.



Figure 9.1.5.1: Method's quirky packaging, design, and plant-based ingredients were all part of its successful brand strategy. (credit: work by Carol Bleistine/Flickr, CC BY 4.0)

The benefits of developing a good brand are several. A brand is the image of a product or service that conveys to customers who when they purchase from a particular brand, they will receive the value (quality, price, and experience) they expect. The next time they see that brand, they will choose it again because their previous expectations were met, simplifying their buying-decision process. New products must also break through crowded marketplaces and be visible to consumers who already have an attachment to other brands.

Trust in a brand can save the consumer time and may create an emotional connection to the company. However, not all benefits work for all brands and all purchase decisions. When a customer is purchasing low-commitment products and services, like cleaning products, the decision process can be quick and heuristic. When purchasing more expensive items such as electronics, vehicles, or vacations, the brand is just one of many attributes the consumer will consider.

Defining and Developing a Brand

A brand should have a clear purpose derived from the company's mission. If the purpose is to provide plant-based cleaners that are not harmful to people, pets, or the environment, as in the case of Method, then the brand must communicate this throughout all of its interactions with its consumers. The unique selling proposition, benefits, qualities, and overall image should be conveyed throughout the marketing mix to tell a story. In addition, the brand should have a well-designed logo, the company/product name, merchandise, promotional items, location of the business (that also provides an image or tells a story), and any other tools that communicate with buyers.

Keep in mind that there are differences in branding regarding business size and type. When starting a business, it is likely that you will brand your entire business with one logo, one name, and matching promotional items, business cards, and product packaging. As your number of products grows, you would likely develop different packaging and different images for other product categories.

Figure 9.1.5.2 provides a checklist of items that help develop a brand for your venture.



Figure 9.1.5.2: When starting a business venture, following a few key steps will help in establishing a strong brand. (CC BY 4.0; Rice University & OpenStax)

Promotion through Brand Advocacy

One way to promote your brand is to identify loyal customers who are willing to share positive feedback about it. A **brand advocate** is someone who is a fan of your products and passes on the word to others. Brand advocacy is a potentially inexpensive means of building a brand and one that entrepreneurs should explore. One simple way to motivate brand advocacy is by asking your best customers and fans to refer other customers to you, leave online reviews, and/or to blog or comment about your company and products online. Companies often offer discounts and promotional codes to encourage brand advocates to spread the word.

The key to effective brand advocacy is to know the goal of your advocacy campaign, look for ambassadors (there are many online and in-person events), ask them to perform a task, and reward them for doing so.

An example of advocacy branding is to create a contest to engage consumers who love your product so they can share pictures on social media. IKEA did this in 2016, when it started a contest to win a personalized wardrobe using the hashtag #JoyOfStorage to entice its most loyal fans to share their IKEA products online. The contest asked customers to post pictures of their IKEA products on Facebook. This campaign allowed IKEA to engage and reward loyal customers in a fun way, while also using word-of-mouth marketing to expand their marketing reach.



Figure 9.1.5.3: The IKEA #JoyofStorage contest engaged loyal fans and rewarded them for being brand advocates. (credit: work by this_could_be_my_house/Flickr, CC BY 2.0)

WORK IT OUT

Forever 21

After living in Los Angeles for a few years, South Korean natives Jin Sook and Do Wong Chang decided to open a clothing store. They named it Fashion 21. The store became a success, bringing in over $700,000 in revenue in 1984. Next, they decided to open new stores twice a year while at the same time changing the name of the store from Fashion 21 to Forever 21, expanding their brand globally. While the stores have historically generated over $3 billion in annual sales, the retailer recently filed for bankruptcy, citing struggles to pay vendors and landlords. The filing comes along with the closing of 178 underperforming US stores and allows Forever 21 to "simplify things so we can get back to doing what we do best."[15]

Bankruptcy aside, Sook and Chang have remained at the helm of the company and their children are also in management, one working in marketing and the other in branding. Branding helps the company remain relevant to its youth segment by positioning itself as trendy, innovative, and particularly adaptive to ever-changing tastes in fashion. The company uses its logo, retail stores, and website to showcase its trendy image.

Forever 21 has been sued several times for copyright infringement, as the essence of the company is to provide fashion looks inspired by runway designs but offered at a lower price point. Forever 21 has a long history of settling copyright suits, including a case involving H&M. It has been in legal battles with Adidas, Puma, and Gucci as well.

- If you were the branding manager, how would you prevent these suits from happening?
- How would you develop a better image of the company?

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9.1.6: Marketing Strategy and the Marketing Plan

Learning Objectives

By the end of this section, you will be able to:

- Distinguish between a marketing strategy, a marketing plan, and a pitch
- Describe the elements of a marketing plan

Now that you have a better idea of what marketing is, you are ready to start developing a marketing strategy and plan. A **marketing strategy** describes how a company will reach consumers and convert them into paying customers. Having a solid-yet-flexible marketing strategy is a good business practice, no matter what kind of business you are in.

A **marketing plan** is a formal business document that is used as a blueprint or guide for how a company will achieve its marketing goals. A marketing plan differs from a business plan in that it focuses more on market research, attracting customers, and marketing strategies, whereas the business plan covers much more than that.

Marketing plans are important tools because they act as roadmaps for everyone involved in an enterprise. Writing a marketing plan forces you to specify goals and develop strategies to reach them, and encourages you to research markets and competition. A strong marketing plan will encourage entrepreneurs to think deeply about their business and profit potential, helping them make better business and marketing decisions. Additionally, a marketing plan can create greater involvement and cohesiveness among employees by clarifying goals and expectations.

A variety of marketing plan templates are available that can be modified to fit your business's product and/or services. One thing to consider is why you are writing your plan and who your audience is. In addition to planning for your venture, will it be used by employees or potential investors? Different audiences will require different kinds of information. If it's an employee, then you must include extra details about the operation of the business. If the plan is geared toward acquiring an investor, be sure to highlight the value that will be gained from investing.

Keep in mind that the various parts of a plan do not need to be written in a certain order. Plans should also be seen as flexible guides rather than absolute rules. All good marketing plans are living, breathing documents that help you measure success while allowing for course corrections when necessary. Table 9.1.6.1 provides the standard components of a marketing plan.

Table 9.1.6.1: Sample Marketing Plan Sample

Marketing Plan Section	Description and Purpose
Executive Summary	Provides a snapshot of the whole plan, including profit potential and major strategic ideas
Situation Analysis	Overviews internal and external environments related to the business and product; internal environments include company background and mission; external environments can include market needs, competition, market research, and an analysis of strengths, weaknesses, opportunities, and threats (SWOT)
Marketing Opportunity (Unmet Need, Proposed Solution, Value Proposition)	Validates the market opportunity being exploited by the business and articulates the potential gain for stakeholders
Business Model	Presents the framework for generation of sales and the business's competitive advantage
Marketing Objectives	Specifies goals for sales (in units or dollars), market share growth, brand awareness, secured distribution channels, inventory, and pricing
Marketing Strategies	Explains target market, projected positioning, and strategies as they relate to the marketing mix (7Ps)
Action Program	Defines who will do what and when
Financials	Discloses sales estimates, projected budgets, and financials that will help readers understand the present and future economic condition of the company
Control Procedures	Describes procedures for measuring results, monitoring goals, and adapting the plan as needed

Executive Summary

The **executive summary** is just that—a clear and concise summary of the major points of your marketing plan. Though it is placed first, it is generally written last because it is based on the information presented in other subsequent sections.

The executive summary is typically one or two pages long and includes key indicators of success for the business and its stakeholders, which may include company owners, managers, consultants, investors, and banks. Your goal is not merely to summarize everything in your plan but to highlight why people should be interested in your venture. Whether the reader is an employee or a potential partner or investor, the executive summary should seek to not only inform but to excite.

Focusing on the opportunity at hand, what makes your business model special, and the potential financial reward is a good way to capture a reader's attention. For example, if your business' strengths include a great marketing team and a significant competitive advantage, you should highlight them as reasons for success. Some readers may only read this section, so make sure you highlight what makes your company special and how you plan on turning that into profit.

Situation Analysis

In many ways, the basis of your marketing plan is found in your **situation analysis**, which is an examination of the internal and external circumstances relevant to your business and product. A good analysis will provide the logical support for the strategies you choose. For example, the research you conduct here explains why you will develop a certain product, how you will price it, and what you will do to reach your target market.

Good situation analyses often include a SWOT analysis, which looks at a company's strengths, weaknesses, opportunities, and threats. They also look at future and current competitors, and include market validation research that has surveyed potential customers. This information is critical because it proves that you have done your due diligence on your product and market.

Marketing Opportunity

Assuming your background research has led you to determine that there is a business opportunity, this is where you explain what and where that opportunity is. For example, if your research led you to discover a gap in the market for educational children's toys, this is where you explain the depth of the opportunity. Here you use your research as evidence to prove to your reader that there is a market gap and that you know how to fill it. If your goal is to get an investor interested, this is where you would let them know what they stand to gain and when they would gain that.

LINK TO LEARNING

The US Small Business Administration strives to help business owners initiate and succeed in developing enterprises. Their website is loaded with helpful information, classes, and templates that can help the entrepreneur navigate the intricacies of marketing, as well as provides helpful tips on developing a marketing plan.

Business Model

In this section, your job is to marry the opportunity you saw with the solution you have created. Here you articulate how your competitive advantage and points of differentiation (nature of the solution and its key features and benefits) will provide value to customers and earn profits that will sustain your business into the foreseeable future. What will you do to create value that attracts customers? How will you generate sales? Who is your target market? If you were opening a gym, this is where you would lay out how you will capture customers, the value they will receive, what types of membership contracts will be available to them, and so on.

A great tool for capturing this information is the Business Model Canvas. The nine building blocks of this model will help you to determine the targeted customer segment, value proposition that you will present each of your segments, channels for the distribution of the proposition or touchpoints, type of customer relationship you will build with your target, types of cost structures and revenue streams based on pricing means, and key resources, activities, and partners that will help you to succeed.

The canvas also allows the entrepreneur to innovate and to change if something doesn't work out. The point of this tool is to put the pieces of a plan together.

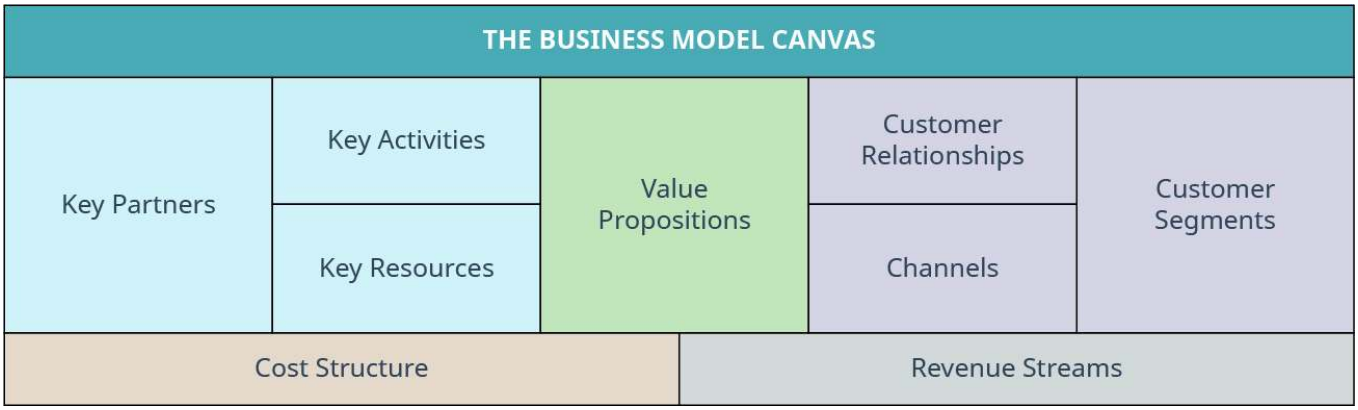


Figure 9.1.6.1: A business model canvas brings together key strategies about the product being launched. (CC BY 4.0; Rice University & OpenStax)

Marketing Objectives

Here you present your specific goals and their tangible outcomes. It is not enough to say that you will be very successful without defining what exactly success means. The point of this section is to quantify your goals as units sold, sales/revenue, market share, or some other practical metric. Goals can also include creating measurable brand awareness and developing a certain number of distribution channels.

For example, good, measurable goals might be selling 300 units per month, selling $600,000 worth of product in a year, or gaining brand awareness of 10 percent of your target market in three months. Avoid goals that are unmeasurable or vague, as they won't help you now or later.

No matter what your goals are, they should be reasonably achievable and as specific as possible. The reason for this is so that later on, you can determine whether you have been successful. If you haven't, you will know something needs to change.

Marketing Strategies

As mentioned earlier, having a good marketing mix will help your business succeed. As an entrepreneur, you want to segment the market and figure out if there are possible pockets of people whom you can serve. The process of segmenting, targeting, and positioning (STP) will help you figure out who is your best customer and allow you to allocate your resources effectively to serve that market.

After going through this process, you can look at the marketing mix, and depending on whether you have a product, service, or a mixture of both, which is usually the case, you will outline your approach to the 7Ps of the marketing mix.

Action Plan

In the action plan, you detail how things will get done in your business on a day-to-day basis, when they will get done, and who will be doing them. Often, new business owners develop extensive strategies, but they don't have the people power to implement them. Obviously, ensuring that you have the necessary human resources in place to execute your goals is important. This is the section where you make it clear that you do. For example, if you have a marketing team in place, highlighting their ability to execute your plans will help convince potential investors that you can put your plan into action.

Financials

Here you include budgets, forecasts, and any other information that will give readers and potential investors a clear picture of your business's financial situation. Being transparent and truthful will create trust and goodwill between your company and potential investors.

This section is also important because it will help you determine how profitable your business might be. One place to start is by determining your expenses and future profits. Since most entrepreneurs tend to overestimate these numbers, it is best to develop financial projections for best- and worst-case scenarios, as well as a projection for an average case scenario.

Many entrepreneurs develop one-, three-, or five-year projections to get a sense of future profits and to prove that their business model is sustainable over the long run. Figure 9.1.6.2 provides an example.

5-Year Financial Projections: Sammy's Grocery Store

	2018	2019	2020	2021	2022
Sales/Revenue	$100,000	$150,000	$170,000	$190,000	$198,000
Cost of Goods Sold	$ 30,000	$ 50,000	$ 55,000	$ 57,000	$ 60,000
Sales and Administrative Expenses	$ 40,000	$ 55,000	$ 60,000	$ 60,000	$ 70,000
Depreciation	$ 10,000	$ 7,000	$ 8,000	$ 8,000	$ 10,000
Operating Profit	$ 20,000	$ 38,000	$ 47,000	$ 65,000	$ 58,000

Figure 9.1.6.2: Growth projections appear in the financial section of the marketing plan. (CC BY 4.0; Rice University & OpenStax)

Key Performance Indicators

Finally, you need to determine your key performance indicators, or how you will evaluate the effectiveness of your strategies, by looking at the progress you have made during a specific timeframe. These include the quantitative milestones that will tell you if you are on the right track, help you analyze your decision-making process and focus on specific strategies, and make changes if these don't work.

For example, one of your milestones might be a sales goal of $50,000 within the first six months. If you are not on track by the time you hit this milestone, it can be an indication that you either overestimated your sales or your strategies are not working. In either case, you will need to make actionable steps to revise your projections or find more effective strategies.

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9.1.7: Sales and Customer Service

Learning Objectives

By the end of this section, you will be able to:

- Explain the importance of sales strategy and provide an example
- Explain the importance of customer service

A **sales strategy** is a plan that the entrepreneur uses to identify and engage a consumer, from prospecting to securing the sale. This strategy should keep in mind the core benefit or competitive advantage that the product or service has and make sure this information filters through the entire sales execution process. The strategy should include a six-step process that is an integrated sales system for how to prospect, pitch, handle rejections, and the like.

Setting objectives is important before reaching out to prospects and current customers because they allow the salesperson to detail the strategy, have an end goal, and measure the results. For example, a salesperson may have a goal of closing one client out of ten prospects he or she sees per week (or through a sales cycle). So the detailed strategy would be:

1. Doing research about prospective clients and creating a list,
2. Calling them to set up an appointment to talk about your product or service,
3. Meeting with them to present a proposal,
4. Handling objections,
5. Closing the deal, and
6. Nurturing the relationship after close.

The end goal would be to gain a prospect as a client and develop a good relationship for future business. And the salesperson would measure the results by looking back at goals and outcomes.

There are many methods, tools, and techniques to sell, and there is no perfect set of strategies for a business. It depends on the goals and resources of the entrepreneur, as well as on the type of product he or she is launching. When selling to customers who are going to be spending a substantial amount on a product or service, like a piece of equipment, a luxury yacht, or an expensive software program, there must be a sales system in place to take consumers from prospects to customers. The preceding six steps are general stages in this system. Let's take a look at each step.

Sample Six-Step Sales Strategy

Figure 9.1.7.1 outlines an example of an effective sales system or strategy using a six-step approach.

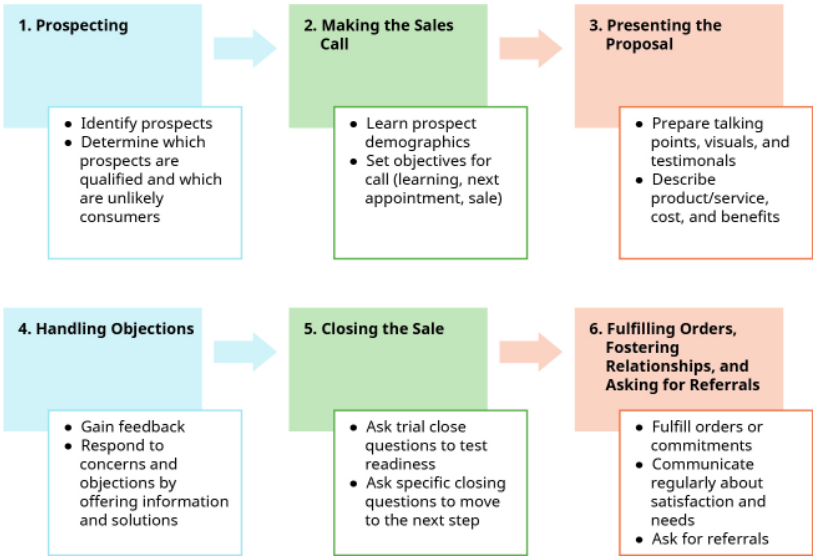


Figure 9.1.7.1: The six-step sales process does not end with the sale but with a positive customer relationship. (CC BY 4.0; Rice University & OpenStax)

Prospecting and Preparing

Prospecting focuses on finding potential new customers for the product or service. This helps acquire new customers, replace customers lost to attrition, and expand sales from current customers. In essence, prospecting allows salespeople to collect information about potential customers and identify any who are not a good fit for the company. It is important to get as many prospects as possible to secure a few customers, as the pool of prospects diminishes through successive steps of the sales process.

You may need to have a list of twenty prospects to secure one or two customers. Prospecting also tends to be more important in certain industries such as financial advising or business-to-business industries. To determine whether a person or organization is a qualified prospect, the salesperson must consider several issues, such as whether this person/business needs my product or service, and if they can afford it.

Making the Sales Call

The next step of the sales system is to prepare for a sales call, contact, or meeting with a prospect. Effective sales people usually prepare well in advance of contacting a prospect. A salesperson can look for information regarding the company's demographics, its competition, clients, and other companies they purchase from. Information can be gathered from online sources or referrals. It is also helpful to set objectives before contacting the prospect. Some of those objectives can include securing an appointment for a presentation, understanding the prospect better, scheduling a second call/contact, or perhaps starting a sale.

LINK TO LEARNING

Neil Rackham wrote a book in 1998 called *Spin Selling*. It's a classic in the sales world. In it, he outlined a new way to approach winning big sales deals. SPIN stands for situation, problem, implication, and need payoff. Visit the SPIN site to learn about Rackham's nontraditional approach to sales and the main principles he advocated.

Presenting the Proposal

Once the salesperson has made a connection with a prospect and understands the prospect's needs, the next step is to meet with the prospect for a sales presentation. A presentation is a great way to expand the prospect's understanding about the offering. Strong presentations include good communication skills with strong visuals and testimonials. In this step, the salesperson can make a better case for the value proposition, citing the strengths of the product and how this would help the prospect in his or her life or how it would help a company's objectives. The presentation can also include the cost of the investment and a projection of the return on investment. In the case of a financial advisor, a presentation at a prospect's home would show the potential products that the prospect might invest in, such as a variety of retirement accounts, life insurance, a college savings plan, or long-term care insurance, along with the costs and benefits of each. In the case of a business, the presentation could take place at the prospect's office, and the meeting could include a slide presentation about a piece of equipment, with video showing how it is used and how it can benefit the company, including cost savings.

Handling Objections

During or after the presentation, a salesperson will likely encounter objections or questions from the prospect. This is a good way for the salesperson to gain feedback and respond to concerns from the prospect. Objections can arise during the appointment setting, during the presentation, or while trying to close the sale. The salesperson must be proficient at dealing with these in a truthful manner so the relationship that is established is based on trust. Some of those objections can include cost concerns, credit capabilities, product benefits, or plain rejection of the product. In this case, the financial advisor could answer questions about the potential benefits of one type of insurance over another, or handle objections on the monthly payment plan. If dealing with a company, these questions can take the form of credit opportunities and amount of cost savings in comparison to a competitor.

Closing the Sale

Once the presentation and objections are handled, the next step is to **close**, or ask for the sale. This is as important as being prepared to present and handle objections because it signals to the prospect that the product is a good fit and the relationship can be created. A good closing includes a trustworthy and logical process. Doing a trial close by asking "How is this so far?" or "Can I answer anything else?" can help the customer feel more at ease with making a decision. The customer will help set the pace for a final closing. Then, the salesperson can set up the next steps or ask the following questions: "Can I place the order for you?" "Can

we open the life insurance account for you?" "Can you come see the demonstration at our office?" "Can we meet next week for the financial terms?"

Fulfilling Orders, Fostering Relationships, and Asking for Referrals

Finally, the salesperson must fulfill the order and make sure that the customer is satisfied with the product or service. The salesperson, in the end, is the one who is the main contact for the customer and therefore is responsible for the fulfillment of a correct order. The order needs to be closely monitored in case there are any delays or issues with it, so the customer can be immediately notified. The process of the order fulfillment has to be monitored until it is fulfilled. Software has now made it easier to keep track of these orders, so the salesperson can spend more time selling and less time on the order process. Customer relationship management tools such as Salesforce (www.salesforce.com/crm/) can help a small entrepreneur or a larger business keep track of its customers, their orders, troubleshooting, and strategies for cost effectiveness.

Building a direct relationship with the customer is also important; therefore, calls or emails to check in consistently is important to assess customer satisfaction and t build the relationship bridge to ask for referrals. Customer retention is more important than ever, as even a small percentage of customers can make up the majority of your sales. Wooing new customers is 5 percent more expensive than keeping your current ones, and in the long run, those who are your VIPs will generate most of your sales. Research shows that retaining even 5 percent of your current customers can generate anywhere from 25 percent to 95 percent of your sales.

Customer Service

One of the most important aspects of making the sale, and one that often wins or loses customers, is customer service. If you have ever stepped into a business where you have been greeted with a smile and treated kindly throughout the purchase process, you will probably want to come back and purchase from that store or salesperson again. However, if the sales associate is rude and doesn't help you find what you need, chances are you will not return to the store a second time. For start-ups, customer service can be an advantage, as the business can focus on a few customers at a time in a more personal manner. The bigger a company is, the harder it is to manage many customers and sales associates on a personal level.

According to Hubspot's top statistics on customer service, 70 percent of the customer experience or journey depends on how they are being treated. The majority of customers fall in love with a brand and are willing to pay a premium for amazing customer service, and they feel that great customer service is more important than price. They will also share positive experiences with other people—an average of eleven, according to Hubspot. When a customer has a negative experience, or feels unappreciated, they are more likely to switch brands, and a company has to work harder to counteract a negative experience. It takes twelve positive reviews to counteract just one negative, unresolved customer issue.

As an entrepreneur, focusing on customer service before and after the purchase is an effective reminder that the company is trying to build trust and have a relationship with its customers. This also helps with the process of branding, as you've learned. Even in business-to-business sales transactions, the most important aspect of the sales process is building that trust relationship so the customer purchases from a "friend" again. Often when companies lose accounts, it is due to a change in sales personnel and the loss of the associated relationship.

One effective way to ensure great customer service is to create an operating manual for your employees that includes proper techniques for customer service. These techniques can include how to greet a customer, how to listen and help them get what they need, the philosophy of your company, how far to go when insuring great service, and how to be creative with customer service. Employees can review the manual when they are hired, and every year after that to ensure they continue to follow the procedures. Training programs before starting work and during the year can be facilitated by the entrepreneur or a consultant to sharpen the skills of the employees. These programs are a great way to energize salespeople to be more people oriented and to develop the proper attitude and positive thinking that is required when helping customers. Sales training programs are a great way to learn more about customer service. Zig Ziglar and Dr. Cialdini programs are designed with the salesperson in mind.

Also, when hiring, focus on candidates who already have customer service experience and those who come with good referrals. Incentives for great customer service such as an employee of the month/year award or financial incentives can also encourage employees to provide great service. Finally, the entrepreneur and any administrators are the leaders of a company who must show the same customer service to their employees. Walk the talk! If they realize that they are there to serve their employees and enable

them to create a great customer service atmosphere, then the employees will share the same enthusiasm and energy toward their customers. Happy employees turn into profitable customers. Figure 9.1.7.2 shows a quick checklist for beginning entrepreneurs.

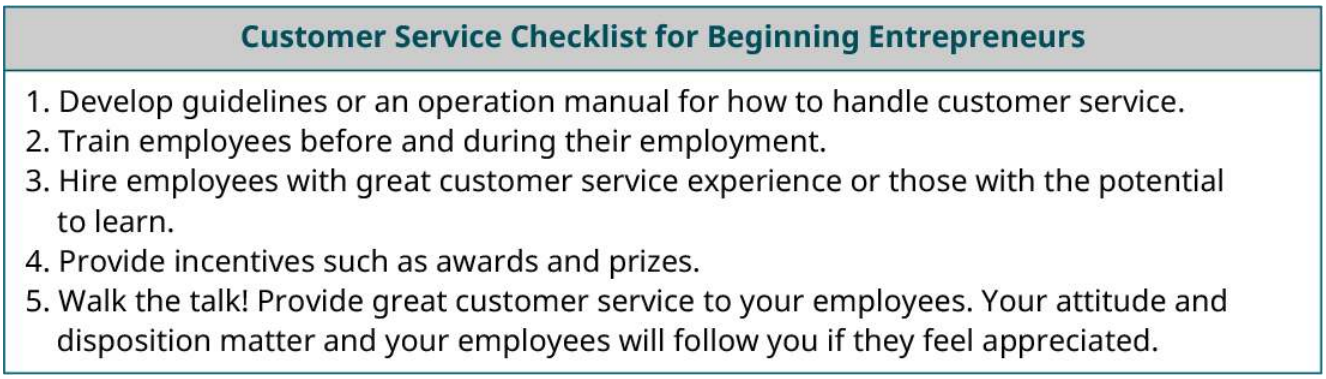


Figure 9.1.7.2: The quality of customer service can make or break a company. Following a few basic steps can ensure great customer service. (CC BY 4.0; Rice University & OpenStax)

Customer service doesn't happen just in person or on the phone. Technology has enabled people and companies to connect through email and social media, taking the conversation and interaction online. Customers can now talk to the company employees, voice their concerns, and get issues resolve through these avenues. These technological advances have provided a bigger platform for customers to rave about companies or complain about them. This love or dislike can translate into social media posts, tweets, pictures, videos, and reviews for thousands or millions of people to see and can help or tarnish a company.

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9.1.8: Key Terms

advertising
mass communication that allows companies to reach a broad audience through TV, radio, newspaper, Internet, magazines, and outdoor ads

brand
image a company promotes and the connotations it fosters of itself and its products

brand advocate
someone who is a fan of your products and passes on the word to others

brand strategy
image a company conveys to its customers

bundling
bundle of products that is discounted to encourage customers to buy in bulk

causal research
identification of cause-and effect-relationships between two or more variables

close
step in the sales process in which the salesperson asks for and gets the sale

conjoint analysis
survey tool in which respondents must rank, choose, or a rate a number of “conjoint,” or linked, features or benefits

cost-led pricing
easiest way to price a product by taking the cost of making the product and marking it up to create profit

customer-led pricing
pricing led by what the customer is willing to pay

digital marketing
online marketing

direct mail
connecting to consumers via email or through printed mailed pieces

entrepreneurial marketing
set of unconventional practices that can help start-ups and younger firms survive in competitive markets

ethnographic research
use of personal observation of the subject by being immersed in the subject’s environment

executive summary
initial section of a business plan document that summarizes the key elements of the entire plan

expeditionary marketing
marketing designed to move established companies and their products into new markets and territories

focus group

gathering of people, typically six to twelve participants, who come together to discuss a topic presented by a moderator, who usually poses questions and collects qualitative data that can be used to answer questions or define research further

guerrilla marketing
creative approaches to marketing that seek to gain maximum exposure through unconventional means

introductory offers
using lower initial prices to attract new customers and build a customer base before prices return to their standard amount

jingle
short song or sound that brands a product or company and helps to promote it

loss leader pricing
using a below-standard price to attract customers in the hope that they will purchase other, more profitable goods and services

market analysis
analysis of the overall interest in the product or service within the industry by its target market

market opportunity
unmet need within a target demographic

market research
collection and analysis of data related to a business's target market

marketing
umbrella term given to those activities that companies use to identify consumers and convert them into buyers

marketing mix
basic set of possible strategies and approaches that marketers use to reach their target market

marketing plan
formal business document that used as blueprint for how a company will achieve its marketing and business goals

marketing strategy
company's game plan for how it will reach consumers and convert them into paying customers

odd numbers strategy
psychological pricing strategy that uses odd numbers in the prices to make a product's price point more attractive to consumers

penetration pricing
pricing below that of a competitor's price

people
company's human resources

personal selling
using face-to-face interactions to communicate and influence a customer to make a purchase

physical environment
where a service takes place or a product is manufactured

place
channels or locations—physical or digital—where products can be found by customers

positioning
(or value proposition) statement of how you want the customer to perceive your company, good, or service

premium pricing
charging a price above a competitor's price

price
value that must be exchanged in order for a customer to receive a product or service

primary research
research that involves gathering new data

process
chain of procedures and/or activities required to provide the product to the customer

product
good or a service that creates value by fulfilling a customer need or desire

profit margin
amount by which revenue exceeds costs, typically described as a percent

promotion
process of communicating value to customers in a way that encourages them to buy

public relations
marketing that focuses on connecting with constituents by developing goodwill

qualitative research
use of open-ended techniques such as observation, focus groups, and interviews to gain an understanding of customers' basic reasons, opinions, and motivations

quantitative research
generation of numerical data through techniques such as surveys and questionnaires

real-time marketing
seeks to turn immediately available sales data into actionable and timely strategies that target the shifting landscape of consumer tastes and trends

relationship marketing
creates customer loyalty through personal interaction and strives for long-term engagement

sales promotion
incentives such as coupons and discounts that help attract customers and help them take action

sales strategy
plan that the entrepreneur uses to identify and engage a consumer, from prospecting to securing the sale and beyond

sample
group of people participating in market research

secondary research
research that uses existing data

segmenting

separating the total population by homogeneous groups of people that have similar tastes, backgrounds, lifestyles, demographics, and culture

serviceable available market (SAM)
portion of the market that a business can serve based on its products, services, and location

situation analysis
examination of the internal and external circumstances relevant to a particular business

skimming
high-pricing strategy that leverages the newness of a product in order to “skim” the most profits off the top at the beginning of a sale

social media
online communication tool for entrepreneurs to connect with consumers, especially younger demographics

tagline
short and catchy positioning statement that quickly communicate some core aspect of the brand to the consumer

target market
specific group of consumers for which a company seeks to provide a good or service

targeting
selecting a customer group based on their ability and willingness to buy

total available market (TAM)
total perceived demand for a product or service within the marketplace

validation
act of verifying that a product can be successful with a target audience

viral marketing
marketing that uses engaging content in the hopes that viewers will share it on their personal and social media networks

word-of-mouth (WOM) marketing
promotion in which a satisfied customer tells others about their positive experience with a good or service

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9.1.9: Summary

9.1.2 Entrepreneurial Marketing and the Marketing Mix

Marketing refers to those activities companies use to identify consumers and convert them into buyers. Entrepreneurial marketing is a set of unconventional practices that can help start-ups and younger firms survive in competitive markets. One way to think of the marketing mix is to break it into the 7Ps: product, promotion, price, place, people, physical environment, and process. Entrepreneurs often don't have deep enough resources to use all of these marketing tools, so they need to be strategic in which ones they choose and how they execute them.

9.1.3 Market Research, Market Opportunity Recognition, and Target Market

Market research is an important aspect of being an entrepreneur. Research can help you vet ideas as well as reveal opportunities that you may not have seen before. Whether you are using secondary data or performing primary research, it is important to know your research questions and goals. Good market research and analysis can help you position your product within your target market.

9.1.4 Marketing Techniques and Tools for Entrepreneurs

Marketing doesn't have to be expensive; entrepreneurs have many affordable techniques at their disposal. The only input necessary for these techniques is plenty of passion, creativity, and energy. These tools include guerrilla, relationship, expeditionary, real-time, viral, digital, and WOM marketing. The pros of using these techniques are plenty, as you can see from the examples shared for each of the tools. They include being able to reach many people at the same time; leveraging the timeliness of feedback; and making real, sincere connections with people. In addition, affordability, creativity, and good results (clicks, shares, comments, purchases, and awareness) can stem from using these techniques. On the negative side, customer reviews that are not so positive can also make their way through these channels and damage the reputation of a company if they are not handled with care.

9.1.5 Entrepreneurial Branding

Branding gives an identity to the product and company to which the customer can identify. It is based on its mission, goals, and product benefits, and it must be integrated with the marketing mix for greater impact. Brands help communicate a message to the consumer about product quality, pricing, and overall benefits. When the communication strategy is not cohesive, the consumer may become confused by the different signals the company sends. The entrepreneur must work hard to create a unified message all the way through.

9.1.6 Marketing Strategy and the Marketing Plan

Once you have an idea of your marketing mix, the next step is to develop actionable strategies and write them down in a marketing plan. A marketing strategy describes how a company will reach consumers and convert them into paying customers. A marketing plan is a formal business document that is used as a blueprint or guide for how a company will achieve its marketing goals. A good marketing plan can be used to guide internal decisions and attract external investors.

9.1.7 Sales and Customer Service

Sales drives profit. They may require a simple sales approach or a complicated sales system. An example of a sales system is a six-step sales strategy: doing research about prospective clients and creating a list; making an appointment to talk about your good or service; meeting with them to present a proposal; handling objections; closing the deal; and nurturing the relationship after close. When selling luxury and expensive items, the sales approach is usually more thorough and requires more sales training and finesse. Customer service is a component that is linked to this process and with proper training can really differentiate a company from the competition.

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9.1.10: Review Questions

1. What are the differences between traditional and entrepreneurial marketing?
2. What is a target market? Why is it important to know the target before creating the marketing mix?
3. What are the components of the marketing mix? Explain each component.
4. What is the difference between pricing a product based on what a competitors charge and pricing a product based on the company's costs?
5. Check out the website http://www.flyzipline.com/. Who is the target market? What are their 7Ps?
6. What is market research? Why is it important to do research before you start a business?
7. How does primary data differ from secondary data?
8. How does STP help entrepreneurs?
9. How does guerrilla marketing differ from viral marketing?
10. What types of activities are involved in digital marketing? Choose one and explain.
11. What is a brand? Why is it important to work toward gaining recognition for the brand, especially for a start-up brand?
12. How does a tagline help with positioning?
13. How does a marketing plan help an entrepreneur?
14. What is the difference between a marketing objective and a marketing strategy?
15. What are the steps in the sales process?
16. How does customer service impact sales of a new business?

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9.1.11: Discussion Questions

1. If you could open a business right now, what would it be? Who would be your target market?
2. Look at the Wag! website https://wagwalking.com/ and determine the 7Ps of this service. Do they work well together? Why or why not?
3. Give an example of a company that uses bundle pricing and explain why it uses this method.
4. Discuss how market research can benefit entrepreneurs.
5. What is the difference between qualitative and quantitative data?
6. Give examples of how entrepreneurs can leverage marketing activities even when strapped for cash.
7. If you had a business that was highly dependent on WOM marketing, how would you ensure the information passed along was positive? If the message passed along was negative, what would you do about it?
8. Describe how a brand advocate might help IKEA position itself as a cost-effective and design-oriented furniture store. Now discuss how a brand advocate can help a new product on the market establish a good reputation.
9. Discuss how the business model canvas can help an entrepreneur create a framework for generating sales. Think of a business you like and describe how it generates sales.
10. Negative referrals can have a great impact on a company's sales. Remember an instance where you were the source of a bad referral for a product or service, and determine what made the experience so negative. What would you have done differently as the salesperson to prevent that?

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9.1.12: Case Questions

1. Claire is a young artist who has decided to sell her paintings to make some money while she finishes college. She doesn't know much about promoting her work, especially through online channels. Since you are studying business, she has asked you for your advice on promoting her work to a young professional demographic who would be inspired by her message through the arts. Describe two types of promotional tools she can use to connect with her ultimate customer.
2. You have recently been hired to work as a marketing manager for a boutique hotel in San Diego. This hotel is the only one of its kind and is not part of a chain. It only has 50 rooms that have been carefully designed to fit a younger, eclectic, design-oriented, and higher-income demographic. The owner needs help pricing the rooms and other hotel services (see the following). Determine which pricing strategy you would use (customer-led, cost-based, competition-based, premium, etc.) for each of the following items and explain why. If necessary, look at some industry reports on how hotels price their services and decide if you should go the same route or try something else.
    a. Room rate (weekly and weekend)
    b. Restaurant food
    c. Parking
    d. Internet and movie access
3. One of your classmates would like to open a food delivery service in town. This service would allow people to buy lunch or dinner through an app from a list of restaurants. She's in the early stages of her analysis and she is asking your advice on possible sources of data that she can use. What kind of resources would you direct her to? Why?
4. One of your classmates recently opened a new gym in an up-and-coming professional area. She is an accomplished trainer, but has little experience in business. She asks your help in coming up with a specific target market. You share with her the STP process.
5. Visit the current Birchbox website, its online promotions, social media, online ads, and anything you can find about its digital marketing strategies. If you were in charge of digital marketing for Birchbox, what would you include or delete from their current activities?
6. Visit the Method website at https://methodhome.com/ and describe all of the branding components they use to position themselves as the best cleaning products in the US market.
7. You have recently become a supplier of heavy equipment to manufacturing plants that build automotive components. You have acquired one customer and would like to add more within the next three months. How would you go about prospecting?

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9.1.13: Suggested Resources

9.1.2 Entrepreneurial Marketing and the Marketing Mix

American Marketing Association: https://www.ama.org

Small Business Administration: https://www.sba.gov/

9.1.4 Marketing Techniques and Tools for Entrepreneurs

AMA Digital Marketing Certification: https://www.ama.org/events-training/...ification.aspx

AMA on Demand course: Digital Marketing: Delivering a Custom Experience: www.ama.org/events-training/...ce-051717.aspx

Google Ads: https://ads.google.com/home/

Google Analytics: https://analytics.google.com/analyti...on/#/provision

Hubspot Google Ads guide: https://blog.hubspot.com/marketing/google-adwords-ppc

9.1.5 Entrepreneurial Branding

Hubspot's Beginner's guide to branding: https://blog.hubspot.com/agency/deve...SHcJI2E.mailto

9.1.6 Marketing Strategy and the Marketing Plan

Business Model Canvas: https://strategyzer.com/canvas/business-model-canvas

Hubspot Marketing Plan templates: https://blog.hubspot.com/marketing/m...late-generator

Small Business Administration: https://www.sba.gov/business-guide/m...arketing-sales

9.1.7 Sales and Customer Service

Cialdini online tools: https://www.influenceatwork.com/

Hoffman Sales Training: https://sellhoffman.com/

Neil Rackman: http://neilrackham.com/

Spin Selling: https://blog.hubspot.com/sales/spin-...ultimate-guide

Zig Ziglar: https://www.ziglar.com/

The State of Customer Service: https://offers.hubspot.com/state-of-...8-5de8fcbb40c1

Cialdini, R. B. (2001). *Influence: Science and Practice* (4th ed.). Boston: Allyn & Bacon: Explains some aspects of the sales process in a fun and fact-based manner.

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SECTION OVERVIEW

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9.2.1: Chapter Introduction

Elegant Touch

Anita Bruscino, the sole proprietor of Elegant Touch, began her career as a mechanical engineer. She worked in her family's manufacturing business until she and her father left because of too many factions in the company. This provided her with the opportunity to start her own business, something she had always known in her heart that she wanted to do.

Anita was inspired to open a gift shop by a family friend who had owned her own gift shop. She gave Anita advice on starting her own business, and Elegant Touch opened in 1994. Anita has since expanded the business and is celebrating the shop's eighteenth anniversary, with the last six years in its larger location. The shop is warm, lovely, and comfortable, featuring unique gifts for all occasions and specializing in American handcrafted gift items and gift baskets. Shoppers will also find maternity gifts, items for the sweet tooth, specialty foods, special seasonal sections—and a friendly smile from Anita. One thing that you will not find at Elegant Touch is what you find in other gift shops in her market area. When selecting products for her shop, Anita asks vendors whether other stores in the area carry the gift line she is considering. She will not carry duplicates. She likes to see new things and follows the trade magazines to help her do that. When asked how she chooses the products to carry, she described the process as instinctive —"from the gut."



Figure 9.2.1.1: *Used with permission from Anita Bruscino.*

Anita describes her customer demographics as mostly women, between thirty and seventy years old, married, and established with a home. Because many of her customers are repeat customers, the reason for fresh products is clear. A stale product line is not something that she can afford. Her pricing strategy is consistent with common practice in the industry, but many of her customers have commented that she delivers very high value for the prices she charges. She is not interested in selling online because she does not want to expand any further. She is at a nice comfort level and does not want to deal with additional inventory implications or the need to hire additional employees. As a result, the Elegant Touch website is for basic information only. In promoting Elegant Touch, Anita says that word of mouth works the best. She advertises in the local paper occasionally, supports local events, and is preparing for her first e-mail blast. She is exploring a Facebook presence but is not yet convinced that it will be of much value to her business.

Like all small businesses, Elegant Touch has been impacted by the ups and downs in the economy, with some times being tougher than others. Because Anita has only two part-time employees, however, she has not been faced with the employee layoffs that have hit other small companies. When asked what keeps her going in the rough times, she answered, "You have to love it." Just walk into her gift shop, and you will see clearly that she does.

Except for the content from CheshirePatch.com, all information herein is based on an interview with Anita Bruscino, owner of Elegant Touch, March 2, 2012.

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9.2.2: The Importance of a Marketing Strategy

Learning Objectives

- Understand how marketing for small businesses differs from marketing for big businesses.
- Understand the most significant risk factor facing small businesses.
- Explain marketing strategy and why it is so important for small businesses.

Small-business marketing and big business marketing are not the same. The basic marketing principles that guide both are the same, but there are important differences with respect to scope, budget, risk factors, and areas of opportunity. Small businesses cannot compete with the marketing budgets of big companies. As a result, small businesses do not have the luxury of large staffs and the staying power that comes with high profits. There is little room for error. Failed strategies can lead to ruin.

The scope of small business marketing does not extend across the same level of multiple products and services that characterize most big businesses. Combined with having few if any products in the pipeline, this significantly reduces the insulation that small businesses have against ups and downs in the marketplace or strategic failures. “Small business marketing strategies have to be more targeted, cost-effective and more elaborately planned [s]o as to minimize the losses in case the strategy fails.”

Competition is the most significant risk factor facing small businesses. Trying to eliminate an established brand takes a lot of work, but it is an overnight job to wipe out a small business. Competition is a huge threat for small businesses. This means that small businesses should be very knowledgeable about their competition to deal effectively with them.

Opportunity areas for small businesses are also very different from those of big businesses. The small business can take advantage of niche markets and local needs and wants. They are much better able to emphasize personal, one-to-one interactions and can market real time in ways that cannot be matched by big businesses. Smaller can actually end up being more powerful.

Given the special marketing vulnerabilities of small businesses, the importance of understanding the components of a **marketing strategy** should be clear. A marketing strategy involves selecting one or more target markets, deciding how to differentiate and position the product or the service, and creating and maintaining a marketing mix that will hopefully prove successful with the selected target market(s)—all within the context of **marketing objectives**. Marketing objectives are what a company wants to accomplish with its marketing strategy: “Strategy is not a wish list, set of goals, mission statement, or litany of objectives… A marketing strategy is a clear explanation of how you’re going to get there, not where or what there is. An effective marketing strategy is a concise explanation of your stated plan of execution to reach your objectives…Marketing without strategy is the noise before failure.”

KEY TAKEAWAYS

- Small-business marketing and big business marketing are not the same.
- The most significant risk factor facing small businesses is competition.
- It is important for a small business to have a marketing strategy so that it is better positioned to choose among options.
- An effective marketing strategy is a concise explanation of a business’s stated plan of execution to reach its objectives.
- Marketing without strategy is the noise before the failure.

EXERCISE

You just started a new job with a twenty-five-employee small business. By accident, you found out that the company does not have a clear marketing strategy. So far, the company has been lucky with its product sales, but you have a feeling that things will not continue at the same pace for much longer because a competitor has entered the marketplace. Assuming that you had the opportunity, how would you go about convincing the owner that the smart thing to do right now is to create a marketing strategy? Make the case to the owner.

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9.2.3: The Marketing Strategy Process

Learning Objectives

- Describe the marketing strategy process.
- Explain why segmentation, target market, differentiation, positioning, and website decisions are so important for the small business.
- Describe the marketing strategy decision areas for each element of the marketing mix.

The focus of this text is on the management of the small business that is up and running as opposed to a start-up operation. As a result, the considerations of marketing strategy are twofold: (1) to modify or tweak marketing efforts already in place and (2) to add products or services as the business evolves. In some instances, it may be appropriate and desirable for a small business to backfit its marketing activities into a complete marketing strategy framework.

The marketing strategy process consists of several components. Each component should be considered and designed carefully: company vision, company mission, marketing objectives, and the marketing strategy itself.



Figure 9.2.3.1: Marketing Strategy Process (*Source: Susan I. Reid, "How to Write a Great Business Vision Statement," Alkamae, February 23, 2009, accessed December 2, 2011, http://alkamae.com/content.php?id=285; "Marketing Plan: Marketing Objectives and Strategies," Small Business Notes, accessed December 2, 2011, http://www.smallbusinessnotes.com/st...trategies.html.*)

Vision and Mission

The **vision statement** tries to articulate the long-term purpose and idealized notion of what a business hopes to become. (Where do we see the business going?) It should coincide with the founder's goals for the business, stating what the founder ultimately envisions the business to be. The **mission statement** looks to articulate the more fundamental nature of a business (i.e., why the business exists). It should be developed from the customer's perspective, be consistent with the vision, and answer three questions: What do we do? How do we do it? And for whom do we do it?

Both the vision statement and the mission statement must be developed carefully because they "provide direction for a new or small firm, without which it is difficult to develop a cohesive plan. In turn, this allows the firm to pursue activities that lead the

organization forward and avoid devoting resources to activities that do not." Although input may be sought from others, the ultimate responsibility for the company vision and mission statements rests with the small business owner. The following are examples of both statements:

- **Vision statement.** "Within the next five years, Metromanage.com will become a leading provider of management software to North American small businesses by providing customizable, user-friendly software scaled to small business needs."
- **Mission statement.** "Studio67 is a great place to eat, combining an intriguing atmosphere with excellent, interesting food that is also very good for the people who eat there. We want fair profit for the owners and a rewarding place to work for the employees."

Marketing Objectives

Marketing objectives are what a company wants to accomplish with its marketing. They lay the groundwork for formulating the marketing strategy. Although formulated in a variety of ways, their achievement should lead to sales. The creation of marketing objectives is one of the most critical steps a business will take. The company needs to know, as precisely as possible, what it wants to achieve before allocating any resources to the marketing effort.

Marketing objectives should be SMART: specific, measurable, achievable, realistic, and time-based (i.e., have a stated time frame for achievement). It has been recommended that small businesses limit the number of objectives to a maximum of three or four. If you have fewer than two objectives, you aren't growing your business like you should be in order to keep up with the market. Having more than four objectives will divide your attention, and this may result in a lackluster showing on each objective and no big successes. If a small business has multiple marketing objectives, they will have to be evaluated to ensure that they do not conflict with each other. The company should also determine if it has the resources necessary to accomplish all its objectives.

For small businesses that already have, or are looking to have, a web presence and sell their products or services online, **e-marketing** objectives must be included with all other marketing objectives. E-marketing is defined as "the result of information technology applied to traditional marketing." The issues of concern and focus will be the same as for traditional marketing objectives. The difference is in the venue (i.e., online versus on ground). Examples of e-marketing objectives are as follows: to establish a direct source of revenue from orders or advertising space; improve sales by building an image for the company's product, brand, and/or company; lower operating costs; provide a strong positive customer experience; and contribute to brand loyalty. The ultimate objective, however, will be "the comprehensive integration of e-marketing and traditional marketing to create seamless strategies and tactics."

The Marketing Strategy

With its focus being on achieving the marketing objectives, marketing strategy involves segmenting the market and selecting a target or targets, making differentiation and positioning decisions, and designing the marketing mix. The design of the product (one of the four Ps) will include design of the company website. Differentiation refers to a company's efforts to set its product or service apart from the competition, and positioning is placing the brand (whether store, product, or service) in the consumer's mind in relation to other competing products based on product traits and benefits that are relevant to the consumer. It has been said that "in some cases strategy just happens because a market and a product find each other and grow organically. However, small businesses that understand the power of an overarching marketing strategy, filtered and infused in every tactical process, will usually enjoy greater success."

KEY TAKEAWAYS

- The marketing strategy process consists of company vision, company mission, marketing objectives, and the marketing strategy itself.
- The company vision: Where do we see the business going?
- The company mission: Why does our business exist?
- Marketing objectives: What do we want to accomplish with our marketing strategy?
- Marketing strategy: How will we accomplish our marketing objectives?
- Marketing objectives should be SMART: specific, measurable, achievable, realistic, and time-based (i.e., have a specific time frame for accomplishment).
- Small businesses should limit the number of objectives to three or four to increase the chances that they will be achieved.

- E-marketing objectives must be included with traditional marketing objectives.
- E-marketing and traditional marketing should be integrated to create seamless marketing strategies and tactics.
- Marketing strategy involves segmenting the market, selecting a target or targets, making differentiation and positioning decisions, and designing the marketing mix. The design of the product will include design of the company website.

EXERCISES

1. Develop the marketing objectives for Frank's All-American BarBeQue restaurant in Darien, Connecticut.
2. Explain the differences between an onground marketing strategy and an online marketing strategy.

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9.2.4: Segmentation and the Target Market

Learning Objectives

- Explain segmentation and the target market.
- Explain why segmentation, the target market, differentiation, positioning, and website decisions are so important for a small business.
- Describe the marketing strategy decision areas for each element of the marketing mix.

Whether market segments and target markets are selected on the basis of intuition, marketing research, or a combination of the two, they are the basis for creating an effective marketing mix for any small business. Segmentation and target market decisions must be made for both on-ground and online customers.

Segmentation

Market segmentation, dividing a market into relatively homogeneous subgroups that behave much the same way in the marketplace, is the necessary precursor to selecting a target market or target markets. The extensive bases on which a company is able to segment a market are presented in Table 6.1.2.1 "Market Segmentation". The challenge is knowing which group(s) to select. Many small business owners have a good intuitive sense of the segments that make sense for the business, and they choose to go with that intuition in devising their marketing strategy. However, that intuition may not be precise or current enough to be of the most help in planning a marketing strategy. Marketing research can be of help here, even to the smallest of businesses.

Marketing research can help the small business identify and refine the segments that offer the greatest opportunities. Part of that process will be to identify segments that meet the requirements of **measurability**, **substantiality**, **stability**, **accessibility**, **actionability**, and **differential response**. Meeting these requirements will increase the chances for successful segmentation.

- **Measurability.** Is it easy to identify and estimate the size of a segment? A small business that moves forward without a clear definition of its market segments is working blind. Intuition can only go so far. Are there people who are interested in freshly baked cookies for dogs (it would seem so), and how many of these people are there?
- **Substantiality.** Is the segment large and profitable enough to justify an investment? A small business may not require a huge number of customers to be profitable, but there should be enough people interested in the product or the service being offered to make operating the business worthwhile. Fancy designer clothes for dogs, for example, is a business that can survive—but not everywhere (see https://www.ralphlauren.com).
- **Stability.** Stability has to do with consumer preferences. Are they stable over time? Although segments will change over time, a small business needs to be aware of preferences that are continuously changing. Small businesses can be more nimble at adapting their businesses to change, but too much volatility can be damaging to a business's operations.
- **Accessibility.** Can a business communicate with and reach the segment? A small business interested in women who work outside the home will present greater communication challenges than will stay-at-home wives and mothers.
- **Actionability.** Is a small business capable of designing an effective marketing program that can serve the chosen market segment? There was a small manufacturer of low-priced cigarettes in Virginia that found it difficult to compete with the big brands and other established lower-priced brands such as Bailey's. The manufacturer's solution was to sell to Russia where "Made in Virginia, USA" worked very well with customers and retailers.
- **Differential response.** The extent to which market segments are easily distinguishable from each other and respond differently to company marketing strategies. For the small business that chooses only one segment, this is not an issue. However, the small manufacturer of ramen noodles in New York City needs to know whether there are different segments for the product and whether the marketing strategy will appeal to those segments in the same positive way.

Once multiple segments have been identified, it is necessary to select a target market or target markets. If only a single segment has been identified, it becomes the target market.

Target Market

The selection of a **target market** or target markets will be based on the segments that have been identified as having the greatest potential for the business. (A target market refers to one or more segments that have been chosen as the focus for business

operations.) Only some of the people in the marketplace will be interested in buying and/or using a company's product or service, and no company has the resources to be all things to all people. Resources are always finite, but this will especially be the case for the small business, so all marketing efforts should be directed as precisely as possible.

Selecting the target market should be guided by several considerations:

- **Financial condition of the firm.** Limited resources may dictate the selection of only one target market.
- **Whether the competition is ignoring smaller segments.** If yes, this may be a ready-made target market.
- **Is the market new to the firm?** If yes, concentrating on one target market may make the most sense.
- **Specific need or want.** Does the proposed target market have a specific need or want for the product or the service?
- **Ability to buy.** Does the proposed target market have the resources to buy the product or the service?
- **Willingness to buy.** Is the proposed target market willing to buy the product or the service?
- **Will this target market be profitable?** There needs to be enough demand to make money.

Choosing the right target market is a critical part of the marketing strategy of a small business. The target market should be the best match for a company's products and services, thus helping to maximize the efficiency and effectiveness of its marketing efforts.

If a small business wants to go with a **niche market**, the same considerations apply. A niche market is a small, more narrowly defined market that is not being served well or at all by mainstream product or service marketers. The great advantage of pursuing a niche market is that you are likely to be alone there: "other small businesses may not be aware of your particular niche market, and large businesses won't want to bother with it." Ideally, a small business marketing to a niche market will be the only one doing so. Niches are very important to small businesses that want to sell pricey chocolates (see, for example, https://cocoadolce.com/company/about-us). They focus on niches such as weddings, seasonal offerings, and specialty items. They also sell online in order to reach a broader market.

KEY TAKEAWAYS

- Market segments and target markets are the basis for creating an effective marketing mix.
- Segmentation and target market decisions must be made for both on-ground and online customers.
- Market segmentation precedes the selection of a target market.
- There are many ways to segment a market.
- Segments must be measurable, substantial, stable, accessible, actionable, and easily distinguishable from other segments.
- The target market should be the segment or segments that show the greatest profit potential for a small business.
- A niche market is a small, more narrowly defined target market that is not being served well or at all by other businesses.

EXERCISES

1. How should the market for Frank's All-American BarBeQue be segmented for his new restaurant in Darien, Connecticut? How should Frank decide on a target market or target market(s)? Be specific. Do not assume that the Darien market is the same as the Fairfield market.
2. Assume that you work for a small manufacturer of children's hair-care products. What criteria would you use for effective segmentation? How would you then decide on a target market or target markets? Be specific.

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9.2.9: Marketing Strategy and Promotion

Learning Objectives

- Understand the role of promotion in the marketing mix and its importance to a company.
- Understand the different ways that a small business can promote its products or services.
- Explain the differences and similarities in the marketing communications mix of online and on-ground businesses.

Promotion, the fourth P in the marketing mix, is now more commonly referred to as **marketing communications**. Marketing communications can be defined as "the means by which firms attempt to inform, persuade, and remind customers—directly or indirectly—about the products and brands they sell. In a sense, marketing communications represent the 'voice' of the company and its brands and are a means by which it can establish a dialogue and build relationships with consumers." Marketing communications are all about getting the word out about a company's products and services because customers cannot buy what they do not know about, and, in the process, creating more of a two-way relationship with customers than was typical of the more traditional notion of promotion. A further conceptual iteration is the term **integrated marketing communications (IMC)**, which is "the coordination and integration of all marketing communication tools, avenues, and sources within a company into a seamless program designed to maximize the communication impact on consumers, businesses, and other constituencies of an organization." Small-business owners should be familiar and comfortable with all three terms because at least one of them will be the basis of conversations with vendors, employees, and other businesses. However, from a small business management perspective, IMC should be the guiding philosophy for a company.

Prior to selecting and designing any communications, however, objectives must be established for the marketing communications program.

IMC Objectives

Every small business must decide what it wants to accomplish with its IMC plan. Although many IMC plans may be oriented toward a single objective, it is possible for a program to accomplish more than one objective at a time. The problem is that this may be confusing to potential customers. IMC objectives can fall into seven major categories: increase demand, differentiate a product (stressing benefits and features not available from competitors), provide more information about the product or the service (more information seen as being correlated with greater likelihood of purchase), build **brand equity** (the value added to a brand by customer perceptions of quality and customer awareness of the brand), reduce purchase risk (important for new products and gaining new customers of current products), stimulate trial (to build new brands and rejuvenate stagnant brands), and brand recognition. As with all objectives, IMC objectives must meet the SMART (specific, measurable, achievable, realistic, and time-based) criteria.

Marketing Communications Mix

The **marketing communications mix** for a small business, either pure-play or brick-and-click, will consist of some combination of the following major modes of communication: advertising, sales promotion, events and experiences, public relations (PR) and publicity, direct marketing, interactive marketing, word-of-mouth communication, and personal selling. Each mode of communication has its own advantages and disadvantages, which should all be considered carefully before any final selections should be made.



Figure 9.2.9.1:The Marketing Communications Mix *Source: Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 473.*

Advertising

Advertising is "any paid form of nonpersonal presentation and promotion of ideas, goods, or services by an identified sponsor." Advertising is around us all the time—for example, ads are on television and radio, in newspapers and magazines, in train stations and on trains, on the sides and inside of buses, in public restrooms, in taxis, on websites, and on billboards. Ads can also be found in other places, and the locations are limited only by the creativity of the company placing the ads.

Small businesses must choose **advertising media** (e.g., radio, television, newspapers, billboards, the Internet, and magazines) based on its product, target audience, and budget. A local travel agency selling spring getaways to college students, for example, might post flyers on campus bulletin boards, run ads in the campus newspaper (for the students) and local newspapers (for the parents), and run ads on the college radio station. Examples of tried and true advertising media for small businesses include the yellow pages, newspaper and magazine advertising, direct mail, business cards, vehicle advertising, radio and cable television advertising, bench/bus stop advertising, local website advertising, e-mail advertising, eBay listings, community involvement, and cross-promotion (joining forces with other businesses). Even advertising in the big leagues is not out of the question for a small business. Salesgenie.com decided to advertise during Super Bowl XLII in February 2008, choosing to risk major capital to connect with the huge Super Bowl customer base.

Advertising on the Internet is also a consideration for the marketing communications mix of any business with a web presence. According to Lorrie Thomas, author of *Online Marketing*, online advertising "can rocket your web marketing into the stratosphere" if it is done correctly. If not done correctly, however, it will "blast a giant crater in your budget." Online advertising includes the following entities: **banner ads** (image ads that range in size and technical capability); **e-mail advertising** (ads in newsletters, an ad in another company's e-mail, e-mailing a list with a dedicated message, or a company advertising to its own customers with its own e-mail list); **news site advertising** (placing ads on news, opinion, entertainment, and other sites that the audience frequents); **blog advertising** (buying ads directly on popular blogs); **social media advertising** (advertising on sites such as Twitter, Facebook, and LinkedIn); and **affiliate marketing** (company A places an ad for its product on the site of company B; company A then pays company B an agreed-on fee when a customer clicks on the ad and buys something.) Another possibility is Google AdWords. A small business can promote itself alongside relevant Google search results and on Google's advertising network. This allows a business to reach people who are already looking online for information about the products and services that a business offers.

Video Clip: Attracting Consumer Attention through Advertising

Relating ads to the target market, making ads appealing, and including the element of surprise.

A YouTube element has been excluded from this version of the text. You can view it online here.

Advertising offers several advantages to the small business. For example, advertising is able to reach a diverse and geographically dispersed audience; it allows the seller to repeat a message many times; and it provides the opportunity for dramatizing the company and its products through the artful use of print, color, and sound. However, the audience does not feel obligated to pay attention or respond to an ad. Whether the advantages of advertising outweigh the costs and disadvantages is something that must be decided by each small business.

Sales Promotion

Given the expense of advertising and the fact that consumers are exposed to so many advertising messages every day, many companies correctly believe that advertising alone is not enough to get people to try a product a product or a service. Enter lower-cost sales promotion techniques. **Sales promotion** refers to the variety of short-term incentives to encourage trial or purchase of a product or a service. Examples of commonly used sales promotions include contests, sweepstakes, coupons, premiums and gifts, product samples, rebates, low-interest financing, price discounting, point-of-sale displays, and frequent user or loyalty programs. These promotions can be used by and offer several advantages to small businesses:

- **Attracting new customers with price.** A reduced price could lure customers away from the competition. For example, a small electronics store that is competing with a large retailer could offer a discounted price on a popular cell phone for a limited time.
- **Gain community favor.** By offering a promotion that helps a worthy cause, you can create a good name for the business. Donate a portion of sales to the local food bank, buy clothing for the homeless, or donate to the local animal shelter to help pay veterinarian bills.
- **Encourage repeat purchases.** Rewards and loyalty programs can be very successful for small businesses. Coffee clubs are popular (buy so many coffees at the regular price and you get one cup free), but this approach can work for sandwiches at a deli, bags of bird food or dog food at the local pet store, shoe repairs at the local cobbler, dry cleaning services, and virtually any other kind of business.
- **Entice reluctant customers.** Giving away a free product or service is usually a good way to get people to try a product or a service for the first time, the hope being that it will lead to a purchase. However, the product or the service has to be good enough to stand on its own so that when the “free” unit is gone, the person will come back to buy.
- **Providing information.** It can be very effective if you run a promotion that helps provide information to potential customers to help them make a decision. This works especially well for products or services that are complicated or unfamiliar to customers, for example, software or product usage (particularly for business-to-business [B2B] customers), financial services, investment services, or estate planning. Free on-ground seminars or **webinars or webcasts** (seminars or presentations that are delivered online and that are typically an hour in length) can be very effective at gaining new customers or clients.

Sales promotions can be delivered to the customer in a variety of ways, such as snail mail (US Postal Service), in person, in local new newspapers and regional editions of national magazines, on television and radio, in e-mail, on websites, and in electronic coupons that are sent to a customer’s mobile device. Groupon, which is described as the hottest thing in retail marketing right now, offers customers coupons at local businesses: everything from restaurants to spas to painting lessons to sleigh rides.

Video Clip: Learn How Groupon Works!

A hot new source of coupons for local businesses.

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Events and Experiences

Events and experiences are “company-sponsored activities and programs designed to create daily or special brand interactions.” A small business could choose to sponsor a Halloween costume event for pets or an entertainment event, such as a battle of the bands, to raise money for local scholarships. Participation in a local business fair could provide exposure for a product or a service and the opportunity to experience the product if that is possible. A local restaurant could participate in a chili competition. Factory tours and company museums, both of which can also be virtual, can offer great experiences for customers.

There are several advantages to events and experiences: (1) A well-chosen event or experience can be very effective because the consumer gets personally involved. (2) Experiences are more actively involving for consumers because they are real time. (3) Events are not hard sell, and most consumers will appreciate the softer sell situation.

Events and experiences also tap into the importance of the customer experience. Today, customers "want products, communications, and marketing campaigns to deliver experiences. The degree to which a company is able to deliver a desirable customer experience—and to use information technology, brands, and integrated communications and entertainment to do so—will largely determine its success." By having special events, a small business will stand out from the rest, and they will create desirable publicity for the company.

Public Relations and Publicity

Public relations (PR) and **publicity** are designed to promote a company's image or its individual products. A small business can also use PR to clarify information in response to negative publicity. (Publicity usually being "an outcome of PR that is produced by the news media and is not paid for or sponsored by the business involved.") Traditional PR tools include press releases and press kits that are sent to the media to generate positive press on behalf of the business. A press kit, the most widely used PR tool, pulls together company and product information to make a good, solid first impression. (Be sure to print the company's website address on everything.) A press kit can be particularly useful for small businesses, although the smallest of businesses may not see the need. Other common platforms include speeches, seminars (online and offline), brochures, newsletters, annual reports, charitable donations, community relations, and company magazines. Increasingly, companies are using the Internet: interactive social media, such as blogs, Twitter, and Facebook; home-page announcements for specific occasions (e.g., messages of sympathy for the victims of a disaster); and e-mail.

Social media services such as Google Alerts and TweetBeep can be very helpful for managing a company's reputation. **Reputation management** "is the process of tracking other's opinions and comments about a company's actions and products, and reacting to those opinions and comments to protect and enhance the company's reputation." Both services notify the business when the company name is mentioned. Addressing extremely negative comments immediately is very important for any small business with a web presence.

Most small businesses are not likely to have PR departments. Instead, there will be one person whose job includes—among many other things—PR and publicity. The key is for PR and marketing to work closely together so that "every piece of communication produced by the company speaks with one voice."

Getting publicity for a small business is usually free. Stories about events and experiences might be of interest to the media. One great idea is to have a group of people outside the business with positive picketing, holding signs such as "Low prices" or "Beware of friendly employees." This was actually done by a small business, and it resulted in the business being on the front page of the local paper.

PR and publicity tend to be underused by all businesses. However, PR and publicity should be particularly appealing to the small business because of the following three distinct qualities:

- **High credibility.** News stories and features are more authentic and credible to readers.
- **Ability to catch buyers off guard.** PR can reach prospects who prefer to avoid salespeople and advertisements.
- **Dramatization.** PR has the potential for dramatizing a company or a product.

Direct Marketing

Direct marketing is the "promotion of a product from the producer directly to the consumer or business user without the use of any type of channel members. Common direct marketing platforms include catalogs; direct mailing; telemarketing; television shopping; electronic shopping; fax mail; voice mail; blogs; websites; e-mail; direct response radio, television, and Internet; social media, such as Facebook and Twitter; and mobile devices. Because channel members are bypassed, direct marketing normally allows for greater profitability; perhaps more importantly, however, it can develop stronger brand loyalty with customers.

Video Clip: What is Direct Marketing?

A brief explanation of direct marketing.

A YouTube element has been excluded from this version of the text. You can view it online here.

Direct marketing is about using information to educate, establish trust, and build a company (or someone in it) as an authority. This can be accomplished in multiple ways, such as website copy, a one-time piece of direct mail, a series of articles that build on one

another, a webcast or webinar, or a blog. There is no one more qualified to educate the market about a need than a small business owner: “They’re the ones who will know their audience and what they’ll find unique, irresistible and compelling. They’re the best people to craft the message. Everything else in the organization can be outsourced, but the knowledge that a small business owner has about the people they serve, that can’t be replicated.”

Direct marketing offers several advantages to both the business-to-consumer (B2C) and B2B small businesses:

- **Flexible targeting.** A business can identify, isolate, and “talk” with well-defined target markets. This can translate into a higher conversion and success rate than if you tried to communicate with everyone in the mass market.
- **Customized messages.** Can be prepared to appeal to the addressed individual.
- **Up-to-date.** Messages can be prepared quickly.
- **Multiple uses.** Direct marketing can be used to sell, but it can also be used to test new markets, trial new products or customers, reward existing customers to reward loyalty, collect information for future campaigns, or segment a customer base.
- **Lower cost per customer acquisition.** The cost can be significantly less than other marketing methods.
- **Control and accountability.** Direct marketing offers great control and accountability than other marketing methods.
- **Swift and flexible.** Direct marketing is swift and flexible in achieving results.

Interactive Marketing

Interactive marketing refers to “online activities and programs designed to engage customers or prospects and directly or indirectly raise awareness, improve image, or elicit sales of products and services.” Everything is personalized and individualized—from the website content to the products being promoted. The audience is engaged with the brand, with customers getting the chance to reshape and market it in their own unique way. Forrester Research forecasts that interactive marketing expenditures will reach $55 billion by 2015, accounting for 21 percent of all expenditures on marketing. The greatest growth is projected to come from social media, with the next biggest growth sector being mobile marketing.

Common interactive marketing tools include e-mail, websites, online shopping, videos, webinars and webcasts, blogs, and social media such as Facebook and Twitter. Because e-mail, websites, online shopping, webinars and webcasts have been mentioned previously, the focus here will be on videos, blogs, and social media. Using online videos has become an increasingly popular strategy in small business marketing. Consumers are much more likely to visit a company after viewing its video, and they can be up to 40 percent more likely to make some sort of contact. Online video content is becoming increasingly popular with avid Internet users, so a small business should consider creating a video for its website. The content can be created easily, and it can be posted on the company’s website as well as in other locations on the Internet (YouTube or on the company’s blog, for instance) to get more page views. According to Ad-ology’s 2011 Small Business Marketing Forecast, 45 percent of US small businesses with fewer than 100 employees plan to use online video. This reflects the fact that small businesses are becoming increasingly savvy about how to use the Internet to market their products and services. Paul Bond Boots, a small US maker of custom-made cowboy boots that are individually handmade to fit, features five really cool videos on its website. Recently, the company has turned to the Internet for most of its sales.

A **blog** “is a web page made up of usually short, frequently updated posts that are arranged chronologically—like a what’s new page or a journal.” Business blogs, as opposed to personal blogs, are used as a company communication tool to share a company’s knowledge and expertise, build additional web traffic, connect with potential customers, develop niche markets, give the business a human face, help reputation management, and provide a free avenue for press releases. For an example, visit Michael Chiarello’s blog at www.michaelchiarello.com. If his name is not familiar, he is the founder of NapaStyle, a high-end small business retailer with both an on-ground and online presence.

Blogs are fairly simple to set up, and they are a great way to keep website content fresh. However, even though small businesses hear much about blogs these days, creating one must be considered carefully. Blogs today “have evolved into multimedia communities where bloggers (and the blogging community) have grown in size, stature, and impact to eclipse all but the largest media outlets.” But this does not mean that it is essential for every small business to have a blog. Maintaining a blog takes a lot of time and energy—and then there need to be people to read it. After careful consideration, it may be better to focus a company’s promotional efforts elsewhere.

Social media "generally refers to websites featuring user-generated content or material created by visitors rather than the website publishers. In turn, these sites encourage visitors to read and respond to that material." Social media is changing the way that people communicate and behave. Social media outlets such as Facebook, LinkedIn, and Twitter are, among other things, driving purchases—and they should be seen "like a virtual cocktail party where all attendees can discuss [a company's] products, services, experiences, and new ideas."

The top four social media networks are Twitter, Facebook, LinkedIn, and YouTube. This is true in general and for small businesses in particular. Overall, small businesses use social media sites for lead generation, monitoring what is being said about their businesses, keeping up with the industry, improving the customer experience, and competitive intelligence. Many small businesses in the B2B sector are already using social media for business as a resource, to engage in initiatives, or both. However, companies with more than one hundred employees are more active than smaller companies.

Despite the hype surrounding social media, and the fact that many small businesses are already connected, small businesses must still consider the use of social media just as carefully as the other modes of marketing communications. Social media has not worked out well for some small businesses that have used it, so each business must decide what social media is expected to do for the company, and then it must be used well and strategically. When considering whether or how to factor social media into an IMC strategy, consider these words from Lisa Barone, co-founder and chief branding officer at *Outspoken Media*, "In 2011, if you're not using social media to gain attention over your competitors, you can bet they're using it to gain attention over you." This will undoubtedly continue to be the case.

Video Clip: Social Media

The top five things you should know about social media.

A YouTube element has been excluded from this version of the text. You can view it online here.

Personal Selling

A small business owner needs to connect with customers before a sale can take place. Sometimes personal selling is the best way to do that. **Personal selling**, "the process of communicating with a potential buyer (or buyers) face-to-face with the purpose of selling a product or service," is absolutely essential in the marketing communications mix of a small business. History has shown that the most successful entrepreneurs have been skilled salespeople who were able to represent and promote their companies and products in the marketplace. It stands to reason that successful small business owners should have the same sales skills.

Although personal selling plays an important role in the sale of consumer products, it is even more important in the sale of industrial and business products. More than four times as many personal selling activities are directed toward industrial and business customers than toward consumers. Regardless of the type of customer or consumer, however, the objectives of personal selling are the same:

- **Building product awareness.** A salesperson should educate customers and consumers on new product offerings.
- **Creating interest.** Because personal selling is a person-to-person, and often a face-to-face, communication, it is a natural way for getting customers and consumers to experience a product for the first time. Creating interest goes hand-in-hand with building product awareness.
- **Providing information.** A large part of the conversation with the customer focuses on product information.
- **Stimulating demand.** The most important objective of personal selling by far is persuading customers and consumers to make a purchase.
- **Reinforcing the brand.** Most personal selling focuses on building long-term relationships with customers and consumers. However, strong relationships can be built only over time, and they require regular communication.

Like all other forms of marketing communications, personal selling offers both advantages and disadvantages. On the plus side, personal selling is flexible and dynamic, providing companies with the best opportunity to tailor a message to satisfy customers' needs. Personal selling's interactive nature also makes it the most effective promotional method for building relationships with customers, particularly in the B2B market, and it is the most practical promotional method for reaching customers who are not easily reached through other methods. Personal selling can help a small business build strong, loyal relationships with customers and consumers.

On the minus side, the biggest disadvantage may be the negative perceptions that many people have of salespeople: pushy, annoying, slippery, and willing to do anything for the sale—whether legal or not. The reality, of course, is that most salespeople (unfortunately, not all) do not fit this stereotype. The successful salesperson is the person who focuses his or her efforts on satisfying customers over the long term as opposed to his or her own selfish interests. Also on the negative side is the high cost of personal selling. Personal sales contacts are very expensive, with the costs incurred (compensation plus sales support) whether the sale is made or not. Then there are the costs of training the sales staff on product knowledge, industry information, and perhaps selling skills. Depending on the size of the company, small businesses will have varying numbers of salespeople, so some of the costs will vary as well.

The traditional sales process is typically seen as a series of six steps:

1. **Prospecting and qualifying.** Locating potential customers who have a need for a product and the ability to pay for it. For example, prospects for a small electric motor company would be all the businesses that use small electric motors. Prospects can be found through a variety of sources, including current customers, trade directories, business associates, and newspaper or magazine articles.
2. **Preapproach.** It is important to learn as much about a prospect as you can. For example, you want to know about the prospect's needs, attitudes about available products and brands, critical product attributes and benefits desired, and current vendor(s).
3. **Presentation and demonstration.** This is where the salesperson tells the product "story" to the buyer: the product's features, advantages, benefits, and value. It is important not to spend too much time on product features because benefits and value will most directly influence the purchase decision. It is also important to ask questions and listen carefully to a prospect's answers because they will provide valuable insights into the prospect's needs.
4. **Overcoming objections.** You should expect customers to pose objections. The key to overcoming these objections is to maintain a positive approach, ask the prospect to clarify the objections, and respond to the objections by reiterating the major benefits of the product or the service and pointing out additional features, guarantees, service, and anything else that would address the objections.
5. **Closing.** This is when the salesperson asks the prospect to buy the product. The request can be direct, or the salesperson can encourage the purchase by using a trial closing approach like asking, "Would you like us to finance product A for you?" Closing the sale is understandably the most difficult step for many salespeople because of the fear that the prospect will say no.
6. **Follow-up and maintenance.** These activities are necessary for customer satisfaction and repeat business. They are key to establishing the strong long-term relationships that every small business desires and needs. The salesperson should schedule a follow-up call to ensure proper installation, instruction, servicing, and troubleshooting and resolution should any problems be detected. Always remember that unhappy customers will defect to competition—and they will spread negative comments about the company. Because it is much cheaper to retain an old customer than to obtain new ones, it is in a company's best interests to provide good follow-up and maintenance services.

Although these steps are helpful as a way to summarize the kinds of things that are relevant to personal selling, the Internet has revolutionized the selling process. The traditional process just described has become largely obsolete, with roles changing. Web searches and online content help prospective customers or clients do their own prospecting and qualifying. This eliminates the most time-consuming part of the traditional sales process. A company's website becomes the first sales presentation and, as a result, is critical in moving a prospect toward a sale. In short, all employees must be fully integrated into web marketing because web marketing is the primary driver of the sales process. The more web-savvy you are, the greater the chances that your selling will beat the competition.

Video Clip: Small Business Selling

An overview of personal selling.

A YouTube element has been excluded from this version of the text. You can view it online here.

KEY TAKEAWAYS

- Promotion and marketing communications are relatively synonymous terms.
- IMC is about pulling all the marketing communications together to convey a consistent message.

- Small-business owners should be familiar and comfortable with the terms *promotion*, *marketing communications*, and *integrated marketing communications (IMC)*.
- There are multiple categories of IMC objectives.
- The marketing communications mix for a small business will consist of some combination of advertising, sales promotion, events and experiences, PR and publicity, direct marketing, interactive marketing, and personal selling. This mix is applicable to both pure-play and brick-and-click businesses.
- There is a lot of hype about blogs and social media. They can be very effective, but they have not worked well for all small businesses that have used them. They should be considered carefully before inclusion in a company's IMC strategy.

EXERCISES

1. Frank's All-American BarBeQue has historically taken a very low-key approach to promoting the business, choosing to rely on word-of-mouth communication. Robert believes that Frank needs to increase the sophistication of the marketing communications. Design an IMC plan for Frank's BarBeQue. Keep the following in mind: (1) Frank's is a small business with a very limited IMC budget; (2) advertising in prime time and national television are not options; and (3) Frank's is selling both food and its BBQ sauces.
2. Choose two products or services that you purchased recently from small businesses, one from an online business and one from an on-ground business. The products should be different from those chosen for price. For each product or service, identify the various media that were used to promote the product or the service and analyze the marketing communications mix. Do you agree with the marketing communications mix that was used? What recommendations would you make for change? Tip: If you are not sure whether an online business can be considered a small business, type in the name of the business plus "corporate HQ" into Google or your preferred search engine. The search should return results that include the number of employees. As long as the company has fewer than five hundred employees, you are all set.

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CHAPTER OVERVIEW

Chapter 10: Products and Pricing

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10.1: Introduction

Learning Objectives

After reading this chapter, you should be able to answer these questions:

- What is the marketing concept and relationship-building?
- How do managers create a marketing strategy?
- What is the marketing mix?
- How do consumers and organizations make buying decisions?
- What are the five basic forms of consumer and business market segmentation?
- What is a product, and how is it classified?
- How do organizations create new products?
- What are the stages of the product life cycle?
- What strategies are used for pricing products, and what are the future trends?
- What trends are occurring in products and pricing?

EXPLORING BUSINESS CAREERS

Rachel Kuhr: Mark Cuban's Shark Tank Empire

Rachel Kuhr is the product innovation and development specialist for Mark Cuban's investments in the ABC show *Shark Tank*. Two years ago, after watching an episode, Kuhr e-mailed Mark Cuban and attached a resume that highlighted her mechanical engineering and product development expertise. Her approach appealed to Cuban, and she was contacted the next day by Abe Minkara, head of Cuban's business development team. After a Skype interview in which Minkara was impressed with Kuhr's skill set of both creativity and attention to process, she was hired to fill that role and work with several start-ups that Cuban acquired an investment in through the show.

Kuhr now coaches and collaborates with over 60 companies that reside in Cuban's business portfolio. Rather than start out with detailed plans and building sophisticated prototypes, Kuhr favors using things like a whiteboard, Post-it notes, colored pens, and highlighters to sketch out the ideas. Such an approach uses the best practices from brainstorming that allow fatal flaws to steer the direction of product development before spending lots of resources, both human and financial, on a single idea for too long. This approach also allows the product development team to incorporate the user experience, which is sometimes overlooked when the focus is squarely on the product.

One of the companies that Kuhr works with created Chapul Cricket Bars. Chapul Cricket Bars was the first company to use insect-based "flour" in the manufacture of high- energy protein bars. After the deal on Shark Tank, company founder Pat Crowley and Kuhr decided to take the flying insect logo off the product design and renamed the bars with names such as Aztec, Matcha, and Chaco instead of the "Cricket Bar" name.

Another Cuban investment was the Austin, Texas–based BeatBox Beverages. To better understand how typical consumers would relate to boxed flavored cocktails, Kuhr attended several fraternity parties at Southern Methodist University and off-campus bars. She asked questions that addressed how a variety of consumers decide on what to drink on different occasions and in different settings. Since securing a $1 million dollar investment from Cuban, and working with Rachel Kuhr, online and distribution sales through stores has skyrocketed according to Justin Fenchel, BeatBox Beverages' CEO.

Marketing plays a key role in the success of businesses. It is the task of marketing to generate sales for the firm. Sales revenue, in turn, pays workers' salaries, buys supplies, covers the costs of new buildings and equipment, and hopefully enables the company to earn a profit. This chapter looks at the nature of marketing and the creation of product and pricing strategies to meet customers' needs. In this chapter, you will learn about the marketing concept, marketing strategies, and consumer and business buying decisions. You will also see how the marketing mix is used to create sales opportunities. We discuss how new products are created and how they go through periods of sales growth and then decline. Next you will discover how managers set prices to reach organizational goals.

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10.2: The Marketing Concept

What is the Marketing Concept and Relationship-building?

Marketing is the process of getting the right goods or services or ideas to the right people at the right place, time, and price, using the right promotion techniques and utilizing the appropriate people to provide the customer service associated with those goods, services, or ideas. This concept is referred to as the *"right" principle* and is the basis of all marketing strategy. We can say that **marketing** is finding out the needs and wants of potential buyers (whether organizations or consumers) and then providing goods and services that meet or exceed the expectations of those buyers. Marketing is about creating exchanges. An **exchange** takes place when two parties give something of value to each other to satisfy their respective needs or wants. In a typical exchange, a consumer trades money for a good or service. In some exchanges, nonmonetary things are exchanged, such as when a person who volunteers for the company charity receives a T-shirt in exchange for time spent. One common misconception is that some people see no difference between marketing and sales. They are two different things that are both part of a company's strategy. Sales incorporates actually selling the company's products or service to its customers, while marketing is the process of communicating the value of a product or service to customers so that the product or service sells.

To encourage exchanges, marketers follow the "right" principle. If a local Avon representative doesn't have the right lipstick for a potential customer when the customer wants it, at the right price, the potential customer will not exchange money for a new lipstick from Avon. Think about the last exchange (purchase) you made: What if the price had been 30 percent higher? What if the store or other source had been less accessible? Would you have bought anything? The "right" principle tells us that marketers control many factors that determine marketing success.

Most successful organizations have adopted the **marketing concept**. The marketing concept is based on the "right" principle. The marketing concept is the use of marketing data to focus on the needs and wants of customers in order to develop marketing strategies that not only satisfy the needs of the customers but also the accomplish the goals of the organization. An organization uses the marketing concept when it identifies the buyer's needs and then produces the goods, services, or ideas that will satisfy them (using the "right" principle). The marketing concept is oriented toward pleasing customers (be those customers organizations or consumers) by offering value. Specifically, the marketing concept involves the following:

- Focusing on the needs and wants of the customers so the organization can distinguish its product(s) from competitors' offerings. Products can be goods, services, or ideas.
- Integrating all of the organization's activities, including production and promotion, to satisfy these wants and needs
- Achieving long-term goals for the organization by satisfying customer wants and needs legally and responsibly

Today, companies of every size in all industries are applying the marketing concept. Enterprise Rent-A-Car found that its customers didn't want to have to drive to its offices. Therefore, Enterprise began delivering vehicles to customers' homes or places of work. Disney found that some of its patrons really disliked waiting in lines. In response, Disney began offering FastPass at a premium price, which allows patrons to avoid standing in long lines waiting for attractions. One important key to understanding the marketing concept is to know that using the marketing concept means the product is created *after* market research is used to identify the needs and wants of the customers. Products are not just created by production departments and then marketing departments are expected to identify ways to sell them based on the research. An organization that truly utilizes the marketing concept uses the data about potential customers from the very inception of the product to create the best good, service, or idea possible, as well as other marketing strategies to support it.

Customer Value

Customer value is the ratio of benefits for the customer (organization or consumer) to the sacrifice necessary to obtain those benefits. The customer determines the value of both the benefits and the sacrifices. Creating customer value is a core business strategy of many successful firms. Customer value is rooted in the belief that price is not the only thing that matters. A business that focuses on the cost of production and price to the customer will be managed as though it were providing a commodity differentiated only by price. In contrast, businesses that provide customer value believe that many customers will pay a premium for superior customer service or accept fewer services for a value price. It is important not to base value on price (instead of service or quality) because customers who only value price will buy from the competition as soon as a competitor can offer a lower price.

It is much better to use marketing strategies based on customer relationships and service, which are harder for the competition to replicate. Southwest Airlines doesn't offer assigned seats, meals, or in-flight movies. Instead the budget carrier delivers what it promises: on-time departures. In "service value" surveys, Southwest routinely beats the full-service airlines such as American Airlines, which actually provide passengers with luxuries such as movies and food on selected long-haul flights.

Customer Satisfaction

Customer satisfaction is a theme stressed throughout this text. **Customer satisfaction** is the customer's feeling that a product has met or exceeded expectations. Expectations are often the result of communication, especially promotion. Utilizing marketing research to identify specific expectations and then crafting marketing strategy to meet or exceed those expectations is a major contributor to success for an organization. Lexus consistently wins awards for its outstanding customer satisfaction. JD Powers surveys car owners two years after they make their purchase. Its Customer Satisfaction Survey is made up of four measures that each describe an element of overall ownership satisfaction at two years: vehicle quality/ reliability, vehicle appeal, ownership costs, and service satisfaction from a dealer. Lexus continues to lead the industry and has been America's top-ranked vehicle for five years in a row.



Figure 10.2.1: Geico—the major auto insurer with the scaly mascot—famously boasts a 97 percent customer-satisfaction rating. Although the firm's claim may be exaggerated a bit, consumers get the message that Geico delivers quality insurance coverage at low prices. *In what way does the company's quirky and ubiquitous advertising—in which customers claim to have saved a bunch of money on car insurance by switching to Geico—influence customers' service expectations?* (Credit: Mike Mozart/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Building Relationships

Relationship marketing is a strategy that focuses on forging long-term partnerships with customers. Companies build relationships with customers by offering value and providing customer satisfaction. Once relationships are built with customers, customers tend to continue to purchase from the same company, even if the prices of the competitors are less or if the competition offers sales promotions or incentives. Customers (both organizations and consumers) tend to buy products from suppliers whom they trust and feel a kinship with, regardless of offerings of unknown competitors. Companies benefit from repeat sales and referrals that lead to increases in sales, market share, and profits. Costs fall because it is less expensive to serve existing customers than to attract new ones. Focusing on customer retention can be a winning tactic; studies show that increasing customer retention rates by 5 percent increases profits by anywhere from 25 to 95 percent.

Customers also benefit from stable relationships with suppliers. Business buyers have found that partnerships with their suppliers are essential to producing high-quality products while cutting costs. Customers remain loyal to firms that provide them greater

value and satisfaction than they expect from competing firms.

Frequent-buyer clubs are an excellent way to build long-term relationships. All major airlines have frequent-flyer programs. After you fly a certain number of miles, you become eligible for a free ticket. Now, cruise lines, hotels, car rental agencies, credit-card companies, and even mortgage companies give away “airline miles” with purchases. Consumers patronize the airline and its partners because they want the free tickets. Thus, the program helps to create a long-term relationship with (and ongoing benefits for) the customer. Southwest Airlines carries its loyalty program a bit further than most. Members get birthday cards, and some even get profiled in the airline’s in-flight magazine.

CONCEPT CHECK

1. Explain the marketing concept.
2. Explain the difference between customer value and customer satisfaction.
3. What is meant by relationship marketing?

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10.4: Developing a Marketing Mix

What is the Marketing Mix?

Once a firm has defined its target market and identified its competitive advantage, it can create the **marketing mix**, which is based on the 5Ps discussed earlier, that brings a specific group of consumers a product with superior value. Every target market requires a unique marketing mix to satisfy the needs of the target customers and meet the firm's goals. A strategy must be constructed for each of the 5Ps, and all strategies must be blended with the strategies of the other elements. Thus, the marketing mix is only as good as its weakest part. For example, an excellent product with a poor distribution system could be doomed to failure. An excellent product with an excellent distribution system but an inappropriate price is also doomed to failure. A successful marketing mix requires careful tailoring. For instance, at first glance you might think that McDonald's and Wendy's have roughly the same marketing mix. After all, they are both in the fast-food business. But McDonald's targets parents with young children through Ronald McDonald, heavily promoted children's Happy Meals, and in-store playgrounds. Wendy's is targeted to a more adult crowd. Wendy's has no playgrounds, but it does have flat-screen TVs, digital menu boards, and comfy leather seating by a fireplace in many stores (a more adult atmosphere), and it has expanded its menu to include more items for adult tastes.

Product Strategy

Marketing strategy typically starts with the product. Marketers can't plan a distribution system or set a price if they don't know exactly what product will be offered to the market. Marketers use the term *product* to refer to *goods*, *services*, or even *ideas*. Examples of goods would include tires, MP3 players, and clothing. Goods can be divided into business goods (commercial or industrial) or consumer goods. Examples of services would be hotels, hair salons, airlines, and engineering and accounting firms. Services can be divided into consumer services, such as lawn care and hair styling, or professional services, such as engineering, accounting, or consultancy. In addition, marketing is often used to "market" ideas that benefit companies or industries, such as the idea to "go green" or to "give blood." Businesses often use marketing to improve the long-term viability of their industries, such as the avocado industry or the milk industry, which run advertising spots and post social media messages to encourage consumers to view their industries favorably. Thus, the heart of the marketing mix is the good, service, or idea. Creating a **product strategy** involves choosing a brand name, packaging, colors, a warranty, accessories, and a service program.

Marketers view products in a much larger context than is often thought. They include not only the item itself but also the brand name and the company image. The names Ralph Lauren and Gucci, for instance, create extra value for everything from cosmetics to bath towels. That is, products with those names sell at higher prices than identical products without the names. Consumers buy things not only for what they do, but also for what they mean.

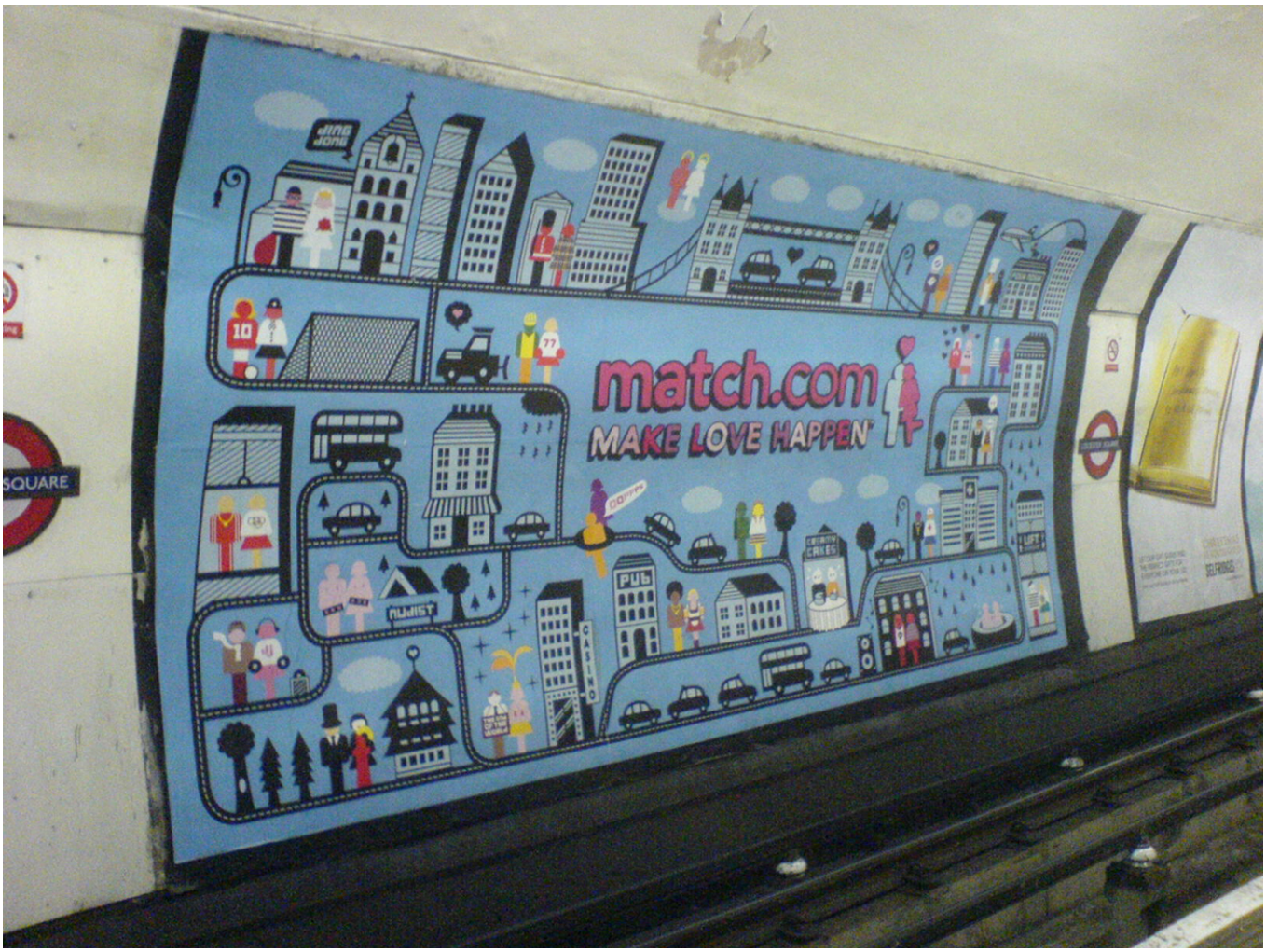


Figure 10.4.1: With their computerized profile-matching capabilities, online dating services are a high-tech way to make a love connection. Today's date-seeking singles want more than automated personals, however. They want advice from experts. At Match.com, popular shrink Dr. Phil guides subscribers toward healthy relationships. At eHarmony.com, Dr. Neil Clark Warren helps the lovelorn find a soulmate. *How do internet dating services use various elements of the marketing mix to bolster the effectiveness of their product strategies?* (Credit: Bixentro/ Flickr/ Attribution-2.0 Generic (CC BY 2.0))

Pricing Strategy

Pricing strategy is based on demand for the product and the cost of producing that product. However, price can have a major impact on the success of a product if the price is not in balance with the other components of the 5Ps. For some products (especially service products), having a price that is too low may actually hurt sales. In services, a higher price is often equated with higher value. For some types of specialty products, a high price is expected, such as prices for designer clothes or luxury cars. Even costume jewelry is often marked up more than 1000 percent over the cost to produce it because of the image factor of a higher price. Special considerations can also influence the price. Sometimes an introductory price is used to get people to try a new product. Some firms enter the market with low prices and keep them low, such as Carnival Cruise Lines and Suzuki cars. Others enter a market with very high prices and then lower them over time, such as producers of high-definition televisions and personal computers.

Place (Distribution) Strategy

Place (distribution) strategy is creating the means (the channel) by which a product flows from the producer to the consumer. Place includes many parts of the marketing endeavor. It includes the physical location and physical attributes of the business, as well as inventory and control systems, transportation, supply chain management, and even presence on the web. One aspect of distribution strategy is deciding how many stores and which specific wholesalers and retailers will handle the product in a

geographic area. Cosmetics, for instance, are distributed in many different ways. Avon has a sales force of several hundred thousand representatives who call directly on consumers. Clinique and Estée Lauder are distributed through selected department stores. Cover Girl and Coty use mostly chain drugstores and other mass merchandisers. Redken products sell through hair salons. Revlon uses several of these distribution channels. For services, place often becomes synonymous with both physical location (and attributes of that location such as atmospherics) and online presence. Place strategy for services also includes such items as supply chain management. An example would be that an engineering firm would develop offices with lush interiors (to denote success) and would also have to manage the supplies for ongoing operations such as the purchase of computers for computer-aided drafting.

Promotion Strategy

Many people feel that promotion is the most exciting part of the marketing mix. **Promotion strategy** covers personal selling, traditional advertising, public relations, sales promotion, social media, and e-commerce. These elements are called the promotional mix. Each element is coordinated with the others to create a promotional blend. An advertisement, for instance, helps a buyer get to know the company and paves the way for a sales call. A good promotional strategy can dramatically increase a firm's sales.

Public relations plays a special role in promotion. It is used to create a good image of the company and its products. Bad publicity costs nothing to send out, but it can cost a firm a great deal in lost business. Public relations uses many tools, such as publicity, crisis management strategy, and in-house communication to employees. Good publicity, such as a television or magazine story about a firm's new product, may be the result of much time, money, and effort spent by a public-relations department. Public-relations activities always cost money—in salaries and supplies. Public-relations efforts are the least "controllable" of all the tools of promotion, and a great deal of effort and relationship-building is required to develop the ongoing goodwill and networking that is needed to enhance the image of a company.

Sales promotion directly stimulates sales. It includes trade shows, catalogs, contests, games, premiums, coupons, and special offers. It is a direct incentive for the customer to purchase the product immediately. It takes many forms and must adhere to strict laws and regulations. For example, some types of contests and giveaways are not allowed in all the states within the United States. McDonald's discount coupons and contests offering money and food prizes are examples of sales promotions.

Social media is a major element of the promotion mix in today's world. Most businesses have a corporate website, as well as pages on different social media sites such as Facebook, Pinterest, and Twitter. Social media is more powerful as a channel for getting the company's message out to the target market (or general public) than traditional advertising, especially for some target markets. Companies (and even individuals) can use social media to create instant branding. E-commerce is the use of the company website to support and expand the marketing strategies of the 5Ps. It can include actual "order online" capabilities, create online communities, and be used to collect data from both existing and potential customers. Some e-commerce websites offer free games and other interactive options for their customers. All of this activity helps to build and strengthen the long-term relationships of customers with the company.

Not-for-Profit Marketing

Profit-oriented companies are not the only ones that analyze the marketing environment, find a competitive advantage, and create a marketing mix. The application of marketing principles and techniques is also vital to not-for-profit organizations. Marketing helps not-for-profit groups identify target markets and develop effective marketing mixes. In some cases, marketing has kept symphonies, museums, and other cultural groups from having to close their doors. In other organizations, such as the American Heart Association, marketing ideas and techniques have helped managers do their jobs better. In the private sector, the profit motive is both an objective for guiding decisions and a criterion for evaluating results. Not-for-profit organizations do not seek to make a profit for redistribution to owners or shareholders. Rather, their focus is often on generating enough funds to cover expenses or generating enough funds to expand their services to assist more people. For example, the Methodist Church does not gauge its success by the amount of money left in offering plates. The Museum of Science and Industry does not base its performance evaluations on the dollar value of tokens put into the turnstile. An organization such as the American Red Cross raises funds to provide basic services, but if enough funds are raised (beyond just the amount to cover expenses), those funds are used to expand services or improve current services.

CONCEPT CHECK

1. What is meant by the marketing mix?
2. What are the components of the marketing mix?
3. How can marketing techniques help not-for-profit organizations?

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10.5: Buyer Behavior

How Do Consumers and Organizations Make Buying Decisions?

An organization that wants to be successful must consider buyer behavior when developing the marketing mix. **Buyer behavior** is the actions people take with regard to buying and using products. Marketers must understand buyer behavior, such as how raising or lowering a price will affect the buyer's perception of the product and therefore create a fluctuation in sales, or how a specific review on social media can create an entirely new direction for the marketing mix based on the comments (buyer behavior/input) of the target market.

To understand buyer behavior, marketers must understand how customers make buying decisions. Consumers and businesses have processes for making decisions about purchases. These decision-making processes are affected by cultural, social, individual, and psychological factors. The consumer decision-making process has several steps, which are shown in Figure 10.5.1.

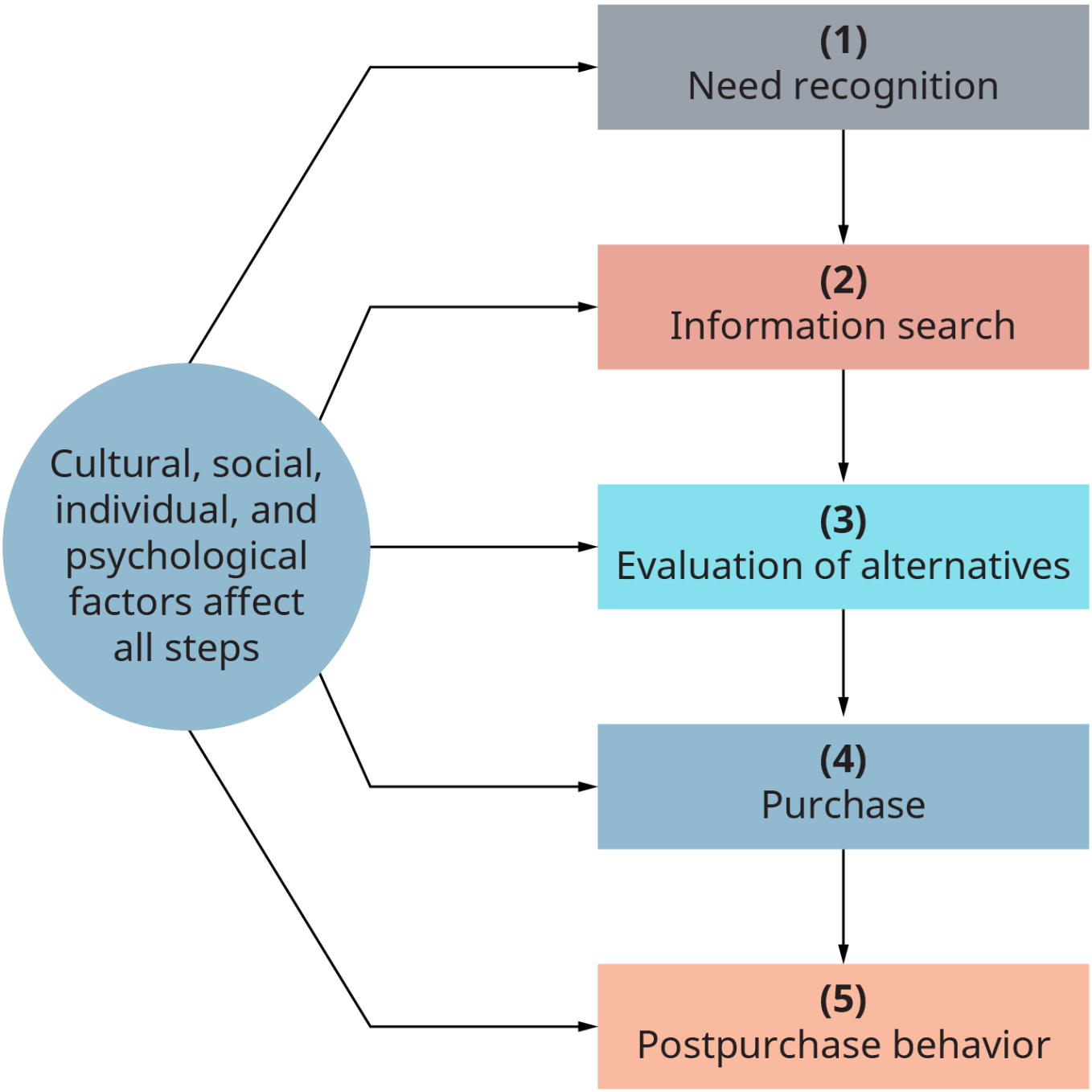


Figure 10.5.1: Consumer Purchase Decision-Making Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

The process starts with need recognition. Need recognition could be as simple as running out of coffee. Need recognition could also take place over several months, such as when repeated car repairs influence a consumer to make a decision to buy a new car (Step 1 in Figure 10.5.1).

Next, the buyer gathers information. If the consumer is making a decision to purchase a house, he or she might research information about financing, available homes, styles, locations, and so forth (Step 2). Once the consumer has gathered the information, he or she must evaluate alternatives (Step 3). For example, a consumer might eliminate all homes that cost over $150,000 or are more than a 30-minute drive to work. After evaluating the alternatives, the consumer will make a decision based on those alternatives. Then the consumer makes the purchase decision, the decision to buy or not to buy (Step 4). Finally, the consumer assesses the decision itself and his or her satisfaction with the purchase, which would include not only the home, but the buying experience as well (Step 5).

Influences on Consumer Decision-Making

Cultural, social, individual, and psychological factors have an impact on consumer decision-making from the time a person recognizes a need through post-purchase behavior. We will examine each of these factors in more detail. It is important to understand the relevance of these influences on consumer decision-making.

Culture

Purchase roles within the family are influenced by culture. **Culture** is the set of values, ideas, attitudes, and symbols created to shape human behavior. Culture is the part of customs and traditions of a group of people that is transformed into its art, food, costumes/clothing, architecture, and language, as well as other unique manifestations of a specific group of related individuals. Culture is environmentally oriented. For example, the nomads of Finland have developed a culture for Arctic survival. Similarly, the natives of the Brazilian jungle have created a culture suitable for jungle living.

Culture by definition is social in nature. It is human interaction that creates values and prescribes acceptable behavior. Culture gives order to society by creating common expectations. Sometimes these expectations are codified into law; for example, if you come to a red light, you stop the car. In some cultures, a young man undergoes a special rite of passage from youth into adulthood (such as a bar mitzvah in Jewish culture). In other cultures, young women have a rite of passage but young men do not (such as a quinceañera in Hispanic culture). As long as a value or belief meets the needs of society, it will remain part of the culture. If it is no longer functional, the value or belief fades away. For example, the value that very large families are “good” is no longer held by a majority of Americans. This is because most Americans live in an urban rather than a rural environment, and children are no longer needed to perform farm chores.

Social Factors

Most consumers are likely to seek out the opinions of others to reduce their search and evaluation effort or uncertainty, especially as the perceived risk of the decision increases. Consumers may also seek out others’ opinions for guidance on new products or services, products with image-related attributes, or products where attribute information is lacking or uninformative. Specifically, consumers interact socially with reference groups, opinion leaders, and family members to obtain product information and decision approval. All the formal and informal groups that influence the buying behavior of an individual are considered that person’s **reference groups**. Consumers may use products or brands to identify with or become a member of a group. They learn from observing how members of their reference groups consume, and they use the same criteria to make their own consumer decisions. A reference group might be a fraternity or sorority, a group you work with, or a club to which you belong.

Individual Influences

A person’s buying decisions are also influenced by personal characteristics unique to each individual, such as gender and personality. Individual characteristics are generally stable over the course of one’s life. For instance, most people do not change their gender, and the act of changing personality requires a complete reorientation of one’s life.

Physiological differences between men and women result in different needs, such as health and beauty products. Just as important are the distinct cultural, social, and economic roles played by men and women and the effects that these have on their decision-making processes. Men and women also shop differently. Studies show that men and women share similar motivations in terms of where to shop—that is, seeking reasonable prices, merchandise quality, and a friendly, low-pressure environment—but they don’t necessarily feel the same about shopping in general. Most women enjoy shopping; their male counterparts claim to dislike the experience and shop only out of necessity. Furthermore, men desire simple shopping experiences, stores with less variety, and convenience. When it comes to online shopping, gender differences continue. According to recent research, women tend to shop based on their future needs, while men tend to shop when their need is immediate. In addition, women tend to make impulse buys more frequently than men, who tend to think logically when making purchase decisions.

Each consumer has a unique personality. **Personality** is a broad concept that can be thought of as a way of organizing and grouping how an individual typically reacts to situations. Thus, personality combines psychological makeup and environmental forces. It includes people’s underlying dispositions, especially their most dominant characteristics. Although personality is one of the least useful concepts in the study of consumer behavior, some marketers believe that personality influences the types and brands of products purchased. For instance, the type of car, clothes, or jewelry a consumer buys may reflect one or more personality traits.

Psychological Influences

An individual's buying decisions are further influenced by psychological factors such as perception, beliefs, and attitudes. These factors are what consumers use to interact with their world. They are the tools consumers use to recognize their feelings, gather and analyze information, formulate thoughts and opinions, and take action. Unlike the other three influences on consumer behavior, psychological influences can be affected by a person's environment because they are applied on specific occasions. For example, individuals will perceive different stimuli and process these stimuli in different ways depending on whether the individual is sitting in class concentrating on an instructor's lecture, sitting outside of class talking to friends, or sitting at home watching television.

B2B Purchase Decision-Making

Business-to-business (B2B) buyer behavior and business markets are different from consumer markets. Business markets include institutions such as hospitals and schools, manufacturers, wholesalers and retailers, and various branches of government. The key difference between a consumer product and a business product is the intended use. For example, if a consumer purchases a certain brand of computer for use at home, it is considered a consumer good. If a purchasing agent for Netflix buys exactly the same computer for Netflix scriptwriter, it is considered a business good. Why? The reason is that Netflix is a business, so the computer will be used in a business environment.

The Decision-Making Process

The purchases that organizations make often involve greater risk than purchases made by individual consumers. For this reason, businesses (and other organizations) tend to base purchase decisions on more data and make purchase decisions based on rational decision-making so purchases will optimize value for the organization and minimize risk. For this reason, the business purchase decision-making process differs from the consumer process. The steps are similar: need recognition, setting specifications, information search (including identification of suppliers), evaluation (including evaluation of suppliers), purchase ("go or no-go"), and post-purchase evaluation. The major difference between the two processes is that businesses decide beforehand what exactly is needed on the purchase (setting specifications) and then seek information regarding products that meet those specifications. In this way, the purchases are more likely to satisfy the needs of the overall organization, thus reducing the risk.

Characteristics of the B2B Market

The main differences between consumer markets and business markets include the following:

1. *Purchase volume:* Business customers buy in much larger quantities than consumers. Mars must purchase many truckloads of sugar to make one day's output of M&Ms. Home Depot buys thousands of batteries each day for resale to consumers. The federal government must use (and purchase) millions of pens each day.
2. *Number of customers:* Business marketers usually have far fewer customers than consumer marketers. As a result, it is much easier to identify prospective buyers and monitor current needs. For example, there are far fewer customers for airplanes or industrial crane companies than there are for consumer goods companies since there are more than 125 million consumer households in the United States.
3. *Location of buyers:* Business customers tend to be much more geographically concentrated than consumers. The computer industry is concentrated in Silicon Valley and a few other areas. Aircraft manufacturing is found in Seattle, Washington; St. Louis, Missouri; and Dallas/Fort Worth, Texas. Suppliers to these manufacturers often locate close to the manufacturers to lower distribution costs and facilitate communication.
4. *Direct distribution:* Business sales tend to be made directly to the buyer because such sales frequently involve large quantities or custom-made items such as heavy machinery. Consumer goods are more likely to be sold through intermediaries such as wholesalers and retailers.

CONCEPT CHECK

1. Explain the consumer purchase decision-making process.
2. Explain the differences between the business purchase decision-making process and the consumer purchase decision-making process.
3. How do business markets differ from consumer markets?

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10.6: Market Segmentation

What are the Five Basic Forms of Consumer and Business Market Segmentation?

Most organizations cannot target the total market for a specific product. For each separate part of the market that an organization wants to target, a marketing mix (a set of 5Ps) must be created. It would be very expensive to try to create a marketing mix for every part of the target market. Instead, companies cut up those targets into specific “segments” of the market that the organization is more strategically positioned to be successful in targeting. Segmentation also varies based on the target market being a consumer market or a business market.

The study of buyer behavior helps marketing managers better understand why people make purchases. To identify the target markets that may be most profitable for the firm, marketers use **market segmentation**, which is the process of separating, identifying, and evaluating the layers of a market to identify a target market. For instance, a target market might be segmented into two groups: families with children and families without children. Families with young children are likely to buy hot cereals and presweetened cereals. Families with no children are more likely to buy health-oriented cereals. Cereal companies plan their marketing mixes with this difference in mind. A business market may be segmented by large customers and small customers or by geographic area.

The five basic forms of consumer market segmentation are demographic, geographic, psychographic, benefit, and volume. Their characteristics are summarized in Table 10.6.1 and discussed in the following sections.

Demographic Segmentation

Demographic segmentation uses categories such as age, education, gender, income, and household size to differentiate among markets. This form of market segmentation is the most common because demographic information is easy to obtain. The U.S. Census Bureau provides a great deal of demographic data, especially about metropolitan areas. For example, marketing researchers can use census data to find areas within cities that contain high concentrations of high-income consumers, singles, blue-collar workers, and so forth. However, even though demographic information is easier to obtain than other types of information, it may not always be the best approach to segmentation because it is limited on what it can reveal about consumers.

Table 10.6.1: Forms of Consumer Market Segmentation

Form General	Characteristics
Demographic segmentation	Age, education, gender, income, race, social class, household size
Geographic segmentation	Regional location (e.g., New England, Mid-Atlantic, Southeast, Great Lakes, Plains States, Northwest, Central, Southwest, Rocky Mountains, Far West), population density (urban, suburban, rural), city or county size, climate
Psychographic segmentation	Lifestyle, personality, interests, values, attitudes
Benefit segmentation	Benefits provided by the good or service
Volume segmentation	Amount of use (light versus heavy)

Many products are targeted to various age groups. Most music CDs, Pepsi, Coke, many movies, the Honda Fit, and thousands of other products are targeted toward teenagers and persons under 25 years old. In contrast, most cruises, medical products, fine jewelry, vacation homes, Teslas, and denture products are targeted toward people 50 years old and up. An example of how Frito Lay targets various age groups for three of its most popular products is shown in Table 10.6.2.

Table 10.6.2: Age Segmentation for Fritos, Doritos, and Tostitos

	Name Derivation	Year Introduced	Main Ingredients	Demographic	Niche, According to Frito Lay
Fritos	“Little fried bits” (Spanish)	1932	Corn, vegetable oil, salt	33- to 51-year-old males	“Hunger satisfaction”
Doritos	“Little bits of gold”	1964	Corn, vegetable oil, cheddar cheese, salt	Teens, mostly males	“Bold and daring snacking”
Tostitos	“Little toasted bits” (Spanish)	1981	White corn, vegetable oil, salt	Upscale consumers born between 1946 and 1964	“Casual interaction through friends and family . . . a social food that brings people together”

Income is another popular way to segment markets. Income level influences consumers’ wants and determines their buying power. Housing, clothing, automobiles, and alcoholic beverages are among the many markets segmented by income. Budget Gourmet frozen dinners are targeted to lower-income groups, whereas the Stouffer’s line and California Pizza Kitchen frozen pizzas are aimed at higher-income consumers.

Geographic Segmentation

Geographic segmentation means segmenting markets by region of the country, city or county size, market density, or climate. *Market density* is the number of people or businesses within a certain area. Many companies segment their markets geographically to meet regional preferences and buying habits. Pizza Hut, for instance, gives easterners extra cheese, westerners more ingredients, and midwesterners both. Both Ford and Chevrolet sell more pickup trucks and truck parts in the middle of the country than on either coast. The well-defined “pickup truck belt” runs from the upper Midwest south through Texas and the Gulf states. Ford“owns” the northern half of this truck belt and Chevrolet the southern half.

Psychographic Segmentation

Race, income, occupation, and other demographic variables help in developing strategies but often do not paint the entire picture of consumer needs. Demographics provide basic data that can be observed about individuals, but psychographics provide vital information that is often much more useful in crafting the marketing message. Demographics provide the skeleton, but psychographics add meat to the bones. **Psychographic segmentation** is market segmentation by personality or lifestyle. People with common activities, interests, and opinions are grouped together and given a “lifestyle name.” For example, Harley-Davidson divides its customers into seven lifestyle segments, from “cocky misfits” who are most likely to be arrogant troublemakers, to “laid-back camper types” committed to cycling and nature, to “classy capitalists” who have wealth and privilege. Two different managers could be described by demographics as male, managers, 35 years old, with $80,000 per year income. A marketer who just saw the demographics might create one advertisement to reach both of them. However, if the marketer knew that one of the managers was president of his homeowner’s association and captain of a rugby league team and the other manager was a holder of opera season tickets and president of the Friends of the Public Library, the messages might be designed very differently in order to be more successful.

Benefit Segmentation

Benefit segmentation is based on what a product will do rather than on consumer characteristics. For years Crest toothpaste was targeted toward consumers concerned with preventing cavities. Recently, Crest subdivided its market. It now offers regular Crest, Crest Tartar Control for people who want to prevent cavities and tartar buildup, Crest for kids with sparkles that taste like bubble gum, and another Crest that prevents gum disease. Another toothpaste, Topol, targets people who want whiter teeth—teeth without coffee, tea, or tobacco stains. Sensodyne toothpaste is aimed at people with highly sensitive teeth.

Volume Segmentation

The fifth main type of segmentation is **volume segmentation**, which is based on the amount of the product purchased. Just about every product has heavy, moderate, and light users, as well as nonusers. Heavy users often account for a very large portion of a product's sales. Thus, a firm might want to target its marketing mix to the heavy-user segment. For example, in the fast-food industry, the heavy user (a young, single male) accounts for only one in five fast-food patrons. Yet this heavy user makes over 60 percent of all visits to fast-food restaurants.

Retailers are aware that heavy shoppers not only spend more, but also visit each outlet more frequently than other shoppers. Heavy shoppers visit the grocery store 122 times per year, compared with 93 annual visits for the medium shopper. They visit discount stores more than twice as often as medium shoppers, and they visit convenience/gas stores more than five times as often. On each trip, they consistently spend more than their medium-shopping counterparts.

Business Market Segmentation

Business markets are segmented differently than consumer markets. Business markets may segment based on geography, volume, and benefits, just as consumer markets are. However, organizations might also segment based on use of the product (such as a petrochemical company having one market segment for purchasers who use polyethylene for instrumentation panels and one for purchasers who use polyethylene for car seats), characteristics of purchasing function (such as purchasing committees, purchasing managers, or purchasing departments), size of the client (one segment for large customers who have different needs than smaller customers), or industry (such as segmenting food systems into restaurants or government agencies such as schools or military bases), as well as other considerations related to characteristics of business customers.

Using Marketing Research to Serve Existing Customers and Find New Customers

How do successful companies learn what their customers value? Through marketing research, companies can be sure they are listening to the voice of the customer. **Marketing research** is the process of planning, collecting, and analyzing data relevant to a marketing decision. The results of this analysis are then communicated to management. The information collected through marketing research includes the preferences of customers, the perceived benefits of products, and consumer lifestyles. Research helps companies make better use of their marketing budgets. Marketing research has a range of uses, from fine-tuning existing products to discovering whole new marketing concepts.

For example, everything at the Olive Garden restaurant chain, from the décor to the wine list, is based on marketing research. Each new menu item is put through a series of consumer taste tests before being added to the menu. Hallmark Cards uses marketing research to test messages, cover designs, and even the size of the cards. Hallmark's experts know which kinds of cards will sell best in which places. Engagement cards, for instance, sell best in the Northeast, where engagement parties are popular. Birthday cards for "Daddy" sell best in the South because even adult southerners tend to call their fathers Daddy.

Marketing research can use either primary data (where the organization actually gets the data and analyzes it) or secondary data (where the organization uses data that has already been developed and published by another entity and the organization is able to utilize the data for its own purposes). There are three basic research methods used for gathering primary data: survey, observation, and experiment.

With **survey research**, data is gathered from respondents—in person, through the internet, by telephone, or by mail—to obtain facts, opinions, and attitudes. A questionnaire is used to provide an orderly and structured approach to data-gathering. Face-to-face interviews may take place at the respondent's home, in a shopping mall, or at a place of business.

Observation research is research that monitors respondents' actions without direct interaction. In the fastest-growing form of observation research, researchers use cash registers with scanners that read tags with bar codes to identify the item being purchased. Technological advances are rapidly expanding the future of observation research. Arbitron research has developed a portable people meter (PPM) about the size of a cell phone that research participants clip to their belts or any article of clothing. They agree to wear it during all waking hours. Before the study participants go to sleep, they put the PPM in a cradle that automatically sends data back to Arbitron (now Nielsen Audio). The PPM will tell the marketing research company exactly which television programs the person watched and for how long. It also records radio programs listened to, any web streaming, supermarket piped-in music, or any other electronic media that the research participant encountered during the day.

In the third research method, **experiment**, the investigator changes one or more variables—price, package, design, shelf space, advertising theme, or advertising expenditures—while observing the effects of those changes on another variable (usually sales). The objective of experiments is to measure causality. For example, an experiment may reveal the impact that a change in package design has on sales.

CONCEPT CHECK

1. Define market segmentation.
2. List and discuss the five basic forms of consumer market segmentation.
3. What are some additional forms of business segmentation?
4. How does marketing research help companies make better use of their marketing budgets?

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10.8: Creating Products That Deliver Value

How Do Organizations Create New Products?

New products pump life into company sales, enabling the firm not only to survive but also to grow. Companies like Allegheny Ludlum (steel), Dow (chemicals), Samsung (electronics), Campbell Soup (foods), and Stryker (medical products) get most of their profits from new products. Companies that lead their industries in profitability and sales growth get a large percentage of their revenues from products developed within the last five years. A recent McKinsey survey found that 94 percent of top executives believed that their companies' innovation approach and process needed to be updated, signaling how important new products are as the lifeblood of a company.

Marketers have several different terms for new products, depending on how the product fits into a company's existing product line. When a firm introduces a product that has a new brand name and is in a product category new to the organization, it is classified as a new product.

A new flavor, size, or model using an existing brand name in an existing category is called a **line extension**. Diet Cherry Coke and caffeine-free Coke are line extensions. The strategy of expanding the line by adding new models has enabled companies like Seiko (watches), Kraft (cheeses), Oscar Mayer (lunch meats), and Sony (consumer electronics) to tie up a large amount of shelf space and brand recognition in a product category. Crayola now offers Crayola bubble bath shampoo. Services companies also develop new products—new services based on market research—or make changes in ongoing services. Services companies can often introduce and adapt their products faster than companies that manufacture goods because service delivery can be more flexible and changes can often be made immediately. Due to this, customers often expect and require immediate improvements to services.

How New Products are Developed

Developing new products is both costly and risky, especially for companies that sell products that are goods. New-product failure rates for household and grocery products can approach 80 percent. Overall, companies report that only 3 percent of their products exceed their initial sales targets in Year 1. Even companies such as Facebook, which launched Facebook Home in 2013 at an initial price of $99 per year, have experienced new product failures. Industrial goods failure rates tend to be lower than those for consumer goods. To increase their chances for success, most firms use the following product development process, which is also summarized in Figure 10.8.1.

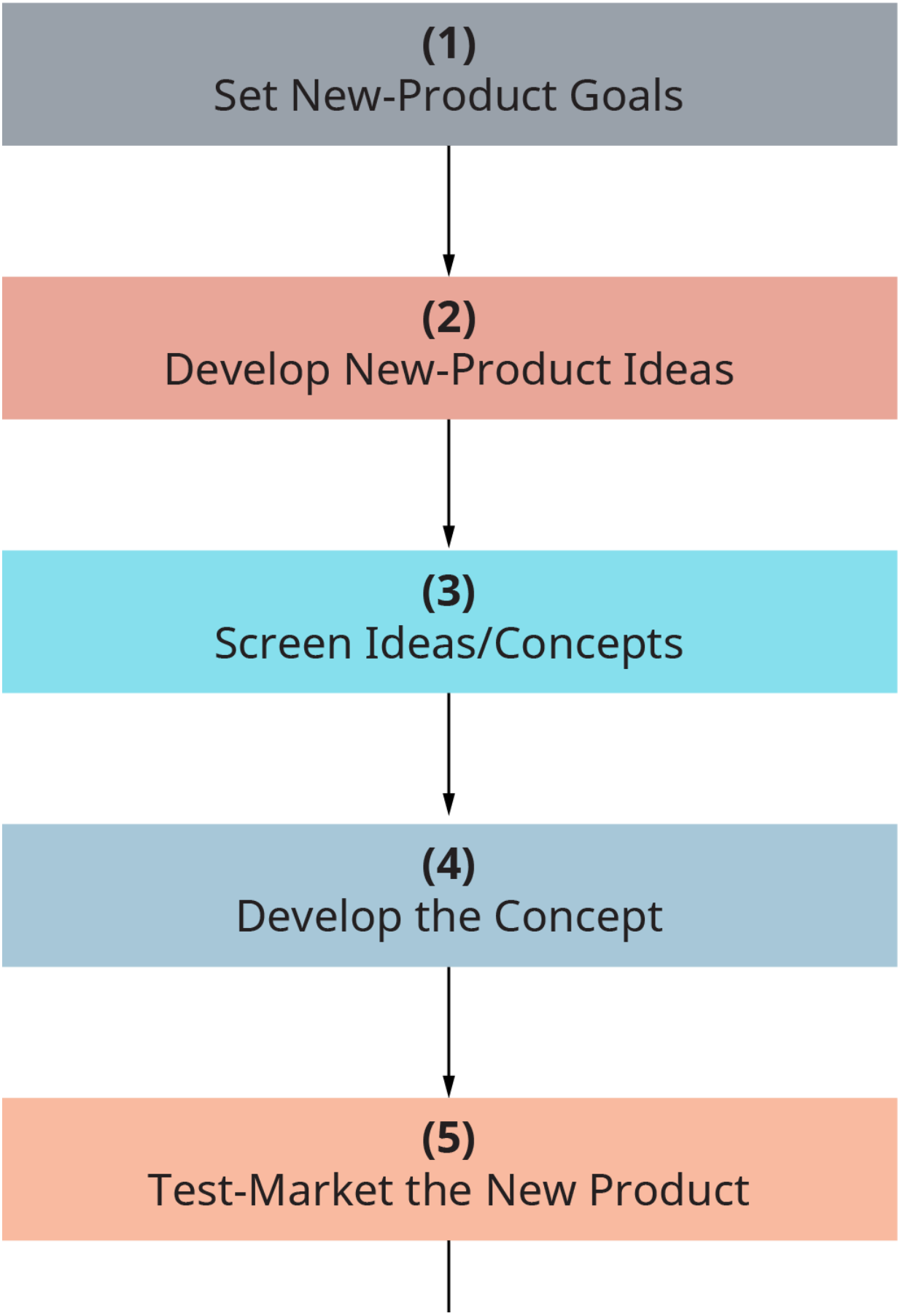

(1)
Set New-Product Goals
(2)
Develop New-Product Ideas
(3)
Screen Ideas/Concepts
(4)
Develop the Concept
(5)
Test-Market the New Product

Figure 10.8.1: Steps to Develop New Products That Satisfy Customers (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

(6) Introduce the Product to the Marketplace

1. *Set new-product goals:* New-product goals are usually stated as financial objectives. For example, a company may want to recover its investment in three years or less. Or it may want to earn at least a 15 percent return on the investment. Nonfinancial goals may include using existing equipment or facilities.
2. *Develop new-product ideas:* Smaller firms usually depend on employees, customers, investors, and distributors for new ideas. Larger companies use these sources and more-structured marketing research techniques, such as focus groups and brainstorming. A **focus group** consists of eight to 12 participants led by a moderator in an in-depth discussion on one particular topic or concept. The goal of focus group research is to learn and understand what people have to say and why. The emphasis is on getting people to speak at length and in detail about the subject at hand. The intent is to find out how they feel about a product, concept, idea, or organization; how it fits into their lives; and their emotional involvement with it. Focus groups often generate excellent product ideas. A few examples of focus group–influenced products are the interior design of the Toyota RAV4, Stick Ups room deodorizers, Swiffer WetJet, and Wendy's Salad Sensations. In the business market, machine tools, keyboard designs, aircraft interiors, and backhoe accessories evolved from focus groups.

   Brainstorming is also used to generate new-product ideas. With **brainstorming**, the members of a group think of as many ways to vary a product or solve a problem as possible. Criticism is avoided, no matter how ridiculous an idea seems at the time. The emphasis is on sheer numbers of ideas. Evaluation of these ideas is postponed to later steps of development.
3. *Screen ideas and concepts:* As ideas emerge, they are checked against the firm's new-product goals and its long-range strategies. Many product concepts are rejected because they don't fit well with existing products, needed technology is not available, the company doesn't have enough resources, or the sales potential is low.
4. *Develop the concept:* Developing the new-product concept involves creating a prototype of the product, testing the prototype, and building the marketing strategy. Building the marketing strategy means developing a test set of 5Ps. The type and amount of product testing varies, depending on such factors as the company's experience with similar products, how easy it is to make the item, and how easy it will be for consumers to use it. If Kraft wanted to develop a new salad dressing flavor, the company would benefit from the fact that the company already has a lot of experience in this area. The new dressing will go directly into advanced taste tests and perhaps home-use tests. To develop a new line of soft drinks, however, Kraft would most likely do a great deal of testing. It would study many aspects of the new product before actually making it.

   While the product is tested, the marketing strategy is refined. Channels of distribution are selected, pricing policies are developed and tested, the target market is further defined, and demand for the product is estimated. Management also continually updates the profit plan.

   As the marketing strategy and prototype tests mature, a communication strategy is developed. A logo and package wording are created. As part of the communication strategy, promotion themes are developed, and the product is introduced to the sales force.
5. *Test-market the new product:* **Test-marketing** is testing the product among potential users. It allows management to evaluate various strategies and to see how well the parts of the marketing mix fit together. Few new-product concepts reach this stage. For those that pass this stage, the firm must decide whether to introduce the product on a regional or national basis.

   Companies that don't test-market their products run a strong risk of product failure. In essence, test-marketing is the "acid test" of new-product development. The product is put into the marketplace, and then the manufacturer can see how it performs against the competition.
6. *Introduce the product:* A product that passes test-marketing is ready for market introduction, called *rollout*, which requires a lot of logistical coordination. Various divisions of the company must be encouraged to give the new item the attention it deserves. Packaging and labeling in a different language may be required. Sales training sessions must be scheduled, spare parts inventoried, service personnel trained, advertising and promotion campaigns readied, and wholesalers and retailers informed about the new item. If the new product is to be sold internationally, it may have to be altered to meet the requirements of the target countries. For instance, electrical products may have to run on different electrical currents.

For services companies, the new product develop process is similar, but developing the prototype can take less time and resources. It will mean developing the service and training service personnel on the new service in order to test it in the market.

The Role of the Product Manager

When a new product enters the marketplace in large organizations, it is often placed under the control of a product or brand manager. A **product manager** develops and implements a complete strategy and marketing program for a specific product or brand of product. Some companies may have numerous brands of the same type of product, such as many versions of laundry soap, each with different target markets, brand names, and attributes. Product management first appeared at Procter & Gamble in 1929. A new company soap, Camay, was not doing well, so a young Procter & Gamble executive was assigned to devote his exclusive attention to developing and promoting this product. He was successful, and the company soon added other product managers. Since then, many firms, especially consumer products companies, have set up product management organizations.

CONCEPT CHECK

1. How do companies organize for new-product development?
2. What are the steps in the new-product development process?
3. How does new-product development differ for services companies?
4. Explain the role of the product manager.

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10.9: The Product Life Cycle

What are the Stages of the Product Life Cycle?

Product managers create marketing mixes for their products as they move through the life cycle. The **product life cycle** is a pattern of sales and profits over time for a product (Ivory dishwashing liquid) or a product category (liquid detergents). As the product moves through the stages of the life cycle, the firm must keep revising the marketing mix to stay competitive and meet the needs of target customers.

Stages of the Life Cycle

As illustrated in Figure 10.9.1, the product life cycle consists of the following stages:

1. *Introduction:* When a product enters the life cycle, it faces many obstacles. Although competition may be light, the *introductory stage* usually features frequent product modifications, limited distribution, and heavy promotion. The failure rate is high. Production and marketing costs are also high, and sales volume is low. Hence, profits are usually small or negative.
2. *Growth:* If a product survives the introductory stage, it advances to the *growth stage* of the life cycle. In this stage, sales grow at an increasing rate, profits are healthy, and many competitors enter the market. Large companies may start to acquire small pioneering firms that have reached this stage. Emphasis switches from primary demand promotion to aggressive brand advertising and communicating the differences between brands. For example, the goal changes from convincing people to buy flat-screen TVs to convincing them to buy Sony versus Panasonic or Sharp.

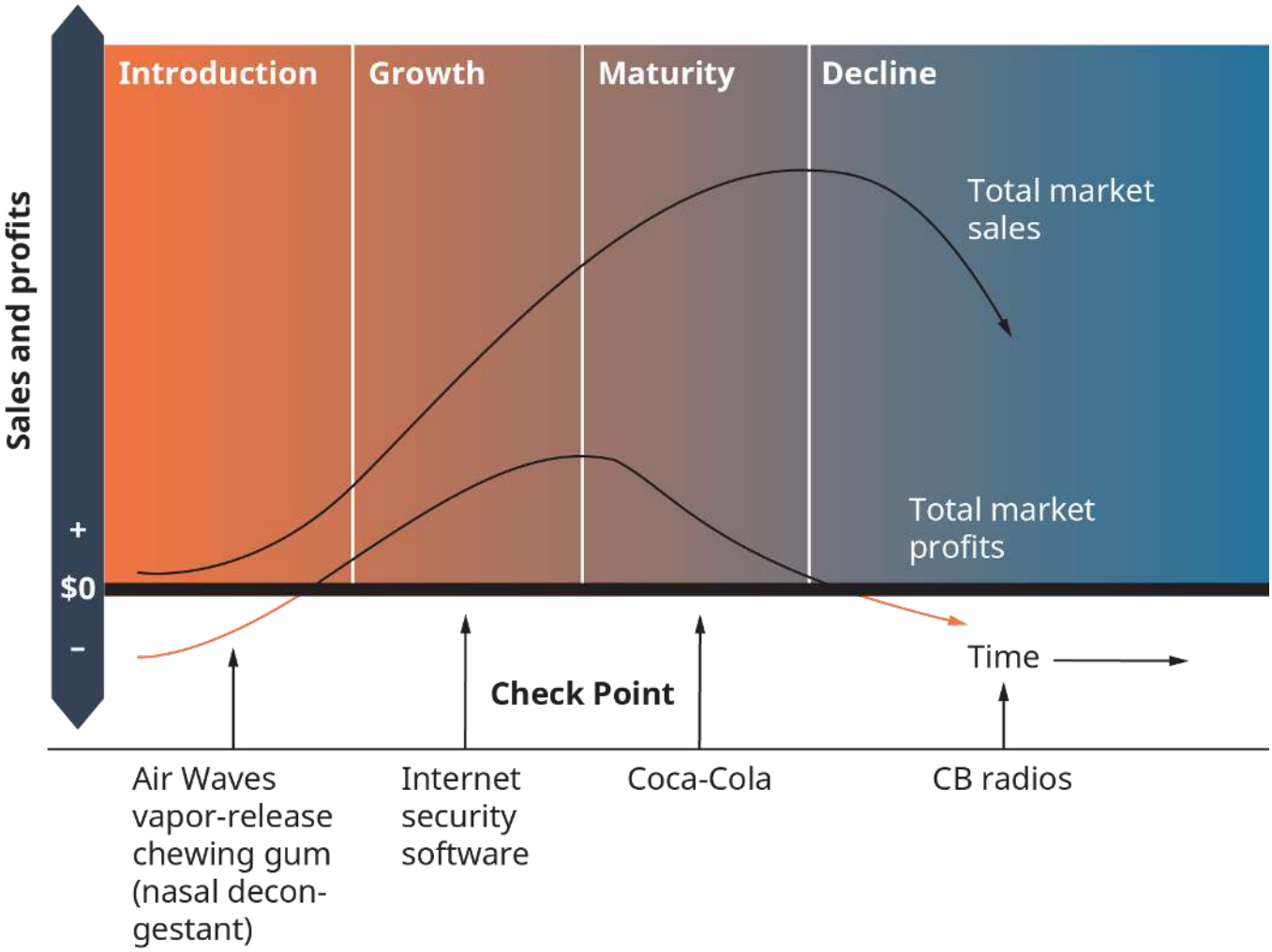


Figure 10.9.1: Sales and Profits during the Product Life Cycle (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Distribution becomes a major key to success during the growth stage, as well as in later stages. Manufacturers scramble to acquire dealers and distributors and to build long-term relationships. Without adequate distribution, it is impossible to establish a strong market position.

Toward the end of the growth phase, prices normally begin falling, and profits peak. Price reductions result from increased competition and from cost reductions from producing larger quantities of items (economies of scale). Also, most firms have recovered their development costs by now, and their priority is in increasing or retaining market share and enhancing profits.

1. *Maturity:* After the growth stage, sales continue to mount—but at a decreasing rate. This is the *maturity stage*. Most products that have been on the market for a long time are in this stage. Thus, most marketing strategies are designed for mature products. One such strategy is to bring out several variations of a basic product (line extension). Kool-Aid, for instance, was originally offered in six flavors. Today there are more than 50, as well as sweetened and unsweetened varieties.
2. *Decline (and death):* When sales and profits fall, the product has reached the *decline stage*. The rate of decline is governed by two factors: the rate of change in consumer tastes and the rate at which new products enter the market. Sony VCRs are an example of a product in the decline stage. The demand for VCRs has now been surpassed by the demand for DVDs and online streaming of content. Sometimes companies can improve a product by implementing changes to the product, such as new ingredients or new services. If the changes are accepted by customers, it can lead to a product moving out of the decline stage and back into the introduction stage.



Figure 10.9.2: Each year Coca-Cola adds new drinks to its product portfolio. While some of these new beverages are close relatives of the original Coca-Cola Classic, others, such as Vitaminwater, constitute entirely new categories of soft drink. *What challenges do new products such as Vitaminwater face during the introduction phase of the product life cycle? (Credit: kobakou/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

The Product Life Cycle as a Management Tool

The product life cycle may be used in planning. Marketers who understand the cycle concept are better able to forecast future sales and plan new marketing strategies. Table 10.9.1 is a brief summary of strategic needs at various stages of the product life cycle. Marketers must be sure that a product has moved from one stage to the next before changing its marketing strategy. A temporary sales decline should not be interpreted as a sign that the product is dying. Pulling back marketing support can become a self-fulfilling prophecy that brings about the early death of a healthy product.

Table 10.9.1: Strategies for Success at Each Stage of the Product Life Cycle

Category	Introduction	Growth	Maturity	Decline
Marketing objectives	Encourage trial, establish distribution	Get triers to repurchase, attract new users	Seek new user or users	Reduce marketing expenses, used to keep loyal users
Product	Establish competitive advantage	Maintain product quality	Modify product	Maintain product
Distribution	Establish distribution network	Solidify distribution relationships	Provide additional incentives to ensure support	Eliminate trade allowances
Promotional	Build brand awareness	Provide information	Reposition product	Eliminate most advertising and sales promotions
Pricing	Set introductory price (skimming or penetration pricing)	Maintain prices	Reduce prices to meet competition	Maintain prices

CONCEPT CHECK

1. What is the product life cycle?
2. Describe each stage of the product life cycle.
3. What are the marketing strategies for each stage of the product life cycle?

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10.10: Pricing Strategies and Future Trends

What Strategies are Used for Pricing Products, and What are the Future Trends?

An important part of the marketing planning process is setting the right price. Price is the perceived value that is exchanged for something else. Value in our society is most commonly expressed in dollars and cents. Thus, price is typically the amount of money exchanged for a product. Note that *perceived value* refers to the perception of the product's value at the time of the transaction. After a consumer has used a product, the consumer may decide that its actual value was less than its perceived value at the time it was purchased. The price paid for a product is based on the *expected satisfaction* that the customer will receive and not necessarily the *actual satisfaction of the customer.*

Although price is usually a dollar amount, it can be anything with perceived value. When products are exchanged for each other, the trade is called *barter*. If a student exchanges this book for a math book at the end of the term, that student has engaged in barter.

Pricing Objectives

Price is important in determining how much a firm earns. The prices charged customers times the number of units sold equals the *gross revenue* for the firm. Revenue is what pays for every activity of the company (production, finance, sales, distribution, and so forth). The money that is left over (if any) is profit. Managers strive to charge a price that will allow the firm to earn a fair return on its investment and will maximize return on investment to the highest extent while still maintaining a fair return.

The chosen price must be neither too high nor too low, and the price must equal the perceived value to target consumers. If consumers think the price is too high, sales opportunities will be lost. Lost sales mean lost revenue. If the price is too low, consumers may view the product as a great value, but the company may not meet its profit goals. Sometimes, as in the case of services, a price that is too low will cause the product to viewed as less than credible and lose sales for the company.

Product Pricing

Managers use various pricing strategies when determining the price of a product, as this section explains. Price skimming and penetration pricing are strategies used in pricing new products; other strategies such as leader pricing and bundling may be used for established products as well.

Price Skimming

The practice of introducing a new product on the market with a high price and then lowering the price over time is called **price skimming**. As the product moves through its life cycle, the price usually is lowered because competitors are entering the market. As the price falls, more and more consumers can buy the product. Recent example are DVD players and flat-screen televisions. When they first came out, DVD players were priced at around $500 while flat-screen televisions were priced at over $1,000. Over time, the price of DVD players has sunk to under $100, while 4-inch Insignia brand flat-screen TVs can be purchased for under $220.

Price skimming has four important advantages. First, a high initial price can be a way to find out what buyers are willing to pay. Second, if consumers find the introductory price too high, it can be lowered. Third, a high introductory price can create an image of quality and prestige. Fourth, when the price is lowered later, consumers may think they are getting a bargain. The disadvantage is that high prices attract competition.

Price skimming can be used to price virtually any new products, such as high-definition televisions, new cancer drugs, and color computer printers. For example, the Republic of Tea recently launched Emperor's White Tea, which it says is among the rarest of teas. Because it is minimally processed, white tea is said to retain the highest level of antioxidants and has a lower caffeine content than black and green teas. The company says the tea is picked only a few days each year, right before the leaf opens, yielding a small harvest. The product retails for $16 per tin of 50 bags. Products don't have to cost hundreds of dollars to use a skimming strategy.

Penetration Pricing

A company that doesn't use price skimming will probably use **penetration pricing**. With this strategy, the company offers new products at low prices in the hope of achieving a large sales volume. Procter & Gamble did this with its SpinBrush toothbrush.

Penetration pricing requires more extensive planning than skimming does because the company must gear up for mass production and marketing. When Texas Instruments entered the digital-watch market, its facilities in Lubbock, Texas, could produce 6 million watches a year, enough to meet the entire world demand for low-priced watches. If the company had been wrong about demand, its losses would have been huge.

Penetration pricing has two advantages. First, the low initial price may induce consumers to switch brands or companies. Using penetration pricing on its jug wines, Gallo has lured customers away from Taylor California Cellars and Inglenook. Second, penetration pricing may discourage competitors from entering the market. Their costs would tend to be higher, so they would need to sell more at the same price to break even.

Leader Pricing

Pricing products below the normal markup or even below cost to attract customers to a store where they wouldn't otherwise shop is **leader pricing**. A product priced below cost is referred to as a **loss leader**. Retailers hope that this type of pricing will increase their overall sales volume and thus their profit.

Items that are leader priced are usually well known and priced low enough to appeal to many customers. They also are items that consumers will buy at a lower price, even if they have to switch brands. Supermarkets often feature coffee and bacon in their leader pricing. Department stores and specialty stores also rely heavily on leader pricing.

Pricing of Services

Pricing of services tends to be more complex than pricing of products that are goods. Services may be priced as standard services, such as the price a hair stylist might charge for a haircut, or pricing may be based on tailored services designed for a specific buyer, such as the prices charged for the design of a new building by an architect.

ETHICS IN PRACTICE

Pricing Before, During, and After Hurricanes

The late summer of 2017 brought several devastating hurricanes that impacted large areas of Texas, Florida, Puerto Rico, and the Virgin Islands. As often happens during events like these, there were several reports of stores, hotels, and service stations engaging in price gouging. Many states have laws against price gouging during natural disasters, but a Twitter photo of a Best Buy store charging $42 for a case of 24 bottles of water was widely circulated. Usually a case of water can be purchased for about $5 to $8, so the $42 price was thought to be an instance of price gouging. Best Buy quickly addressed the exorbitant price and issued an apology, stating they normally do not sell cases of water, and that an employee wanting to provide a service in advance of the hurricane simply multiplied the price of a single bottle they normally sell by 24 to arrive at the price-per-case total. Best Buy's response was clearly aimed at deflecting any negative public reaction to the pricing "error."

Another example of how companies might be accused of price gouging occurs with companies that use "**dynamic pricing**," which uses computer algorithms to analyze demand and automatically raises prices as demand increases. Amazon, the large online retailer, uses dynamic pricing, and consumers saw an increase in the price of things like generators and water in the days prior to hurricanes Harvey, Irma, and Juan in 2017.

There are some economists and business thought leaders who believe that price increases during events like hurricanes is a good thing. Economists from the Chicago School of Economics state that regulating lower prices during natural disasters actually discourages consumers from purchasing essential supplies such as water and gasoline until the disaster occurs because they can anticipate regulated prices. In addition, let's say that a hotel usually rents a room for $50 a night and decides to raise the price during a hurricane to $100. A family might decide to stay in one room rather than rent two rooms, thus saving some money while at the same time increasing the supply of hotel rooms for people who need them the most.

Critical Thinking Questions

1. What risks do companies such as Best Buy and Amazon face when selling a product that they normally don't sell and then are accused of price gouging, or when they using dynamic pricing?
2. Why is the use of dynamic pricing deemed acceptable for selling tickets to sporting events but not during a natural disaster?
3. Do you agree with the arguments in support of higher prices put forth by free-market economists?

Bundling

Bundling means grouping two or more related products together and pricing them as a single product. Marriott's special weekend rates often include the room, breakfast, and free Wi-Fi. Department stores may offer a washer and dryer together for a price lower than if the units were bought separately.

The idea behind bundling is to reach a segment of the market that the products sold separately would not reach as effectively. Some buyers are more than willing to buy one product but have much less use for the second. Bundling the second product to the first at a slightly reduced price thus creates some sales that otherwise would not be made. For example, Aussie 3-Minute Miracle Shampoo is typically bundled with its conditioner because many people use shampoo more than conditioner, so they don't need a new bottle of conditioner.

Odd-Even Pricing

Psychology often plays a big role in how consumers view prices and what prices they will pay. **Odd-even pricing** (or **psychological pricing**) is the strategy of setting a price at an odd number to connote a bargain and at an even number to imply quality. For years, many retailers have priced their products in odd numbers—for example, $99.95 or $49.95—to make consumers feel that they are paying a lower price for the product.

Prestige Pricing

The strategy of raising the price of a product so consumers will perceive it as being of higher quality, status, or value is called **prestige pricing**. This type of pricing is common where high prices indicate high status. In the specialty shops on Rodeo Drive in Beverly Hills, which cater to the super-rich of Hollywood, shirts that would sell for $65 elsewhere sell for at least $150. If the price were lower, customers would perceive them as being of low quality. Prestige pricing is also very prevalent in services because services providers with reputations for excellent service are more in demand, often with a waiting list. This is due to the fact that services are tied directly to the people who provide them and those people have only so much time in a week in which to provide services. Once the calendar fills up, the demand goes up, and the prices become prestige prices.

CONCEPT CHECK

1. What is the difference between penetration pricing and price skimming?
2. Explain the concept of price bundling.
3. Describe odd-even pricing and prestige pricing.
4. Why is prestige pricing prevalent in services?

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10.11: Trends in Developing Products and Pricing

What Trends are Occurring in Products and Pricing?

As customer expectations increase and competition becomes fiercer, perceptive managers will find innovative strategies to satisfy demanding consumers and establish unique products in the market. Satisfying customers requires the right prices. The internet has delivered pricing power to both buyers and sellers. Another significant trend is the use of one-to-one marketing to create a customized marketing mix for each consumer.

Impact of the Internet on Pricing

The internet, corporate networks, and wireless setups are linking people, machines, and companies around the globe—and connecting sellers and buyers as never before. This link is enabling buyers to quickly and easily compare products and prices, putting them in a better bargaining position. At the same time, the technology enables sellers to collect detailed data about customers' buying habits, preferences, and even spending limits so that they can tailor their products and prices. Amazon, as well as online businesses from traditional retailers such as Walmart, have drastically changed the retail landscape. Amazon's Prime membership, which offers free shipping and other amenities for an annual fee, has also taken market share from traditional low-cost warehouse clubs such as Costco and Sam's Club.

Online price-comparison engines, known as shopbots, are continuing to add new features. ShopSmarter.com now includes coupons and additional retailer discounts in its price results. In the past, consumers had to click deep into a retailer's site to find out about these additional savings. Vendio eCommerce introduced a toolbar that people can download. If a person is on the web page of a particular product—whether it's an iPhone or a Canon digital camera—the toolbar flashes a blinking alert when it finds a lower price for that same item somewhere else. The person can then open a window on the side of the site to learn details of the cheaper price—or simply ignore the alert. BuySAFE introduced a website that lets consumers search among about 1.5 million products that are backed by antifraud guarantees. If a buyer purchases one of the items and the seller fails to deliver, the buyer can get reimbursed for the full cost up to $25,000. Merchants on the site include those that sell on eBay and Overstock.com.

Use of these sites has boomed in the past few years as people have become more reliant on the web both as a research tool and as a place to shop. According to a recent survey, more than 90 percent of consumers have used a smartphone when comparison-shopping in stores. Much of the growth has come from the more-established sites such as Shopify, Bizrate, and NexTag, as well as the shopping sections of Amazon, Microsoft's MSN, and Google. The big attraction with shopping comparison services, of course, is the hunt for a better bargain. Merchants like the sites because they help drive consumer spending. Consumers who use comparison-shopping sites for product information or in-store discount coupons spend more than those who don't.

One-to-One Marketing

One-to-one marketing is creating a unique marketing mix for every consumer. The key to creating one-to-one marketing is a good marketing database. The information contained in a marketing database helps managers know and understand customers, and potential customers, on an individual basis. A **marketing database** is a computerized file of customers' and potential customers' profiles and purchase patterns.

In the 1960s, network television enabled advertisers to "get the same message to everyone simultaneously." Database marketing can get a customized, individual message to everyone simultaneously through direct mail or through the internet. This is why database marketing is sometimes called *micromarketing.* Database marketing can create a computerized form of the old-fashioned relationship that people used to have with the corner grocer, butcher, or baker. "A database is sort of a collective memory," says Richard G. Barlow, president of Frequency Marketing, Inc., a Cincinnati-based consulting firm. "It deals with you in the same personalized way as a mom-and-pop grocery store, where they knew customers by name and stocked what they wanted."

You have also probably heard the term **big data**. Companies such as Facebook and Google can process information and then tailor information to provide marketers with higher-probability targets. For instance, imagine that you and some friends are discussing a spring break vacation and you are searching for possible locations on the Florida gulf coast. That data, along with the social group considering the vacation, can be sold to companies that provide travel services, airline flights, hotel rentals, and the like. Suddenly, you and your friends see travel offers and alternate destinations on your Facebook page. Likewise, imagine you are looking for a mystery novel to read on a long flight. Let's say that you are also searching for ways to remove a rust stain on a favorite sweater.

When you go to your Amazon page, you see several new mystery novels as well as cleaning solutions highlighted on your page. All of this was done through the use of big data and analytics to provide consumers solutions they are looking for as well as products that they don't even know that they want. Figure 10.11.1 contrasts the differences in approaches in traditional advertising versus targeted marketing using big data.

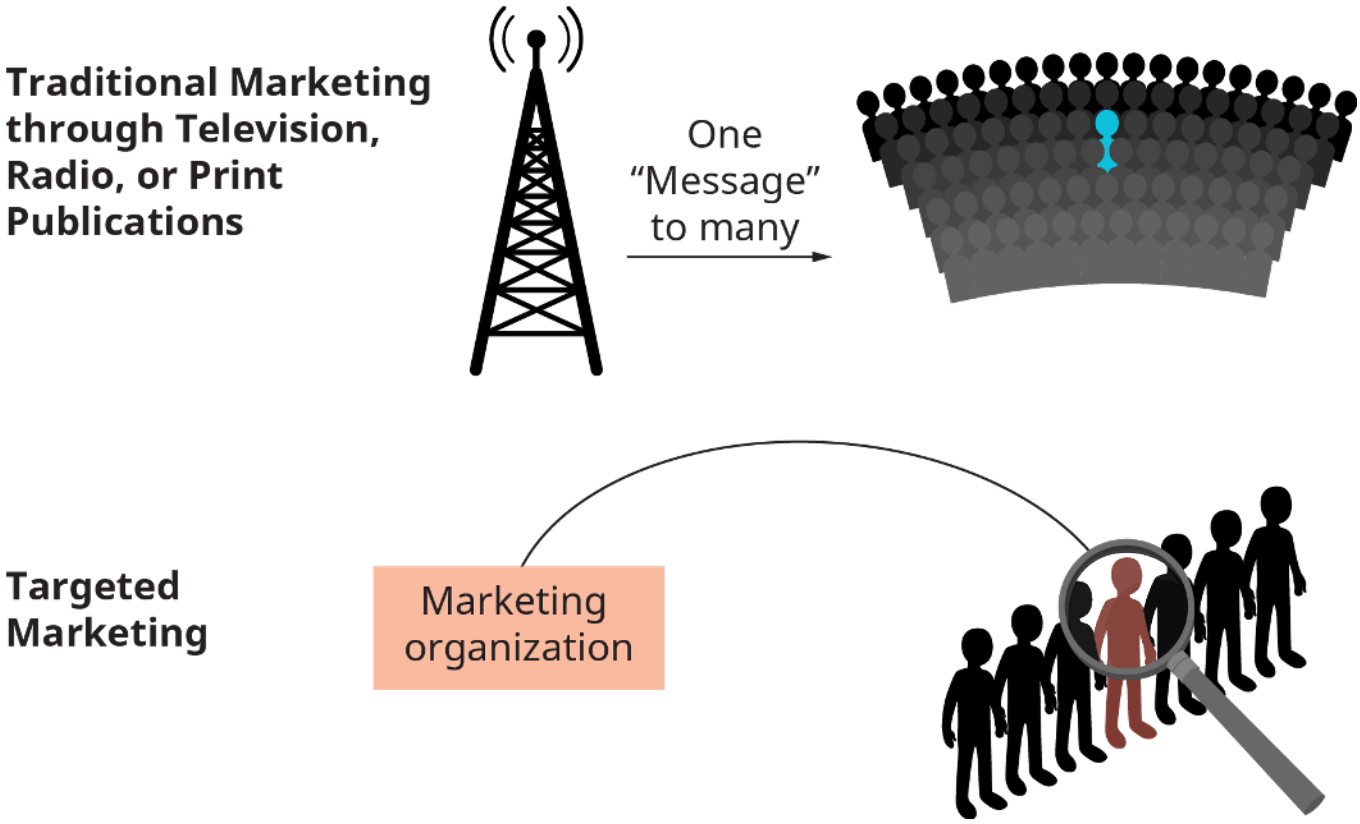


Figure 10.11.1: Traditional Advertising and Targeted Marketing Using Big Data (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

The size of some databases is impressive: Ford Motor Company's is about 50 million names; Kraft General Foods, 30 million; Citicorp, 30 million; and Kimberly Clark, maker of Huggies diapers, 10 million new parents. American Express can pull from its database all cardholders who made purchases at golf pro shops in the past six months, who attended symphony concerts, or who traveled to Europe more than once in the past year, as well as the very few people who did all three.

Companies are using their marketing databases to implement one-to-one marketing. For example, Novartis Seeds, Inc., a Minneapolis-based agriculture business, produces individually customized, full-color brochures for 7,000 farmers. Each piece features products selected by Novartis dealers specifically for the farmer based on information collected about the farm operation and the types of crops grown. Instead of the 30-page catalog Novartis traditionally sent, these customers get a one-page brochure with only the five or six products they need, plus other complementary products dealers feel they should consider.

CONCEPT CHECK

1. How have online price-comparison engines helped consumers shop for the best price?
2. Describe one-to-one marketing and the role of marketing databases.

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Chapter 11: Distribution and Promotion

Page ID

148881

11.1: Introduction

Learning Objectives

After reading this chapter, you should be able to answer these questions:

- What is the nature and function of distribution (place)?
- What is wholesaling, and what are the types of wholesalers?
- What are the different kinds of retail operations?
- How can supply-chain management increase efficiency and customer satisfaction?
- What is promotion, and what are the key elements of a promotional mix?
- How are advertising media selected?
- What is personal selling?
- What are the goals of a sales promotion, and what are several types of sales promotion?
- How does public relations fit into the promotional mix?
- What is social media, and how has it changed promotion?
- What is e-commerce, and how does it affect promotion?

EXPLORING BUSINESS CAREERS

Steve Piehl, Harley-Davidson

A road not taken is the next adventure waiting. Live to ride; ride to live. These are just a few of the creeds that Harley riders live by. Whether it's the vision of the open road, the shine of chrome, or the smell of dust mixed with exhaust, people are drawn to Harley-Davidson motorcycles. How often do you see someone with "Honda" tattooed on their chest? Harleys are the stuff that dreams and identities are made of.

Steve Piehl, who was the director of communications at Harley-Davidson before retiring in 2015, helped shape people's dreams for more than 25 years. He used traditional marketing channels such as print, radio, and television advertising; however, Harley also, understandably, approaches marketing nontraditionally.

The focus of Harley marketing is not selling a product, but selling an experience. Piehl explains, "The difference of that experience is what has given us success. We don't categorize what that experience is. We leave it up to people to make it their own." For some, a Harley is a ticket to freedom; for others, it is a knockout ride to work. Harley's promotion of accessories supports this idea. As Piehl says, "No two Harleys on the street are the same." A part of the purchasing process is a meeting with a "chrome consultant" who can help with customizing and accessorizing your bike. In this way, the bike becomes part of one's identity.

Part of Harley's focus on experience is its support of motorcycle riding as a sport. On its website and at the dealerships, it provides tips and classes for rider improvement. Through the Harley Owners Group (HOG), a membership group of Harley owners, Harley promotes events and rallies where owners can get together and ride. They form what Piehl calls "brothers and sisters of the road."

It is with this focus on the "sport" that Harley creates its most powerful marketing tool: the motorcycle mentor. Through the nature of the Harley community, previous owners coach new owners on buying a more advanced bike, taking an overnight trip, or packing for long-distance rides. Piehl says, "We would be doing a disservice if we said we reach everyone with our product announcements. But when we put it out, it works its way through the customer base. Our owners sell our products. They encourage people to get more involved in the sport." And tools such as chat rooms on the Harley website or magazines such as *HOGtales* and *Motorcycle Enthusiast* facilitate that sharing.

So how does Harley-Davidson measure its marketing success? It participates in Customer Satisfaction Index studies to measure satisfaction for people who purchase new motorcycles. But it is the statistic that over 90 percent of Harley owners will repurchase a Harley that carries the weight. "When we get a customer, we can pretty much keep them. Our marketing is to get new customers and to keep existing [customers] happy," Piehl says.

> It is just another part of Harley's creed: We believe life is what you make it, and we make it one heck of a ride.

This chapter continues to reveal the role of marketing, starting with a discussion of the distribution system and concluding with a look at traditional and nontraditional marketing channels. It explores how organizations use a distribution system to enhance the value of a product and examines the methods used to move products to locations where consumers wish to buy them. Distribution is also known as "place" in terms of the **5Ps**, key components of the marketing mix. It is important to have an understanding of the members of a distribution system and to explore the role of wholesalers and retailers in delivering products to customers. In addition to understanding how the supply chain works to increase efficiency and customer satisfaction, marketers must also develop tactics for promotion, the last element of the marketing mix. Promotion is comprised of six parts, which include traditional advertising, sales promotion, personal selling, public relations, social media, and e-commerce.

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11.4: The Competitive World of Retailing

What are the Different Kinds of Retail Operations?

Some 15 million Americans are engaged in retailing. Of this number, almost half work in service businesses such as barbershops, lawyers' offices, and amusement parks. Although most retailers are involved in small businesses, most sales are made by the giant retail organizations, such as Walmart, Target, and Macy's. Half of all retail sales come from fewer than 10 percent of all retail businesses. This small group employs about 40 percent of all retail workers. Retailers feel the impact of changes in the economy more than many other types of businesses. Survival depends on keeping up with changing lifestyles and customer shopping patterns. In recent years, online retailing trends have significantly impacted retailing organizations, providing more opportunity for smaller retailers and more competition for larger retailers.

Types of Retail Operations

There is a great deal of variety in retail operations. The major types of retailers are described in Table 11.4.1, which divides them into two main categories: in-store and non-store retailing. Examples of *in-store retailing* include Walmart, Target, Macy's, and Neiman Marcus. These retailers get most of their revenue from people who come to the store to buy what they want. Many in-store retailers also do some catalog and telephone sales.

Table 11.4.1: Retailing Takes Many Forms

Types of In-Store Retailing	Description	Examples
Department store	Houses many departments under one roof with each treated as a separate buying center to achieve economies of buying, promotion, and control	Macy's, Nordstrom, Bloomingdale's, Kohl's
Specialty store	Specializes in a category of merchandise and carries a complete assortment	Toys "R" Us, Zales Jewelers
Convenience store	Offers convenience goods with long store hours and quick checkout	7-Eleven, Circle K
Supermarket	Specializes in a wide assortment of food, with self-service	Safeway, Kroger, Winn-Dixie
Discount store	Competes on the basis of low prices and high turnover; offers few services	Walmart, Target
Off-price retailer	Sells at prices 25 percent or more below traditional department store prices in a spartan environment	TJ Maxx, HomeGoods
Factory outlet	Owned by manufacturer; sells closeouts, factory seconds, and canceled orders	Levi Strauss, Dansk
Catalog store	Sends catalogs to customers and displays merchandise in showrooms where customers can order from attached warehouse	Ikea
Types of Non-store Retailing	**Description**	**Examples**
Vending machine	Sells merchandise by machine	Canteen
Direct selling	Sells face-to-face, usually in the person's home	Avon, Amway
Direct-response marketing	Attempts to get immediate consumer sale through media advertising, catalogs, pop-up ads, or direct mail	K-Tel Music, Ronco
Home shopping networks	Selling via cable television	Home Shopping Network, QVC
Internet retailing (e-retailing)	Selling over the internet	Bluefly.com, landsend.com, gap.com, Amazon.com, Wayfair.com, Dell.com

Non-store retailing includes vending, direct selling, direct-response marketing, home shopping networks, and internet retailing. Vending uses machines to sell food and other items, usually as a convenience in institutions such as schools and hospitals.

Atmosphere and Retail Image

In considering retailing as a distribution strategy (place in the 5Ps), it is important to understand that place includes more than channel members or logistics. It also includes atmospherics—the image of the actual retailing store (or, in the case of non-store retailing, the platform from which the product is offered, such as a website or vending machine). An important task in retailing is to create this image. Marketers combine the store's merchandise mix, service level, and atmosphere to make up a retail image. *Atmosphere* refers to the physical layout and décor of the store. They can create a relaxed or busy feeling, a sense of luxury, a friendly or cold attitude, and a sense of organization or clutter.

These are the most influential factors in creating a store's atmosphere:

- *Employee type and density:* Employee type refers to an employee's general characteristics—for instance, neat, friendly, knowledgeable, or service-oriented. Density is the number of employees per 1,000 square feet of selling space. A discount retailer such as Target has a low employee density that creates a "do-it-yourself" casual atmosphere.
- *Merchandise type and density:* The type of merchandise carried and how it is displayed add to the atmosphere the retailer is trying to create. A prestigious retailer such as Saks or Nordstrom carries the best brand names and displays them in a neat, uncluttered arrangement. Other retailers such as Dollar Tree may display goods in a more cluttered, crowded, disheveled way because their target market (lower-income individuals) equates clutter with open markets (and with lower prices and "deals").



Figure 11.4.1: Whether peering through department store windows, buying holiday gifts, or going on a spending spree, people love to shop. Shopping makes people feel good, and a growing body of research suggests that shopping activates key areas of the brain, boosting one's mood—at least until the bill arrives. Feelings of pleasure and satisfaction derived from a buying binge may be linked to brain chemicals that produce a "shopping high." *How might retailers use atmosphere to stimulate consumers' natural impulse to shop?* (Montgomery County Planning Commission/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

- *Fixture type and density:* Fixtures can be elegant (rich woods) or trendy (chrome and smoked glass), or they can be old, beat-up tables, as in an antique store. The fixtures should be consistent with the general atmosphere the store is trying to create. By displaying its merchandise on tables and shelves rather than on traditional pipe racks, the Gap creates a relaxed and uncluttered atmosphere that enables customers to see and touch the merchandise more easily. In addition to traditional display racks, Cabela's retail stores feature two 5,000-gallon aquariums stocked with carp, trout, and other fish and a diorama featuring elephants, lions, zebras, hyenas, and other animals. A typical Cabela's has several million customers a year. It is not unusual for someone to drive many miles to get to a Cabela's, where you can often see license plates from many states and Canadian provinces.
- *Sound:* Sound can be pleasant or unpleasant for a customer. Classical music at a nice Italian restaurant helps create ambiance, just as country and western music does at a truck stop. Music can also entice customers to stay in the store longer and buy more, or it can encourage them to eat quickly and leave a table for others.

- *Odors:* Smell can either stimulate or detract from sales. The wonderful smell of pastries and breads entices bakery customers, as does the smell of freshly brewed coffee in a shopping mall. Conversely, customers can be repulsed by bad odors, such as cigarette smoke, musty smells, antiseptic odors, and overly powerful room deodorizers.

EXPANDING AROUND THE GLOBE

Creative Retailing at Selfridges

To steer traffic to its flagship store in London, Selfridges sought divine intervention—that is, a 50-foot statue of Jesus. The small-scale replica of Rio de Janeiro's famous monument gazed down on shoppers during a month-long Brazilian-themed promotion.

Combined with a radical redesign of the retail space that makes each of Selfridges' four outlets feel more like a collection of quirky boutiques than one gargantuan marketplace, stunts like the Brazil 40° celebration have transformed the once-staid 95-year-old British retail chain into a premier arbiter of hip. Selfridges' success has spurred retailers worldwide to take a closer look. "A department store chief who has not made his way to Selfridges to study its operation," says Arnold Aronson, former CEO of Saks Fifth Avenue, "is an executive not doing his job."

Typically, department stores develop their own merchandising strategies, resulting in a retail space crowded with Tommy Hilfiger, Ralph Lauren, and other predictable names arranged in displays that rarely vary from one chain to the next. Selfridges, however, operates on the theory that no one understands a product better than the designer or vendor that created it. So individual designers are allotted space in Selfridges and asked to create in-store displays that highlight their work. Traditional "departments" such as shoes, cosmetics, and men's business wear have been organized by lifestyle—youth, sports, or women's contemporary. This helps expose customers to merchandise they might not otherwise see.

Recently, Selfridges asked a tattoo and body-piercing parlor called Metal Morphosis to set up shop next to some women's fashion vendors. Metal Morphosis was such a huge hit with shoppers en route to the clothing racks that it will soon expand to other Selfridges outlets.

Selfridges is also known for its "happenings." They recently opened a low-cost interfaith charity shop within the confines of their luxury brand Oxford street store in London. Performance artist Miranda July was involved in the creation of this shop-within-a-shop, which partners with Islamic, Jewish, and other faith groups to promote the charity store. Ironically, shoppers can find bargain-priced donated blouses just feet away from some priced at over $3,000.

Critical Thinking Questions

1. Selfridges opened a new store described as a "silver blob" or "spaceship." The building has no straight lines and is covered with 15,000 anodized aluminum disks. The atrium is an array of high-gloss white elevators and balconies that are all slanted to avoid "the atrium look." Do you think Selfridges is becoming too cool or hip? What impact will this have on sales?
2. Would Selfridges be successful in the United States? Why or why not?

CONCEPT CHECK

1. Describe at least five types of in-store retailing and four forms of non-store retailing.
2. What factors most influence a retail store's atmosphere?

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11.6: Promotion Strategy

What is Promotion, and What are the Key Elements of a Promotional Mix?

Promotion is an attempt by marketers to inform, persuade, or remind consumers and B2B users to influence their opinion or elicit a response. Most firms use some form of promotion. Because company goals vary widely, so do promotional strategies. The goal is to stimulate action from the people or organizations of a target market. In a profit-oriented firm, the desired action is for the consumer to buy the promoted item. Mrs. Smith's, for instance, wants people to buy more frozen pies. Not-for-profit organizations seek a variety of actions with their promotions. They tell us not to litter, to buckle up, to join the military, or to attend the ballet. (These are examples of products that are ideas marketed to specific target markets.)

Promotional goals include creating awareness, getting people to try products, providing information, retaining loyal customers, increasing the use of products, and identifying potential customers, as well as teaching potential service clients what is needed to "co-create" the services provided. Any promotional campaign may seek to achieve one or more of these goals:

1. *Creating awareness:* All too often, firms go out of business because people don't know they exist or what they do. Small restaurants often have this problem. Simply putting up a sign and opening the door is rarely enough. Promotion through ads on social media platforms and local radio or television, coupons in local papers, flyers, and so forth can create awareness of a new business or product.

   Large companies often use catchy slogans to build brand awareness. For example, Dodge's wildly successful ads where a guy in a truck yells over to another truck at a stoplight, "Hey, that thing got a Hemi?" has created a huge number of new customers for Dodge trucks. Hemi has become a brand within a brand. Now, Chrysler is extending the Hemi engine to the Jeep brand, hoping for the same success.

2. *Getting consumers to try products:* Promotion is almost always used to get people to try a new product or to get nonusers to try an existing product. Sometimes free samples are given away. Lever, for instance, mailed over two million free samples of its Lever 2000 soap to targeted households. Coupons and trial-size containers of products are also common tactics used to tempt people to try a product. Celebrities are also used to get people to try products. Oprah Winfrey, for example, recently partnered with Kraft Heinz to launch a new line of refrigerated soups and side dishes made with no artificial flavors or dyes. Kate Murphy, director of strategic partnerships at the social marketing platform Crowdtap, weighed in on the strategy. "Celebrity endorsements can provide immense value to a product/brand when done right," Murphy said. "If a celebrity aligns with a product, they bring a level of trust and familiarity to the table."[2]
3. *Providing information:* Informative promotion is more common in the early stages of the product life cycle. An informative promotion may explain what ingredients (for example, fiber) will do for a consumer's health, describe why the product is better (for example, high-definition television versus regular television), inform the customer of a new low price, or explain where the item may be purchased.

   People typically will not buy a product or support a not-for-profit organization until they know what it will do and how it may benefit them. Thus, an informative ad may stimulate interest in a product. Consumer watchdogs and social critics applaud the informative function of promotion because it helps consumers make more intelligent purchase decisions. StarKist, for instance, lets customers know that its tuna is caught in dolphin-safe nets.

4. *Keeping loyal customers:* Promotion is also used to keep people from switching brands. Slogans such as Campbell's soups are "M'm! M'm! Good!" and "Intel Inside" remind consumers about the brand. Marketers also remind users that the brand is better than the competition. For years, Pepsi has claimed it has the taste that consumers prefer. Southwest Airlines brags that customers' bags fly free. Such **advertising** reminds customers about the quality of the product or service.

   Firms can also help keep customers loyal by telling them when a product or service is improved. Domino's recently aired candid advertisements about the quality of their product and completely revamped their delivery operations to improve their service. This included advertisements highlighting a Domino's pizza being delivered by reindeer in Japan and by drone in New Zealand. According to University of Maryland marketing professor Roland Rust, "delivery" stands out in how Domino's has broadly improved its quality, and "the customized delivery vehicles are a competitive advantage."[3]

5. *Increasing the amount and frequency of use:* Promotion is often used to get people to use more of a product and to use it more often. The National Cattlemen's Beef Association reminds Americans to "Eat More Beef." The most popular promotion to increase the use of a product may be frequent-flyer or -user programs. The Marriott Rewards program awards points for each dollar spent at a Marriott property. At the Platinum level, members receive a guaranteed room, an upgrade to the property's finest available accommodations, access to the concierge lounge, a free breakfast, free local phone calls, and a variety of other goodies.[4]
6. *Identifying target customers:* Promotion helps find customers. One way to do this is to list a website as part of the promotion. For instance, promotions in *The Wall Street Journal* and *Bloomberg Businessweek* regularly include web addresses for more information on computer systems, corporate jets, color copiers, and other types of business equipment to help target those who are truly interested. Fidelity Investments ads trumpet, "Solid investment opportunities are out there," and then direct consumers to go to **www.fidelity.com.** A full-page ad in *The Wall Street Journal* for Sprint unlimited wireless service invites potential customers to visit **www.sprint.com.** These websites typically will ask for your e-mail address when you seek additional information.
7. *Teaching the customer:* For service products, it is often imperative to actually teach the potential client the reasons for certain parts of a service. In services, the service providers work with customers to perform the service. This is called "co-creation." For example, an engineer will need to spend extensive time with team members from a client company and actually teach the team members what the design process will be, how the interaction of getting information for the design will work, and at what points each part of the service will be delivered so that ongoing changes can be made to the design. For services products, this is more involved than just providing information—it is actually teaching the client.

The Promotional Mix

The combination of traditional advertising, personal selling, sales promotion, public relations, social media, and e-commerce used to promote a product is called the **promotional mix**. Each firm creates a unique promotional mix for each product. But the goal is always to deliver the firm's message efficiently and effectively to the target audience. These are the elements of the promotional mix:

- *Traditional advertising:* Any paid form of nonpersonal promotion by an identified sponsor that is delivered through traditional media channels.
- *Personal selling:* A face-to-face presentation to a prospective buyer.
- *Sales promotion:* Marketing activities (other than personal selling, traditional advertising, public relations, social media, and e-commerce) that stimulate consumer buying, including coupons and samples, displays, shows and exhibitions, demonstrations, and other types of selling efforts.
- *Public relations:* The linking of organizational goals with key aspects of the public interest and the development of programs designed to earn public understanding and acceptance. Public relations can include lobbying, publicity, special events, internal publications, and media such as a company's internal television channel.
- *Social media:* The use of social media platforms such as Facebook, Twitter, Pinterest, Instagram, and various blogs to generate "buzz" about a product or company. The skills and knowledge needed to generate information as well as to defend the company against problems (such as incriminating videos "going viral") are separate skills from those related to traditional advertising. Even promotional strategies such as paying celebrities to wear a specific line of clothing and posting these images on Twitter or Instagram (a form of advertising) requires different types of planning and expertise than traditional advertising.
- *E-commerce:* The use of a company's website to generate sales through online ordering, information, interactive components such as games, and other elements of the website. Website development is mandatory is today's business world. Understanding how to develop and utilize a website to generate sales is imperative for any marketer.

Ideally, marketing communications from each promotional-mix element (personal selling, traditional advertising, sales promotion, public relations, social media, and e-commerce) should be integrated. That is, the message reaching the consumer should be the same regardless of whether it comes from an advertisement, a salesperson in the field, a magazine article, a blog, a Facebook posting, or a coupon in a newspaper insert.

Integrated Marketing Communications

This disjointed approach to promotion has propelled many companies to adopt the concept of **integrated marketing communications (IMC)**. IMC involves carefully coordinating all promotional activities—traditional advertising (including direct marketing), sales promotion, personal selling, public relations, social media and e-commerce, packaging, and other forms of promotion—to produce a consistent, unified message that is customer focused. Following the concept of IMC, marketing managers carefully work out the roles the various promotional elements will play in the marketing mix. Timing of promotional activities is coordinated, and the results of each campaign are carefully monitored to improve future use of the promotional mix tools. Typically, a company appoints a marketing communications director who has overall responsibility for integrating the company's marketing communications.



Figure 11.6.1: When Weight Watchers signed up DJ Khaled to be one of its celebrity endorsers, many were surprised by the choice. Khaled will broadcast his quest to slim down across Facebook, Instagram, Twitter, and Snapchat in a bid to attract more men to sign up for the program. Khaled is not the usual choice for a Weight Watchers spokesperson, but once you scratch below the surface, he's actually a great brand fit. Authenticity and relevance are words bandied about like the gospel in influencer marketing, but they are the most important ingredients when it comes to working with any level of influencer. *What challenges and payoffs are associated with integrated marketing communications?* (Credit: megran.roberts/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Southwest Airlines relied on IMC to launch its "Transfarency" campaign. The campaign integrated and promoted the concept on its website, as well as through advertising and airport signage. The campaign has resonated with consumers because most competitors add extra fees for baggage and premium seats. One of the taglines Southwest uses is "Reward seats only on days ending with the letter 'y.'" The integrated marketing campaign was created in collaboration with Southwest's advertising agency, GSD&M, based in Dallas, Texas.

The sections that follow examine the elements of the promotional mix in more detail.

CONCEPT CHECK

1. What is the objective of a promotional campaign?
2. What is the promotional mix?
3. What are the features of an integrated marketing communications campaign?

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11.7: The Huge Impact of Advertising

How are Advertising Media Selected?

Most Americans are bombarded daily with advertisements to buy things. **Traditional advertising** is any paid form of nonpersonal presentation by an identified sponsor. It may appear on television or radio; in newspapers, magazines, books, or direct mail; or on billboards or transit cards. In the United States, children between the ages of two and 11 are exposed to more than 25,600 exposures to advertising through TVs and online exposures a year. Adults are exposed to three times as many—more than two million commercials in a lifetime.

The money that big corporations spend on advertising is mind-boggling. Total advertising expenses in this country were estimated at more than $206 billion in 2017. Global advertising expenditures are approximately $546 billion annually. General Motors is America's largest advertiser, spending over $3.1 billion annually. This is slightly over $350,000 per hour, seven days a week, 24 hours per day. America's biggest global spender on advertising is Procter & Gamble at $4.6 billion.

Nissan was a sponsor of the 2016 Rio Olympic Games and provided 5,000 vehicles for the events. Ads for the 2018 Super Bowl cost between $5 million and $5.5 million for a 30-second commercial. A 30-second spot on NBC's *Sunday Night Football* costs about $650,000.

The Impact of Technology and the Internet on Traditional Advertising

Many new media are not hardwired or regulated, and digital technology is delivering content anytime, anywhere. Cable, satellite, and the internet have highly fragmented audiences, making them tougher than ever to reach. In the late 1950s, *Gunsmoke* on CBS captured a 65 percent share of the TV audience nearly every Saturday night. Only one event, the Super Bowl, has a chance to do that now.

Traditional forms of entertainment are being rapidly digitized. Magazines, books, movies, shows, and games can be accessed through a laptop or a cell phone. In 2017, 93 million U.S. homes have broadband connections—nearly as many as the 119.6 million that now have cable and satellite hookups.

Technology is driving many of the changes, but so is consumer behavior. Advertiser questions abound. How do you market a product to young people when millions of them are glued to video game screens instead of TVs? How do you reach TV audiences when viewers can TiVo their way past your ads? How do you utilize social media to get the word out about your product, and once you do, how do you control the message if something goes viral? What role do influencers play in promoting products and services via various electronic platforms? What should you make of blogs? How do you plan a website that fosters sales and continually provides information and other forms of value for your customers? Product placements in films and streaming content? Podcasts? We will touch on each of these later in the chapter.

Choosing Advertising Media

The channels through which advertising is carried to prospective customers are the **advertising media**. Both product and institutional ads appear in all the major advertising media. Each company must decide which media are best for its products. Two of the main factors in making that choice are the cost of the medium and the audience reached by it.

Advertising Costs and Market Penetration

Cost per contact is the cost of reaching one member of the target market. Naturally, as the size of the audience increases, so does the total cost. Cost per contact enables an advertiser to compare media vehicles, such as television versus radio or magazine versus newspaper, or, more specifically, *Forbes* versus *The Wall Street Journal*. An advertiser debating whether to spend local advertising dollars for TV spots or radio spots could consider the cost per contact of each. The advertiser might then pick the vehicle with the lowest cost per contact to maximize advertising punch for the money spent. Often costs are expressed on a **cost per thousand (CPM)** contacts basis.

Reach is the number of different target consumers who are exposed to a commercial at least once during a specific period, usually four weeks. Media plans for product introductions and attempts at increasing brand awareness usually emphasize reach. For example, an advertiser might try to reach 70 percent of the target audience during the first three months of the campaign. Because

the typical ad is short-lived and often only a small portion of an ad may be perceived at one time, advertisers repeat their ads so consumers will remember the message. **Frequency** is the number of times an individual is exposed to a message. Average frequency is used by advertisers to measure the intensity of a specific medium's coverage.



Figure 11.7.1: In addition to listing hundreds of scrumptious menu choices and cheesecakes, the Cheesecake Factory's magazine-sized menus feature a number of full-page glossy ads for Bebe, Macy's, Mercedes-Benz, and more. An increasingly popular media option, menu advertising offers many promotional benefits: huge readership by a captive audience, outstanding demographic selectivity, and great value—less than a penny per exposure. *How do advertisers decide whether or not menu advertising is right for their promotional mixes?* (Credit: Mighell xp/ Flickr/ Attribution 2.0 Generic (CC BY 2.0)

Media selection is also a matter of matching the advertising medium with the product's target market. If marketers are trying to reach teenage females, they might select *Seventeen* magazine. If they are trying to reach consumers over 50 years old, they may choose *AARP: The Magazine*. A medium's ability to reach a precisely defined market is its **audience selectivity**. Some media vehicles, such as general newspapers and network television, appeal to a wide cross section of the population. Others—such as *Brides*, *Popular Mechanics*, *Architectural Digest*, MTV, ESPN, and Christian radio stations—appeal to very specific groups. Marketers must also consider utilizing various social media platforms and which platforms are most likely to reach the targeted market.

CONCEPT CHECK

1. How is technology impacting the way advertisers reach their markets?
2. What are the two main factors that should be considered when selecting advertising media?

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11.8: The Importance of Personal Selling

What is Personal Selling?

Advertising acquaints potential customers with a product and thereby makes personal selling easier. **Personal selling** is a face-to-face sales presentation to a prospective customer. Sales jobs range from salesclerks at clothing stores to engineers with MBAs who design large, complex systems for manufacturers. About 6.5 million people are engaged in personal selling in the United States. Slightly over 45 percent of them are women. The number of people who earn a living from sales is huge compared, for instance, with the nearly 300,000 workers employed in the traditional advertising sector. Personal selling offers several advantages over other forms of promotion:

- Personal selling provides a detailed explanation or demonstration of the product. This capability is especially desirable for complex or new goods and services.
- The sales message can be varied according to the motivations and interests of each prospective customer. Moreover, when the prospect has questions or raises objections, the salesperson is there to provide explanations. In contrast, advertising and sales promotion can respond only to the objections the copywriter thinks are important to customers.
- Personal selling can be directed only to qualified prospects. Other forms of promotion include some unavoidable waste because many people in the audience are not prospective customers.
- Personal selling costs can be controlled by adjusting the size of the sales force (and resulting expenses) in one-person increments. In contrast, advertising and sales promotion must often be purchased in fairly large amounts.
- Perhaps the most important advantage is that personal selling is considerably more effective than other forms of promotion in obtaining a sale and gaining a satisfied customer.

The Selling Process

Selling is a process that can be learned. Experts have spelled out the steps of the selling process, shown in Figure 11.8.1, and professional salespeople use them all the time. These steps are as follows:

1. *Prospecting and qualifying:* To start the process, the salesperson looks for **sales prospects**, those companies and people who are most likely to buy the seller's offerings. This activity is called **prospecting**. Because there are no surefire ways to find prospects, most salespeople try many methods.

   For many companies, the inquiries generated by advertising and promotion are the most likely source of prospects. Inquiries are also known as sales leads. Leads usually come in the form of letters, cards, e-mail addresses, telephone calls, or through social media sites. Some companies supply salespeople with prospect lists compiled from external sources, such as Chamber of Commerce directories, newspapers, public records, club membership lists, internet inquiries, and professional or trade publication subscription lists. Meetings, such as professional conventions and trade shows, are another good source of leads. Sales representatives attend such meetings to display and demonstrate their company's products and to answer the questions of those attending. The firm's files and records can be another source of prospects. Correspondence with buyers can be helpful. Records in the service department can identify people who already own equipment and might be prospects for new models. Finally, friends and acquaintances of salespeople can often supply leads.

   One guideline is that not all prospects are "true" opportunities for a sale. Just because someone has been referred or has made an inquiry does not mean that the person is a genuine prospect. Salespeople can avoid wasting time and increase their productivity by qualifying all prospects. **Qualifying questions** are used to separate prospects from those who do not have the potential to buy. The following three questions help determine who is a real prospect and who is not:

   - Does the prospect have a need for our product?
   - Can the prospect make the buying decision?
   - Can the prospect afford our product?

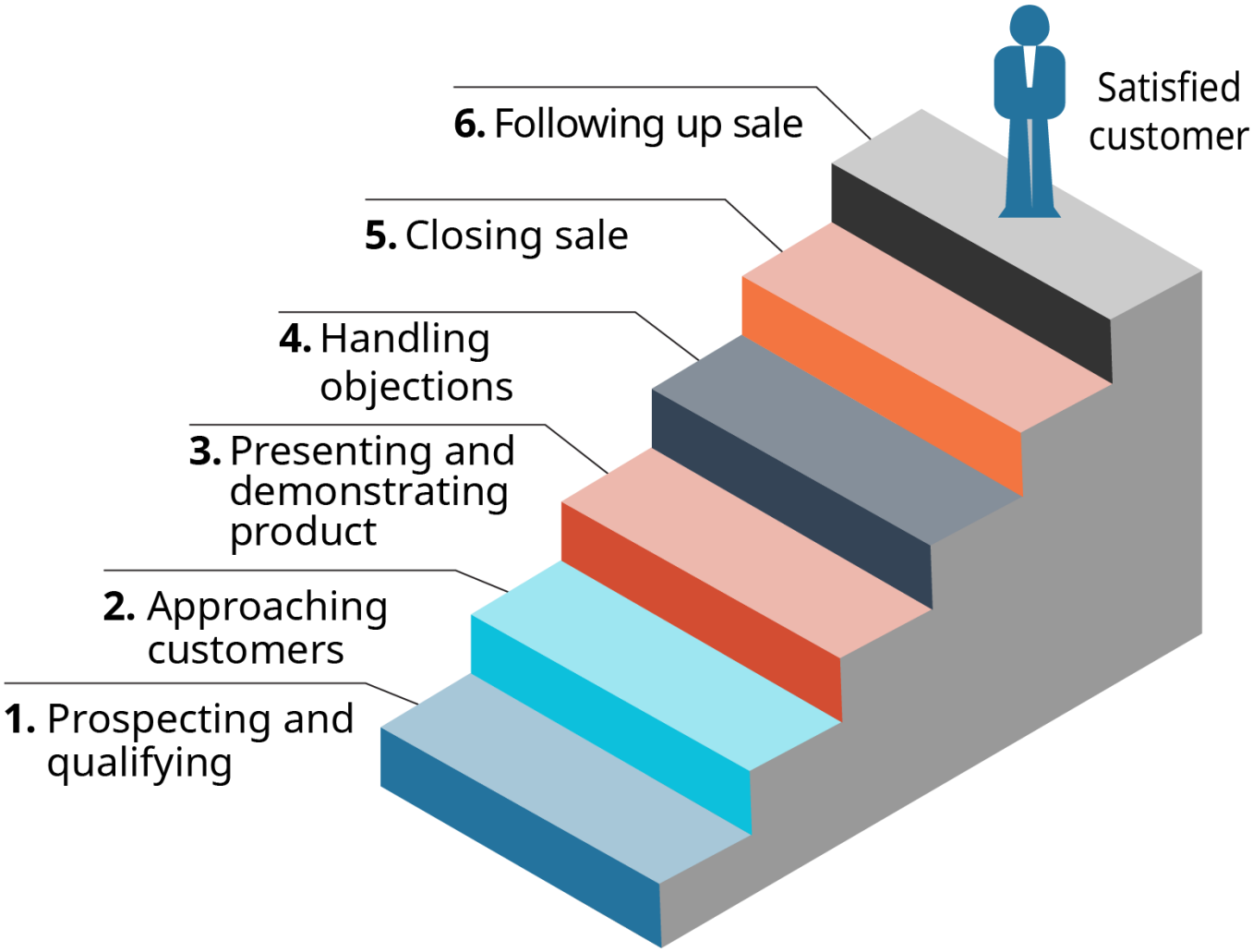


Figure 11.8.1: Steps in Making a Successful Sale (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

2. *Approaching customers:* After identifying a prospect, the salesperson explains the reason for wanting an appointment and sets a specific date and time. At the same time, the salesperson tries to build interest in the coming meeting. One good way to do this is to impart an interesting or important piece of information—for instance, "I think my product can cut your shipping and delivery time by two days."
3. *Presenting and demonstrating the product:* The presentation and demonstration can be fully automated, completely unstructured, or somewhere in between. In a fully automated presentation, the salesperson shows a movie or slides or makes a PowerPoint presentation and then answers questions and takes any orders. In today's business world, in which relationships are most important for long-term sales, canned or structured presentations are not well received, nor do they support the idea of building a great bond with the customer. A completely unstructured presentation that has no set format is a much more successful approach. It may be a casual conversation, with the salesperson presenting product benefits and assisting the customer in solving his or her problems (like a partner on the client company's team) in a way that might interest the potential buyer.
4. *Handling objections:* Almost every sales presentation, structured or unstructured, meets with some objection. Rarely does a customer say, "I'll buy it," without asking questions or voicing concerns. The professional salesperson tries to anticipate objections so they can be countered quickly and with assurance. The best way to counter objections is to have a thorough knowledge of the product offering so that a solution can be found that overcomes the objection.

   Often employed in business, the "higher authority" objection is frequently used when one of the parties says, "This agreement looks good, but I'll have to run it by my committee" (or wife or any other "higher authority"). The result is that that sales presentation turns out to be just a preliminary, nonbinding round. After the higher authority responds, often disapproving the agreement, the sale goes into round two or starts all over again.

For example, when a customer wants to buy a house, car, or anything expensive, the salesperson will say, “If we find the house (or car) that you really like, is there any reason you could not make the purchase today?” Once they get the green light, the salesperson will spend whatever time it takes to find the right product for the customer. However, if the client says his uncle has to give the final approval because he will be loaning the money, the salesperson will try and set up an appointment when the uncle can be present.

5. *Closing the sale:* After all the objections have been dealt with, it’s time to close the sale. Even experienced salespeople sometimes find this part of the sales process awkward. Perhaps the easiest way to close a sale is to ask for it: “Ms. Jones, may I write up your order?” One of the best techniques is to act as though the deal has been concluded: “Mr. Bateson, we’ll have this equipment in and working for you in two weeks.” If Mr. Bateson doesn’t object, the salesperson can assume that the sale has been made.
6. *Following up on the sale:* The salesperson’s job isn’t over when the sale is made. In fact, the sale is just the start. The salesperson must write up the order properly and turn it in promptly. This part of the job may be easy for many consumer products, but for B2B products or services, it may be more complex. An order for a complex piece of industrial equipment may include a hundred pages of detail. Each detail must be carefully checked to ensure that the equipment is exactly what was ordered.

   After the product is delivered to the customer, the salesperson must make a routine visit to see that the customer is satisfied. This follow-up call may also be a chance to make another sale. But even if it isn’t, it will build goodwill for the salesperson’s company and may bring future business. Repeat sales over many years are the goal of professional salespeople.

CONCEPT CHECK

1. What are the advantages of personal selling?
2. Explain the selling process.

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11.9: Sales Promotion

What are the Goals of Sales Promotion, and What are Several Types of Sales Promotion?

Sales promotion helps make personal selling and advertising more effective. **Sales promotions** are marketing events or sales efforts —not including traditional advertising, personal selling, and public relations—that stimulate buying. Sales promotion can be developed as part of the social media or e-commerce effort just as advertising can, but the methods and tactics are much different. Sales promotion is a $300 billion—and growing—industry. Sales promotion is usually targeted toward either of two distinctly different markets. Consumer sales promotion is targeted to the ultimate consumer market. Trade sales promotion is directed to members of the marketing channel, such as wholesalers and retailers.

The goal of many promotion tactics is immediate purchase. Therefore, it makes sense when planning a sales-promotion campaign to target customers according to their general behavior. For instance, is the consumer loyal to the marketer's product or to the competitor's? Does the consumer switch brands readily in favor of the best deal? Does the consumer buy only the least expensive product, no matter what? Does the consumer buy any products in your category at all?

Procter & Gamble believes shoppers make up their mind about a product in about the time it takes to read this paragraph.

This "first moment of truth," as P&G calls it, is the three to seven seconds when someone notices an item on a store shelf. Despite spending billions on traditional advertising, the consumer-products giant thinks this instant is one of its most important marketing opportunities. It recently created a position entitled Director of First Moment of Truth, or Director of FMOT (pronounced "EFF-mott"), to produce sharper, flashier in-store displays. There is a 15-person FMOT department at P&G headquarters in Cincinnati as well as 50 FMOT leaders stationed around the world.



Figure 11.9.1: Pet lovers want the best for their animals, and choosing a proper diet is an essential part of raising happy, healthy pets. That's why many dog food providers such as Purina and Blue Buffalo are creating specific size- and age-appropriate diets for dogs. They often use sales promotion to encourage animal lovers to transition their pets to premium-brand food, encourage pet owners to track their pets' performance during the trial, and evaluate the "before and after" health of their pets. *What promotional objectives underlie these practices?* (Credit: Ted Van Pelt/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

One of P&G's most prominent in-store promotions has been for a new line of Pampers. In the United States, P&G came up with what it calls a "shopper concept"—a single promotional theme that allows it to pitch products in a novel way. The theme for Pampers was "Babies First." In stores, the company handed out information on childhood immunizations, car-seat safety, and healthy diets while promoting its diapers and wipes in other parts of the store. To market Pampers diapers in the United Kingdom, P&G persuaded retailers earlier this year to put fake doorknobs high up on restroom doors, to remind parents how much babies need to stretch.

The objectives of a promotion depend on the general behavior of target consumers, as described in Table 11.9,1. For example, marketers who are targeting loyal users of their product don't want to change behavior. Instead, they want to reinforce existing behavior or increase product usage. Frequent-buyer programs that reward consumers for repeat purchases can be effective in strengthening brand loyalty. Other types of promotions are more effective with customers prone to brand switching or with those who are loyal to a competitor's product. Cents-off coupons, free samples, or an eye-catching display in a store will often entice shoppers to try a different brand.

The use of sales promotion for services products depends on the type of services. Consumer services, such as hairstyling, rely heavily on sales promotions (such as providing half off the price of a haircut for senior citizens on Mondays). Professional services, however, use very little sales promotion. Doctors, for example, do not often use coupons for performing an appendectomy, for example. In fact, service product companies must be careful not to utilize too many sales-promotion tactics because they can lower the credibility of the firm. Attorneys do not have a sale on providing services for divorce proceedings, for example.

Figure 11.9.1: Types of Consumers and Sales Promotion Goals

Type of Behavior	Desired Results	Sales Promotion Examples
Loyal customers: People who buy your product most or all of the time	Reinforce behavior, increase consumption, change purchase timing	Loyalty marketing programs, such as frequent-buyer cards and frequent-shopper clubs Bonus packs that give loyal consumers an incentive to stock up or premiums offered in return for proof of purchase
Competitor's customers: People who buy a competitor's product most or all of the time	Break loyalty, persuade to switch to your brand	Sweepstakes, contests, or premiums that create interest in the product
Brand switchers: People who buy a variety of products in the category	Persuade to buy your brand more often	Sampling to introduce your product's superior qualities compared to their brand
Price buyers: People who consistently buy the least expensive brand	Appeal with low prices or supply added value that makes price less important	Trade deals that help make the product more readily available than competing products Coupons, cents-off packages, refunds, or trade deals that reduce the price of the brand to match that of the brand that would have been purchased

Two growing areas of sales promotion are couponing and product placement. American consumers receive over $321 billion worth of coupons each year and redeem about $3 billion. Almost 85 percent of all Americans redeem coupons. Sunday newspaper supplements remain the number one source, but there has been explosive growth of online or consumer-printed coupons. General Mills, Kimberly-Clark, and General Electric like online coupons because they have a higher redemption rate. Coupons are used most often for grocery shopping. Do they save you money? One study found that people using coupons at the grocery store spent eight percent more than those who didn't.

Product placement is paid inclusion of brands in mass media programming. This includes movies, TV, books, music videos, and video games. So when you see Ford vehicles in the latest James Bond movie or Tom Hanks putting on a pair on Nikes on-screen, that is product placement. Product placement has become a huge business. For example, companies paid more than $6 billion in a recent year to have their products placed prominently in a film or television program; that figure is expected to reach more than $11 billion by 2019. It is easy to go overboard with this trend and be portrayed as a parody, however. The 2017 *Emoji Movie* is an example of failed product placements. The theme of the movie centered on various emojis caught in a smartphone as they are forced to play Candy Crush and say glowing things about such apps as Dropbox and Instagram as they make their way through the phone. Also, some have suggested that product placement might doom the products and companies. For example, Atari products appeared in the classic 1982 film *Blade Runner*, but the original company went out of business shortly after the movie was released, while another product, the Cuisinart food processor, had to settle a price-fixing scandal after making an appearance in the

film. This has not stopped companies such as Sony, Peugeot, and Coca-Cola from tempting fate by appearing in the recently released *Blade Runner 2049*. Many large companies are cutting their advertising budgets to spend more on product placements. One area of product placement that continues to raise ethical issues is so-called "experts" being paid to mention brands on the air.



Figure 11.9.2: Whether making a cameo appearance or starring in a major role, brands are top talent in the entertainment world. NASCAR drivers, racing cars, and tracks are speckled with corporate brands, and Coca-Cola sits at the judges' table on *American Idol*. Drive through the video game *Need for Speed* and you will see Best Buy stores along the way, as well as billboards for Burger King and other products. And Reese's Pieces are forever immortalized in the movie *E.T. the Extra-Terrestrial*. *Does product placement blur the lines between advertising and content, and should viewers be concerned?* (Credit: roger blake/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

ETHICS IN PRACTICE

Influencer Marketing and Product Placement: Are They Always Ethical?

Traditional marketing vehicles such as advertising have been regulated to include limitations on promotions for such products as tobacco and alcohol. One area that has not had the same type of regulatory oversight has been the practice of product placement and companies working with "influencers" to market their products.

In a classic scene from *Forrest Gump*, actor Tom Hanks, who plays Gump, meets President Kennedy and says, "The best thing about visiting the president is the food! Now, since it was all free, and I wasn't hungry but thirsty, I must have drank me 15 Dr Peppers." Since Forrest Gump was a family film seen by many children, this scene could influence them to think that consuming large quantities of the beverage was appropriate and might even give them the stamina to undertake cross-country marathons (one of Gump's other activities in the film). Unlike traditional television and print advertising, product placement in films, television shows, and even video games has not been heavily regulated, but that's about to change. For instance, in

Australia, the Alcohol Beverages Advertising Code (ABAC) is instituting expanded regulation of advertising and product placement for new, nontraditional media that have not been regulated previously.

Companies are also enlisting influencers to help them reach customers. Influencers might be people who have achieved recognition as an expert in a certain area, or someone who has amassed a large number of followers on platforms such as Facebook, Twitter, or Instagram. The use of influencers has raised concern about the ethics of companies such as Amazon, Apple, and Google when they enlist teachers such as Kayla Delzer, who has her own brand, Top Dog Teacher, that touts her teaching approaches through workshops. Since Delzer incorporates technology into her classroom, she has attracted the attention of both small start-ups such as Seesaw and large companies such as Apple, which provide her with products and services in the hope that disseminating her experiences through blogs, tweets, and workshops will encourage her followers to adopt their technologies. Because there is little research-based evidence that these technologies actually improve student outcomes, this situation presents an ethical dilemma for school administrators.

Another ethical dilemma is that some influencers use fake followers to increase the appearance of extended media reach, thus being able to command larger sums of money from various companies for their services. One of the most blatant examples of signing up fake followers was the appearance of a vending machine in Moscow where patrons could use a credit card to purchase likes, favorites, and followers for their social media sites.

Critical Thinking Questions

1. What is the role of industry trade groups, government agencies, and marketers to self-regulate ethical practices?
2. Do you think it's unethical to pay people to use products and services that influence consumer purchases? Explain your reasoning.

CONCEPT CHECK

1. How does sales promotion differ from advertising?
2. Describe several types of sales promotion.

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11.10: Public Relations Helps Build Goodwill

How Does Public Relations Fit into the Promotional Mix?

Like sales promotion, public relations can be a vital part of the promotional mix. **Public relations** is any communication or activity designed to win goodwill or prestige for a company or person. This could include **publicity**, information about a company or product that appears in the news media and is not directly paid for by the company. Publicity can be good or bad. Reports of children overeating fast food, which can lead to obesity, is an example of negative publicity. Public relations includes many other activities, such as lobbying, event planning, acting as a press agent, managing internal communication, and coordinating crisis management for communications.

Naturally, firms' public relations departments try to create as much good publicity as possible. They furnish company speakers for business and civic clubs, write speeches for corporate officers, and encourage employees to take active roles in such civic groups as the United Way and the Chamber of Commerce. One of the tools of the public relations department is the *press release*, a formal announcement of some newsworthy event connected with the company, such as the start of a new program, the introduction of a new product, or the opening of a new plant. Public relations departments may perform any or all of the functions described in Figure 11.10.1.

Figure 11.10.1: The Functions of a Public Relations Department

Public Relations	Function Description
Press relations	Placing positive, newsworthy information in the news media to attract attention to a product, a service, or a person associated with the firm or institution
Product publicity	Publicizing specific products or services
Corporate communications	Creating internal and external messages to promote a positive image of the firm or institution
Public affairs	Building and maintaining national or local community relations
Lobbying	Influencing legislators and government officials to promote or defeat legislation and regulation
Employee and investor relations	Maintaining positive relationships with employees, shareholders, and others in the financial community
Crisis management	Responding to unfavorable publicity or a negative event

Much of sales promotion and publicity is about creating buzz. Buzz marketing (or viral marketing) is intense word-of-mouth marketing. Word-of-mouth is essentially a linear process with information passing from one individual to another, then to another. A marketer has successfully created a buzz when the interactions are so intense that the information moves in a matrix pattern rather than a linear one and everyone is talking about the topic. Leading-edge firms now feel that they get more bang for their buck using buzz marketing than other forms of promotion.

CONCEPT CHECK

1. How does public relations differ from advertising?
2. Describe several types of publicity.

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11.11: Trends in Social Media

What is Social Media, and How Has it Changed Promotion?

Advances in technology continue to change the marketing landscape. As you will see in the following sections, marketers are harnessing new technology to hone their marketing message and reach more customers.

The business world now relies on the internet for much of its communications, marketing or otherwise. Almost all companies have Facebook accounts, and individual leaders of companies have separate individual accounts on Linked In, Twitter, Instagram, and other social media sites. New social media sites are popping up almost every week. The phenomenon of social media has created a business climate in which thousands of impressions can be made with one social media post. That impression could be positive or negative. Within social media, there are "stars" of social media—individuals who have developed audiences in the millions who follow their posts every day. **Social media** is a hugely powerful tool for marketers. It has it challenges, though, because the platforms are constantly changing and evolving. Also, the audiences being reached often read (or view) and believe the messages seen on various social media platforms without understanding the context of the message. A social media post that goes viral can close down a business, even if the post is not true. That's what makes social media the newest challenge/opportunity for marketers. Companies that want to retain market share and build their image must develop tactics for the use of social media and for defending against problems created by the use of this powerful marketing tool.

Promotion Through Blogs

Blogs provide marketers with a real-time dialogue with customers and an avenue to promote their products or services. A *blog* is an online journal with regularly updated content. This content is pushed to subscribers by RSS (really simple syndication) or e-mail and allows for response and discussion from site visitors. RSS enables users to automatically gather updates from various websites, especially news sites and blogs, and display headlines and a brief summary of those updates in a single location. Blogs can be considered to be offerings of social media unless the site is actually part of the company's main web page.

Well-run marketing blogs usually focus tightly on one niche area, product line, or vertical market segment. The aim is to provide the blog's readers with a constantly renewing source of news and insight about that topic. About 366 million blogs are registered on Tumblr, and more than 23 million blog entries are posted daily.

Many companies have set up their own blogs, including General Motors, Apple, the American Cancer Society, and Microsoft, to name a few. These companies blog because they: (1) get real-time input from customers and prospects; (2) create and maintain relationships; (3) can have a continuing dialogue with loyal customers and prospective clients; and (4) can zero in on specific marketing goals. For example, Disney uses a blog called Disney Baby to cater to the needs of new mothers. Each of their bloggers has a personal bio that helps provide a connection for the new mother to the blogger and provides a deeper connection to the Disney brand.

Firms can also use emerging search tools such as BlogPulse, Feedster, PubSub, and Technorati to monitor conversations about their company and brands. A public relations department might then decide to feed new-product information to bloggers who are evangelists for their brand.

Advertisers Jump on Podcasts and Videos

Podcasts are basically blogs with a multimedia file. The trend developed when a new version of iTunes software made it easy for people to create their own podcasts and post them on a website. There are more than 8,000 podcasters in the United States. Besides individuals, companies are beginning to do their own podcasts as well as posting videos from the company on YouTube as another marketing channel. For listeners, the advantage of a podcast is convenience. Companies now have the ability to use streaming video, which potential customers can download to their mobile devices; for example, ABC News offering a digital version of its programming. The customers' favorite programs download automatically from the internet, usually free of charge, and they can listen to the programs any time they wish. They can also listen wherever they wish, if they have a mobile device to receive the downloads.

Gimlet Media is one of the nation's largest podcasters, offering material from nearly 40 different stations as podcasts. At first ad-free, Gimlet's podcasts are done for direct-to-consumer companies like Blue Apron, as well as for traditional advertisers like Pepsi

and Ford. Gimlet now includes a short advertisement before the programming—short enough that people won't fast-forward through it. Gimlet also received a $5 million investment from advertising giant WPP, a clear sign that the business community sees a bright future in podcasts.

Pet owners can go to http://www.purina.com and opt in to receive Purina's podcasts. The products will offer advice ranging from animal training to pet insurance to nutrition for older pets. Weekly tips will also be sent on things such as how to help your dog lose weight. Owners spend close to $25 billion a year on pet food. The aim of the podcasts is to build brand loyalty with a soft sell.

Videos have become another important promotions channel. Literally hundreds of thousands of videos can be viewed on YouTube, the top video-hosting site on the internet. Many people now log in to YouTube to watch videos on a particular product and how the product can be used. Entrepreneurs and other small-business owners have made extensive use of YouTube to provide value to their customers by creating and uploading informational videos that highlight their products.

CONCEPT CHECK

1. How are companies embracing social media as a way to connect with customers?
2. What has been the effect of social media on traditional advertising?

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11.12: Trends in E-Commerce

What is E-commerce, and How Has it Affected the Retail Sector?

E-commerce is related to social media and other new online platforms because it utilizes the internet for marketing communication. **E-commerce** refers to the development and maintenance of a company's website and the facilitation of commerce on the website, such as the ability for customers to order products online, to get questions answered about products, and for the company to introduce new products and ideas. E-commerce can include special components designed specifically for separate target market segments, such as information boxes or games. Anything associated with an actual company website related to marketing can be considered e-commerce.

Estimates by various researchers say that more than half of all retail sales involve an online component; direct internet purchases in 2016 were more than 13 percent of *all* retail sales, and that percentage will continue to grow. Why? One reason is the economics of shopping. Think about time spent engaged in making a purchase in a brick-and-mortar location: the cost of fuel, finding a parking spot, locating your intended store, deciding on a purchase, and then driving home. Now think about the time spent reviewing products on a website, deciding what to purchase, and clicking a mouse or swiping a mobile device screen—it takes no time at all!

Countless small businesses have taken the plunge to serve the growing army of online shoppers. Many e-commerce businesses, including e-jeweler Blue Nile, luggage site eBags, and shoe and accessory retailer Zappos, are experiencing sales of $100 million a year or more. The increasing sophistication of search technology and comparison-shopping sites have allowed online businesses to market their products to millions of potential customers cheaply and effectively. Often, these innovations are bringing less-well-known brands and merchants to consumers' attention.

Online merchants can offer a far broader array of merchandise than specialty brick-and-mortar retailers because they don't have to keep the products on store shelves. In response to this challenge, traditional retailers are turning to technology to gain an advantage, outfitting their sales associates with voice headgear so they can look up prices and product information to assist customers.

After a slow start, the world's largest retailer, Walmart, has begun moving into e-retailing in a big way. It is now in almost every major category of web-related consumer commerce. It is estimated that Walmart has approximately 200 million items across all of its outlets, compared to 300 million items available through Amazon. The company has taken some innovative steps to leverage the web to drive people to its stores. In 2016, CEO Doug McMillon purchased Jet.com for $3.3 billion and put Jet.com's CEO Mark Lore in charge of running Walmart's online business. A case in point is the company's online tire service, which allows you to order automobile tires to be picked up and mounted at a Walmart tire center. Customers can order prescription refills for delivery by mail or for pickup at a Walmart pharmacy department. Walmart's online photo service, in addition to providing a way to store pictures on the web, allows customers to send digital pictures to be printed in a Walmart store of their choice, with a one-hour turnaround.

CONCEPT CHECK

1. How can brick-and-mortar stores use technology to compete with online giants such as Amazon?
2. What factors contribute to the internet's soaring growth in retailing?

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12.1.2: Global Trade in the United States

Why is Global Trade Important to the United States, and How is it Measured?

No longer just an option, having a global vision has become a business imperative. Having a **global vision** means recognizing and reacting to international business opportunities, being aware of threats from foreign competitors in all markets, and effectively using international distribution networks to obtain raw materials and move finished products to the customer.

U.S. managers must develop a global vision if they are to recognize and react to international business opportunities, as well as remain competitive at home. Often a U.S. firm's toughest domestic competition comes from foreign companies. Moreover, a global vision enables a manager to understand that customer and distribution networks operate worldwide, blurring geographic and political barriers and making them increasingly irrelevant to business decisions. Over the past three decades, world trade has climbed from $200 billion a year to more than $1.4 trillion. U.S. companies play a major role in this growth in world trade, with 113 of the Fortune 500 companies making over 50 percent of their profits outside the United States. Among these companies are recognizable names such as Apple, Microsoft, Pfizer, Exxon Mobil, and General Electric.

Starbucks Corp. is among the fastest growing global consumer brands and one of the most visible emblems of U.S. commercial culture overseas. Of Starbucks's 24,000 total stores, almost 66 percent are international stores that contribute a substantial amount to the company's revenues, which have grown from $4.1 billion in 2003 to $21.3 billion in 2016.

Go into a Paris McDonald's and you may not recognize where you are. There are no Golden Arches or utilitarian chairs and tables and other plastic features. The restaurants have exposed brick walls, hardwood floors, and armchairs. Some French McDonald's even have faux marble walls. Most restaurants have TVs with continuous music videos. You can even order an espresso, beer, and a chicken on focaccia bread sandwich. It's not America.

Global business is not a one-way street, where only U.S. companies sell their wares and services throughout the world. Foreign competition in the domestic market used to be relatively rare but now occurs in almost every industry. In fact, U.S. makers of electronic goods, cameras, automobiles, fine china, tractors, leather goods, and a host of other consumer and industrial products have struggled to maintain their domestic market shares against foreign competitors. Toyota now has 14 percent of the U.S. auto market, followed by Honda at 9 percent and Nissan with 8 percent. Nevertheless, the global market has created vast new business opportunities for many U.S. firms.

The Importance of Global Business to the United States

Many countries depend more on international commerce than the United States does. For example, France, Great Britain, and Germany all derive more than 55 percent of their gross domestic product (GDP) from world trade, compared to about 28 percent for the United States. Nevertheless, the impact of international business on the U.S. economy is still impressive:

- Trade-dependent jobs have grown at a rate three times the growth of U.S.-dependent jobs.
- Every U.S. state has realized a growth of jobs attributable to trade.
- Trade has an effect on both service and manufacturing jobs.

These statistics might seem to imply that practically every business in the United States is selling its wares throughout the world, but most is accounted for by big business. About 85 percent of all U.S. exports of manufactured goods are shipped by 250 companies. Yet, 98 percent of all exporters are small and medium-size firms.

The Impact of Terrorism on Global Trade

The terrorist attacks on America on September 11, 2001, and the Charlie Hebdo terrorist attacks in Paris in 2015 have changed the way the world conducts business. The immediate impacts of these events have included a short-term shrinkage of global trade. Globalization, however, will continue because the world's major markets are too vitally integrated for globalization to stop. Nevertheless, terrorism has caused the growth to be slower and costlier.

Companies are paying more for insurance and to provide security for overseas staff and property. Heightened border inspections slow movements of cargo, forcing companies to stock more inventory. Tighter immigration policies curtail the liberal inflows of

skilled and blue-collar workers that allowed companies to expand while keeping wages in check. The impact of terrorism may lessen over time, but multinational firms will always be on guard.

Measuring Trade between Nations

International trade improves relationships with friends and allies; helps ease tensions among nations; and—economically speaking—bolsters economies, raises people's standard of living, provides jobs, and improves the quality of life. The value of international trade is over $16 trillion a year and growing. This section takes a look at some key measures of international trade: exports and imports, the balance of trade, the balance of payments, and exchange rates.

Exports and Imports

The developed nations (those with mature communication, financial, educational, and distribution systems) are the major players in international trade. They account for about 70 percent of the world's exports and imports. **Exports** are goods and services made in one country and sold to others. **Imports** are goods and services that are bought from other countries. The United States is both the largest exporter and the largest importer in the world.

Each year the United States exports more food, animal feed, and beverages than the year before. A third of U.S. farm acreage is devoted to crops for export. The United States is also a major exporter of engineering products and other high-tech goods, such as computers and telecommunications equipment. For more than 60,000 U.S. companies (the majority of them small), international trade offers exciting and profitable opportunities. Among the largest U.S. exporters are Apple, General Motors Corp., Ford Motor Co., Procter & Gamble, and Cisco Systems.

Despite our impressive list of resources and great variety of products, imports to the United States are also growing. Some of these imports are raw materials that we lack, such as manganese, cobalt, and bauxite, which are used to make airplane parts, exotic metals, and military hardware. More modern factories and lower labor costs in other countries make it cheaper to import industrial supplies (such as steel) and production equipment than to produce them at home. Most of Americans' favorite hot beverages—coffee, tea, and cocoa—are imported. Lower manufacturing costs have resulted in huge increases in imports from China.

Balance of Trade

The difference between the value of a country's exports and the value of its imports during a specific time is the country's **balance of trade**. A country that exports more than it imports is said to have a *favorable* balance of trade, called a **trade surplus**. A country that imports more than it exports is said to have an *unfavorable* balance of trade, or a **trade deficit**. When imports exceed exports, more money from trade flows out of the country than flows into it.

Although U.S. exports have been booming, we still import more than we export. We have had an unfavorable balance of trade throughout the 1990s, 2000s and 2010s. In 2016, our exports totaled $2.2 trillion, yet our imports were $2.7 trillion. Thus, in 2016 the United States had a trade deficit of $500 billion. America's exports continue to grow, but not as fast as our imports: The export of goods, such as computers, trucks, and airplanes, is very strong. The sector that is lagging in significant growth is the export of services. Although America exports many services—ranging from airline trips to education of foreign students to legal advice—part of the problem is due to piracy, which leads companies to restrict the distribution of their services to certain regions. The FBI estimates that the theft of intellectual property from products, books and movies, and pharmaceuticals totals in the billions every year.

Balance of Payments

Another measure of international trade is called the **balance of payments**, which is a summary of a country's international financial transactions showing the difference between the country's total payments to and its total receipts from other countries. The balance of payments includes imports and exports (balance of trade), long-term investments in overseas plants and equipment, government loans to and from other countries, gifts and foreign aid, military expenditures made in other countries, and money transfers in and out of foreign banks.

From 1900 until 1970, the United States had a trade surplus, but in the other areas that make up the balance of payments, U.S. payments exceeded receipts, largely due to the large U.S. military presence abroad. Hence, almost every year since 1950, the United States has had an unfavorable balance of payments. And since 1970, both the balance of payments *and* the balance of trade

have been unfavorable. What can a nation do to reduce an unfavorable balance of payments? It can foster exports, reduce its dependence on imports, decrease its military presence abroad, or reduce foreign investment. The U.S. balance of payments deficit was over $504 billion in 2016.

The Changing Value of Currencies

The exchange rate is the price of one country's currency in terms of another country's currency. If a country's currency *appreciates*, less of that country's currency is needed to buy another country's currency. If a country's currency *depreciates*, more of that currency will be needed to buy another country's currency.

How do appreciation and depreciation affect the prices of a country's goods? If, say, the U.S. dollar depreciates relative to the Japanese yen, U.S. residents have to pay more dollars to buy Japanese goods. To illustrate, suppose the dollar price of a yen is $0.012 and that a Toyota is priced at 2 million yen. At this exchange rate, a U.S. resident pays $24,000 for a Toyota ($0.012 × 2 million yen = $24,000). If the dollar depreciates to $0.018 to one yen, then the U.S. resident will have to pay $36,000 for a Toyota.

As the dollar depreciates, the prices of Japanese goods rise for U.S. residents, so they buy fewer Japanese goods—thus, U.S. imports decline. At the same time, as the dollar depreciates relative to the yen, the yen appreciates relative to the dollar. This means prices of U.S. goods fall for the Japanese, so they buy more U.S. goods—and U.S. exports rise.

Currency markets operate under a system called **floating exchange rates**. Prices of currencies "float" up and down based upon the demand for and supply of each currency. Global currency traders create the supply of and demand for a particular currency based on that currency's investment, trade potential, and economic strength. If a country decides that its currency is not properly valued in international currency markets, the government may step in and adjust the currency's value. In a **devaluation**, a nation lowers the value of its currency relative to other currencies. This makes that country's exports cheaper and should, in turn, help the balance of payments.

In other cases, a country's currency may be undervalued, giving its exports an unfair competitive advantage. Many people believe that China's huge trade surplus with the United States is partially because China's currency was undervalued. In 2017, the U.S. Department of Commerce issued a fact sheet detailing how it accused China of dumping steel on the U.S. market as well as providing financial assistance to Chinese companies to produce, manufacture, and export stainless steel to the United States from the People's Republic of China.

CONCEPT CHECK

1. What is global vision, and why is it important?
2. What impact does international trade have on the U.S. economy?
3. Explain the impact of a currency devaluation.

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12.1.3: Why Nations Trade

Why Do Nations Trade?

One might argue that the best way to protect workers and the domestic economy is to stop trade with other nations. Then the whole circular flow of inputs and outputs would stay within our borders. But if we decided to do that, how would we get resources like cobalt and coffee beans? The United States simply can't produce some things, and it can't manufacture some products, such as steel and most clothing, at the low costs we're used to. The fact is that nations—like people—are good at producing different things: you may be better at balancing a ledger than repairing a car. In that case you benefit by "exporting" your bookkeeping services and "importing" the car repairs you need from a good mechanic. Economists refer to specialization like this as *advantage*.

Absolute Advantage

A country has an **absolute advantage** when it can produce and sell a product at a lower cost than any other country or when it is the only country that can provide a product. The United States, for example, has an absolute advantage in reusable spacecraft and other high-tech items.

Suppose that the United States has an absolute advantage in air traffic control systems for busy airports and that Brazil has an absolute advantage in coffee. The United States does not have the proper climate for growing coffee, and Brazil lacks the technology to develop air traffic control systems. Both countries would gain by exchanging air traffic control systems for coffee.

Comparative Advantage

Even if the United States had an absolute advantage in both coffee and air traffic control systems, it should still specialize and engage in trade. Why? The reason is the **principle of comparative advantage**, which says that each country should specialize in the products that it can produce most readily and cheaply and trade those products for goods that foreign countries can produce most readily and cheaply. This specialization ensures greater product availability and lower prices.

For example, India and Vietnam have a comparative advantage in producing clothing because of lower labor costs. Japan has long held a comparative advantage in consumer electronics because of technological expertise. The United States has an advantage in computer software, airplanes, some agricultural products, heavy machinery, and jet engines.

Thus, comparative advantage acts as a stimulus to trade. When nations allow their citizens to trade whatever goods and services they choose without government regulation, free trade exists. **Free trade** is the policy of permitting the people and businesses of a country to buy and sell where they please without restrictions. The opposite of free trade is **protectionism**, in which a nation protects its home industries from outside competition by establishing artificial barriers such as tariffs and quotas. In the next section, we'll look at the various barriers, some natural and some created by governments, that restrict free trade.

The Fear of Trade and Globalization

The continued protests during meetings of the World Trade Organization and the protests during the convocations of the World Bank and the International Monetary Fund (the three organizations are discussed later in the chapter) show that many people fear world trade and globalization. What do they fear? The negatives of global trade are as follows:

- Millions of Americans have lost jobs due to imports or production shifting abroad. Most find new jobs, but often those jobs pay less.
- Millions of others fear losing their jobs, especially at those companies operating under competitive pressure.
- Employers often threaten to export jobs if workers do not accept pay cuts.
- Service and white-collar jobs are increasingly vulnerable to operations moving offshore.

Sending domestic jobs to another country is called **outsourcing**, a topic you can explore in more depth. Many U.S. companies, such as Dell, IBM, and AT&T, have set up call service centers in India, the Philippines, and other countries. Now even engineering and research and development jobs are being outsourced. Outsourcing and "American jobs" were a big part of the 2016 presidential election with Carrier's plan to close a plant in Indianapolis and open a new plant in Mexico. While intervention by President Trump did lead to 800 jobs remaining in Indianapolis, Carrier informed the state of Indiana that it will cut 632 workers from its Indianapolis factory. The manufacturing jobs will move to Monterrey, Mexico, where the minimum wage is $3.90 per day.



Figure 12.1.3.1: Anti-globalization groups oppose America's free-trade stance, arguing that corporate interests are hurting the U.S. economy and usurping the power of the American people. The recent protests at the G20 meetings in Hamburg, Germany, expressed anti-free-trade sentiment, supporting the idea that multinational corporations wield too much power. *Are fears expressed by anti-globalization activists and nationalists justified?*(Credit: fiction of reality/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

So is outsourcing good or bad? If you happen to lose your job, it's obviously bad for you. However, some economists say it leads to cheaper goods and services for U.S. consumers because costs are lower. Also, it should stimulate exports to fast-growing countries. No one knows how many jobs will be lost to outsourcing in coming years. According to estimates, almost 2.4 million U.S. jobs were outsourced in 2015.

Benefits of Globalization

A closer look reveals that globalization has been the engine that creates jobs and wealth. Benefits of global trade include the following:

- Productivity grows more quickly when countries produce goods and services in which they have a comparative advantage. Living standards can increase faster. One problem is that big **G20** countries have added more than 1,200 restrictive export and import measures since 2008.
- Global competition and cheap imports keep prices down, so inflation is less likely to stop economic growth. However, in some cases this is not working because countries manipulate their currency to get a price advantage.
- An open economy spurs innovation with fresh ideas from abroad.
- Through infusion of foreign capital and technology, global trade provides poor countries with the chance to develop economically by spreading prosperity.
- More information is shared between two trading partners that may not have much in common initially, including insight into local cultures and customs, which may help the two nations expand their collective knowledge and learn ways to compete globally.

CONCEPT CHECK

1. Describe the policy of free trade and its relationship to comparative advantage.
2. Why do people fear globalization?
3. What are the benefits of globalization?

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12.1.4: Barriers to Trade

What are the Barriers to International Trade?

International trade is carried out by both businesses and governments—as long as no one puts up trade barriers. In general, trade barriers keep firms from selling to one another in foreign markets. The major obstacles to international trade are natural barriers, tariff barriers, and non-tariff barriers.

Natural Barriers

Natural barriers to trade can be either physical or cultural. For instance, even though raising beef in the relative warmth of Argentina may cost less than raising beef in the bitter cold of Siberia, the cost of shipping the beef from South America to Siberia might drive the price too high. *Distance* is thus one of the natural barriers to international trade.

Language is another natural trade barrier. People who can't communicate effectively may not be able to negotiate trade agreements or may ship the wrong goods.

Tariff Barriers

A **tariff** is a tax imposed by a nation on imported goods. It may be a charge per unit, such as per barrel of oil or per new car; it may be a percentage of the value of the goods, such as 5 percent of a $500,000 shipment of shoes; or it may be a combination. No matter how it is assessed, any tariff makes imported goods more costly, so they are less able to compete with domestic products.

Protective tariffs make imported products less attractive to buyers than domestic products. The United States, for instance, has protective tariffs on imported poultry, textiles, sugar, and some types of steel and clothing, and in March of 2018 the Trump administration added tariffs on steel and aluminum from most countries. On the other side of the world, Japan imposes a tariff on U.S. cigarettes that makes them cost 60 percent more than Japanese brands. U.S. tobacco firms believe they could get as much as a third of the Japanese market if there were no tariffs on cigarettes. With tariffs, they have under 2 percent of the market.

Arguments for and Against Tariffs

Congress has debated the issue of tariffs since 1789. The main arguments *for* tariffs include the following:

- Tariffs protect infant industries. A tariff can give a struggling new domestic industry time to become an effective global competitor.
- Tariffs protect U.S. jobs. Unions and others say tariffs keep foreign labor from taking away U.S. jobs.
- Tariffs aid in military preparedness. Tariffs should protect industries and technology during peacetime that are vital to the military in the event of war.

The main arguments *against* tariffs include the following:

- Tariffs discourage free trade, and free trade lets the principle of competitive advantage work most efficiently.
- Tariffs raise prices, thereby decreasing consumers' purchasing power. In 2017, the United States imposed tariffs of 63.86 percent to 190.71 percent on a wide variety of Chinese steel products. The idea was to give U.S. steel manufacturers a fair market after the Department of Commerce concluded their antidumping and anti-subsidy probes. It is still too early to determine what the effects of these tariffs will be, but higher steel prices are likely. Heavy users of steel, such as construction and automobile industries, will see big increases in their production costs. It is also likely that China may impose tariffs on certain U.S. products and services and that any negotiations on intellectual property and piracy will bog down.

Non-tariff Barriers

Governments also use other tools besides tariffs to restrict trade. One type of non-tariff barrier is the **import quota**, or limits on the quantity of a certain good that can be imported. The goal of setting quotas is to limit imports to the specific amount of a given product. The United States protects its shrinking textile industry with quotas. A complete list of the commodities and products subject to import quotas is available on line at the U.S. Customs and Border Protection Agency website.

A complete ban against importing or exporting a product is an **embargo**. Often embargoes are set up for defense purposes. For instance, the United States does not allow various high-tech products, such as supercomputers and lasers, to be exported to

countries that are not allies. Although this embargo costs U.S. firms billions of dollars each year in lost sales, it keeps enemies from using the latest technology in their military hardware.

Government rules that give special privileges to domestic manufacturers and retailers are called **buy-national regulations**. One such regulation in the United States bans the use of foreign steel in constructing U.S. highways. Many state governments have buy-national rules for supplies and services. In a more subtle move, a country may make it hard for foreign products to enter its markets by establishing customs regulations that are different from generally accepted international standards, such as requiring bottles to be quart size rather than liter size.

Exchange controls are laws that require a company earning foreign exchange (foreign currency) from its exports to sell the foreign exchange to a control agency, usually a central bank. For example, assume that Rolex, a Swiss company, sells 300 watches to Zales Jewelers, a U.S. chain, for US$600,000. If Switzerland had exchange controls, Rolex would have to sell its U.S. dollars to the Swiss central bank and would receive Swiss francs. If Rolex wants to buy goods (supplies to make watches) from abroad, it must go to the central bank and buy foreign exchange (currency). By controlling the amount of foreign exchange sold to companies, the government controls the amount of products that can be imported. Limiting imports and encouraging exports helps a government to create a favorable balance of trade.

CONCEPT CHECK

1. Discuss the concept of natural trade barriers.
2. Describe several tariff and non-tariff barriers to trade.

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12.1.5: Fostering Global Trade

How Do Governments and Institutions Foster World Trade?

Antidumping Laws

U.S. firms don't always get to compete on an equal basis with foreign firms in international trade. To level the playing field, Congress has passed antidumping laws. **Dumping** is the practice of charging a lower price for a product (perhaps below cost) in foreign markets than in the firm's home market. The company might be trying to win foreign customers, or it might be seeking to get rid of surplus goods.

When the variation in price can't be explained by differences in the cost of serving the two markets, dumping is suspected. Most industrialized countries have antidumping regulations. They are especially concerned about *predatory dumping*,the attempt to gain control of a foreign market by destroying competitors with impossibly low prices.

The United States recently imposed tariffs on softwood lumber from Canada. Canada was found guilty of pricing softwood lumber at between 7.72 and 4.49 percent below their costs. U.S. customs officers will now levy tariffs on Canadian timber exports with tax rates from 17.41 percent to 30.88 percent, depending on the business.

From our discussion so far, it might seem that governments act only to restrain global trade. On the contrary, governments and international financial organizations work hard to increase it, as this section explains.

Trade Negotiations and the World Trade Organization

The **Uruguay Round** of trade negotiations is an agreement that dramatically lowers trade barriers worldwide. Adopted in 1994, the agreement has been now signed by 148 nations. The most ambitious global trade agreement ever negotiated, the Uruguay Round reduced tariffs by one-third worldwide, a move that is expected to increase global income by $235 billion annually. Perhaps the most notable aspect of the agreement is its recognition of new global realities. For the first time, an agreement covers services, intellectual property rights, and trade-related investment measures such as exchange controls.

As a follow-up to the Uruguay Round, a negotiating round started in the capital of Qatar in 2001 is called the Doha Round. To date, the round has shown little progress in advancing free trade. Developing nations are pushing for the reduction of farm subsidies in the United States, Europe, and Japan. Poor countries say that the subsidies stimulate overproduction, which drives down global agricultural prices. Because developing nations' primary exports are agricultural commodities, low prices mean that they cannot compete in the global marketplace. On the other hand, the United States and Europe are interested in bringing down trade barriers in services and manufacturing. The continuing talks have served as a lightning rod for protesters, who claim that the World Trade Organization (WTO) serves the interests of multinational corporations, promotes trade over preserving the environment, and treats poor nations unfairly.

The **World Trade Organization** replaces the old General Agreement on Tariffs and Trade (GATT), which was created in 1948. The GATT contained extensive loopholes that enabled countries to evade agreements to reduce trade barriers. Today, all WTO members must fully comply with all agreements under the Uruguay Round. The WTO also has an effective dispute settlement procedure with strict time limits to resolve disputes.

The WTO has emerged as the world's most powerful institution for reducing trade barriers and opening markets. The advantage of WTO membership is that member countries lower trade barriers among themselves. Countries that don't belong must negotiate trade agreements individually with all their trading partners. Only a few countries, such as North Korea, Turkmenistan, and Eritrea, are not members of the WTO.



Figure 12.1.5.1: Headquartered in Toulouse, France, Airbus is one of the world's top commercial aircraft manufacturers, operating design and manufacturing facilities in Europe, Japan, China, and the United States. The airliner's current product lineup of 12 jet-aircraft types ranging from 100 seats to 600 seats is heavy competition for Boeing, a top U.S. airline firm with which Airbus has ongoing subsidy-related disputes. *What is the World Trade Organization's role in settling disputes between competing multinational corporations?* (Credit: Bartlomiej Mostek/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

The United States has had mixed results in bringing disputes before the WTO. To date, it has won slightly fewer than half of the cases it has presented to the WTO. America has also won about one-third of the cases brought against it by other countries. One of America's recent losses came in a ruling where the U.S. claimed that tuna imported from Mexico was not meeting the "dolphin safe" criteria, meaning that dolphins were not being killed during the process to catching tuna. The WTO ruled in favor of Mexico. Recently, the United States targeted Europe, India, South Korea, Canada, and Argentina to file cases against. The disputes ranged from European aviation practices to Indian trade barriers affecting U.S. automakers.

One of the biggest disputes before the WTO involved the United States and the European Union. The United States claims that Europe has given Airbus $15 billion in aid to develop airplanes. The European Union claims that the U.S. government has provided $23 billion in military research that has benefited Boeing's commercial aircraft business. It also claimed that Washington State (the home of Boeing manufacturing) has given the company $3.2 billion in unfair tax breaks.

The World Bank and International Monetary Fund

Two international financial organizations are instrumental in fostering global trade. The **World Bank** offers low-interest loans to developing nations. Originally, the purpose of the loans was to help these nations build infrastructure such as roads, power plants, schools, drainage projects, and hospitals. Now the World Bank offers loans to help developing nations relieve their debt burdens. To receive the loans, countries must pledge to lower trade barriers and aid private enterprise. In addition to making loans, the World Bank is a major source of advice and information for developing nations. The United States has granted the organization millions to create knowledge databases on nutrition, birth control, software engineering, creating quality products, and basic accounting systems.

The **International Monetary Fund (IMF)** was founded in 1945, one year after the creation of the World Bank, to promote trade through financial cooperation and eliminate trade barriers in the process. The IMF makes short-term loans to member nations that are unable to meet their budgetary expenses. It operates as a lender of last resort for troubled nations. In exchange for these emergency loans, IMF lenders frequently extract significant commitments from the borrowing nations to address the problems that led to the crises. These steps may include curtailing imports or even devaluing the currency.

Some global financial problems do not have a simple solution. One option would be to pump a lot more funds into the IMF, giving it enough resources to bail out troubled countries and put them back on their feet. In effect, the IMF would be turned into a real lender of last resort for the world economy.

The danger of counting on the IMF, though, is the "moral hazard" problem. Investors would assume that the IMF would bail them out and would therefore be encouraged to take bigger and bigger risks in emerging markets, leading to the possibility of even deeper financial crises in the future.

CONCEPT CHECK

1. Describe the purpose and role of the WTO.
2. What are the roles of the World Bank and the IMF in world trade?

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12.1.7: Participating in the Global Marketplace

How Do Companies Enter the Global Marketplace?

Companies decide to “go global” for a number of reasons. Perhaps the most urgent reason is to earn additional profits. If a firm has a unique product or technological advantage not available to other international competitors, this advantage should result in major business successes abroad. In other situations, management may have exclusive market information about foreign customers, marketplaces, or market situations. In this case, although exclusivity can provide an initial motivation for going global, managers must realize that competitors will eventually catch up. Finally, saturated domestic markets, excess capacity, and potential for cost savings can also be motivators to expand into international markets. A company can enter global trade in several ways, as this section describes.

Exporting

When a company decides to enter the global market, usually the least complicated and least risky alternative is **exporting**, or selling domestically produced products to buyers in another country. A company, for example, can sell directly to foreign importers or buyers. Exporting is not limited to huge corporations such as General Motors or Apple. Indeed, small companies typically enter the global marketplace by exporting. China is the world’s largest exporter, followed by the United States. Many small businesses claim that they lack the money, time, or knowledge of foreign markets that exporting requires. The U.S. Small Business Administration (SBA) now offers the Export Working Capital Program, which helps small and medium-size firms obtain working capital (money) to complete export sales. The SBA also provides counseling and legal assistance for small businesses that wish to enter the global marketplace. Companies such as American Building Restoration Products of Franklin, Wisconsin, have benefited tremendously from becoming exporters. American Building is now selling its chemical products to building restoration companies in Mexico, Israel, Japan, and Korea. Exports account for more than 5 percent of the firm’s total sales.

Plenty of governmental help is available when a company decides to begin exporting. Export Assistance Centers (EAC) provide a one-stop resource for help in exporting. Over 700 EACs are placed strategically around the country. Often the SBA is located in the same building as the EAC. The SBA can guarantee loans of $50,000 to $100,000 to help an exporter grow its business. Online help is also available at http://www.ustr.gov. The site lists international trade events, offers international marketing research, and has practical tools to help with every step of the exporting process. Companies considering exporting for the first time can go to http://www.export.gov and get answers to questions such as: What’s in it for me? Am I ready for this? What do I have to do? The site also provides a huge list of resources for the first-time exporter.

Licensing and Franchising

Another effective way for a firm to move into the global arena with relatively little risk is to sell a license to manufacture its product to a firm in a foreign country. **Licensing** is the legal process whereby a firm (the *licensor*) agrees to let another firm (the *licensee*) use a manufacturing process, trademark, patent, trade secret, or other proprietary knowledge. The licensee, in turn, agrees to pay the licensor a royalty or fee agreed on by both parties.

International licensing is a multibillion-dollar-a-year industry. Entertainment and character licensing, such as DVD movies and characters such as Batman, is the largest single category. Trademarks are the second-largest source of licensing revenue. Caterpillar licenses its brand for both shoes and clothing, which is very popular in Europe.

U.S. companies have eagerly embraced the licensing concept. For instance, Labatt Brewing Company has a license to produce Miller High Life in Canada. The Spalding Company receives more than $2 million annually from license agreements on its sporting goods. Fruit of the Loom lends its name through licensing to 45 consumer items in Japan alone, for at least 1 percent of the licensee’s gross sales.

The licensor must make sure it can exercise sufficient control over the licensee’s activities to ensure proper quality, pricing, distribution, and so on. Licensing may also create a new competitor in the long run if the licensee decides to void the license agreement. International law is often ineffective in stopping such actions. Two common ways that a licensor can maintain effective control over its licensees are by shipping one or more critical components from the United States and by locally registering patents and trademarks in its own name.

Franchising is a form of licensing that has grown rapidly in recent years. Many U.S. franchisors operate thousands of outlets in foreign countries. More than half of the international franchises are for fast-food restaurants and business services. McDonald's, however, decided to sell its Chinese stores to a group of outside investors for $1.8 billion, but retained 20 percent of the equity.

Having a big-name franchise doesn't always guarantee success or mean that the job will be easy. In China, Home Depot closed its stores after opening 12 to serve the large Chinese population. Had they done market research, they would have known that the majority of urban dwellers live in recently built apartments and that DIY (Do It Yourself) is viewed with disdain in Chinese society, where it is seen as a sign of poverty. When Subway opened its first sandwich shop in China, locals stood outside and watched for a few days. Patrons were so confused that the franchisee had to print signs explaining how to order. Customers didn't believe the tuna salad was made from a fish because they couldn't see the head or tail. And they didn't like the idea of touching their food, so they would hold the sandwich vertically, peel off the paper wrap, and eat it like a banana. Most of all, the Chinese customers didn't want sandwiches.

It's not unusual for Western food chains to adapt their strategies when selling in China. McDonald's, aware that the Chinese consume more chicken than beef, offered a spicy chicken burger. KFC got rid of coleslaw in favor of seasonal dishes such as shredded carrots or bamboo shoots.

Contract Manufacturing

In **contract manufacturing**, a foreign firm manufactures private-label goods under a domestic firm's brand. Marketing may be handled by either the domestic company or the foreign manufacturer. Levi Strauss, for instance, entered into an agreement with the French fashion house of Cacharel to produce a new Levi's line, Something New, for distribution in Germany.

The advantage of contract manufacturing is that it lets a company test the water in a foreign country. By allowing the foreign firm to produce a certain volume of products to specification and put the domestic firm's brand name on the goods, the domestic firm can broaden its global marketing base without investing in overseas plants and equipment. After establishing a solid base, the domestic firm may switch to a joint venture or direct investment, explained below.

Joint Ventures

Joint ventures are somewhat similar to licensing agreements. In a **joint venture**, the domestic firm buys part of a foreign company or joins with a foreign company to create a new entity. A joint venture is a quick and relatively inexpensive way to enter the global market. It can also be very risky. Many joint ventures fail. Others fall victim to a takeover, in which one partner buys out the other.

Sometimes countries have required local partners in order to establish a business in their country. China, for example, had this requirement in a number of industries until recently. Thus, a joint venture was the only way to enter the market. Joint ventures help reduce risks by sharing costs and technology. Often joint ventures will bring together different strengths from each member. In the General Motors-Suzuki joint venture in Canada, for example, both parties have contributed and gained. The alliance, CAMI Automotive, was formed to manufacture low-end cars for the U.S. market. The plant, which was run by Suzuki management, produces the Chevrolet Equinox and the Pontiac Torrent, as well as the new Suzuki SUV. Through CAMI, Suzuki has gained access to GM's dealer network and an expanded market for parts and components. GM avoided the cost of developing low-end cars and obtained models it needed to revitalize the lower end of its product line and its average fuel economy rating. After the successful joint venture, General Motors gained full control of the operation in 2011. The CAMI factory may be one of the most productive plants in North America. There GM has learned how Japanese automakers use work teams, run flexible assembly lines, and manage quality control.

Direct Foreign Investment

Active ownership of a foreign company or of overseas manufacturing or marketing facilities is **direct foreign investment**. Direct investors have either a controlling interest or a large minority interest in the firm. Thus, they stand to receive the greatest potential reward but also face the greatest potential risk. A firm may make a direct foreign investment by acquiring an interest in an existing company or by building new facilities. It might do so because it has trouble transferring some resources to a foreign operation or obtaining that resource locally. One important resource is personnel, especially managers. If the local labor market is tight, the firm may buy an entire foreign firm and retain all its employees instead of paying higher salaries than competitors.

Sometimes firms make direct investments because they can find no suitable local partners. Also, direct investments avoid the communication problems and conflicts of interest that can arise with joint ventures. IBM, in the past, insisted on total ownership of its foreign investments because it did not want to share control with local partners.

General Motors has done very well by building a $4,400 (RMB 29,800) minivan in China that gets 43 miles per gallon in city driving. The Wuling Sunshine has a quarter the horsepower of U.S. minivans, weak acceleration, and a top speed of 81 miles per hour. The seats are only a third of the thickness of seats in Western models, but look plush compared to similar Chinese cars. The minivans have made GM the largest automotive seller in China, and have made China a large profit center for GM.

Walmart now has over 6,000 stores located outside the United States. In 2016, international sales were over $116 billion. About one-third of all new Walmart stores are opened in global markets.

Not all of Walmart's global investments have been successful. In Germany, Walmart bought the 21-store Wertkauf hypermarket chain and then 74 unprofitable and often decrepit Interspar stores. Problems in integrating and upgrading the stores resulted in at least $200 million in losses. Like all other German stores, Walmart stores were required by law to close at 8 p.m. on weekdays and 4 p.m. on Saturdays, and they could not open at all on Sundays. Costs were astronomical. As a result, Walmart left the German retail market.

Walmart has turned the corner on its international operations. It is pushing operational authority down to country managers in order to respond better to local cultures. Walmart enforces certain core principles such as everyday low prices, but country managers handle their own buying, logistics, building design, and other operational decisions.

Global firms change their strategies as local market conditions evolve. For example, major oil companies like Shell Oil and ExxonMobil had to react to dramatic changes in the price of oil due to technological advances such as more efficient automobiles, fracking, and horizontal drilling.

MANAGING CHANGE

Managing the Drop in Oil Prices

In 2014, crude oil was $90 a barrel, but increased production due to the shale oil boom and the reluctance of OPEC countries to reduce output led to a price drop to $45–$60 throughout the first quarter of 2015. While this is terrific news for consumers, it does provide challenges to managers at both large and small companies connected to the oil industry. Companies such as Chevron, Royal Dutch Shell, and ExxonMobil saw dramatic reductions in their earnings, which were also reflected in lower stock prices.

The action taken by senior executives at Chevron was to trim their planned capital expenditures by $5 billion in 2016, resulting in the elimination of 1,500 jobs, while ExxonMobil executives Jeff Woodbury and CEO Rex Tillerson (now the former U.S. Secretary of State) were less specific; they planned several belt-tightening strategies and forecast several years of low oil prices. Likewise, Ben van Beurden, the CEO of Royal Dutch Shell, announced plans to eliminate 6,500 jobs and also predicted long-range low prices for oil.

In addition to layoffs, actions that oil company managers can employ include mergers for companies that don't have the ability to become fully efficient themselves. They can merge with other companies that can improve overall efficiencies and operations. Contrary to the cost-cutting plans mentioned earlier, some companies might consider increasing their spending plans. Going against the reduced expenditures trend is Encana, a North American oil producer, which plans to increase its overall spending. Some of the factors that allowed Encana to increase spending was its low debt-to-equity ratio and its growth, which exceeded the industry average.

Growth is an important component of a company's strategy, and reactive short-term strategies can often hurt long-term growth. By implementing performance-improvement programs, companies can address problems and inefficiencies within the company and allow them to focus on innovation. Another strategy that companies can use is to review and alter their supply chain by focusing on costs and efficiency. Companies can expand their supplier base, thus increasing competition and reducing costs. This also requires companies to embrace a lean manufacturing mindset.

New technology can also be used as a cost driver. New technologies such as microseismic sensors used to monitor fracking operations in drilling operations miles under the earth can boost production. Adopting new technology can also lead to changes

in the workers that companies employ. New technology usually requires higher-skilled workers, while reducing the number of lower-skilled workers.

The drop in oil prices has produced a survival-of-the-fittest competition among energy companies. The companies that employ multiple strategies to improve efficiency are the ones that will survive and prosper.

Critical Thinking Questions

1. Do you think that Royal Dutch Shell and ExxonMobil would have been more successful if they had considered strategies other than cutting spending and eliminating jobs? Why or why not?
2. How should oil companies react if oil prices rise to the $90 to $100 per barrel level? Explain your reasoning.

Countertrade

International trade does not always involve cash. Today, countertrade is a fast-growing way to conduct international business. In **countertrade**, part or all of the payment for goods or services is in the form of other goods or services. Countertrade is a form of barter (swapping goods for goods), an age-old practice whose origins have been traced back to cave dwellers. The U.S. Commerce Department says that roughly 30 percent of all international trade involves countertrade. Each year, about 300,000 U.S. firms engage in some form of countertrade. U.S. companies, including General Electric, Pepsi, General Motors, and Boeing, barter billions of goods and services every year. Recently, the Malaysian government bought 20 diesel-powered locomotives from China and paid for them with palm oil.

CONCEPT CHECK

1. Discuss several ways that a company can enter international trade.
2. Explain the concept of countertrade.

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12.1.8: Threats and Opportunities in the Global Marketplace

What Threats and Opportunities Exist in the Global Marketplace?

To be successful in a foreign market, companies must fully understand the foreign environment in which they plan to operate. Politics, cultural differences, and the economic environment can represent both opportunities and pitfalls in the global marketplace.

Political Considerations

We have already discussed how tariffs, exchange controls, and other governmental actions threaten foreign producers. The political structure of a country may also jeopardize a foreign producer's success in international trade.

Intense nationalism, for example, can lead to difficulties. **Nationalism** is the sense of national consciousness that boosts the culture and interests of one country over those of all other countries. Strongly nationalistic countries, such as Iran and New Guinea, often discourage investment by foreign companies. In other, less radical forms of nationalism, the government may take actions to hinder foreign operations. France, for example, requires pop music stations to play at least 40 percent of their songs in French. This law was enacted because the French love American rock and roll. Without airtime, American music sales suffer. In another example of nationalism, U.S.-based PPG made an unsolicited bid to acquire Netherlands-based AzkoNobel NV. There was a chorus of opposition from Dutch politicians to the idea of a foreign takeover of AzkoNobel, the Dutch paint manufacturer. The government warned that it would move to defend AzkoNobel from a hostile takeover attempt. AzkoNobel played up the sentiment, tweeting about its rejection of the hostile takeover with the hashtag #DutchPride.

In a hostile climate, a government may *expropriate* a foreign company's assets, taking ownership and compensating the former owners. Even worse is *confiscation*, when the owner receives no compensation. This happened during rebellions in several African nations during the 1990s and 2000s.

Cultural Differences

Central to any society is the common set of values shared by its citizens that determine what is socially acceptable. Culture underlies the family, educational system, religion, and social class system. The network of social organizations generates overlapping roles and status positions. These values and roles have a tremendous effect on people's preferences and thus on marketers' options. For example, in China Walmart holds live fishing contests on the premises, and in South Korea the company hosts a food competition with variations on a popular Korean dish, kimchee.

Language is another important aspect of culture. Marketers must take care in selecting product names and translating slogans and promotional messages so as not to convey the wrong meaning. For example, Mitsubishi Motors had to rename its Pajero model in Spanish-speaking countries because the term refers to a sexual activity. Toyota Motor's MR2 model dropped the *2* in France because the combination sounds like a French swear word. The literal translation of Coca-Cola in Chinese characters means "bite the wax tadpole."

Each country has its own customs and traditions that determine business practices and influence negotiations with foreign customers. For example, attempting to do business in Western Europe during the first two weeks in August is virtually impossible. Businesses close, and everyone goes on vacation at the same time. In many countries, personal relationships are more important than financial considerations. For instance, skipping social engagements in Mexico may lead to lost sales. Negotiations in Japan often include long evenings of dining, drinking, and entertaining; only after a close personal relationship has been formed do business negotiations begin. Table 12.1.8.1 presents some cultural dos and don'ts.

Table 12.1.8.1: Cultural Dos and Don'ts Guidelines and Examples

DO:	DON'T:
• Always present your business card with both hands in Asian countries. It should also be right-side-up and print-side-showing so that the recipient can read it as it is being presented. If you receive a business card, accept it with gratitude and examine it carefully. Don't quickly put it into your pocket. • Use a "soft-sell" and subtle approach when promoting a product in Japan. Japanese people do not feel comfortable with America's traditional hard-selling style. • Understand the role of religion in business transactions. In Muslim countries, Ramadan is a holy month when most people fast. During this time everything slows down, particularly business. • Have a local person available to culturally and linguistically interpret any advertising that you plan to do. When American Airlines wanted to promote its new first-class seats in the Mexican market, it translated the "Fly in Leather" campaign literally, which meant "Fly Naked" in Spanish.	• Glad-hand, back-slap, and use first names on your first business meeting in Asia. If you do, you will be considered a lightweight. • Fill a wine glass to the top if dining with a French businessperson. It is considered completely uncouth. • Begin your first business meeting in Asia talking business. Be patient. Let your clients get to know you first.

Economic Environment

The level of economic development varies considerably, ranging from countries where everyday survival is a struggle, such as Sudan and Eritrea, to countries that are highly developed, such as Switzerland and Japan. In general, complex, sophisticated industries are found in developed countries, and more basic industries are found in less developed nations. Average family incomes are higher in the more developed countries than in the least-developed markets. Larger incomes mean greater purchasing power and demand, not only for consumer goods and services but also for the machinery and workers required to produce consumer goods. Table 12.1.8.2 provides a glimpse of global wealth.

Business opportunities are usually better in countries that have an economic infrastructure in place. **Infrastructure** is the basic institutions and public facilities upon which an economy's development depends. When we think about how our own economy works, we tend to take our infrastructure for granted. It includes the money and banking system that provide the major investment loans to our nation's businesses; the educational system that turns out the incredible varieties of skills and basic research that actually run our nation's production lines; the extensive transportation and communications systems—interstate highways, railroads, airports, canals, telephones, internet sites, postal systems, and television stations—that link almost every piece of our geography into one market; the energy system that powers our factories; and, of course, the market system itself, which brings our nation's goods and services into our homes and businesses.

Table 12.1.8.2: Where the Money Is

The Top 20	Gross National Income Per Capita* US$
Luxembourg	103,199
Switzerland	79,243
Norway	70,392
Ireland	62,562
Qatar	60,787
Iceland	59,629
United States	57,436
Denmark	53,744
Singapore	52,961
Australia	51,850
Sweden	51,165
San Marino	46,447
Netherlands	45,283
Austria	44,498
Finland	43,169
Canada	42,210
Germany	41,902
Belgium	41,283
United Kingdom	40,096
Japan	38,912
The Bottom Five	
Madagascar	391
Central African Republic	364
Burundi	325
Malawi	295
South Sudan	233

* **Gross National Income** is the value of the final goods and services produced by a country (Gross Domestic Product) together with its income received from other countries (such as interest and dividends) less similar payments made to other countries.

Final goods are the goods ultimately consumed rather than used in the production of another good. For example, a car sold to a consumer is a final good; the components, such as tires sold to the car manufacturer, are not. They are intermediate goods used to make the final good. The same tires, if sold to a consumer, would be a final good.

Sources: Some data refers to IMF staff estimates and some are actual figures for the year 2017, made on April 12, 2017. Adapted from the World Economic Outlook Database—April 2017, International Monetary Fund, accessed on April 18, 2017.

CONCEPT CHECK

1. Explain how political factors can affect international trade.
2. Describe several cultural factors that a company involved in international trade should consider.
3. How can economic conditions affect trade opportunities?

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12.1.9: The Impact of Multinational Corporations

What are the Advantages of Multinational Corporations?

Corporations that move resources, goods, services, and skills across national boundaries without regard to the country in which their headquarters are located are **multinational corporations**. Some are so rich and have so many employees that they resemble small countries. For example, the sales of both Exxon and Walmart are larger than the GDP of all but a few nations in the world. Multinational companies are heavily engaged in international trade. The successful ones take political and cultural differences into account.

Many global brands sell much more outside the United States than at home. Coca-Cola, Philip Morris's Marlboro brand, Pepsi, Kellogg, Pampers, Nescafe, and Gillette, are examples.

The Fortune 500 made over $1.5 trillion in profit in 2016. In slow-growing, developed economies like Europe and Japan, a weaker dollar helps, because it means cheaper products to sell into those markets, and profits earned in those markets translate into more dollars back home. Meanwhile, emerging markets in Asia, Latin America, and Eastern Europe are growing steadily. General Electric expects 60 percent of its revenue growth to come from emerging markets over the next decade. For Brown-Forman, the spirits company, a fifth of its sales growth of Jack Daniels, the Tennessee whiskey, is coming from developing markets like Mexico and Poland. IBM had rapid sales growth in emerging markets such as Russia, India, and Brazil.

The largest multinational corporations in the world are shown in Table 12.1.9.1.

Despite the success of American multinationals abroad, there is some indication that preference for U.S. brands may be slipping.



Figure 12.1.9.1: As overseas investment grows, so does the need for global branding. The Wisconsin National Guard picked NBA star Giannis Antetokounmpo to be the face of its recruiting and marketing effort. Recognizable to NBA fans the world over, Antetokounmpo personifies a youthful, dynamic spirit that transcends cultural and geographic boundaries. *Why is it increasingly important that multinational advertisers identify and sign celebrity spokespersons capable of bridging different cultures?*(Credit: Erik Drost/ Flickr/ Attribution-ShareAlike 2.0 Generic (CC BY 2.0))

The Multinational Advantage

Large multinationals have several advantages over other companies. For instance, multinationals can often overcome trade problems. Taiwan and South Korea have long had an embargo against Japanese cars for political reasons and to help domestic automakers. Yet Honda USA, a Japanese-owned company based in the United States, sends Accords to Taiwan and Korea. In another example, when the environmentally conscious Green movement challenged the biotechnology research conducted by BASF, a major German chemical and drug manufacturer, BASF moved its cancer and immune-system research to Cambridge, Massachusetts.

Another advantage for multinationals is their ability to sidestep regulatory problems. U.S. drugmaker SmithKline and Britain's Beecham decided to merge in part so that they could avoid licensing and regulatory hassles in their largest markets. The merged company can say it's an insider in both Europe and the United States. "When we go to Brussels, we're a member state [of the European Union]," one executive explains. "And when we go to Washington, we're an American company."



Figure 12.1.9.2: South Korea's Samsung is a leading manufacturer of giant high-definition TVs. Samsung produces the largest curved ultra-high-definition (UHD) screens for the worldwide home-theater market. Samsung's monster 110-inch curved UHD screen is among the world's largest such screens. Unfortunately, for most of the world's consumers, the giant Samsung TVs can be too costly, but the 88-inch version can be purchased for under $20,000. *How does being a multinational corporation enable Samsung to succeed in the high-end electronics market?* (Credit: Chris F/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Multinationals can also shift production from one plant to another as market conditions change. When European demand for a certain solvent declined, Dow Chemical instructed its German plant to switch to manufacturing a chemical that had been imported from Louisiana and Texas. Computer models help Dow make decisions like these so it can run its plants more efficiently and keep costs down.

Table 12.1.9.1: The World's Top 11 Largest Multinational Corporations

RANK	RANK COMPANY	Revenues ($M)	Home Country
1	Walmart	$482,130	United States
2	State Grid	$329,601	China
3	China National Petroleum	$299,271	China
4	Sinopec Group	$294,344	China
5	Royal Dutch Shell	$272,156	Netherlands
6	Exxon Mobil	$246,204	United States
7	Volkswagen	$236,600	Germany
8	Toyota Motor	$236,592	Japan
9	Apple	$233,715	United States
10	BP	$225,982	United Kingdom
11	Berkshire Hathaway	$210,821	United States

Source: Adapted from "The World's Largest Corporations," *Fortune*, http://fortune.com/global500/, accessed June 30, 2017.

EXPANDING AROUND THE GLOBE

U.S. Brands Face Global Competition

America is the cradle of the consumer goods brand. Here, a free-spending and marketing-saturated public nurtured Apple, Google, Coca-Cola, Microsoft, and countless others to maturity. Many of those brands grew up to conquer other societies, as well.

But American brands' domination in the global marketplace is eroding. From Samsung to Toyota to Mercedes Benz to SAP, companies in Europe and Asia are turning out top-quality goods and selling them as such rather than competing on price. "There are longer-term trends toward greater competition. The United States was the only global brand country [but] that's no longer the case," says Earl L. Taylor, chief marketing officer of the Marketing Science Institute. "Consumers prefer brands that they take to be of higher quality" regardless of the country of origin, he notes. "Increasingly, there will be other successful global brands in the U.S. [market]."

Of the brands at the top of Interbrand's recent list of the world's most valuable, four of the top five still originate in the United States; the five most valuable are Apple, Google, Coca-Cola, and Microsoft, while Toyota (Japan) comes in at number five. American companies have lost the most ground in the middle tier of recognizable brand names, says George T. Haley, professor of marketing at the University of New Haven's School of Business.

One area from which U.S. brands are feeling the pressure is the Asia-Pacific region, which harbors the fastest-growing emerging markets today. In the appliance category, two Chinese companies, Haier and Kelon, are becoming top competitors for well-known U.S. brands Whirlpool and Maytag. In fact, Haier bought GE's appliance division in 2016. The Chinese branding trend is not confined only to hard goods. Sporting goods and sportswear brand Li Ning, well known within China, is building its international profile. While the Chinese basketball team wore Nike uniforms at the Athens Olympic Games, the Spanish team wore Li Ning apparel. The threat to U.S. brands is not confined to China, however. South Korean brands, such as Samsung, LG, and Hyundai, have emerged on the global stage in specific categories, such as smartphones, household appliances, and automobiles.

The animosity that many Europeans feel toward the United States is translated into a preference for European or even Asian brands at the expense of U.S. brands. Plus, experts say, European brands are simply becoming stronger and more consistent.

Meanwhile, European brands are gaining momentum in the areas of white goods and consumer goods, putting the pressure on such well-known U.S. brands as Bissell and Hoover, experts say. For instance, Gaggenauis a popular, high-end European kitchen appliance brand, along with Bosch and Dyson. Other European brands maintaining cachet—if not always the allure of luxury—include Absolut, Virgin, Mini (as in Cooper), Red Bull, and Ikea.

Critical Thinking Questions

1. What can U.S. multinational firms do to regain and maintain their leadership in global branding? Are there sectors and product areas where U.S. brands are gaining share?
2. Do you think that the quality of American products and services is declining, or that the rest of the world is just getting better? Explain your answer.

Multinationals can also tap new technology from around the world. In the United States, Xerox has introduced some 80 different office copiers that were designed and built by Fuji Xerox, its joint venture with a Japanese company. Versions of the super-concentrated detergent that Procter & Gamble first formulated in Japan in response to a rival's product are now being sold under the Ariel brand name in Europe and under the Cheer and Tide labels in the United States. Also, consider Otis Elevator's development of the Elevonic 411, an elevator that is programmed to send more cars to floors where demand is high. It was developed by six research centers in five countries. Otis's group in Farmington, Connecticut, handled the systems integration, a Japanese group designed the special motor drives that make the elevators ride smoothly, a French group perfected the door systems, a German group handled the electronics, and a Spanish group took care of the small-geared components. Otis says the international effort saved more than $10 million in design costs and cut the process from four years to two.

Finally, multinationals can often save a lot in labor costs, even in highly unionized countries. For example, when Xerox started moving copier-rebuilding work to Mexico to take advantage of the lower wages, its union in Rochester, New York, objected

because it saw that members' jobs were at risk. Eventually, the union agreed to change work styles and to improve productivity to keep the jobs at home.

CONCEPT CHECK

1. What is a multinational corporation?
2. What are the advantages of multinationals?

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SECTION OVERVIEW

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12.2.2: US Small Business in the Global Environment

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12.2.2: US Small Business in the Global Environment

Learning Objectives

- Understand and appreciate the role of small businesses in the global environment.
- Learn about the global growth opportunities for small businesses.
- Understand the advantages and the disadvantages of a small business going global.

Although small businesses make up a disproportionately large share of the number of companies that export and import, this represents only about 1 percent of the total number of small businesses. Thus many small businesses have yet to compete globally. The opportunities are there. “So much of what America makes is in great demand,” said US Commerce Secretary Gary Locke in an interview, adding further that the growth potential for small companies is outside the United States. Dale Hayes, vice president of US marketing for UPS concurs, observing that the demand for high-quality American products is huge. It may be that a small business is already competing globally because foreign-owned companies are competing in our own backyards.

Yet the global marketplace is not relevant to most small businesses. Given that 99 percent of the small businesses in the United States are not operating globally—preferring to grow (if they want to) locally, regionally, and perhaps nationally—it is reasonable to conclude that going global will interest only a few. Those few, however, must undertake careful analyses before jumping into the global arena.

The Small Business Global Presence

It may seem to many that the global market is the domain of the large corporations, but the statistics tell a very different story. Small businesses actually account for close to 97.6 percent of US exporters and 32.8 percent of the value of US exports as well as 97.1 percent of all identified importers and 31.9 percent of the known import value. Consider the following additional facts:

- Small businesses account for 96.4 percent of all manufacturing exporters, which is 17.2 percent of the sector’s $562 billion in exports.
- Nearly 100 percent (99.2 percent) of exporting wholesalers were small businesses, which is 61.1 percent of the sector’s $218 billion in exports.
- Of other companies with exports, 96.9 percent were small businesses. These companies include manufacturing companies of prepackaged software and books, freight forwarders and other transportation service firms, business services, engineering and management services, gas and oil extraction companies, coal mining companies, and communication services, to name a few.
- Small businesses account for 93.6 percent of all manufacturing importers, which is 12.9 percent of the sector’s $602 billion in imports.
- Nearly 100 percent (99.2 percent) of wholesaler importers were small businesses, contributing 56.8 percent of the sector’s $451 billion in imports.
- Small businesses accounted for 94.3 percent of the companies that both exported and imported, accounting for 29 percent of the export value and 27 percent of the import value.

This tells us that small businesses are very active in the global marketplace, and small business success in international markets is extremely important to the welfare of the United States. Although it is true that small businesses are major users of imported goods, the focus of this chapter is on small business exporting because exporting can be an effective way to diversify the customer base, manage market fluctuations, grow, and become more competitive.

Small businesses are limited in the products and the services that they export. Small business exports are concentrated in four main product categories: computers and electronic products, chemicals, machinery, and transportation equipment. However, the leading product categories in terms of market share were wood products, apparel and accessories, tobacco products, beverages, and leather products.

Although the United States is one of the world’s largest participants in global services trade, very little information exists with respect to services exports by small businesses. What is known is that it is increasingly common for most US services firms to establish a **foreign affiliate**—a branch or a subsidiary of the parent company established outside the national boundaries of the parent company’s home market—because most services are better supplied in close proximity to the principal or final

customers. Additionally, in some business sectors, foreign regulations may restrict the delivery of some services to affiliates only. For example, to comply with domestic solvency requirements, some countries require that personal lines of insurance be carried out only by affiliates. Another example is the protection of intellectual property rights. This is often accomplished through the services of affiliates, thus intellectual property is kept in-house.

What is particularly interesting is that most of the service exporting occurs in businesses with 0–19 employees, with the least service exporting done by small businesses with 300–499 employees. This may be the exact opposite of what you would expect.

The Advantages of Going Global

The flexibility of a smaller company may make it possible to meet the demands of global markets and redefine a company's programs more quickly than might occur in the larger **multinational corporation**. A multinational corporation is a company that operates on a worldwide scale without ties to any specific nation or region; it is organized under the laws of its own country. This flexibility of the smaller company is particularly true of the **micromultinationals**, a relatively new category of tiny companies that operate globally, having a presence and people in multiple countries.

These micromultinationals outsource virtually everything to specialists all over the world and sell to people all over the world through the Internet. The Internet is inexpensive technology, and the services designed to help small businesses make it possible for the small company to operate across borders with the same effectiveness and efficiencies as large businesses.

Micromultinationals

Generation Alliance is a branding and design firm that provides services to clients all over the world. They have core employees in Australia and specialist contractors in New Zealand, the United Kingdom, Germany, Switzerland, Jamaica, Dubai, and Singapore. One of their more interesting projects was to rebrand the country of Botswana for the global market.

Jadience sells a line of health and skincare products that has its roots in traditional oriental medicine. Their physical products are sent to customers, mostly spas, in the United States, Canada, and Mexico.

Worketc operates in the large and competitive business software market. Their focus is small businesses, selling web-based customer relationship management (CRM), project management, billing, shared calendars, help desk, and document management software. The company is headquartered in Sydney, Australia, and it claims happy customers in sixteen countries. The United States accounts for 86 percent of its customers.

There are many reasons why small businesses should consider going global:

- A small business that thinks and sells only domestically may be reaching only a small share of its potential customers because 95 percent of the world's consumers live outside the United States.
- Exporting enables companies to diversify their portfolios and weather changes in the domestic economy. This stabilizes seasonal and cyclical market fluctuations.
- Exporting helps small businesses grow and become more competitive in all their markets, which reduces the dependence on existing markets.
- Exporting increases sales and profits, also extending the sales potential of existing products. Research has shown that exporting can expand total sales 0.6 percent to 1.3 percent faster than would otherwise be the case.
- Exporting companies are able to sell excess production capacity.
- Exporting companies are nearly 8.5 percent less likely to go out of business.
- There are higher worker earnings as well, which contributes to the betterment of the community.

According to the US Small Business Administration (SBA), US exporting businesses experience faster annual employment growth by 2 to 4 percentage points over their non-exporting counterparts. Workers employed in exporting companies have better paying jobs and better opportunities for advancement. Research has estimated that blue-collar worker earnings in firms that export are 13 percent higher than those in non-exporting plants, 23 percent higher when comparing large plants, and 9 percent higher when comparing small plants. White-collar employees also benefit from higher salaries, 18 percent more than their non-exporting counterparts. Less skilled workers also earn more at companies that export. Lastly, the benefits that all workers receive at exporting plants are 37 percent higher and include improved medical insurance and paid leave.

The Disadvantages of Going Global

There is no question that the benefits of going global are considerable. However, disadvantages or barriers must also be considered. For example, a small business will incur additional costs, such as modifying its product or its packaging (perhaps even changing the name of its product so that it does not convey negative meanings outside the United States), developing new promotional materials, administrative costs (such as hiring staff to launch the export expansion and dedicating personnel for traveling), traveling to foreign locations (very important), and shipping. It may also be necessary for the owner to subordinate short-term profits to long-term gains, wait longer for payments, apply for additional financing, and obtain special export licenses. There will be differences in consumer needs, wants, and usage patterns for products; differences in consumer response to the elements of the marketing mix and differences in the legal environment may conflict with those of the United States. Then, of course, there are cultural and language issues along with the all-too-familiar fear of the unknown. A recent survey of exporting and non-exporting members of the National Small Business Association (NSBA) and the Small Business Exporters Association (SBEA) reported the following main barriers to small businesses selling their goods and/or services to foreign customers:

- I do not have goods and/or services that are exportable: 49 percent.
- I do not know much about it and am not sure where to start: 38 percent.
- I would worry too much about getting paid: 29 percent.
- It is too costly: 27 percent.
- It would take too much time away from my regular, domestic sales: 17 percent.
- I cannot obtain financing to offer products or services to foreign customers: 7 percent.

Three things were identified as the single largest challenge: worrying about getting paid (26 percent), feeling that exporting is confusing and difficult to do (24 percent), and having limited goods and/or services that are exportable (18 percent).

Richard Ginsburg in the SBA's Office of International Trade has commented that most US small businesses simply do not understand the value of taking their business global, further noting that "the number-one barrier to trade is the psychological acceptance that global business is necessary."

Small businesses also face some resource constraints that reduce their ability to export. For example, small businesses are more likely than larger firms to face scarcities of financial and human resources that limit their ability to take advantage of global opportunities. Limited personnel, the inability to meet quality standards, the lack of financial backing, and insufficient knowledge of foreign markets are important constraints affecting the ability of small businesses to export. Fortunately, being proactive, innovative, and willing to take risks have helped small businesses overcome export impediments and improve export performance.

The disadvantages of going global may warrant a go-slow approach, but they should not be viewed as knockout factors. If a business's financial situation is weak, the timing may not be right for becoming an exporter… but perhaps exporting makes sense in the future. In any case, very careful thinking should precede the decision to export.

2010 Winner of the Growth through Global Trade Award

The UPS Growth through Global Trade Award recognizes businesses with fewer than five hundred employees that are excelling in international trade. The inaugural winner was SteelMaster Buildings LLC, in Virginia Beach, Virginia, a manufacturer, designer, and supplier. The UPS award was followed up by two other national awards and four regional awards related to SteelMaster's increases in global trade plus a mention in a September 2010 speech by the former US Secretary of Commerce, Gary Locke, at a trade conference. The company earned first place in the 2011 Export Video Contest cosponsored by the SBA and VISA.



Figure 12.2.2.1: *Source: SteelMaster Buildings. Reprinted with permission.*

SteelMaster employs fifty people, excluding distributors. It exports to more than forty countries and has distributorship relationships in more than fifty international markets (e.g., South Korea, Romania, Mexico, Angola, Chile, Peru, Slovakia, South Sudan, and Australia). This distributor network has provided an important source of market differentiation. Since the company began exporting in 2006, in response to the very competitive and saturated US market, the company's revenue has quadrupled, and exporting now represents over 20 percent of its total revenue. In addition,

- The SteelMaster website is user-friendly and offers a bilingual choice for Spanish-speaking viewers. Live chat is also available. In addition, various parts of the website have been translated to other languages (i.e., Korean, French, Romanian, Portuguese, and Arabic) to serve the company's international customers in their own languages.
- SteelMaster buildings are environmentally friendly and can be recycled. Green buildings are offered that protect against nonuniform weathering and reduce energy loads on buildings due to a long-term, bright service that helps heat reflectivity.
- SteelMaster's Galvalume Plus coated steel has been approved by the ENERGY STAR program for both low-slope and high-slope applications.
- The SteelMaster product can be easily used in the wake of natural disasters, such as earthquakes, flooding, or hurricanes. The company has participated in humanitarian relief efforts, specifically in Haiti. The company stands ready to provide safe and reliable construction solutions to people in need around the world.

KEY TAKEAWAYS

- Small businesses make up a disproportionately large share of the number of companies that export and import. However, this is only about 1 percent of the total number of small businesses.
- The growth potential for small companies outside the United States is huge because of the demand for high-quality American products.
- Small businesses account for close to 98 percent of US exporters and 33 percent of the value of US exports.
- Small business success in international trade is extremely important to the welfare of the United States.
- There are many advantages and disadvantages of a small business going global. These must be analyzed very carefully before deciding to enter the global marketplace.
- A recent survey of small business owners revealed that the number one barrier to exporting was the feeling that their businesses did not have exportable goods and/or services. The number one challenge was worrying about getting paid.

EXERCISE

Go to www.trade.gov/mas/ian/statereports. Select your state and prepare a profile of small business exporting. Review additional sites as well, for example, websites sponsored by your state's commerce and/or economic development departments. When looking at government sites, you may see the term *small- and medium-sized businesses* or something similar. They are simply referring to businesses with fewer than five hundred employees. This is the small business group for your purposes.

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12.2.3: What You Should Know Before Going Global

Learning Objectives

- Learn about the different ways that a business can export.
- Understand the importance of an industry analysis.
- Understand that it is important to carefully assess a business.
- Learn about the marketing decisions that must be made.
- Learn about the kinds of legal and political issues that will affect the exporting activities of a business.
- Understand why the currency exchange rate is important to determining price.
- Learn about the different sources of financing.

Although expanding into global markets offers many important benefits, not the least of which is increased profits, it will also introduce new complexities into the operations of a small business. There are several key decisions that will need to be made, including the following:

- Determine which foreign market(s) to enter.
- Analyze the expenditures required to enter a new market and determine the source(s) of financing.
- Determine the best way to organize the overseas operation in concert with the US organization.
- Determine the extent to which, if any, the marketing mix will need to be adapted to the needs of the foreign market(s).
- Figure out the best way for the business to get paid.

These decisions, and others, will be based on an assessment of the ways to export, an analysis of the industry and the business, marketing and cultural factors, legal and political conditions, currency exchange issues, and sources of financing.



Figure 12.2.3.1: Factors Affecting the Decision to Go Global

Ways to Export

Small businesses can choose from two basic ways to export: directly or indirectly. There are advantages and disadvantages of each that should be understood before making a choice.

Direct Exporting

In **direct exporting**, a small business exports directly to a customer who is interested in buying a particular product. The small business owner makes all the arrangements for shipping and distributing the product overseas, is responsible for the marketing research, and collects payment. This approach gives the owner greater control over the entire transaction and entitles him or her to higher profits—although these higher profits are accompanied by the need to invest significantly more resources and efforts. It also requires a significantly changed internal organizational structure, which entails more risk.

Table 12.2.3.1: Advantages and Disadvantages of Direct Exporting

Advantages	Disadvantages
Potential profits are greater because intermediaries are eliminated.	It takes more time, energy, and money than an owner may be able to afford.
The owner has a greater degree of control over all aspects of the transaction.	It requires more “people power” to cultivate a customer base.
The owner knows customers, and the customers know the owner. Customers feel more secure in doing business directly with the owner.	Servicing the business will demand more responsibility from every level in the organization. The owner is held accountable for whatever happens. There is no buffer zone.
Business trips are much more efficient and effective because an owner can meet directly with the customer responsible for selling the product.	The owner may not be able to respond to customer communications as quickly as a local agent can.
The owner knows whom to contact if something is not working. The owner gets slightly better protection for trademarks, patents, and copyrights.	The owner must handle all the logistics of the transaction. If it is a technological product, the owner must be prepared to respond to technical questions and provide on-site start-up training and ongoing support services.
The owner is presented as fully committed and engaged in the export process and develops a better understanding of the marketplace. As a business develops in the foreign market, the owner has greater flexibility to improve or redirect marketing efforts.	

Indirect Exporting

Indirect exporting involves entering “into an agreement with an agent, distributor, or a traditional exporting house for the purpose of selling (or marketing and selling) the products in the target market.” Many small businesses choose this option, at least at the outset. It is the simplest approach, particularly when a business does not have the necessary human and financial resources to promote products in foreign markets in any other way. The easiest way to export indirectly is to sell to an intermediary in the United States because the business will normally not be responsible for collecting payment from the overseas customer or coordinating the shipping logistics.

Table 12.2.3.2: Advantages and Disadvantages of Indirect Exporting

Advantages	Disadvantages
Does not require a lot of organizational effort or staff workers.	Not all types of goods lend themselves to indirect exporting (e.g., technically complex goods and services).
The producer of the goods is subject to only small dangers and risk (e.g., a short-term drop in the exchange rate).	The profits of a business will be lower, and control over foreign sales is lost.
It is an almost risk-free way to begin. It demands minimal involvement in the export process. It allows the owner to continue to concentrate on its domestic business.	A business very rarely knows who its customers are, thus losing the opportunity to tailor its offerings to their evolving needs.
The business has limited liability for product marketing problems. There is always someone else at which to point the finger.	When an owner visits, he or she is a step removed from the actual transaction and feels out of the loop.
The owner learns on the fly about international marketing. Depending on the type of intermediary with which the owner is dealing, the owner does not have to be concerned with shipment and other logistics.	The intermediary might be offering products similar to a particular business's products, including directly competitive products, to the same customers instead of providing exclusive representation.
A business can field-test its products for export potential. In some instances, the local agent can field technical questions and provide necessary product support.	The long-term outlook and goals for an export program can change rapidly, and if a business has put its product in someone else's hands, it is hard to redirect efforts accordingly.

Industry Analysis

Before jumping into the global pond, it is a good idea to identify where an industry currently is and then look at the trends and directions that are predicted over the next three years. This will be true whether a business is only on the ground, only online, or both brick and click.

A business should try to determine how competitive an industry is in the global market. Try to get as good a picture of the market as possible because the better informed a business is, the better its chances of a successful global entry. Learn a product's potential in a given market, where the best prospects for success seem to be, and common business practices.

A small business owner may be reticent about conducting market research before going global, particularly if domestic research efforts have been limited or nonexistent. However, the global market is a very different animal compared to the domestic market. It is even more important to conduct thorough market research to help identify possible risks in advance so that the appropriate steps can be taken to avoid mistakes. This ultimately portrays the business as forward-thinking, trustworthy, and credible.

- Several resources should be consulted. However, the best guide to exporting for the small business comes from the US government.
- The SBA is a great place to start to find information to help a business break into the global game. The information on exporting and importing is comprehensive and easily understood.
- The US government portal Export.gov provides online trade resources and one-on-one assistance for global businesses. Export.gov provides particularly helpful information on regulations, licenses, and trade data and analysis. Trade data can help a business identify the best countries to target for exports. A business can gauge the size of the market for a product or a service and develop a pricing strategy to become competitive.
- The US International Trade Commission offers market information, trade leads, and overseas business contacts. Trade professionals are available to help a business every step of the way with information counseling that can reduce costs, risks, and the mystery of exporting.
- The US Department of Commerce provides trade opportunities for US business, export-related assistance, and market information.
- Information about protecting intellectual property abroad can be found at http://www.stopfakes.gov. This is important because counterfeiting and piracy cost the world economy approximately $650 billion per year.

Other sources to be consulted include people in the same business or industry, industry-specific magazines, trade fairs, seminars, and export training and technical assistance that is available to small businesses through the states and the federal government. The Federation of International Trade Associations is a global trade portal that provides trade leads, market research, links to eight thousand import/export websites, and even travel services. WorldBid.com describes itself as the largest network of international trade marketplaces in the world, providing trade leads and new business contacts.

The Internet makes it possible to gather and view tremendous amounts of information. If a business is thinking seriously about going global, there is no better time to take advantage of this quick-and-easy access than now.

Business Assessment: Are You Ready?

It is important to honestly self-evaluate a business to determine whether it is really ready to go global or not… or at least not yet. If a business is thinking about expanding globally, it is probably already doing something right to have reached this point. However, that does not preclude the importance of assessing its strengths and its weaknesses to determine the approach that should be taken in the global market. This will be true no matter what role e-commerce plays in a business. Even a micromultinational business should assess its strengths and its weaknesses, although its instantaneous presence as a global business means that the assessment must be done at start-up and then must continue as products and services move from country to country.

There are several issues that should be addressed. The following are some of the questions that should be asked:

- Why is a business successful in the domestic market? What is its growth rate? What are its strengths?
- What products have export potential? Do the products fill a niche that is exclusive to the US market? Are they packaged in a way that can be understood by non-English-speaking consumers? Do they violate any cultural taboos or contain ingredients that will prohibit their sale in a foreign market? Identify the key selling features of the products, identify the needs that they satisfy, and identify any selling constraints.
- What are the competitive advantages of a particular business's products over other domestic and international businesses?
- What competitive products are sold abroad and by whom?
- Does the product require complementary goods and technologies? If so, who will provide them?
- How will the business provide customer service?
- Can production handle a wider demographic? Can the business increase output without sacrificing quality?
- Does the business have the money to market globally?
- Is the entire business (including all staff) committed to a global effort?

If a product is an industrial good, a business will want to know things such as what firms will likely use it, whether its use or life might be affected by climate, and whether geography will present transportation problems that will affect purchase. In the case of a consumer good, a business will want to know who will consume it; how frequently it will be purchased; whether it will be restricted abroad; whether climate or geography will negatively impact accessibility for purchase; and—perhaps most importantly—whether it conflicts with traditions, taboos, habits, or the beliefs of customers abroad.

A helpful tool to assess readiness is the export questionnaire available at www.export.gov/begin/assessment.asp. This questionnaire highlights characteristics common to successful exporters and identifies areas that need to be strengthened to improve export activities.

Marketing

Just as it is necessary to offer a different marketing mix for different target markets, it will generally be necessary to adapt the marketing mix to the global market in general and different countries in particular. A business's unique **value proposition** (the set of benefits offered to customers to satisfy their needs and wants consisting of some combination of products, services, information, and experiences) is what will differentiate one marketplace offering from the competition. Given the more diversified competition in the global marketplace, identifying the value proposition is even more critical—and most likely more difficult—than in the domestic market.



Figure 12.2.3.2: The Marketing Mix

Product

The ideal situation is when a product developed for the US market can be sold in a foreign country without any changes. Although some kinds of products can be introduced with no changes (e.g., cameras, consumer electronics, and many machine tools), most products usually have to be altered in some way to meet conditions in a foreign market. From a small business perspective, the owner will want to market products that do not require drastic changes to be accepted. Relatively minor packaging changes, such as size or the language on the package, can be made inexpensively, but more drastic changes should be avoided. If a product must be changed drastically to market it globally, conduct an in-depth cost analysis to determine whether the additional costs will outweigh the anticipated benefits. If a product is a food or a beverage, for example, is the business prepared to make the changes necessary to appeal to widely varying tastes?

Products need to be adapted for many reasons, including the following:

- Different physical or mandated requirements must be met (e.g., electrical goods will need to be rewired for different voltage systems).
- The legal, economic, political, technological, and climatic requirements of the local marketplace vary (e.g., varying laws will set specific packaging sizes and safety and quality standards).
- The product or the company name must translate flawlessly to the new target market so that it does not convey an unintended, perhaps very negative, meaning. One of the most well-known examples of a translation blunder is the Chevy Nova. In Spanish, “nova” means “no go.”
- The package label may need to be changed. Imagine the horror of a well-known baby food producer that introduced small jars of baby food in Africa when it found out that the consumers inferred from the baby picture on the jars that the jars contained ground-up babies. This shows us that even big companies can make big mistakes.

- A change in flavor or fragrance may be necessary to bring a product in line with what is expected in a culture. The pine and hints of ammonia or chlorine scents that are popular in the United States were flops in Japan because many Japanese sleep on the floor on futons. With their heads so close to the floor, a citrus scent is more pleasing.

The less economically developed a market happens to be, the greater may be the need for product adaptation. Research has found that only one in ten products can be marketed in developing countries without some kind of product adaptation.

Cultural Differences

It is important to know that cultural and social differences are intertwined with the perceived value and importance that a market places on a product. "A product is more than a physical item: It is a bundle of satisfactions (or *utilities*) that the buyer receives. These include its form, taste, color, odor, and texture; how it functions in use; the package; the label; the warranty; the manufacturer's and retailer's servicing; the confidence or prestige enjoyed by the brand; the manufacturer's reputation; the country of origin; and any other symbolic utility received from the possession or use of the goods. In short, the market relates to more than a product's physical form and primary function."

The values, customs, rituals, language, and taboos within a culture will determine the acceptability of a product or a service. Cultural sensitivity is particularly important in cyberspace. Website visitors may come from anywhere in the world. Icons and gestures that seem friendly to US visitors may shock people from other cultures. For example, a high-five hand gesture would be insulting to a visitor from Greece. Knives and scissors should not be given as gifts in South America because they symbolize the severing of a friendship.

The **psychological attributes** of a product (features that have little to do with the primary function of the product but add value to customer satisfaction, e.g., color, size, design, brand name, and price) can also vary across cultures, and the meaning and the value assigned to those attributes can be positive or negative. It may be necessary to adapt the nonphysical features of the product to maximize the positive meanings and eliminate the negative ones. When Coca-Cola, the number one global brand, introduced Diet Coke to Japan, it found that Japanese women do not like to admit to dieting. Further, the idea of diet was associated with medicine and sickness. Coca-Cola ended up changing the name to Coke Light. This happened in Europe as well, so if a product is associated with weight loss, a business must be very careful with its marketing.

The Package

The package for a product includes its design, colors, labeling, trademarks, brand name, size, product information, and the actual packaging materials. There are many reasons why a package may have to be adapted for a particular country. There may be laws that stipulate a specific type of bottle or can, package sizes, measurement units, extra heavy packaging, and the use of particular words on the label. In some cases, the expense of package adaptation may be cost prohibitive for entering a market. Consider the following examples:

- In Japan, a poorly packaged product is seen as an indicator of product quality.
- Prices are required to be printed on the labels in Venezuela, but putting prices on labels or in any way suggesting the retail price in Chile is illegal.
- A soft-drink company from the United States incorporated six-point stars as decoration on its package labels. But it had inadvertently offended some of its Arab customers who interpreted the stars as symbolizing pro-Israeli sentiment.
- Soft drinks are sold in smaller sizes in Japan to accommodate the smaller Japanese hand.
- Descriptive words such as giant or jumbo on a package or a label may be illegal in some countries.

The message here is clear. Before going global with a product, examine the packaging so that each element is in compliance with appropriate laws and regulations so that nothing will offend prospective customers.

Global Packaging

Canada's oldest candymaker, Ganong Brothers, is located about one mile from Maine. The company chairman, David Ganong, can see the US border from his office window. You would think it would be easy for Ganong Brothers to sell to the US market. Not so. In Canada, nutritional labels read *5 mg*, with a space between the number and the unit of measurement. Ganong's jellybeans cannot get into America unless the label reads *5mg*, without the space. This difference, as well as differences in Canada's nutritional guidelines, means that Ganong must produce and package its US products separately, which reduces its efficiency. Small

differences can and do have a significant effect on cross-border trade. This may be the reason why there is not as much trade between the United States and Canada as you would think. This notwithstanding, however, Canada remains the number one exporting destination for US small businesses.

The Business Website

As part of product preparations, a business will need to make its website ready for international business. Remember that the website is a very cost-effective way to sell a product or a service across borders. Here are four ways to ready the website:

1. **Internationalize website content.** A business must account for language differences, and cultural differences may require different graphics and different colors. One way to deal with the additional costs is to translate text or provide country-specific sites only for the country or countries where the most products are sold. One organization that provides resources to help businesses localize their products and resources is the Globalization and Localization Association.
2. **Calculate the buyer's costs and estimate shipping.** Shipping internationally will take longer, is more complicated, and will be more expensive than shipping domestically. Fortunately, there are shipping management software packages available that will automatically figure the costs and delivery times for overseas orders, giving a close estimate. Large shipping carriers, such as UPS and FedEx, offer such software; other companies include E4X Inc., eCustoms, and Kewill Systems Plc.
3. **Optimize site and search marketing for international web visitors.** With the increase in cross-border selling, websites can be optimized for visitors from specific countries, and techniques can be used to attract international visitors through search engines and search ads. This is a growing specialty among search marketers. A business should definitely check out the cost of hiring such a marketer as a consultant. It would be well worth the investment.
4. **Comply with government export regulations.** A business does not need government approval to sell most goods and services across international borders. There are, of course, notable exceptions. For example, the US government restricts defense or military goods, and agricultural, plant, and food items may have restrictions or special labeling requirements. Such restrictions should be addressed on the website. It may be necessary to restrict the sale of certain products to certain countries only.

Translation Blunders in Global Marketing

We often hear it said that something was lost in the translation. Here are some global marketing examples of translation blunders. Something important to note is that most of these blunders were committed by the "big guys," companies that are extremely marketing-savvy—proof positive that no one is immune from this kind of error.

- When Coca-Cola was first translated phonetically into Chinese, the result was a phrase that meant "bite the wax tadpole." When Coca-Cola discovered the error, the company was able to find a close phonetic equivalent that could be loosely translated as "happiness in the mouth."
- When Pope John Paul II visited Miami in 1987, an ambitious entrepreneur wanted to sell t-shirts with the logo, "I saw the Pope" in Spanish. The entrepreneur forgot that the definite article in Spanish has two genders. Instead of printing "El Papa" ("the Pope"), he printed "La Papa" ("the potato"). Needless to say, there was no market for t-shirts that read "I saw the potato."
- Sunbeam got into trouble when it did not change the name of its Mist-Stick curling iron when marketing it in Germany. As it turned out, "mist" is German slang for manure. Not surprisingly, German women did not want to use a manure stick in their hair.
- A proposed new soap called "Dainty" in English came out as "aloof" in Flemish (Belgium), "dimwitted" in Farsi (Iran), and "crazy person" in Korean. The product was dropped. The company either did not have the resources to research a new name or did not want to take the time and incur the costs to do so.
- Kellogg's Bran Buds sounded like "burned farmer" in Swedish.

Given that misunderstanding foreign languages can destroy a brand, it is worth the investment to hire someone who is proficient in the native language in the intended market—including the use of slang. This will help a small business avoid a fatal mistake because it does not have the resources of the big companies to fix the mistakes. This concern must be extended to the web presence as well because the website is an integral part of the product.

Price

Pricing for the global market is not an easy thing to do. Many factors must be taken into account, the first of which are traditional price considerations: fixed and variable costs, competition, company objectives, proposed positioning strategies, the target group,

and willingness to pay. Add to these factors things such as the additional costs that are incurred due to taxes, tariffs, transportation, retailer margin, and currency fluctuation risks; the nature of the product or industry, the location of production facility, and the distribution system; the psychological effects of price; the rest of the marketing mix; and the price transparency created by the Internet and a business can begin to appreciate the challenges of global price setting. About the only thing that can be seen as a certainty is that a small business should expect the price of its product or service to be different, usually higher, in a foreign market. The specifics of that difference need to be worked out carefully, with thorough analysis.

Setting the right price for a product or a service is critical to success. It will be a challenge to navigate the pricing waters of each different country—to learn why, for example, a product sells for $16 in the United States but $23 in Britain.

Place

As challenging as distribution may be for a small business in the domestic market, it is even more so for the global market. No matter the product, it has to go through a **distribution process**—the physical handling and distribution of goods, the passage of ownership or title, and the buying and selling negotiations between producers and middlemen and middlemen and customers. It would make sense to be able to take advantage of existing transportation systems, retailers, and suppliers to sell goods and provide services. Unfortunately, adequate distribution systems do not exist in all countries, so a business will need to develop ways to get products to customers in as cost-effective a manner as possible.

Before deciding on a channel or channels of distribution, a business needs information. The following are some basic questions as a starting point:

- Is the selected market dominated by major retailers or is the retail sector made up of small independent retailers?
- How many intermediaries will be involved? In Japan, for example, a product must go through approximately five different types of wholesalers before it reaches the final consumer.
- Can we use the manufacturer, wholesaler, retailer, or consumer channel or can we export directly to a retailer?
- Should we work with a foreign partner? Unless a business plans to establish a retail operation on foreign soil, it will need to establish business-to-business (B2B) sales relationships. Then products can be sold directly to foreign retailers or foreign distributors who will sell to those retailers. A foreign partner can provide valuable insights about local import regulations, product marketability, and local customs. The US Department of Commerce website contains directories of foreign buyers. Small businesses excel at forming strategic partnerships.
- Where can we attend a trade show or a trade mission? Going to these events can help a business find distribution channels.
- Is the Internet commonly used to distribute my product?

In the final analysis, the behavior of distribution channel members will be the result of the interaction between cultural, economic, political, legal, and marketing environments. A small business that is looking to go global—or is already there—will encounter channel structures that range from a minimally developed marketing infrastructure, such as in emerging markets, to highly complex, multilayered systems, such as in Japan.

When deciding to enter the global marketplace, a determination must be made as to whether the current channel structure in the selected country (or countries) will meet the business's needs or whether some additional arrangements will be needed. The means of distribution will necessarily be a country-by-country decision. No matter the arrangement, however, figure on the costs being greater than in the United States.

Promotion

It is understandable that a small business owner may want to use the same integrated marketing communications (IMC) programs used in the home market to inform customers in foreign markets and persuade them to buy. This "one voice" approach offers the advantage of enabling a business or a product to gain broader recognition in the global marketplace; it also helps reduce costs, minimize redundancies in personnel, and maximize the speed of implementation. However, things are not that easy. Cultural, social, language, and legal differences from country to country will usually make it necessary to modify IMC messages to not offend current or prospective customers. Modification is more of a challenge for the small business because the resources needed to make the changes are more limited.

A business communicates with its customers through some combination of its website, advertising, publicity, public relations, sales promotion, sales personnel, e-mail, and social media. The actual mix will be a function of the selected country or countries. For example, in some less-developed countries, the major portion of the promotional effort in rural and less-accessible parts of the market is sales promotion; in other markets, product sampling works especially well when the product concept is new or has a very small market share. In Saudi Arabia, there is an appreciation for fancy packaging, and point-of-sale advertising elicits the best reaction. However, the appropriateness of IMC activities for a small business will depend on the product being marketed, the industry in which it is competing, and the country in which it hopes to sell the product.

Of all the four Ps, decisions involving advertising are thought to be those most often affected by cultural differences in foreign markets. Consumers respond in terms of their culture, style, feelings, value systems, attitudes, beliefs, and perceptions. Because advertising's function is to interpret or translate the qualities of products and services in terms of consumer needs, wants, desires, and aspirations, emotional appeals, symbols, persuasive approaches, and other characteristics in an advertisement must coincide with cultural norms if the ad is to be effective.

Examples abound of international advertising mistakes that have offended different cultures. Three are presented here. Although they are linked to large corporations, there are lessons to be learned by small businesses. No business is immune from making mistakes from time to time.

- Burger King ran in-store ads for three restaurants in Spain that depicted the Hindu goddess Lakshami on top of a ham sandwich. The caption read, "a snack that is sacred." Many Hindus are vegetarian and were offended by the ad. Burger King pulled it.
- Burger King ran a campaign in Europe for the Texican Whopper that featured a lanky American cowboy; a short, round Mexican draped in a cape resembling Mexico's flag; and the caption, "the taste of Texas with a little spicy Mexican." There was an immediate uproar, with the Mexican ambassador to Spain objecting publicly.
- During a time when Fiat was trying to take advantage of auto sales growth in China, it released an ad in Italy in which actor Richard Gere drove a Lancia Delta from Hollywood to Tibet. The ad did not air in China, but it caused an online uproar nonetheless. Richard Gere is hated in China because he is an outspoken supporter of the Dalai Lama. His selection as the Fiat spokesperson was a major faux pas by Fiat.

The reality of international advertising is that its cost and the effort required to prepare and place the ads correctly may be prohibitive for most small businesses, therefore pushing the emphasis on other elements of the IMC mix. However, a business will not know that for sure until it does the proper research before making a decision. Consider the characteristics of the target market, how the market uses media in that country, and which media are actually available. Some countries do not have commercial television, and some do not have advertising in newspapers. There will be newspaper and magazine circulation differences from country to country; in countries with a low literacy rate, radio and television advertising (if available) will be more effective than print media.

Fortunately, small businesses that want to go global can look to social media for assistance. The social web is a low-cost way to catapult a small business brand into the global arena. Facebook, the most popular social networking site in the world, has developed a self-serve advertising tool that has created the greatest interest among small businesses that might not have had the means to launch a global advertising campaign before. This would be a good place to start—along with a map of the world's most popular media applications country by country and culture by culture, which is available at www.appappeal.com/the-most-popular-app-per-country/social-networking.

No matter the mix of the IMC program, and no matter whether a business is business-to-consumer (B2C) or B2B, the way a business communicates internationally will be a major determinant of success. Each IMC component is a communication channel in its own right. A business must consider the appropriateness of each message in each channel. For example, is the message adequate? Does it contain correct cultural interpretations? Are the colors and graphics right? In the case of advertising, have the media been chosen that match the behavior of the intended audience? Have you correctly assessed the needs and wants or the thinking processes of the target market?

Careful consideration of these and other communication issues will not guarantee success, but it should help reduce the chances of making a major marketing blunder.

Legal and Political Issues

It is impossible for any small business to know all the laws that pertain to exporting from the United States. Thus it is important to consult an attorney who is knowledgeable about the legal implications of globalization: international trade laws, tax laws, local regulations, international border restrictions, customs rules, and duties and taxes.

To varying degrees, each small business must be concerned with the following. However, this list is not exhaustive; it is a sampling only.

- The Foreign Corrupt Practices Act makes it illegal for companies to pay bribes to foreign officials, candidates, or political parties. The challenge for all US businesses is that bribery is a common business practice in many countries, even though it is illegal. Interestingly, private business bribes are tax deductible in Germany as long as the German businessperson discloses both his or her identity and the recipient of the bribe(s). Although it is supposedly rarely used, it is available.
- Specific licenses and permits are required or additional paperwork must be completed if the following specific products are exported or imported: agricultural products, automobiles (not a likely product for a small business), chemicals, defense products, food and beverage products, industrial goods, and pharmaceutical and biotechnology products.
- There is heightened sensitivity since September 11, 2011, about exporting products that could even remotely be used in a military or a terrorist capacity.
- Brand names, trademarks, products, processes, designs, and formulas are among the more valuable assets a small business can possess. These need to be protected—domestically and internationally. US officials estimate that $300 billion of intellectual property assets are ripped off every year.
- There are commercial laws within countries related to marketing, environmental issues, and antitrust.

In addition to legal considerations, no small business can conduct global business without understanding the influence of the political environments in which it will be operating. Every nation has the sovereign right to grant or withhold permission to do business within its political boundaries and control where its citizens do business, so the political environment of countries is necessarily a critical concern to any small business. Political issues include the stability of government policies (a stable and friendly government being the ideal), the forms of government (with some being more open to foreign commerce than others), political parties and their influence on economic policy, the degree of nationalism (the greater the nationalism, the greater the bias against foreign business and investments may be), fear and/or animosity that is targeted toward a specific country, and trade disputes. One or all these things create political risk that must be assessed. The most severe political risk is confiscation, the seizing of a company's assets without payment.

Currency Exchange Issues

The **exchange rate** is the rate at which one country's currency can be exchanged for the currency of another country. For example, assume that on a particular day, $1 exchanged for 0.75643 euros and 49.795 Indian rupees. These exchange rates then changed the next day, when $1 exchanged for 0.6891 euros and 49.845 Indian rupees, meaning that the value of the US dollar *increased* in value with respect to the euro and *decreased* in value against the Indian rupee. Currency exchange rates change daily, and they are important because currency fluctuations can present additional problems for the small business looking to go global. The appreciation and depreciation of a currency will have an effect on the prices of goods and services. For example, as the dollar declines in value against the euro, the price of goods and services from the European Union for US customers will increase, likely reducing their purchases. The following are other implications of exchange rate fluctuations:

- Inattention to exchange rates in long-term contracts could result in large unintended discounts.
- Rapid and unexpected currency fluctuations can make pricing in local currencies very difficult.
- Shifts in exchange rates can influence the attractiveness of various business decisions, not the least of which is whether doing business in a particular country is worthwhile.

Different strategies may be needed when the dollar is weak versus when it is strong. For example, when the US dollar is weak, a business should stress price benefits. When the dollar is strong, a business can engage in non-price competition by improving quality, delivery, and after-sale services. To navigate these challenging currency exchange waters, it will be necessary to tap into accounting and finance expertise.

Sources of Financing

How a business finances an export project is often a critical factor in its success. Financing decisions extend to working capital and export transactions. Working capital is needed to finance operations before and after a sale, and money is needed to sustain a business until it is paid for the goods and services that have been provided (export transactions). The International Trade Association in the US Department of Commerce identifies the following factors as important to consider when making financing decisions.

- **The need for financing to make the sale.** Offering favorable payment terms can make a product more competitive.
- **The length of time the product is being financed.** The term of the loan required determines how long a business will have to wait before the buyer pays for the product, which will influence the choice of how to finance the transaction.
- **The cost of different methods of financing.** Interest rates and fees will vary, and a business should probably expect to assume some of the financing costs. Before providing an invoice to the buyer, a business must understand how these costs will affect price and profit.
- **The risks associated with financing the transaction.** The riskier the transaction, the more difficult and costly it will be for a business to finance it because there will likely be a higher chance for default. The level of risk will be influenced by several things, not the least of which is the political and economic stability of the buyer's country. In risky situations, the financing provider may require the most secure method of payment—a letter of credit or export credit insurance.
- **The need for pre-shipment financing and post-shipment working capital.** Working capital could experience unexpected and severe strains with the production of an unusually large order or a surge of orders. Inadequate working capital can limit exporting growth—even during normal periods.

Where to Go

Small businesses have reported that problems with access to financing for their exporting operations are a major barrier to exporting. The difficulties they experience in obtaining both trade finance and working capital often prevent small businesses from financing purchases by foreign buyers. This encourages foreign buyers to choose suppliers that are able to extend credit. Small businesses must also face the perception of lending institutions that they are a higher risk than larger companies coupled with a lack of familiarity with exporting by community banks.

Despite any anticipated difficulties, small businesses need to find export financing. They can look for financing in several places. The first place to look is internally. Does it already have the funds to finance global efforts? If the answer is yes, then all is well. This was the case for Center Rock, the small business featured at the beginning of this chapter. If the answer is no, which will most likely be the case, it will be necessary to look for external financing. A range of options is available for small businesses to consider. As you will see, most financing sources are available from the government. A small business must become familiar with the financing, insurance, and grant programs that are available to help it finance transactions and carry out export operations.

Table 12.2.3.3: Sources of Export Financing for the Small Business

Source	Information
Extending credit to foreign buyers working with commercial banks	Liberal financing can enhance export competitiveness, but extending credit must be weighed carefully. Some commercial bank services used to finance domestic business, including revolving lines of credit for working capital, are often needed to finance export sales until payment is received. However, commercial banks prefer to establish an ongoing business relationship instead of financing solely on the basis of an individual order. Most US banks do not lend against export orders, export receivables, or letters of credit.
Export Express 7(a) Loan Programs	Offered by the SBA, this streamlined program helps small businesses develop or expand their export markets. A business may be able to obtain SBA-backed financing for loans and lines of credit up to $500,000.
Export Working Capital Program (EWCP) 7(a) Loan Programs	This SBA loan program targets small businesses that are able to generate export sales but need additional working capital to support these sales. The SBA provides lenders guarantees of up to 90 percent on export loans to ensure that qualified exporters do not lose viable export sales due to a lack of working capital.
International Trade Loan Program 7(a) Loan Programs	Loans are available for businesses that plan to start or continue exporting or have been adversely affected by competition from imports. The loan proceeds must enable the borrower to be in a better position to compete. The program offers borrowers a maximum SBA-guaranteed portion of $1.75 million.
Export-Import Bank	An independent federal agency that provides working capital loan guarantees, export-credit insurance, and other forms of financing for US exporters of all sizes. The funds are aimed at offsetting the added risks of doing business abroad, from complex trade rules to unpaid bills.
Using export intermediaries	Many export intermediaries, for example, trading companies and export management companies, can help finance export sales. The intermediaries may provide short-term financing or may purchase the goods to be exported directly from the manufacturer, thus eliminating any risks to the manufacturer that are associated with the export transaction as well as the need for financing.

KEY TAKEAWAYS

- Expanding into global markets introduces new complexities into small business operations.
- The decision to go global should be based on an assessment of the ways to export, an analysis of the industry and a particular company, marketing and cultural factors, legal and political conditions, currency exchange rates, and sources of financing.
- There are two basic ways to export: direct or indirect. In direct exporting, a small business exports directly to a customer who is interested in buying the product. Indirect exporting involves using a middleman for marketing and selling the product in the target market.
- Industry analysis involves looking at where an industry currently is and the trends and directions predicted over the next three years so that a business can try to determine how competitive an industry is in the global market.
- It is important to honestly self-evaluate a business to determine whether it is ready to go global or not.

- It will generally be necessary to adapt the marketing mix to the global market in general and different countries in particular.
- Legal issues include international trade laws, tax laws, and local regulations.
- No small business can conduct global business without understanding the influence of the political environments in which it will be operating.
- Currency exchange rates are important because currency fluctuations can present additional problems for a small business that is looking to go global. In particular, the appreciation and depreciation of a currency will have an effect on the prices of goods and services.
- How a business finances an export project is often a critical factor in its success.
- Working capital is needed before and after the sale, and money is needed until the goods and services that have been provided have been paid for.
- Many—perhaps most—of the sources for small business exporting activity are governmental.

EXERCISES

1. Comment on the following: a small business owner firmly believes that because a product is successful in Chicago, Illinois, it will be successful in Tokyo or Berlin. Be as specific as you can in your comments.
2. There has been tremendous growth in online business, which has introduced new elements to the legal climate of global business. Patents, brand names, copyrights, and trademarks are difficult to monitor because there are no boundaries with the Internet. What steps could a small business take to protect its trademarks and brands in this environment? Prepare at least five suggestions.
3. Find a local small business that exports its products. Talk to the owner about his or her experiences. Ask questions such as the following: What convinced you to export? How did you decide on the product(s) to export? Did you have to adapt your product(s) in any way? What were the greatest barriers you had to face?

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12.3: Strategies for Expanding Globally

Learning Objective

- What are the main strategies that companies can use to go international?

In the previous sections, you have learned about the need for a serious international management student to appreciate how countries differ and some possible ways to address these differences. Any company involved in business today also needs to understand the global business environment and how it can play a role in this environment. In the final two sections of the chapter, we look at the three main strategies available to companies as they internationalize and learn how companies can use these strategies to enter global markets.

Global Strategy

Companies can choose to pursue one of three main strategies:

- A **global strategy**, whereby all operations and activities are managed fairly similarly worldwide
- A **regional strategy**, whereby activities and operations are adapted to regional requirements
- A **local strategy**, whereby the company's operations are adapted to fit specific countries.

Global Strategy

A global strategy is based on the assumption that the world is extremely interconnected and that patterns of consumption and production are fairly homogeneous worldwide.[30] In such cases, the company simply extends its domestic strategy to the global arena.

Global strategies represent a potential solution to reduce costs. Using standardized products and processes in each of the markets it enters allows a company to possibly achieve economies of scale and scope. The global company will scan the world for opportunities and respond by expanding into those areas where there is potential. Furthermore, it will deploy those activities worldwide depending on where most value is achieved.

A good example of a global strategy is the one pursued by Ford Motor Company. Ford has decided that electric cars will be the vehicles of the future, and it is therefore pursuing a "global electrification strategy," whereby it will use a global platform across many different models and styles. For instance, Ford is now using the "C-platform" to make a variety of vehicles ranging from compact cars (e.g., the Ford Focus) to larger five-passenger cars (e.g., the C-Max). This platform can also be used to build hybrid electric and battery electric cars.



Figure 12.3.1: Electric and Hybrid Vehicles. In addition to Ford, many automobile manufacturers have taken a strategic decision to provide electric and hybrid vehicles for the global market. Pictured here is the Toyota Prius hybrid electric vehicle. Toyota takes a regional approach to its global operations. (Credit: Mariordo59/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Why do some companies pursue global strategies? One major reason is the nature of the industry in which they operate. For instance, the automotive industry lends itself to global approaches because the use of the product and the product being sold are similar worldwide. Thus, if there is the possibility of global markets where global customer needs can be met, a global strategy works well. Additionally, as mentioned earlier, a global strategy also enables cost savings. Because activities are not being adapted to local needs, a company can enjoy the benefits of having the same operations worldwide and enjoying synergistic benefits.

Current discussion of research suggests that few companies are truly global. A recent examination of the Fortune Global 500 companies found that only nine companies were truly global as measured by how sales were globally distributed across a number of countries. These companies include Canon, Coca-Cola, Flextronics, IBM, Intel, LVMH, Nokia, Philips, and Sony.

Regional Strategy

A regional strategy is one in which the company decides that it makes sense to organize its functional activities, such as marketing, finance, etc., around geographical regions that play a critical role in terms of sales. Toyota is an example of a company that has successfully implemented a regional strategy. Because regions such as Europe and North America are sufficiently large but different markets, Toyota has decided that it is worth customizing its operations by regions. In this case, the company has several regional offices that operate independently of Japanese headquarters.

A regional strategy is appropriate if companies find that the benefits from dispersing their activities far outweigh the benefits of coordination. For Toyota, having independent units based on regions makes a lot of sense because each region has specific needs that can better be addressed with a regional rather than a global approach. For instance, consider that the price of gasoline is significantly higher in Europe than in the United States. Using a regional approach to the design and manufacture of more- or less-fuel-efficient cars makes much more sense than having a “one size fits all” car designed for a global market.

Local Strategy

The local strategy is the one in which a company adapts its products to meet the needs of the local market. For instance, experts argue that despite the perception that customers want global products, significant cultural and national value differences still suggest that some level of customization is necessary. This is especially critical for some functional areas, such as marketing. People across cultures have different purchasing and usage habits. Furthermore, they respond differently to promotional campaigns and other advertising messages. In such cases, a local strategy may be necessary.

An example of a local strategy is McDonald's product offerings in India. Given the taste and vegetarian preference of India as well as the consideration that cows are sacred, the company famous for its hamburgers does not offer any beef or pork products. Rather than offend its customers, McDonald's restaurants in India offer burgers made of potatoes and peas (McAloo Tikki); burgers made of beans, green peas, onions, and carrots (McVeggie); and burgers made of paneer, India's cheese (McSpicy Paneer). The only meats that McDonald's sells at its restaurants in India are chicken (McChicken) and fish. Furthermore, the products are adapted to fit the local preference for spicy foods, and offerings such as the Masala Grill chicken and the McSpicy Chicken.

Despite the attractiveness of a local strategy, it is not without disadvantages. The local strategy is much more costly because it requires companies to duplicate resources and departments around the world. Additionally, because of the differences in local activities and operations, it may be difficult for the company to achieve learning or cost savings across subsidiaries. The nature of some markets, however, may require that a local strategy be adopted.

MANAGERIAL LEADERSHIP

From Regional to Global

Bayer Crop Science is a division of Bayer, a leading global company based in Leverkusen Germany. The Crop Science division's main goal "is to be able to produce enough food, feed, fiber and renewable raw materials for a growing world population on the limited land available."[33] It has been involved in many of the latest innovations in agriculture, such as developing apps for farmers to help them understand their crops, climates, and so on and developing the ability to use drones to assess crop quality.

One of Bayer Crop Science's units is the Global Public and Government Affairs (GPGA) division, which is in charge of monitoring and proactively complying with local government policies. In 2012, Bayer Crop Science had a large number of independent country GPGA divisions that acted independently, thereby limiting collaboration and cooperation. As a result of this regional strategy as described earlier, critical information about policy priorities from different regions was slow to reach headquarters, and Bayer Crop Science was not able to quickly address policy challenges worldwide.

In 2013, Bayer Crop Science hired Lisa Coen to implement a more global strategy in the GPGA division.34 Her main task was to make the GPGA division a truly global organization. To accomplish her task, she first travelled extensively around the world to meet with the business unit leaders and the public affairs team members. Through this process, she wanted to engage with the key stakeholders to prevent any resistance to change from building up. During these meetings, she discovered that the various local and regional GPGA units had deep knowledge that would greatly help Bayer Crop Science face and manage public policy issues all over the world. The meetings also allowed her to come up with the best strategy to turn the various regional units into a global unit.

To build a more collaborative organization, Coen had to move from a traditional and hierarchical organization based on regions to a globalized network of units. To demonstrate the need for such a system, Coen invited key individuals to a global meeting to work collectively on public policy issues. Through this exercise, she was able to show the group the critical importance of a network organization. Through team-building exercises, Coen showed how the entire group had to move around to meet with the key people in each region. This interaction allowed the group to commit to a network model that would support and build a global organization.

Discussion Questions

1. Why did Bayer Crop Science decide to move from its original regional organization of units to a more global network of units? What were the advantages and disadvantages of this approach?
2. How did Coen build support for the change? Do you believe this was an appropriate way?
3. What challenges do you anticipate as Coen continues to build a network organization?

Summary

Companies choose international strategies based on their capabilities and skills as well as on the structure and nature of the industry in which they operate. Companies choose regional strategies if they feel that the regions have differences significant enough to justify such an approach. In contrast, companies elect a global strategy if they believe they have global products that can satisfy global consumer needs.

It is important to note, however, that companies rarely adopt the pure forms of strategy as we've described them. Many companies adopt hybrid structures, where some functional areas may be approached globally while other activities may be approached more regionally or locally.

CONCEPT CHECK

How and why do companies take various approaches to global operations?

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504 Gateway Timeout ERROR

The request could not be satisfied.

We can't connect to the server for this app or website at this time. There might be too much traffic or a configuration error. Try again later, or contact the app or website owner.
If you provide content to customers through CloudFront, you can find steps to troubleshoot and help prevent this error by reviewing the CloudFront documentation.

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Generated by cloudfront (CloudFront) HTTP3 Server
Request ID: LKLpWO5hyPoYjpx3gNanFKe9d3AuTnytGQSPcZTj0hcC4e8CaaOXzg==
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13.1.5: Managing, Following, and Adjusting the Initial Plan

Learning Objectives

By the end of this section, you will be able to:

- Explain the difference between a business plan and a lean plan
- Know how to develop a lean plan quickly and accurately
- Run the build-measure-learn loop

In this chapter, we've discussed how to start the imperfect business using the lean startup approach. We've looked at the build-measure-learn loop and how to test an MVP. We've also covered how to deal with fear of failure and how to overcome negative thinking. In addition, we've covered how minorities can tap into resources to help them be successful. Now it's time to build the lean plan to help you launch your venture.

As you must realize, having a lean plan is important to executing its process. A **lean plan** follows the path of lean methodology. It is a brief business plan shown to potential investors and employees that is a fast and effective way to set, manage, and evaluate goals and strategies in a business. Figure 13.1.5.1 shows its components.

Traditionally, a business plan requires a detailed document of the company's background, the target, objectives, financials, and marketing strategies. Developing this usually takes a long time, from a few months to a year. A full business plan requires robust information as it's developed for internal purposes, for banks or investors who need proof that the business is a good investment, and for other stakeholders. In contrast, a lean plan is short and includes only specific information, sufficient to go through the build-measure-learn loop. This plan is where you clarify initial ideas about the product to help you work through the loop and to share with potential investors and employees who need only so much information to decide on their role in the project.

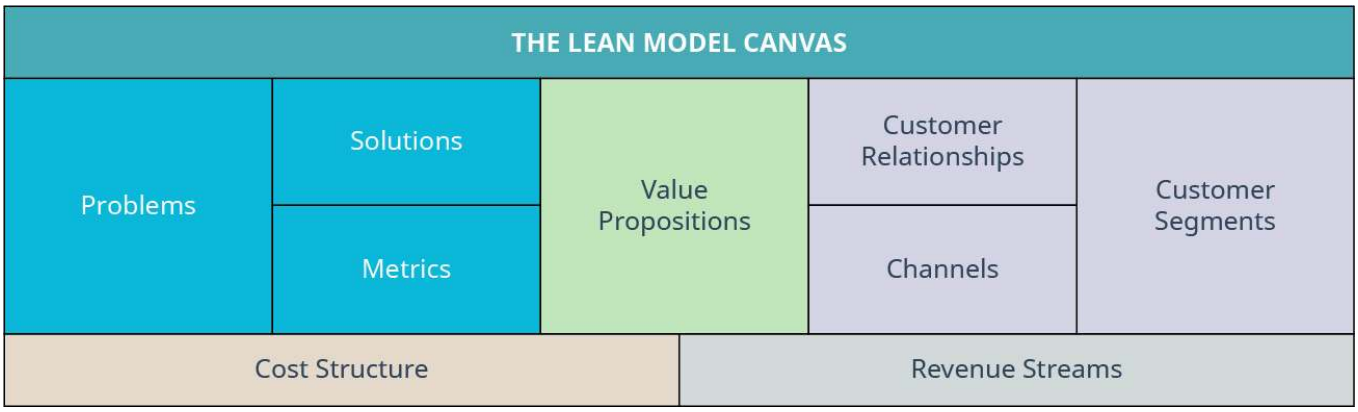


Figure 13.1.5.1: The founders of a business create a lean plan to help them set expectations and goals. (CC BY 4.0; Rice University & OpenStax)

Developing a Lean Plan

As mentioned earlier, a lean plan uses lean methodology. This type of planning begins by drafting a short living set of lists to guide you, meaning you can update it as you go. The plan shouldn't take months to develop; you can set it up in a few days. The plan focuses on the business core, so only important details about marketing, the business model, finances, the build-measure-learn loop, and the MVP are added to it.

The following is a list of basic procedures and details to include in a lean plan.

1. Write a short and simple document.
2. Test your MVP through the build-measure-learn loop.
3. Review your results.
4. Revise your plan.

Once these steps are complete, the entrepreneur can start or continue the venture.

Write a Short and Simple Document

This plan does not need to include an executive summary, a company background, or team information. It is literally a short pitch that you can use to share with investors and potential partners. Focus on what is important and include the following:

- Basic strategies for product, price, place, promotion; add people, physical environment, and process if it is a service
- Basic strategies for target market and positioning
- Day-to-day tactics, which include specific tasks or actions that will get an objective done
- A schedule with dates for acquiring needed licenses, launch date, and when to review and revise the plan
- A business model that details how you will make money
- A basic forecast of sales, costs, profit, and break-even analysis

This plan is just a bare bones list of things that need to get done and by whom. It also includes a timeline, a cost, and a reward. It is less like a traditional document and more a series of lists and bullet points. In this case, the entrepreneur is only writing down the essentials of the business to achieve the goal at hand. Later on, when a document is needed for outside stakeholders or bank loans, then a full plan can be developed with research and details about the market, the environment, trends, and strategies that are more fleshed out.

For example, an entrepreneur who is just opening a prosthetics company can start a lean plan by describing its main product, which can focus on creating custom prosthetics for children. Then it can add a basic price or range of prices for its basic product since it's a custom product, and it will probably vary in price from customer to customer. Another strategy to keep in the plan is where to conduct the business. A central location would probably be a good idea, especially close to doctors and hospitals. Finally, basic promotional strategies used in reaching out to this market, which can include speaking to children's hospitals and local doctors who can refer the patients to the company, can also be listed. In addition, the entrepreneur may decide to create a basic website, online ads, and simple brochures to give information to potential customers. Once all the strategies are laid out, then the timelines can be added from the inception until the launch date, which includes assignments for everyone who will be in charge of the activities in this new business. These can include an office manager, the prosthetist, and a marketer.

Next, the entrepreneur may detail how the money will be made. Will the new business charge the client directly for the product? How about accepting insurance and co-payments? These are questions that need to be written down. Then a basic forecast of the market demand will help forecast sales, expenses, and profit.

Test Your MVP through the Build-Measure-Learn Loop

Once the lean plan has been put into place, the next step is to execute it and test the MVP through the build-measure-learn loop. Here is where the rubber will meet the road, and all the assumptions that were made in the plan will be tested in real life.

- Build your MVP.
- Test your idea by sharing it with potential customers.
- Measure results by talking to customers and recording feedback.
- Ask questions such as: Are we building a product people want? What benefits do we need to add? Is this our target market?
- Test different versions and cohorts of users.

In our example, the entrepreneur will have a chance to build the prosthetics and ask questions that will help create a better product over time. At this time, the entrepreneur might find out that the product can be expanded to include orthotics and not just prosthetics, and perhaps that adults can also be included in the market.

Review Your Results

This step should be done at least once a month, where customer feedback, marketing, and outcomes are thoroughly reviewed. This is a great opportunity for the entrepreneur to assess if goals have been met and identify areas for improvement. However, many times, you will encounter that reviewing results can stir resistance from employees (if there are any), as they may become tired of planning, having meetings about planning, and demonstrating results. The reviewing process can inspire some fear or negative feelings over concerns of being blamed, but as a leader, you must always assure them that this process helps them get better at what they do and gives them the information and tools necessary to make the changes that will steer the business onto a more successful path. This is about managing the results and not being deterred by them.

- Review customer feedback and go back to your plan to compare.
- Review target market, 7Ps of marketing, features, and benefits.
- Review numbers or outcomes, which may include sales, profit, customer signups, and even customer reactions to advertisements and product attributes.

In our example, if the prosthetics business is not bringing in enough customers to sustain it, then this is the opportunity to see where issues exist so changes can be made to the lean plan.

ARE YOU READY?

A Lean Scooter Plan

You are interested in opening a new electric scooter business in your small city, as there is no competition. You would like to enable your small town to have smart mobility that is environmentally conscious while reducing dependence on regular transportation such as buses and vehicles.

- Create a lean plan that details how you plan to start your business.

Revise the Plan

Make changes to the plan as needed. Once metrics have been measured against results, marketing is tested and measured, and customer feedback is received, then it is time to revise the plan and make adjustments. This can take the form of adding a feature to the product, adding new products, changing promotional tactics, or communicating differently with customers and consultants.

If there aren't enough customers to sustain the prosthetic business, here is where the founders can make changes to correct course. It may be that customers are not aware of the business, or there aren't enough pediatric customers and perhaps adults can be added to the target market. Once the plan is revised and the resulting changes are made, the business can continue and the process of testing restarts. As you can see in Figure 13.1.5.2, this is a continuous process. It requires constant updating and cooperation from everyone involved in the business. Once the process is set up, then it is easier to maintain it and see it as necessary within the business that helps it grow.

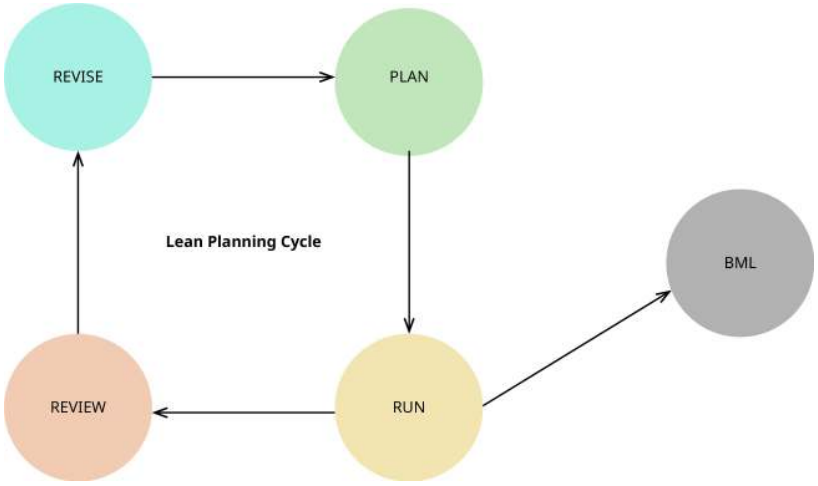


Figure 13.1.5.2: The lean plan cycle for small businesses. (CC BY 4.0; Rice University & OpenStax)

Tim Berry—entrepreneur, former Apple employee, writer, and now a lean startup guru—advises businesses on the art of lean planning, as he does not like long planning himself and has little patience for extensive plans and coding. For Berry, lean planning does not contain elaborate information and details that are unnecessary for the business to run. It is not a document per se, but an assortment of short bullet points, some lists, and tables. For Berry, the most important steps to lean planning are to have the following:

1. A lean strategy or plan in place
2. Execution of the plan (or run it like in the Figure 13.1.5.2)
3. Review of the results and check against milestones

4. Revision of the plan—change what didn’t work and start the whole process again

ARE YOU READY?

Developing a Lean Plan

A local entrepreneur owns a print shop that has been in business for 20 years. The owner focuses mainly on printing business cards, flyers, posters, brochures, and banners for local businesses. He has noticed that his sales have been declining for the past five years because promotions have been evolving into digital ads, social media, and other Internet marketing techniques rather than printed material. He will need to innovate if he wants to stay in business.

Last week, he came to see one of your entrepreneurship professors to ask for a student or someone to help him. Since you aced the class, your professor thinks that you can show him how to develop a lean plan, and he offers you an internship. You accept gladly and begin to work on the project.

- Develop a lean plan and explain to the owner how this can help him grow in the next three years.

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13.1.12: Suggested Resources

13.1.12.2 Launching the Imperfect Business: Lean Startup

Lean startup: http://theleanstartup.com/#principles

Toyota's Way: vimeo.com/44328452

14 Management Principles of Toyota: http://www.panview.nl/en/lean-produc...-liker-summary

Innovation accounting video: https://www.inc.com/eric-ries/entrep...st-growth.html

13.1.12.3 Why Early Failure Can Lead to Success Later

Global Entrepreneurship Monitor: http://www.gemconsortium.org/

13.1.12.4 The Challenging Truth about Business Ownership

Asian American Chamber of Commerce: http://www.asian-americanchamber.org/

Black Chamber of Commerce: https://www.nationalbcc.org/

Hispanic Chamber of Commerce: https://ushcc.com/

Ladies Who Launch: https://www.ladieswholaunch.org/

Minority Business Development Agency: https://www.mbda.gov/

National Association of Professional Women: http://womenforhire.com/company/nati...al-women-napw/

National Association for Women Owners: https://www.nawbo.org/

Small Business Agency: https://www.sba.gov/

The Female Entrepreneur Association: https://femaleentrepreneurassociation.com/

Women's Business Center at SBA: https://www.sba.gov/tools/local-assistance/wbc

Women's Business Enterprise National Council: https://www.wbenc.org/

13.1.12.5 Managing, Following, and Adjusting the Initial Plan

Tim Berry's Lean Business Planning Guide: https://leanplan.com/

13.1.12.6 Growth: Signs, Pains, and Cautions

International Franchise Association: https://www.franchise.org/

US Small Business Administration Licenses and Permits: https://www.sba.gov/business-guide/l...censes-permits

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SECTION OVERVIEW

13.2: Management and Leadership in Today's Organizations

Learning Objectives

After reading this chapter, you should be able to answer these questions:

- What is the role of management?
- What are the four types of planning?
- What are the primary functions of managers in organizing activities?
- How do leadership styles influence a corporate culture?
- How do organizations control activities?
- What roles do managers take on in different organizational settings?
- What set of managerial skills is necessary for managerial success?
- What trends will affect management in the future?

13.2.1: Introduction

13.2.2: The Role of Management

13.2.3: Planning

13.2.4: Organizing

13.2.5: Leading, Guiding, and Motivating Others

13.2.6: Controlling

13.2.7: Managerial Roles

13.2.8: Managerial Skills

13.2.9: Trends in Management and Leadership

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13.2.1: Introduction

EXPLORING BUSINESS CAREERS

Jalem Getz

BuyCostumes.com/Wantable, Inc. You might ask, “How does one come to work in the world of online costume retail?” A passion for holiday make-believe and dress-up? A keen eye for business potential? The drive to capitalize on a competitive advantage? If you’re Jalem Getz, the answer is: all of these. Getz is the founder of BuyCostumes.com, an online costume and accessories retailer and, most recently, founder of Wantable, Inc.

As with most businesses, BuyCostumes.com and Wantable, Inc., are the result of careful planning. BuyCostumes.com was a response to what Getz saw as inherent flaws of resource allocation with the business model of brick-and-mortar costume retailers. “As a brick-and-mortar business, we were the gypsies of retail, which caused scale problems since we started over every year. Because we only were in a mall four or five months a year, locations we had one year often were rented the next. So we had to find new stores to rent each year. Then we had to find management to run the stores, and train employees to staff them. We also had to shuffle the inventory around each year to stock them. It’s almost impossible to grow a business like that.” By turning to the internet, however, Getz was able to bypass all of those issues. The virtual “space” was available year-round, and inventory and staff were centralized in a single warehouse location.

Getz grew BuyCostumes.com to a multimillion-dollar business before selling it, with a staff of about 600 employees during its peak season. Before Getz sold the business, it carried over 10,000 Halloween items and had upwards of 20 million visitors each holiday season. In one year, it shipped over 1 million costumes across the world, including 45 countries outside the United States. “We say that our goal is to ensure that anytime anyone buys a costume anywhere in the world, it will be from BuyCostumes.com. And, although to some extent we’re kidding, we’re also very serious.”

To keep track of all this action, Getz mixed ideals of a strong work ethic, a willingness to take risks, and an interest in having fun while making a profit. Given the size of the company, BuyCostumes.com organized its management to help keep the company focused on the corporate goal of continued growth. For Getz, his role in the management hierarchy was to “hire excellent people who have similar goals and who are motivated the same way I am and then put them in a position where they can succeed.” Beyond that? “Inspect what you expect.” This maxim is a concise way to say that, although he does not believe in constantly watching over his employees’ shoulders, he does believe in periodically checking in with them to ensure that both he and they are on the same page. By considering the process of management a conversation between himself and his employees, he exhibits a strong participative leadership style.

Getz will joke that he wishes he could say that he spent his childhood dreaming of the day he could work with costumes. The truth, though, is that he saw an opportunity, grabbed it, and hasn’t let go since. And sometimes, especially during Halloween, truth can be even more satisfying than fiction.

After selling BuyCostumes.com, Getz experimented with other digital start-ups but quickly realized he worked best with retail. In 2012, he launched Wantable, Inc., an online personal shopping service. In its first four years, Getz led the company to exceed 28,000% annual revenue growth and to hire more than 100 employees. It became profitable in 2016 and looked to double its income the following year.

Today’s companies rely on managers to guide daily operations using human, technological, financial, and other resources to create a competitive advantage. For many beginning business students, being in “management” is an attractive but somewhat vague future goal. This vagueness is due in part to an incomplete understanding of what managers do and how they contribute to organizational success or failure. This chapter introduces the basic functions of management and the skills managers need to drive an organization toward its goals. We will also discuss how leadership styles influence a corporate culture and highlight the trends that are shaping the future role of managers.

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13.2.3: Planning

What are the Four Types of Planning?

Planning begins by anticipating potential problems or opportunities the organization may encounter. Managers then design strategies to solve current problems, prevent future problems, or take advantage of opportunities. These strategies serve as the foundation for goals, objectives, policies, and procedures. Put simply, planning is deciding what needs to be done to achieve organizational objectives, identifying when and how it will be done, and determining who should do it. Effective planning requires extensive information about the external business environment in which the firm competes, as well as its internal environment.

There are four basic types of planning: strategic, tactical, operational, and contingency. Most of us use these different types of planning in our own lives. Some plans are very broad and long term (more strategic in nature), such as planning to attend graduate school after earning a bachelor's degree. Some plans are much more specific and short term (more operational in nature), such as planning to spend a few hours in the library this weekend. Your short-term plans support your long-term plans. If you study now, you have a better chance of achieving some future goal, such as getting a job interview or attending graduate school. Like you, organizations tailor their plans to meet the requirements of future situations or events. A summary of the four types of planning appears in Table 13.2.3.1.

Strategic planning involves creating long-range (one to five years), broad goals for the organization and determining what resources will be needed to accomplish those goals. An evaluation of external environmental factors such as economic, technological, and social issues is critical to successful strategic planning. Strategic plans, such as the organization's long-term mission, are formulated by top-level managers and put into action at lower levels in the organization. For example, when Mickey Drexler took over as CEO of J.Crew, the company was floundering and had been recently purchased by a private equity group. One of Drexler's first moves was to change the strategic direction of the company by moving it out of the crowded trend-following retail segment, where it was competing with stores such as Gap, American Eagle, and Abercrombie and back into the preppie, luxury segment where it began. Rather than trying to sell abundant inventory to a mass market, J.Crew cultivated scarcity, making sure items sold out early rather than hit the sale rack later in the season. The company also limited the number of new stores it opened during a two-year span but planned to double the number of stores in the next five to six years. Drexler led the company through public offerings and back to private ownership before bringing on a new CEO in 2017. He remained chairman with ownership in the company.

Table 13.2.3.1: Types of Planning

Type of Planning	Time Frame	Level of Management	Extent of coverage	Purpose and Goal	Breadth of Content	Accuracy and Predictability
Strategic	1–5 years	Top management (CEO, vice presidents, directors, division heads)	External environment and entire organization	Establish mission and long-term goals	Broad and general	High degree of uncertainty
Tactical	Less than 1 year	Middle management	Strategic business units	Establish mid-range goals for implementation	More specific	Moderate degree of certainty
Operational	Current	Supervisory management	Geographic and functional divisions	Implement and activate specific objectives	Specific and concrete	Reasonable degree of certainty
Contingency	When an event occurs or a situation demands	Top and middle management	External environment and entire organization	Meet unforeseen challenges and opportunities	Both broad and detailed	Reasonable degree of certainty once event or situation occurs

CATCHING THE ENTREPRENEURIAL SPIRIT

Changing Strategy Can Change Your Opportunities

Since 1949, Gordon Bernard, a printing company in Milford, Ohio, focused exclusively on printing fundraising calendars for a variety of clients, such as cities, schools, scout troops, and fire departments. The company's approximately 4,000 clients nationwide, 10 percent of which have been with the company for over 50 years, generated $4 million in revenue in 2006. In order to better serve customers, company president Bob Sherman invested $650,000 in the purchase of a Xerox iGEN3 digital color press so that the company could produce in-house a part of its calendar product that had been outsourced. The high-tech press did more for the company than simply reduce costs, however.

The new press gave the company four-color printing capability for the first time in its history, and that led the management of Gordon Bernard to rethink the company's strategy. The machine excels at short runs, which means that small batches of an item can be printed at a much lower cost than on a traditional press. The press also has the capability to customize every piece that rolls off the machine. For example, if a pet store wants to print 3,000 direct mail pieces, every single postcard can have a personalized greeting and text. Pieces targeted to bird owners can feature pictures of birds, whereas the dog owners' brochure will contain dog pictures. Text and pictures can be personalized for owners of show dogs or overweight cats or iguanas.

Bob Sherman created a new division to oversee the implementation, training, marketing, and creative aspects of the new production process. The company even changed how it thinks of itself. No longer does Gordon Bernard consider itself a printing firm, but as a marketing services company with printing capabilities. That change in strategy prompted the company to seek more commercial work. For example, Gordon Bernard will help clients of its new services develop customer databases from their existing information and identify additional customer information they might want to collect. Even though calendar sales accounted for 97 percent of the firm's revenues, that business is seasonal and leaves large amounts of unused capacity in the off-peak periods. Managers' goals for the new division were to contribute 10 percent of total revenue within a couple years of purchase.

Critical Thinking Questions

1. What type of planning do you think Gordon Bernard is doing?
2. Because Gordon Bernard's strategy changed only after it purchased the iGEN3, does the shift constitute strategic planning? Why or why not?

An organization's **mission** is formalized in its **mission statement**, a document that states the purpose of the organization and its reason for existing. For example, Twitter's mission statement formalizes both concepts while staying within its self-imposed character limit; see Table 13.2.3.2.

Table 13.2.3.2: Twitter's Mission, Values, and Strategy

Mission: Give everyone the power to create and share ideas and information instantly, without barriers.
Values: We believe in free expression and think every voice has the power to impact the world.
Strategy: Reach the largest daily audience in the world by connecting everyone to their world via our information sharing and distribution platform products and be one of the top revenue generating Internet companies in the world.
Twitter combines its mission and values to bring together a diverse workforce worldwide to fulfill its strategy.
The 3 Parts of a Company Mission Statement: • Purpose • Value • Action

In all organizations, plans and goals at the tactical and operational levels should clearly support the organization's mission statement.

Tactical planning begins the implementation of strategic plans. Tactical plans have a shorter (less than one year) time frame than strategic plans and more specific objectives designed to support the broader strategic goals. Tactical plans begin to address issues of

coordinating and allocating resources to different parts of the organization.

Under Mickey Drexler, many new tactical plans were implemented to support J.Crew's new strategic direction. For example, he severely limited the number of stores opened each year, with only nine new openings in the first two years of his tenure (he closed seven). Instead, he invested the company's resources in developing a product line that communicated J.Crew's new strategic direction. Drexler dumped trend-driven apparel because it did not meet the company's new image. He even cut some million-dollar volume items. In their place, he created limited editions of a handful of garments that he thought would be popular, many of which fell into his new luxury strategy. For example, J.Crew now buys shoes directly from the same shoe manufacturers that produce footwear for designers such as Prada and Gucci. In general, J.Crew drastically tightened inventories, a move designed to keep reams of clothes from ending up on sale racks and to break its shoppers' habit of waiting for discounts.

This part of the plan generated great results. Prior to Drexler's change in strategy, half of J.Crew's clothing sold at a discount. After implementing tactical plans aimed to change that situation, only a small percentage does. The shift to limited editions and tighter inventory controls has not reduced the amount of new merchandise, however. On the contrary, Drexler created a J.Crew bridal collection, a jewelry line, and Crew Cuts, a line of kids' clothing. The results of Drexler's tactical plans were impressive. J.Crew saw same-store sales rise 17 percent in one year.

Operational planning creates specific standards, methods, policies, and procedures that are used in specific functional areas of the organization. Operational objectives are current, narrow, and resource focused. They are designed to help guide and control the implementation of tactical plans. In an industry where new versions of software have widely varying development cycles, Autodesk, maker of software tools for designers and engineers, implemented new operational plans that dramatically increased profits. Former CEO Carol Bartz shifted the company away from the erratic release schedule it had been keeping to regular, annual software releases. By releasing upgrades on a defined and predictable schedule, the company is able to use annual subscription pricing, which is more affordable for small and midsize companies. The new schedule keeps Autodesk customers on the most recent versions of popular software and has resulted in an overall increase in profitability.

The key to effective planning is anticipating future situations and events. Yet even the best-prepared organization must sometimes cope with unforeseen circumstances, such as a natural disaster, an act of terrorism, or a radical new technology. Therefore, many companies have developed **contingency plans** that identify alternative courses of action for very unusual or crisis situations. The contingency plan typically stipulates the chain of command, standard operating procedures, and communication channels the organization will use during an emergency.

An effective contingency plan can make or break a company. Consider the example of Marriott Hotels in Puerto Rico. Anticipating Hurricane Maria in 2017, workers at the San Juan Marriott had to shift from their regular duties to handling the needs of not only customers, but everyone who needed assistance in the wake of the hurricane that devastated the island. A contingency plan and training for events such as this were a key part of managing this crisis. The company achieved its goal of being able to cater to guest and general needs due to planning and training while having a contingency plan in place. One guest commented on TripAdvisor, "Could not believe how friendly, helpful & responsive staff were even during height of hurricane. Special thanks to Eydie, Juan, Jock, Ashley and security Luis. They kept us safe & were exemplary. Will always stay at Marriott from now on." Within one month after Hurricane Maria hit, operations were back to normal at the San Juan Marriott.

MANAGING CHANGE

Boeing Takes Off in New Direction

Boeing and Airbus have been locked in fierce competition for the world's airplane business for decades. What characterized most of that time period was a focus on designing larger and larger airplanes. Since its development in the 1970s, Boeing revamped its pioneering B747 numerous times and at one time boasted over 1,300 of the jumbo jets in operation around the world. As part of this head-to-head competition for bragging rights to the largest jet in the air, Boeing was working on a 747X, a super-jumbo jet designed to hold 525 passengers. In what seemed to be an abrupt change of strategy, Boeing conceded the super-jumbo segment of the market to its rival and killed plans for the 747X. Instead of trying to create a plane with more seats, Boeing engineers began developing planes to fly fewer people at higher speeds. Then, as the rising price of jet fuel surpassed the airlines' ability to easily absorb its increasing cost, Boeing again changed its strategy, this time focusing on developing jets that use less fuel. In the end, Boeing's strategy changed from plane capacity to jet efficiency.

The new strategy required new plans. Boeing managers identified gaps in Airbus's product line and immediately set out to develop planes to fill them. Boeing announced a new 787 "Dreamliner," which boasted better fuel efficiency thanks to lightweight composite materials and next-generation engine design. Even though the 787 has less than half the seating of the Airbus A380, Boeing's Dreamliner is a hit in the market. Orders for the new plane have been stronger than anticipated, forcing Boeing to change its production plans to meet demand. The company decided to accelerate its planned 787 production rate buildup, rolling out a new jet every two days or so.

Airbus was not so lucky. The company spent so much time and energy on its super-jumbo that its A350 (the plane designed to compete with Boeing's 787) suffered. The 787 uses 15 percent less fuel than the A350, can fly nonstop from Beijing to New York, and is one of the fastest-selling commercial planes ever.

The battle for airline supremacy continues to switch between the two global giants. In 2017, Boeing beat Airbus on commercial jet orders at the Paris Air Show and continues to push forward. A spokesperson has hinted at a hybrid fuselage for midrange planes, which could carry passengers farther at lower costs. If successful, Boeing will regain market share lost to the Airbus A321.

Critical Thinking Questions

1. What seems to be the difference in how Boeing and Airbus have approached planning?
2. Do you think Airbus should change its strategic plans to meet Boeing's or stick with its current plans? Explain.

CONCEPT CHECK

1. What is the purpose of planning, and what is needed to do it effectively?
2. Identify the unique characteristics of each type of planning.

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13.2.4: Organizing

What are the Primary Functions of Managers in Organizing Activities?

A second key function of managers is **organizing**, which is the process of coordinating and allocating a firm's resources in order to carry out its plans. Organizing includes developing a structure for the people, positions, departments, and activities within the firm. Managers can arrange the structural elements of the firm to maximize the flow of information and the efficiency of work processes. They accomplish this by doing the following:

- Dividing up tasks *(division of labor)*
- Grouping jobs and employees *(departmentalization)*
- Assigning authority and responsibilities *(delegation)*

These and other elements of organizational structure are discussed in detail elsewhere. In this chapter, however, you should understand the three levels of a managerial hierarchy. This hierarchy is often depicted as a pyramid, as in Figure 13.2.4.1. The fewest managers are found at the highest level of the pyramid. Called **top management**, they are the small group of people at the head of the organization (such as the CEO, president, and vice president). Top-level managers develop *strategic plans* and address long-range issues such as which industries to compete in, how to capture market share, and what to do with profits. These managers design and approve the firm's basic policies and represent the firm to other organizations. They also define the company's values and ethics and thus set the tone for employee standards of behavior. For example, Jack Welch, the former CEO of General Electric, was a role model for his managers and executives. Admirers say that he had an extraordinary capacity to inspire hundreds of thousands of people in many countries and he could change the direction of a huge organization like General Electric as if it were a small firm. Following his leadership, General Electric's executives turned in impressive results. During his tenure, General Electric's average annual shareholder return was 25 percent.

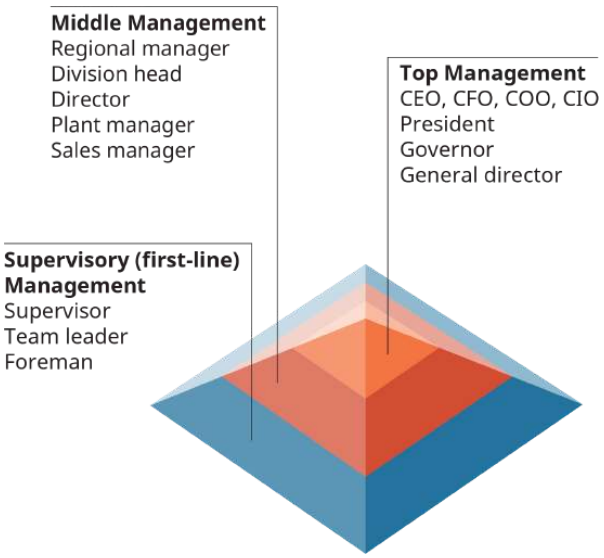


Figure 13.2.4.1: The Managerial Pyramid (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

The second and third tiers of the hierarchy are called **middle management** and **supervisory (first-line) management**, respectively. Middle managers (such as division heads, departmental managers, and regional sales managers) are responsible for beginning the implementation of strategic plans. They design and carry out *tactical plans* in specific areas of the company. They begin the process of allocating resources to meet organizational goals, and they oversee supervisory managers throughout the firm. Supervisors, the most numerous of the managers, are at the bottom of the managerial pyramid. These managers design and carry out *operational plans* for the ongoing daily activities of the firm. They spend a great deal of their time guiding and motivating the employees who actually produce the goods and services.

CONCEPT CHECK

1. Explain the managerial function of organizing.
2. What is the managerial pyramid?

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13.2.6: Controlling

How Do Organizations Control Activities?

The fourth key function that managers perform is **controlling**. Controlling is the process of assessing the organization's progress toward accomplishing its goals. It includes monitoring the implementation of a plan and correcting deviations from that plan. As Figure 13.2.6.1 shows, controlling can be visualized as a cyclical process made up of five stages:

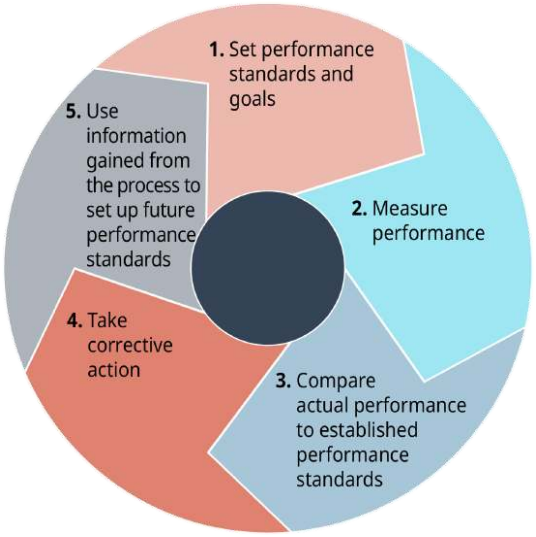


Figure 13.2.6.1: The Control Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Performance standards are the levels of performance the company wants to attain. These goals are based on its strategic, tactical, and operational plans. The most effective performance standards state a measurable behavioral objective that can be achieved in a specified time frame. For example, the performance objective for the sales division of a company could be stated as "$200,000 in gross sales for the month of January." Each individual employee in that division would also have a specified performance goal. Actual firm, division, or individual performance can be measured against desired performance standards to see if a gap exists between the desired level of performance and the actual level of performance. If a performance gap does exist, the reason for it must be determined and corrective action taken.

Feedback is essential to the process of control. Most companies have a reporting system that identifies areas where performance standards are not being met. A feedback system helps managers detect problems before they get out of hand. If a problem exists, the managers take corrective action. Toyota uses a simple but effective control system on its automobile assembly lines. Each worker serves as the customer for the process just before his or hers. Each worker is empowered to act as a quality control inspector. If a part is defective or not installed properly, the next worker won't accept it. Any worker can alert the supervisor to a problem by tugging on a rope that turns on a warning light (i.e., feedback). If the problem isn't corrected, the worker can stop the entire assembly line.

Why is controlling such an important part of a manager's job? First, it helps managers to determine the success of the other three functions: planning, organizing, and leading. Second, control systems direct employee behavior toward achieving organizational goals. Third, control systems provide a means of coordinating employee activities and integrating resources throughout the organization.

CONCEPT CHECK

1. Describe the control process.
2. Why is the control process important to the success of the organization?

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13.2.7: Managerial Roles

What Roles Do Managers Take on in Different Organizational Settings?

In carrying out the responsibilities of planning, organizing, leading, and controlling, managers take on many different roles. A role is a set of behavioral expectations, or a set of activities that a person is expected to perform. Managers' roles fall into three basic categories: *informational roles*, *interpersonal roles*, and *decisional roles*. In an **informational role**, the manager may act as an information gatherer, an information distributor, or a spokesperson for the company. A manager's **interpersonal roles** are based on various interactions with other people. Depending on the situation, a manager may need to act as a figurehead, a company leader, or a liaison. When acting in a **decisional role**, a manager may have to think like an entrepreneur, make decisions about resource allocation, help resolve conflicts, or negotiate compromises.

Managerial Decision Making

In every function performed, role taken on, and set of skills applied, a manager is a decision-maker. Decision-making means choosing among alternatives. Decision-making occurs in response to the identification of a problem or an opportunity. The decisions managers make fall into two basic categories: programmed and non-programmed. **Programmed decisions** are made in response to routine situations that occur frequently in a variety of settings throughout an organization. For example, the need to hire new personnel is a common situation for most organizations. Therefore, standard procedures for recruitment and selection are developed and followed in most companies.

Table 13.2.7.1: The Many Roles Managers Play in an Organization

Role	Description	Example
Information Roles		
Monitor	• Seeks out and gathers information relevant to the organization	• Finding out about legal restrictions on new product technology
Disseminator	• Provides information where it is needed in the organization	• Providing current production figures to workers on the assembly line
Spokesperson	• Transmits information to people outside the organization	• Representing the company at a shareholders' meeting
Interpersonal Roles		
Figurehead	• Represents the company in a symbolic way	• Cutting the ribbon at ceremony for the opening of a new building
Leader	• Guides and motivates employees to achieve organizational goals	• Helping subordinates to set monthly performance goals
Liaison	• Acts as a go-between among individuals inside and outside the organization	• Representing the retail sales division of the company at a regional sales meeting
Decisional Roles		
Entrepreneur	• Searches out new opportunities and initiates change	• Implementing a new production process using new technology
Disturbance handler	• Handles unexpected events and crises	• Handling a crisis situation such as a fire
Resource allocator	• Designates the use of financial, human, and other organizational resources	• Approving the funds necessary to purchase computer equipment and hire personnel
Negotiator	• Represents the company at negotiating processes	• Participating in salary negotiations with union representatives

Infrequent, unforeseen, or very unusual problems and opportunities require **non-programmed decisions** by managers. Because these situations are unique and complex, the manager rarely has a precedent to follow. The earlier example of the Norfolk Southern employee, who had to decide the best way to salvage a five-mile-long piece of railroad track from the bottom of Lake Pontchartrain, is an example of a non-programmed decision. Likewise, when Hurricane Katrina was forecast to make landfall, Thomas Oreck, then CEO of the vacuum manufacturer that bears his name, had to make a series of non-programmed decisions. Oreck's corporate headquarters were in New Orleans, and its primary manufacturing facility was in Long Beach, Mississippi. Before the storm hit, Oreck transferred its computer systems and call-center operations to backup locations in Colorado and planned to move headquarters to Long Beach. The storm, however, brutally hit both locations. Oreck executives began searching for lost employees, tracking down generators, assembling temporary housing for workers, and making deals with UPS to begin distributing its product (UPS brought food and water to Oreck from Atlanta and took vacuums back to the company's distribution center there). All of these decisions were made in the middle of a very challenging crisis environment.

Whether a decision is programmed or non-programmed, managers typically follow five steps in the decision-making process, as illustrated in Figure 13.2.7.1:

1. Recognize or define the problem or opportunity. Although it is more common to focus on problems because of their obvious negative effects, managers who do not take advantage of new opportunities may lose competitive advantage to other firms.
2. Gather information so as to identify alternative solutions or actions.
3. Select one or more alternatives after evaluating the strengths and weaknesses of each possibility.

4. Put the chosen alternative into action.
5. Gather information to obtain feedback on the effectiveness of the chosen plan.

It can be easy (and dangerous) for managers to get stuck at any stage of the decision-making process. For example, entrepreneurs can become paralyzed evaluating the options. For Gabby Slome, the co-founder of natural pet food maker Ollie, the idea for starting the company came after her rescue dog began having trouble digesting store-bought pet food after living on scraps. Slome decided that the pet food industry, a $30 billion a year business, was ripe for a natural food alternative. She laments, however, that she let perfect be the enemy of the very good by indulging in "analysis paralysis."

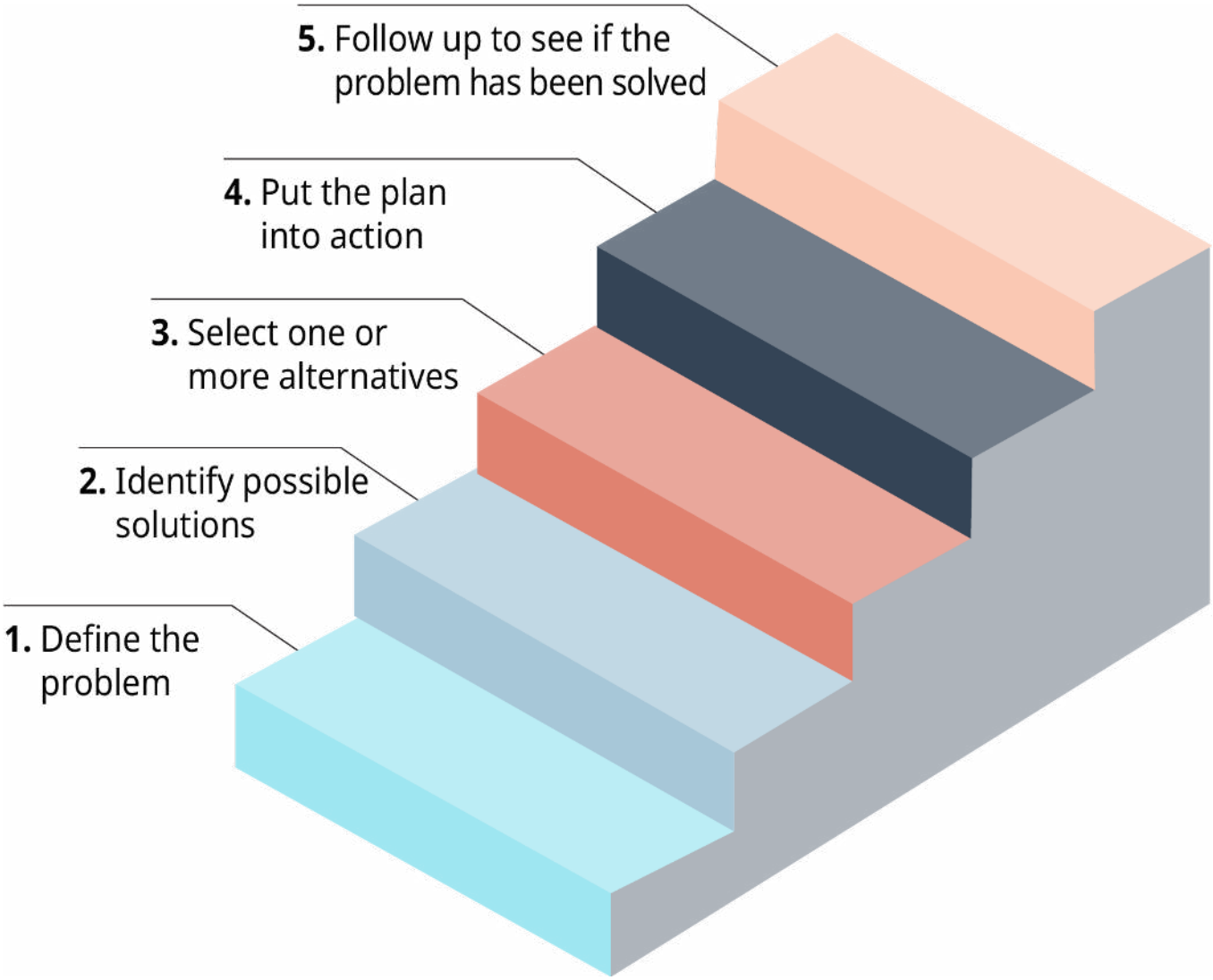


Figure 13.2.7.1: The Decision-Making Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

CONCEPT CHECK

1. What are the three types of managerial roles?
2. Give examples of things managers might do when acting in each of the different types of roles.
3. List the five steps in the decision-making process.

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13.2.8: Managerial Skills

What Set of Managerial Skills is Necessary for Managerial Success?

In order to be successful in planning, organizing, leading, and controlling, managers must use a wide variety of skills. A *skill* is the ability to do something proficiently. Managerial skills fall into three basic categories: technical, human relations, and conceptual skills. The degree to which each type of skill is used depends upon the level of the manager's position as seen in Figure 13.2.8.1. Additionally, in an increasingly global marketplace, it pays for managers to develop a special set of skills to deal with global management issues.

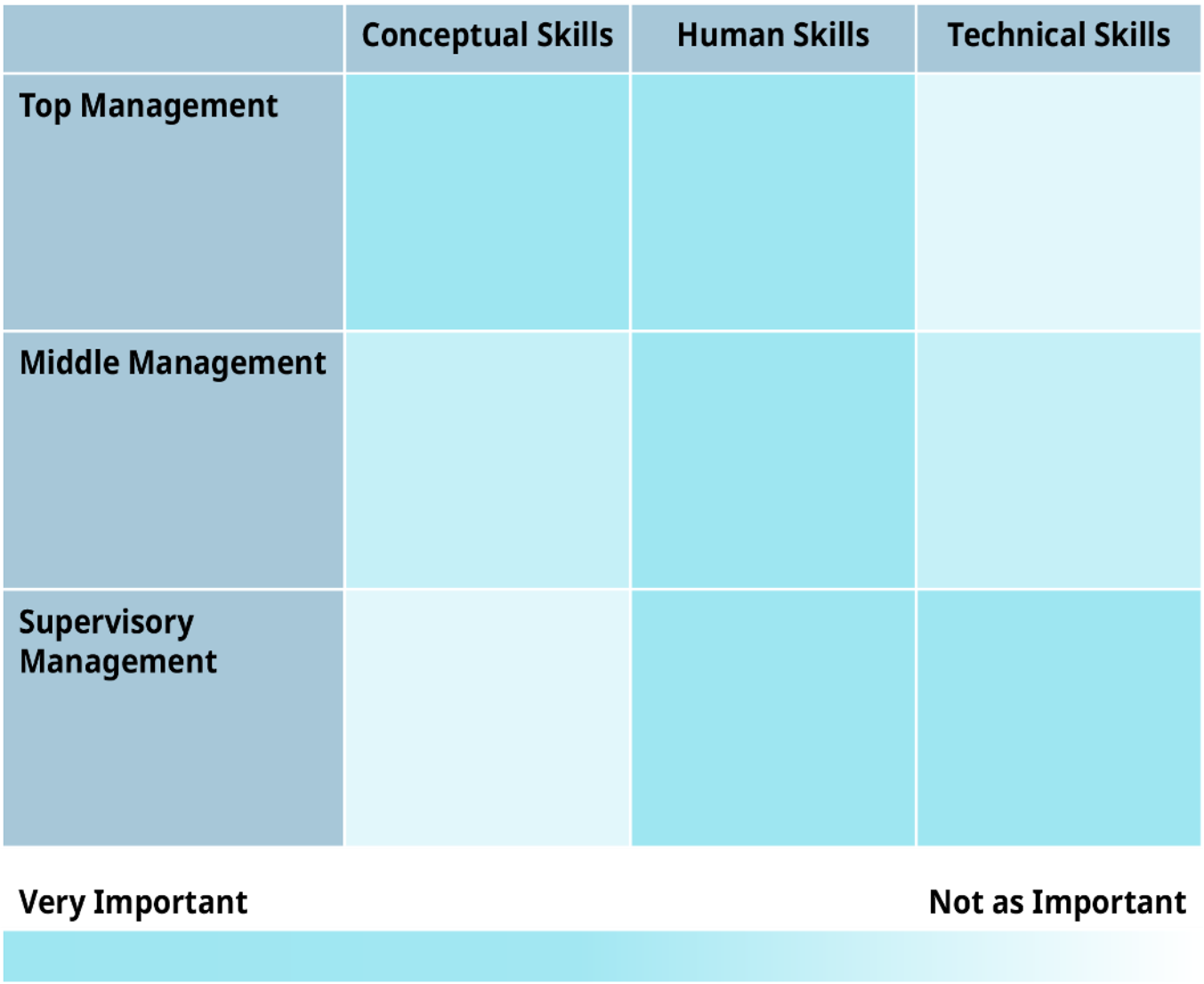


Figure 13.2.8.1: The Importance of Managerial Skills at Different Management Levels(Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Technical Skills

Specialized areas of knowledge and expertise and the ability to apply that knowledge make up a manager's **technical skills**. Preparing a financial statement, programming a computer, designing an office building, and analyzing market research are all examples of technical skills. These types of skills are especially important for supervisory managers because they work closely with employees who are producing the goods and/or services of the firm.

Human Relations Skills

Human relations skills are the interpersonal skills managers use to accomplish goals through the use of human resources. This set of skills includes the ability to understand human behavior, to communicate effectively with others, and to motivate individuals to accomplish their objectives. Giving positive feedback to employees, being sensitive to their individual needs, and showing a willingness to empower subordinates are all examples of good human relations skills. Identifying and promoting managers with human relations skills are important for companies. A manager with little or no people skills can end up using an authoritarian leadership style and alienating employees.

Conceptual Skills

Conceptual skills include the ability to view the organization as a whole, understand how the various parts are interdependent, and assess how the organization relates to its external environment. These skills allow managers to evaluate situations and develop alternative courses of action. Good conceptual skills are especially necessary for managers at the top of the management pyramid, where strategic planning takes place.

CONCEPT CHECK

1. Define the basic managerial skills.
2. How important is each of these skill sets at the different levels of the management pyramid?

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13.2.9: Trends in Management and Leadership

What Trends Will Affect Management in the Future?

Four important trends in management today are crisis management, outside directors, the growing use of information technology, and the increasing need for global management skills.

Crisis Management

Crises, both internal and external, can hit even the best-managed organization. Sometimes organizations can anticipate crises, in which case managers develop contingency plans, and sometimes they can't. Take, for example, the sudden death of McDonald's CEO Jim Cantalupo. The company had a solid succession plan in place and immediately named Charlie Bell as new CEO. Only a few months later, Bell announced that he had terminal cancer. Even though the company had prepared for the event of its leader's untimely death, surely it couldn't have anticipated that his successor would also be stricken by a terminal illness at almost the same time. Likewise, consider the devastation caused by Hurricanes Harvey, Irma, Maria, and Nate in 2017. Part of Marriott Hotels' crisis management plan included relaxing its "no pets" policy and allowing patrons fleeing the storm to check in with their pets because it was the right thing to do.

Crises cannot be fully anticipated, but managers can develop contingency plans to help navigate through the aftermath of a disaster. For example, consider the challenges that faced Rajiv Joseph, the author of several plays including *Bengal Tiger at the Baghdad Zoo*, who was in Houston preparing to open his new play, *Describe the Night*, at the Alley Theater when Hurricane Harvey hit and flooded the theater a few weeks prior to opening night. The six New York–based actors, the director, the stage manager, and Joseph decided to help in the relief efforts and made their way to the George Brown Convention Center, which had become the central location for relief efforts. When they arrived and the staffers discovered they were theater artists, they were deployed to handle the writing and deployment of public address announcements and manage the incoming crowds. What made the relief efforts successful was planning—matching the skill sets of volunteers with tasks they are best able to perform. Even though those in charge of the relief efforts had contingency plans, they still needed to make dozens of non-programmed decisions to effectively manage the ever-changing situation.

No manager or executive can be completely prepared for these types of unexpected crises. However, how a manager handles the situation could mean the difference between disaster, survival, and even financial gain. No matter the crisis, there are some basic guidelines managers should follow to minimize negative outcomes. Managers should not become immobilized by the problem or ignore it. Managers should face the problem head-on. Managers should always tell the truth about the situation and then put the best people on the job to correct the problem. Managers should ask for help if they need it, and finally, managers must learn from the experience to avoid the same problem in the future. Table 13.2.9.1 describes what CEOs and other leaders learned about crisis management.

Managers and Information Technology

The second trend having a major impact on managers is the proliferation of data and analytics in information technology. An increasing number of organizations are selling technology, and an increasing number are looking for cutting-edge technology to make and market the products and services they sell. One particularly useful type of technology is dashboard software. Much like the dashboard in a car, dashboard software gives managers a quick look into the relevant information they need to manage their companies. Most large companies are organized in divisions, and often each division relies on a particular type of application or database software. Dashboard software allows employees to access information from software they don't routinely use, for example, from an application used by a different division from their own. More important, however, is the ability of a dashboard to show up-to-the-minute information and to allow employees to see all the information they need—such as financial and performance data—on a single screen.

Table 13.2.9.1: Lessons Leaders Learned about Managing Crises

Howard Schultz Chairman, Starbucks	Learn from one crisis at a time. After the Seattle earthquake of 2001, the company invested in a notification system that could handle text messaging. The night before Hurricane Katrina hit, Starbucks sent out 2,300 phone calls to associates in the region, telling them about available resources.
Gary Loveman CEO, Harrah's	Make life easier for your employees. Before the storm hit, management announced that in the event of total entertainment disaster, employees would be paid for at least 90 days. The decision was meant to provide employees with some certainty during a very uncertain time.
J. W. Marriott CEO, Marriott	Communicate for safety. Marriott moved its email system out of New Orleans before Katrina hit. As a result, employees were able to communicate with each other and vendors to get food and water to affected areas. A massive publicity campaign (Dial 1-800-Marriott) helped the company find 2,500 of its 2,800 people in the region.
Geno Auriemma University of Connecticut Basketball Coach	It's about doing it in a way that it can't be done any better. That is the goal every day.
Danny Gavin VP, Brian Gavin Diamonds	"Create an unforgettable customer experience" may sound like a cliché, but this is our golden rule. Despite waist-high water and treacherous conditions, we had several international orders that needed to be shipped the Wednesday after Hurricane Harvey hit. FedEx and UPS had ceased operations around the Houston area during the storm, but our CEO Brian Gavin was determined to deliver an outstanding customer service experience. That's why he drove with the packages in hand to the nearest FedEx store that was open: College Station. The standard three-hour round trip ended up taking five hours.
Bob Nardelli CEO, Home Depot	Prepare for the next big one. After each catastrophic event, Home Depot does a postmortem on its response efforts so that employees and managers can become more experienced and better prepared. Before Katrina hit, the company prestaged extra supplies and generators, sent 1,000 relief associates to work in the stores in the Gulf Region, and made sure that area stores were overstocked with first-response items such as insecticides, water, and home generators.
Scott Ford CEO, Alltel	Take care of everybody. When Katrina hit, Alltel was missing 35 employees. When the company had found all but one, managers used the company's network infrastructure to track her phone activity, contact the last person she had called, and work with the army to find her.
Paul Pressler CEO, Gap	Empower the workforce. Gap had 1,300 employees affected by Katrina, and one of the biggest problems the company faced was getting people their paychecks. The company, which had extended payroll by 30 days to affected employees, now encourages all employees to use direct deposit as a means to ensure access to their pay.
Jim Skinner CEO, McDonald's	Be flexible with company assets. McDonald's had 280 restaurants close in the immediate aftermath of the storm, but shortly

	afterward, 201 were already open. During the crisis, McDonald's converted its human resource service center into a crisis command center. The quickly formed help center fielded 3,800 calls.
Robert Baugh COO, Chiles Restaurants	With Hurricane Irma approaching, Baugh communicated with staff for several days before the storm to prepare and to find out which employees would be evacuating, which would be staying, and which had special needs. The Chiles Group used Hot Schedules, a platform all employees log into, to create a timeline to secure all three restaurants (since these restaurants have lots of outdoor seating and outdoor bars, it was a huge chore) and to broadcast when the restaurants would reopen. Team leaders were responsible for communicating with their members. Vendors and chefs were told earlier in the week to reduce food orders to minimize loss. Freezers and refrigerators were packed with hundreds of bags of ice.

Such integrated functionality made dashboards extremely popular. A Gartner commentary suggests that companies put data and analytics at the heart of every company business decision. Despite the increasing popularity of dashboard technology, the control tool has some drawbacks, such as focusing too intently on short-term results and ignoring the overall progress toward long-term goals. And some employees might bristle at being monitored as closely as dashboard tools allow.

Nonetheless, companies are seeing real results from implementing dashboard software. Robert Romanoff, a partner at the law firm of Levenfeld Romanoff in Chicago, uses dashboards that aggregate data from clients, strategic partners, and internal staff from the mailroom to the boardroom to improve what he calls the 3 *P*s. The 3 *P*s are process efficiency, project management, and strategic pricing.



Figure 13.2.9.1: Marketing and sales professionals are increasingly turning to advanced software programs called “dashboards” to monitor business and evaluate performance. These computer tools use analytics and big data to help managers identify valuable customers, track sales, and align plans with company objectives—all in real-time. A typical dashboard might include sales and bookings forecasts, monthly close data, customer satisfaction data, and employee training schedules. This example tracks customers attending the Consumer Electronics Show so that the buzz created by influencers can be measured. *How does information technology affect managerial decision-making?* (Credit: Intel Free Press/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Managing Multinational Cultures

The increasing globalization of the world market has created a need for managers who have **global management skills**, that is, the ability to operate in diverse cultural environments. With more and more companies choosing to do business in multiple locations around the world, employees are often required to learn the geography, language, and social customs of other cultures. It is expensive to train employees for foreign assignments and pay their relocation costs; therefore, choosing the right person for the job is especially important. Individuals who are open-minded, flexible, willing to try new things, and comfortable in a multicultural setting are good candidates for international management positions.

As companies expand around the globe, managers will continue to face the challenges of directing the behavior of employees around the world. They must recognize that because of cultural differences, people respond to similar situations in very different ways. The burden, therefore, falls on the manager to produce results while adapting to the differences among the employees he or she manages.

How a manager gets results, wins respect, and leads employees varies greatly among countries, cultures, and individuals. For example, different cultures have different approaches to time. American, German, and Swiss cultures, among others, take a linear view of time, whereas southern European counties such as Italy take a multi-active time approach, and many Eastern cultures, such as China, take a cyclic approach. An American manager with a linear view of time will approach scheduling planning with a different approach than colleagues with a multi-active or cyclic approach. Despite differences such as these (examples of which can be cited for every country in the world), managing within a different culture is only an extension of what managers do every day: working with differences in employees, processes, and projects.

CONCEPT CHECK

1. How can information technology aid in decision-making?
2. What are the three principles of managing multinational cultures?
3. Describe several guidelines for crisis management.

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13.3: Managing a Small Business

Learning Objective

- Why does managing a small business present special challenges for the owner?

Managing a small business is quite a challenge. Whether you start a business from scratch or buy an existing one, you must be able to keep it going. The small-business owner must be ready to solve problems as they arise and move quickly if market conditions change.

MANAGING CHANGE

Learning How to Pivot

Most small business owners either use, or at least know of, the iconic email service MailChimp, a company that is growing by more than $120 million every year and is on track to bring in $525 million over the coming year. But Ben Chestnut, the CEO and co-founder, says it took MailChimp several years to figure out what it did well.

When Chestnut was laid off from his job at the Cox Media Group in Atlanta, he founded Rocket Science Group, a web design firm. Co-founder Dan Kurzius (who taught himself to code) joined Chestnut, and they began to focus their sales efforts on tech companies. But when the tech bubble burst, they pivoted to focus on selling to airline and travel companies. Then 9/11 hit, and they needed to change focus again, this time on the real estate market. However, both Chestnut and Kurzius discovered they didn't enjoy sales (and they weren't very good at it), nor did they like the bureaucracy of working with large companies. "The only companies we could relate to were small businesses, and they always asked for email marketing."

This insight helped Chestnut to recall a product feature the Rocket Science Group had previously developed for an email greeting card project. So Chestnut and Kurzius evaluated the marketing software and began to test it with small businesses. "Our day jobs felt like going to these big organizations and pitching to them, and it was miserable," Chestnut says. "But we really loved our nighttime jobs, which were helping the small businesses use this email marketing app." Their passion, along with market feedback, led to their decision to completely focus on email marketing for small businesses. But it wasn't until almost 2009 that MailChimp found its sweet spot. The founders initially wanted to give away one product that collected subscribers and then charge for another, which was sending emails, but it would have been very difficult to divide the product into two pieces. That's when they landed on the Freemium idea. "Let's just make the whole thing free," said Chestnut.

The idea was that if they made it cheap and easy for small businesses to try MailChimp, their business would grow and they would be happy to pay for MailChimp services. MailChimp allows customers to send an email for free to 1,999 people at once but charges for emails sent to over 2,000 people and for premium features. MailChimp charges a monthly recurring fee starting at $10 for sending more than 12,000 emails a month.

The idea quickly proved to be a huge success. MailChimp went from a few hundred thousand users to 1 million users in a year. The next year they added another million users.

The MailChimp founders learned a lot of lessons during their 17 years in business. One of their most important lessons is knowing when to change. When you see an opportunity, don't be afraid to pivot and change course, especially if it means focusing on a market you're passionate about. Listening to market feedback and following their passion earned MailChimp's founders recognition as "2017 Business of the Year" by *Inc.* magazine.

Critical Thinking Questions

1. What led MailChimp's founders to change its focus on the customers they were selling to?
2. What was MailChimp's "big idea" that changed the business, and why was it so successful?

A sound business plan is key to keeping the small-business owner in touch with all areas of his or her business. Hiring, training, and managing employees is another important responsibility because the owner's role may change over time. As the company grows, others will make many of the day-to-day decisions while the owner focuses on managing employees and planning for the firm's long-term success. The owner must constantly evaluate company performance and policies in light of changing market and

economic conditions and develop new policies as required. He or she must also nurture a continual flow of ideas to keep the business growing. The types of employees needed may change too as the firm grows. For instance, a larger firm may need more managerial talent and technical expertise.

Using Outside Consultants

One way to ease the burden of managing a business is to hire outside consultants. Nearly all small businesses need a good certified public accountant (CPA) who can help with financial record keeping, decision-making, and tax planning. An accountant who works closely with the owner to help the business grow is a valuable asset. An attorney who knows about small-business law can provide legal advice and draw up essential contracts and documents. Consultants in areas such as marketing, employee benefits, and insurance can be used on an as-needed basis. Outside directors with business experience are another way for small companies to get advice. Resources such as these free the small-business owner to concentrate on medium- and long-range planning and day-to-day operations.

Some aspects of business can be outsourced or contracted out to specialists. Among the more common departments that use outsourcing are information technology, marketing, customer service, order fulfillment, payroll, and human resources. Hiring an outside company—in many cases another small business—can save money because the purchasing firm buys just the services it needs and makes no investment in expensive technology. Management should review outsourced functions as the business grows because at some point it may be more cost-effective to bring them in-house.

Hiring and Retaining Employees

It is important to identify all the costs involved in hiring an employee to make sure your business can afford it. Recruiting, help-wanted ads, extra space, and taxes will easily add about 10–15 percent to their salary, and employee benefits will add even more. Hiring an employee may also mean more work for you in terms of training and management. It's a catch-22: To grow you need to hire more people, but making the shift from solo worker to boss can be stressful.

Attracting good employees is more difficult for a small firm, which may not be able to match the higher salaries, better benefits, and advancement potential offered by larger firms. Small companies need to be creative to attract the right employees and convince applicants to join their firm. Once they hire an employee, small-business owners must make employee satisfaction a top priority in order to retain good people. A company culture that nurtures a comfortable environment for workers, flexible hours, employee benefit programs, opportunities to help make decisions, and a share in profits and ownership are some ways to do this.

Duane Ruh figured out how to build a $1.2 million business in a town with just 650 residents. It's all about treating employees right. The log birdhouse and bird feeder manufacturer, Little Log Co., located in Sargent, Nebraska, boasts employee-friendly policies you read about but rarely see put into practice. Ruh offers his employees a flexible schedule that gives them plenty of time for their personal lives. During a slow period last summer, Ruh cut back on hours rather than lay anyone off. There just aren't that many jobs in that part of Nebraska that his employees could go to, so when he received a buyout offer that would have closed his facility but kept him in place with an enviable salary, he turned it down. Ruh also encourages his employees to pursue side or summer jobs if they need to make extra money, assuring them that their Little Log jobs are safe.

Going Global with Exporting

More and more small businesses are discovering the benefits of looking beyond the United States for market opportunities. The global marketplace represents a huge opportunity for U.S. businesses, both large and small. Small businesses' decision to export is driven by many factors, one of which is the desire for increased sales and higher profits. U.S. goods are less expensive for overseas buyers when the value of the U.S. dollar declines against foreign currencies, and this creates opportunities for U.S. companies to sell globally. In addition, economic conditions such as a domestic recession, foreign competition within the United States, or new markets opening up in foreign countries may also encourage U.S. companies to export.

Like any major business decision, exporting requires careful planning. Small businesses may hire international-trade consultants or distributors to get started selling overseas. These specialists have the time, knowledge, and resources that most small businesses lack. Export trading companies (ETCs) buy goods at a discount from small businesses and resell them abroad. Export management companies (EMCs) act on a company's behalf. For fees of 5–15 percent of gross sales and multi-year contracts, they handle all aspects of exporting, including finding customers, billing, shipping, and helping the company comply with foreign regulations.

Many online resources are also available to identify potential markets for your goods and services, as well as to decipher the complexities involved in preparing to sell in a foreign country. The Small Business Association's Office of International Trade has links to many valuable sites. The Department of Commerce offers services for small businesses that want to sell abroad. Contact its Trade Information Center, 1-800-USA-TRADE, or its Export Center (http://www.export.gov).

CONCEPT CHECK

1. How does the small-business owner's role change over time?
2. How does managing a small business contribute to its growth?
3. What are the benefits to small firms of doing business internationally, and what steps can small businesses take to explore their options?

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SECTION OVERVIEW

14.1: Building Networks and Foundations

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14.1.1: Introduction

US Route 1 in southern Florida connects 43 islands of the Florida Keys via 42 bridges. It is a bidirectional economic path from the US mainland to its endpoint at Key West and for all points in between. Without the bridges it provides, residents, workers, and tourists would be required to ferry to their destinations, sacrificing time, money, economic efficiency, market productivity, and recreation. The bridges ensure an unimpeded flow of economic activities that benefit residents and visitors, increasing tourism across the entire state, and ensuring Key West is not economically and socially isolated.



Figure 14.1.1.1: US 1 is the route into and out of the Florida Keys that residents and visitors alike take to their intended destinations. But more importantly, US 1, a physical structure of steel-reinforced concrete, is the artery through which economic exchanges are created and enhanced. (Credit: modification of “Seven mile bridge” by Tinsley Advertising/Wikimedia Commons, CC BY)

Every entrepreneur can learn a few lessons from US 1. First, independent market players are stronger and more stable when connected to other independent market players. Second, connections are not always easy to establish. The idea of connecting all of the keys met resistance, and engineers had to solve many challenges. Third, you must be prepared to repair connections whenever they are severed. A hurricane destroyed the original railroad that connected the islands, but replacing it with an automobile highway was a major improvement. Other lessons are that benefits should outweigh costs, and that it takes time to build new connections: The original railroad took seven years to build. Costs of ongoing repair and maintenance have exceeded $1.8 billion (adjusted for inflation) but produced $2.7 billion in annual economic activity for 2017. Today, no one in Florida would dream of doing without the highway.

How are businesses similar to Key West? Every business includes people who produce goods and services for customers to purchase. In turn, businesses and those who work for them need to consume the products and services provided by their own vendors. Finding and establishing relationships with vendors and customers, in addition to the support of community organizations and educational resources, facilitates the exchange of information, products, and services. The connection between a business and its vendors or its customers makes up a network.

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14.1.2: Building and Connecting to Networks

Learning Objectives

By the end of this section, you will be able to:

- Define networking and describe its role in entrepreneurship
- Describe networking opportunities
- Describe local and trade organization networking opportunities
- Identify nonprofit and governmental agencies offering networking opportunities

When you begin thinking about your new and exciting entrepreneurial venture, you may feel somewhat like the citizens of Key West did many years ago—isolated. No matter which way you turn, you eventually come to the end of your limited community, and what you have is not enough. You can either sit on the beach and dream about what could be or commence working on building personal and professional connections to broaden your scope and improve the depth of relationships with those individuals who will assist you in becoming a successful entrepreneur. Now is the time to start building bridges and connecting yourself with the greater business community. Networking is about building bridges not about collecting tolls.

ENTREPRENEUR IN ACTION

Colonel Sanders and Building Connections

Harland David Sanders, the founder of Kentucky Fried Chicken (KFC), was a successful entrepreneur who personally experienced and understood the value of roadways and customer access. Sanders, better known as “Colonel” Sanders, owned a successful Shell service station with a small restaurant. He perfected his recipe for fried chicken and added it to his menu. Demand from satisfied customers soon exceeded seating capacity. To increase customer capacity, he purchased a building across the street that had a larger seating area. Business was steady and profitable until the new interstate system bypassed his location. Sanders lost his connection to his customers and closed his business. He did not give up, however.

Sanders began scouring the country for restaurants that would buy his recipe in exchange for $0.04 per piece of chicken sold. He reestablished a connection with an acquaintance in Salt Lake City, Utah, who became the first KFC franchisee. With immediate success in Utah, Sanders began a nationwide campaign to connect with other successful restaurants and signed them on as franchisees. Eventually, Sanders formed a network of restaurants across the country that sold his chicken and grew a market that could never have been developed by one person in one location. In 2019, KFC had over 21,000 locations in 130 countries (www.kfc.com/about).

Sanders took his personal experience of losing easy customer access to his business and applied it to building a network of franchises where customers, across the United States and on multiple continents, could purchase his chicken. Just as tourists, residents, and businesses in Key West need roads and bridges to connect them to their destinations and suppliers, entrepreneurs need connections and networks to get supplies from their vendors and products to their customers.

For an entrepreneur, **networking** is finding and establishing relationships with business professionals with whom you can exchange information, ideas, and products; more importantly, you can claim these networks as trusted business colleagues. Be ready to use the networks you already have. Be intentional in seeking out established business professionals in your local chamber of commerce or at SCORE (see the following). Position yourself to contribute to the larger community. Be active in expanding your sphere of influence.

A good way to get started is to begin brainstorming a list of people who can help you along the entrepreneurial path. These potential trusted advisors will be beneficial to you as you develop your idea and start your business. In these early stages, you will encounter challenges and obstacles in many areas. Having a “go-to” list of dependable consultants can help you find solutions, reduce mistakes, and hasten your success in your new business. Anyone can be on that list—don’t exclude anyone, no matter how unlikely it seems that you will need their expertise. People you already know have knowledge and skills. They can be a valuable resource.

On the other hand, you too have knowledge and skills. You too can be a valuable resource. That is why you are starting your own business or developing a new product. Begin connecting with people who need you, perhaps even people who need you more than you currently need them. Present yourself as the expert, not the salesperson to be avoided at all costs. Become known as the "go-to" person: the person others will seek out and put on their list of experts. When you become respected as the professional expert, success will follow.

We begin developing personal connections—relationships with other people—early in our lives. (Later in life, these connections become our networks.) Typically, the first social groups we join are family, neighbors, and schoolmates. Playing with siblings and cousins, and learning to meet new friends in the neighborhood and at elementary school help us develop the social skills that we will need later in life when we meet and work with others in the professional world. As you enter adulthood, social connections that you establish and nurture become more complex and have longer-lasting benefits. You may establish some of those lifelong personal connections during your college years or perhaps in your first "big" job.

Campus Connections

During your college years, you will have many opportunities to make connections with new people. Taking advantage of these opportunities allows you to perfect your skills in initiating and developing new and even lifetime connections. You can establish new friendships with roommates, classmates, social club members, special interest groups, academic organizations, competitive and intramural athletic teams, and many others. All of these groups not only encourage new social relationships but also foster opportunities for developing and improving leadership skills.

Chances to meet and work with new people abound on college campuses. The diagram in Figure 14.1.2.1 shows some of the many social networking opportunities on college campuses.

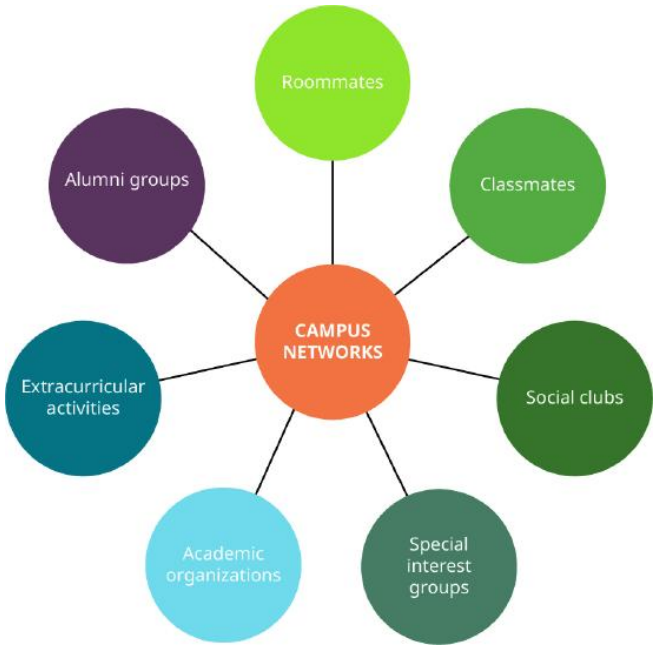


Figure 14.1.2.1: You can find many social networking opportunities through your college or university. (CC BY 4.0; Rice University & OpenStax)

Your college or university is usually where you make the transition from student to professional. One method of learning to become a professional is through membership and leadership roles in academic or professional clubs. Leadership positions usually rotate annually. Academic clubs are formed around disciplines, departments, or professions. Professors, alumni, or industry professionals serve as sponsors and may provide connections to other industry professionals. Members learn the value of being active participants, discussing relevant topics. Fundraising or other special activities provide opportunities for developing leadership and organizational skills. Friendships and personal connections made in an academic club may become lifelong professional connections.

Honor societies are another type of academically oriented group, established to recognize the outstanding academic performance of students who have achieved a specific grade point average. Membership in an honor society brings with it the prestige of membership, opportunities for leadership roles, and access to professionals in many industries. Some honor societies offer scholarships for future studies in graduate school or study-abroad programs, which introduce members to students from other universities and countries with similar backgrounds and interests. Some honor societies open doors to conference memberships and presentations, and important access to other industry professionals.

Another type of collegiate organization is the special interest group. These groups may focus on social causes, promote and advance interests in the arts or other hobbies, or encourage participation in political, religious, or athletic events. Students from all disciplines and social backgrounds join special interest clubs. With such a broad spectrum of members, you have the opportunity to learn from many people from multiple backgrounds, expand your self-development, learn how to work with people who have different viewpoints, and potentially establish firm personal relationships.

Some clubs offer members the opportunity to perform or showcase their talent in a more relaxed and supportive atmosphere, or are centered around a personal interest. For example, a drama club for students not majoring in theater can offer a forum for participating in musicals and plays without the rigor demanded by the more structured academic program. Other groups that bring in nonacademic members include choral groups, visual arts gatherings, astronomy clubs, and gaming societies. These groups provide opportunities for the maturation and perfection of the interpersonal skills you need for success in the professional world. You can develop key interpersonal attributes among friends and colleagues while enjoying a common activity or interest.

Social clubs—sororities for women and fraternities for men—provide other opportunities to expand your circle of friends, as these organizations focus on social activities. Although many social clubs concentrate strictly on “get-together” activities, you can learn and perfect acceptable public-protocol behaviors at formal events as well as mastering skills in organizational negotiations and compromise. A few colleges and universities are beginning to formalize clubs for online students, including access to and membership in campus-based Greek life. One of the first online Greek clubs is Theta Omega Gamma, founded in 2009 at the Florida Institute of Technology.

College groups have high turnover rates in their membership and involvement. This can make it easier for you to learn and perfect the skills necessary for establishing social and professional connections through constant repetition of introducing yourself to new people, learning their backgrounds, and describing your own. Learning how to introduce yourself and become acquainted with strangers is a soft skill that you can learn more easily early in life than in later years, and knowing how to develop a personal relationship with others will benefit you for many years to come. One unintended benefit is that mistakes can be quickly forgotten. If you make a social blunder one semester, many in the group will soon forget your faux pas, and new members will never be aware of it.

Perhaps the largest university club is one whose membership extends beyond graduation—the alumni association. Membership in alumni associations is higher among students who earned an undergraduate degree than among those with a graduate degree. Furthermore, members of the alumni association are more dedicated and loyal to their alma mater than nonmembers. Because of their commitment to past and current students, members of alumni associations have an automatic connection to other members. Loyalty is an important characteristic of active members of the alumni association, so bonding with them links you to established professionals who can help you in your new business. One way to connect with alumni is through LinkedIn, a social network of business professionals.

The campus setting—either traditional or virtual—is one of the earliest multifaceted environments to which you as a young adult will belong. Learning how to maneuver on the college campus and within the parameters of university culture prepares you for your future environment.

Nontraditional and virtual students also can benefit from their college campus experience. These students come from a variety of industry and professional backgrounds, and they are exposed to diverse operational methods and strategies during class activities or assignments. Furthermore, becoming personally acquainted with project team members opens opportunities for building connections that might be professionally beneficial in the future.

Institutions of higher learning have become fundamentally self-contained communities. Each one functions almost like a small city, with students mingling throughout the day with people at all stages of life, from multiple backgrounds, and in various roles. It is a

great place to start building a foundation of personal contacts or enhancing your current portfolio of contacts before entering a competitive world.

ARE YOU READY?

What I Need and Who I Know

Create a table with two columns. On the left, list questions or issues associated with starting a new business, such as: How much money do I need to start? What licenses should I get? Do I lease or buy? Where do I find customers? Where do I find employees? How does payroll work? What kind of insurance should I get?

On the right side, write down specific answers that you already know. For questions and issues that you can't answer, write down the name of a person you could ask to help answer that issue. If you do not know someone, who might help you get to the person who can give you an answer?

Local Organizations

Every community includes groups of individuals who have something in common. People group themselves together around shared beliefs, objectives, responsibilities, goals, or situations. Joining a local organization can place thousands of potential connections within your reach. Before seeking acceptance into a specific group, consider the type of group that fits your own personal and professional goals, and what you can contribute to the group's continuity.

An **open group** has a fluid membership; people may freely join or separate at any given time. Open groups tend to be informal, operate around a loose structure, and frequently focus on a personal or social cause. Open-membership groups include activities-oriented groups such as bridge clubs, scrapbooking groups, or photography clubs. Some open groups, such as Mothers Against Drunk Drivers (MADD) or People for the Ethical Treatment of Animals (PETA), focus on a specific topic or cause.

A **closed group** typically has either formal or informal criteria that you must meet before you can become a full member. Some organizations require sponsorship by a current member. Examples of closed groups include religious organizations, homeowners' or renters' associations, community performing arts groups, or sports groups.

Some community groups have features common to both open and closed groups. These **hybrid groups** have barriers or criteria that you must meet prior to joining, but those barriers are low, and prospective members can easily meet the criteria. Frequently, low barriers are an administrative feature to distinguish between participants who are serious about the group's activities and those who have an impulsive interest with no long-term commitment to the cause. Table 14.1.2.1 shows the differences among open, closed, and hybrid groups.

Table 14.1.2.1: Open, Closed, and Hybrid Groups

Open Groups	Closed Groups	Hybrid Groups
• Fluid membership • Loosely structured, informal • May focus on personal/social cause	• Membership criteria/process • Structured • Formal purpose	• Low barriers to membership • Maintain barriers to ensure members are serious

Groups that have a formal legal structure, an oversight board, and a professional management staff are more effective than those groups that are impulsively formed around a good idea. Professionally organized groups have skilled employees who set long-term goals and handle day-to-day activities. With the increase in structure and management, costs increase. To cover employee wages and benefits along with operational expenses of the group, many professional groups have membership dues and revenue-generating activities that members are expected to participate in. Some professional groups are self-supporting, whereas others are joint efforts among local and regional governments, universities, and the private sector.

One of the most successful private-public partnerships is the chamber of commerce arrangement. Local business entities establish a chamber of commerce organization to enhance the local community while expanding their own businesses. In some instances, the local government provides some type of monetary support for the chamber, but the chamber is neither an agency nor a function of government. For major community events, business members of a local chamber of commerce may provide their employees as volunteer staff who use their professional skills to organize and plan the event's activities. The community benefits, because a

professionally managed event is held with minimal labor costs. The company receives publicity and exposure to potential customers within the local community at nominal costs. A close working partnership between the local chamber of commerce and government can produce outcomes that are mutually beneficial to local businesses and community citizens.

Trade associations are formed within specific industries and concentrate their efforts on issues and topics particular to one trade, profession, or philosophy. Functional trade associations include auto mechanics (Automotive Maintenance Repair Association, amra.org), architects (the Association of Licensed Architects, https://www.alatoday.org/), and marketing professionals (American Association of Advertising Agencies, aaaa.org). Education groups, such as the Association of American Educators, focus on defining competencies and qualifications for teachers and publicly advocating for standards and regulations that affect teachers. Specialized groups also form associations, such as the National Association for the Education of Young Children. Entrepreneurs who are looking for a franchise opportunity might consider an association that caters to franchisees, such as the International Franchise Association (franchise.org) or the American Association of Franchisees and Dealers (aafd.org). Companies interested in "going green" can join the Green Business Network at Green America (greenamerica.org/gbn/). The American Retirement Association (usaretirement.org) or AARP (formerly the American Association of Retired Persons, aarp.org) target retired individuals. Whatever the profession or industry, a trade association is certain to emerge to provide standards, training, support, and services to industry professionals and to be the industry's collective voice to legislatures and government officials in establishing regulations, laws, and licensure qualifications.

Businesses need a steady supply of new customers to replace former customers who no longer have an active relationship with them. The main purpose of *networking groups* is to help entrepreneurs gain new customers. These groups come in all kinds and sizes. Business Network International (BNI, www.bni.com) is dedicated to providing qualified referrals to members. BNI limits its membership to only one person per industry or profession. Members are expected to exchange contact information regarding a qualified potential customer.

Meetup (meetup.com) is a platform where people can meet others with similar wants and interests in an electronic or face-to-face engagement. Meetup's groups are social or professional, business or entertainment, or relational or transactional. Anyone can start a Meetup group if one doesn't already exist for their needs or interests. Each group's founders or members make the rules.

Whether a new entrepreneur needs a lot of support and guidance during the early stages of firm development, or a mature organization needs new potential customers, local organizations can provide an avenue to close connections and professionals who are committed to the local community and its businesses and people. As with all decisions, you must assess each opportunity in terms of the cost of membership and involvement in relation to the benefits you will receive overtime.

Business Incubators

Business incubators are normally associations established by a consortium of local organizations such as a chamber of commerce, local banks and other traditional businesses, and universities to provide complementary support to startup businesses and those in the early stages of development. Services provided may include office space for rent at nominal charges; simple business expertise in accounting, legal matters, and marketing; and management support. Some incubators function as independent organizations, each with its own board of directors, whereas others may be stand-alone units of a university program. One of the best byproducts of being associated with business incubators is the communal contact with all the members' connections. **Business accelerators** function much like business incubators. A key difference between incubators and accelerators is equity investment. Business accelerators usually make some type of equity investment in their members' companies. Because the financial commitment raises the stakes for accelerators, these organizations carefully screen their prospects and select only those businesses that have a reasonable chance of financial success. An entrepreneur who joins an accelerator can expect to receive a lot of support in exchange for a commitment to the organization and a share of the profits. Table 14.1.2.2 illustrates the differences between business incubators and accelerators.

Table 14.1.2.2: Business Incubators and Accelerators

Functional Item	Incubators	Accelerators
Duration	One to five years	Three to six months
Cohorts	No	Yes
Business model	Rent; nonprofit	Investment; can also be nonprofit
Selection	Noncompetitive	Competitive, cyclical
Venture stage	Early or late	Early
Education	Ad hoc, human resources, legal	Seminars
Mentorship	Minimal, tactical	Intense, by self and others
Venture locations	On-site	On-site

Service Corps of Retired Executives (SCORE)

The Service Corps of Retired Executives (SCORE) is a nonprofit organization based in Herndon, Virginia. SCORE partners with the federal Small Business Administration (SBA) and with retired executives from private businesses to offer education, training, and mentoring to small business owners. According to the SCORE website, it is the largest network of volunteer and expert business mentors, with around 350 chapters. Small business owners can attend a workshop or view training videos available on the website. Templates of financial statements and business and marketing plans are also available on the website. Perhaps the most valuable service SCORE offers is a one-to-one mentoring program that can align a mentor with the specific skills that the business owner needs the most.

LINK TO LEARNING

The SCORE website includes a wealth of online resources on starting a business such as online courses and regional workshops. You can also fill out a form to request a mentor to help you start your entrepreneurial journey.

Government Agencies

Economic stability over the long term depends on a continual supply of new companies and organizations. A business entity will close when the owner decides to cease operations or achieves the goals of starting the business. Sometimes a business is unable to sustain operations or is forced into closure by regulatory agencies or licensing requirements. Regardless of why businesses close, new businesses must continually arise to replace them and grow the economy. Governments at the federal, state, county, and municipal levels have established agencies and programs to encourage new business development, support new businesses in the early years of operations, and help young businesses mature to the point of self-sustainment. These include the SBA, Small Business Development Centers, Women's Business Centers, and HUBZones. Figure 14.1.2.2 illustrates some of the government agencies that assist small businesses.



Figure 14.1.2.2: Several government agencies exist to support entrepreneurs and small business owners. (CC BY 4.0; Rice University & OpenStax)

Small Business Administration

One of the most popular agencies that helps businesses in the startup and early operations stages is the SBA. The SBA was established as an agency of the US federal government in 1953. In 2012, the SBA merged with the divisions of the Department of Commerce, the Office of the US Trade Representative, the Export-Import Bank, the Overseas Private Investment Corporation, and the US Trade and Development Agency. At that time, the leadership of the SBA became a cabinet-level position.

The purpose of the SBA at the macro level is to assist and safeguard small businesses, protect and defend a competitive environment, and fortify the national economy. At the micro-level, the SBA helps individuals “start, build, and grow” their businesses and companies through direct counseling, educational seminars and webinars, and public-private partnerships with institutions of higher education and foundations with similar goals and objectives.

Some of the most important activities of the SBA revolve around finances for small businesses. The SBA provides education in finance and money management, and guarantees loans through private lenders for capital, inventory, and startup costs. A business must meet the SBA’s qualifications for funding, but the application and approval of the loan is handled at the local level by officers of a local bank or other SBA-approved financial vendor.

LINK TO LEARNING

Are you looking for a lender to help you start your own business venture? The Small Business Administration’s Lender Match page helps you find lenders.

Once a business is established and operating, ongoing activities are necessary to generate the cash flow to sustain the business. The SBA supports the ongoing operations of small businesses by being the liaison between small businesses and the federal government on bids and contracts. For the fiscal year 2017, the federal government purchased a total of $105 billion in products from small businesses. However, becoming a vendor to the US government is not like selling to a private business or the general public. Free education and training materials are available from the SBA to introduce new businesses to the types of products that the government buys, the government’s purchasing process for products and services, and the technical terms the government uses.

The SBA helps small businesses to maneuver through government purchasing processes through education, training, and support. Furthermore, the SBA has programs and funding operations that help economically disadvantaged individuals. These programs are self-contained within the SBA. Public-private partnerships or partnerships with universities or with other nonprofit organizations are also possible.

Small Business Development Centers (SBDCs)

Over one thousand SBDCs are funded through state grants with matching funds from the SBA. Most SBDCs are located on the campuses of local colleges or universities. Others are located in entrepreneurial hubs or are connected with business incubator programs. The coordinator of a local SBDC may be an employee of either the university or the organization that provides the office space. SBDC coordinators provide advice and information to small business owners at no charge because their fees and salaries are covered by the grants. Mostly, the coordinators provide information, steer business owners to other sources of information, and provide a context for making operational or strategic decisions.

Office of Women's Business Ownership

The Women's Business Center (WBC) is a program funded in part or in whole by the SBA to focus specifically on helping women start and operate their own businesses. Women business owners face the same challenges that men encounter, but women normally must add the role of business owner to their list of other personal responsibilities. Also, women have more limitations in access to capital and other financial resources than men typically experience. The WBC can provide support and access to resources that are unique to women. The WBC is operated through independent and educational centers in most states.

Veteran's Business Outreach Center (VBOC)

The SBA operates twenty VBOCs that focus on helping veterans and their families start and operate a new business. A popular program of the VBOC is the Boots to Business program, which assists veterans making the transition from the military to the owner-operator role. Another program dedicated to veterans is the Service-Disabled Veteran-Owned (SDVO) Small Business Concern (SBC) program, administered through the Office of Small and Disadvantaged Business Utilization. To qualify for the SDVO SBC program, the disabled veteran must directly own and control, at minimum, 51 percent of the business and have input into the day-to-day operations as well as a long-term strategy. Requirements vary according to the legal structure that is chosen. Title 13, Section 125 of the electronic Code of Federal Regulations lists other requirements and restrictions to be recognized as an SDVO SBC.

HUBZone

A HUBZone is a geographic location that has historically experienced low employment. Many are also low-income areas because of limited transportation or educational opportunities. Through the HUBZone program, the SBA certifies and supports HUBZone businesses in acquiring government contracts and buying opportunities. Businesses that qualify may receive preferences in pricing. Qualifications for HUBZone designation are explained on the SBA/Government Contracting webpage. As of 2018, the federal government's goal is to award 3 percent of all federal contracting dollars to certified HUBZone business.

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14.1.3: Building the Entrepreneurial Dream Team

Learning Objectives

By the end of this section, you will be able to:

- Understand key resource needs for entrepreneurial ventures: accountant, attorney, banker/financial institution, insurance agent, and industry expert
- Understand the value of developing a cross-functional team

Over the weekend of July 4, 1970, Casey Kasem started *American Top 40*, a radio broadcast that played songs listed in *Billboard* magazine's top 100 singles. What started as a simple compilation of popular songs that were played in ascending order of popularity ended thirty-nine years later on the July 4th weekend of 2009. When Kasem signed off for the final time, he gave credit to those with whom he worked. "Success doesn't happen in a vacuum. You're only as good as the people you work with and the people you work for. I've been lucky. I've worked for and with the very best."

Jay Samit, a vice chairman at Deloitte Consulting LLP, specializes in exponential technologies, a revolutionary method of creating and manipulating information and data for learning, planning, and communicating. Working with multiple clients who each have their own unique limitations and face a wide variety of challenges, Samit and his colleagues at Deloitte devise tailored solutions that resolve each client's problems while overcoming each client's constraints.

Two professionals, two eras, two industries, and two vastly different technologies, but one concept: Entrepreneurial success is sustained by those around you. The concept that teamwork leads to individual success is evident in many other areas. All the great National Football League quarterbacks will tell you that they depend as much on their linemen as on their receivers. Pitchers in Major League Baseball need a very close relationship with their catchers, but the fielders are the ones who make most of the outs in the game and can make a pitcher look very good. Surgeons need nurses and anesthesiologists, police officers need good partners as well as dispatchers, ground troops need air support, and airline pilots need fantastic ground crews and maintenance crews, and so on.

In reality, no one works alone. As an entrepreneur, you have the luxury of searching, soliciting, and selecting your own team (Figure 14.1.3.1). Entrepreneurial success depends on who is included on that team, and who is excluded from the team. In this section, we discuss advisors and cross-disciplinary teams.



Figure 14.1.3.1: Building the right team is crucial. (Credit: modification of "Achievement American Analysis" by "rawpixel"/Pixabay, CC0)

Advisor: Accountant

One of the most important decisions that a business owner will make before beginning a new venture is hiring a good accountant (Figure 14.1.3.2). Businesses and their owners must be in sound financial health, or the company risks being closed because of financial difficulties. Just as doctors are trained to diagnose and treat health issues and symptoms, accountants are trained to

recognize and treat symptoms and issues associated with the financial health of a company. And just as doctors can determine the health of an infant before birth, accountants can determine the likely financial health of a business before it begins.



Figure 14.1.3.2: A professional accountant's work is an important asset to any business. (Credit: "Numbers And Finance" by "reynermedia"/Flickr, CC BY 2.0)

In the early stages of planning a business, the entrepreneur's personal financial history is the only financial picture that investors, creditors, vendors, or lenders can review. Therefore, it is essential to have a professionally prepared tax return in hand before you approach anyone about opening a new business. Having a professional accountant prepare and file personal tax returns establishes credibility and confidence in an aspiring business owner's financial decision-making. Furthermore, when a business owner is willing to let someone else see all of their finances, it indicates to other professionals that the owner is willing to expose a very personal and sensitive realm—money management.

A highly skilled accountant will help any small business owner set up proper procedures that track cash transactions and record financial activities. Accountants assist in creating a **pro forma**, a financial statement that shows how much and where monies will be collected and spent in the early stages of business creation. For an income statement, many of the figures used in a pro forma are hypothetical, a mere guess, but still are loosely based on historical industry or market data. Documenting debt service (explained in the following text) and other fixed expenses can be a simple task. However, projecting future sales with variable costs can clearly become complicated. Many times, approval for a loan or a building lease will depend on reasonable and sound projections of future sales and expenses. Too often, entrepreneurs overestimate income and underestimate expenses. An accountant frequently brings a reality check to the entrepreneur's wishful thinking and keeps income and expense projections credible.

Tax payments, especially payroll taxes, must be made on time to avoid large, costly penalties. Annual income tax for both a business—whether a sole proprietor, a partnership, or a corporation—and the individuals involved can become very complicated. Tax laws constantly change, but a good accountant will know how these changes will affect the company and how the company should respond. Often, the accountant's fees are lower than any penalty and fine assessed by tax authorities.

Besides tracking tax obligations, accountants can help identify trends within the financial picture. Many new business owners focus on profitability of the company and not cash flow. However, cash flow is far more important to the existence of a new company. **Cash flow** includes money collected by the business through revenue and funding versus money disbursed by the business through expenses. In other words, cash flow equals money in minus money out.

It's true that profitability can be affected by depreciation of assets, and an accountant can apply different depreciation rules to reduce profits and tax liabilities. However, the business must maintain positive cash flows to pay its weekly or monthly obligations. Although today's accounting software can easily generate cash flow reports, the expense of paying a professional pales in comparison to the money and time a business owner would spend in purchasing an accounting package, maintaining yearly upgrades, and learning how to run reports.

When a small business needs to expand or make **capital improvements**, major repairs or improvements that add to the life of an asset by improving its longevity, increasing its value or productivity, or extending its usefulness, it may be necessary for the business to take out a loan. Banks expect and require the company to have a professional accounting service prepare and file federal and state tax returns. Without the impartial eye of a professional accountant reviewing the financial health of the company, lenders may consider the business to be high risk and therefore would be unlikely to offer any loans. Expansion may be delayed or halted because lenders want to know if the company has properly managed its existing business before they are willing to finance additional operations and larger financial transactions.

Bankers will want to see not only income statements, balance sheets, and tax returns, normally for the past three years, but also cash flow statements over the same time period. If the company is functioning as a sole proprietor, LLC, or S-corporation, the bank may require all individuals with management authority or ownership to submit copies of both federal and state individual tax returns plus personal net worth statements. Any investments outside the entrepreneurial company will need to be disclosed as well. All of these requests from lending officers at the bank indicate that they are looking for something. An experienced accountant will be able to interpret their requests, create documents that provide the information they ask for, and advise the entrepreneur on how to address the bankers' concerns.

Inventory management and debt service are other key financial areas where accountants can quickly identify problems that need attention and then offer advice to the entrepreneur. **Inventory management** consists of business operations that include managing the quantity of inventory units in stock, scheduling and cataloguing replacement inventory, organizing shelf location for unit storage, paying for inventory received, and processing, fulfilling, packaging, and shipping customer orders. **Debt service** is repayment of a loan, including principal and interest.

Some vendors will require the same professionally prepared financial documents as bank loan officers do. **Creditworthiness**, or a lender's assessment of how reliable a company is in repaying a debt, is a valuable asset for a business. Being able to buy inventory on credit can greatly improve a company's marketing and overall performance. However, creditors have a different concern about a company's financial health. A vendor that sells inventory on credit may not be able to recoup a loss once the inventory is delivered to the new business. Banks can seize a building, equipment, land, and cash deposits, but creditors are not afforded that luxury. Therefore, creditors are skittish about releasing inventory to financially unstable businesses. Additionally, some businesses may owe inventory or personal property tax on inventory that is in stock.

Advisor: Attorney

If hiring an attorney to keep you out of trouble is expensive, hiring one to get you out of trouble will be exorbitant. Getting an attorney involved with a business in the very early stages, even in the idea development stage, can be a very good investment that will save a lot of legal expenses and protect the company's income. Areas of expertise and the ability to practice in certain areas of the law will vary among attorneys. Entrepreneurs must first determine what legal issue they need help with. Then, they would determine the cost of getting legal help as well as the cost of not getting legal help.

Hiring an attorney can be similar to hiring someone to do construction work on your home. Hiring a general contractor who can do most of the work will be cheaper than hiring a general contractor who subcontracts everything out to specialists. Some attorneys are generalists, with a practice that spans many areas in which the entrepreneur or small business owner will need help. Other attorneys are specialists who limit their practice to a few specific areas of expertise and refer clients with needs outside those areas to other specialists. Generalists are frequently less expensive than specialists, who charge higher fees for their in-depth knowledge of particular areas. In many situations, the entrepreneur or small business owner will not need a high level of legal expertise. When in doubt about hiring an attorney, the new entrepreneur can visit with a few members of their established network to get their input before making a decision.

One of the important questions to ask up front is how the attorney bills for services. Some may charge a flat rate for specific services, whereas others will bill at an hourly rate. Attorneys may add any additional costs and expenses to the client's bill. For example, when filing papers at the county courthouse to register a new company, the attorney may charge for copying, tolls to drive to the courthouse, parking, and mailing fees in addition to completing the actual registration papers. Knowing how the attorney calculates the bill—what fees will be charged and what additional costs will be added—is very important in deciding which attorney to hire.

Attorneys may be associates or partners of a firm. A large firm may have several equity partners and junior associates who are supported by paralegals. Larger firms offer a wider range of expertise and support for your attorney, but that extra help and larger resource pool are available at a higher price. On the other hand, an attorney who is in a stand-alone or small boutique firm may be less expensive but has fewer resources to tap into if necessary and may be unavailable for extended periods of time when actively working for other clients.

An attorney in your specific geographic area or community could be a valuable source of uncommon knowledge. Another consideration to think about when selecting an attorney is the location of their office. Office location may seem trivial, but

attorneys in large office buildings probably have higher fees because they have higher office expenses. However, they are more likely to know other business professionals in their building, and those connections may be helpful at some point. Moreover, attorneys are often keenly aware of major developments in markets, such as real estate transactions and development, new roadways, and regulations.

Law practices can be divided into broad categories and specific areas. If you look at the landing pages of many of the country's prominent law schools, you will find only one commonality among all of them—they include specialized areas in their programs. Five broad categories of law that are relevant to the entrepreneur are administrative, civil, corporate, criminal, and family law. For the entrepreneur, corporate and family law are probably the most important, because entrepreneurs may have family investors and personal assets at risk. An attorney who is skilled in family law would know how to protect the entrepreneur as well as family members if the startup business fails. If you are considering starting a business in a regulated profession, such as electrical repair, HVAC, or childcare, you will want an attorney familiar with the state's administrative code. Hopefully, a startup entrepreneur will not need a criminal defense lawyer. One of the first areas where you should consult an attorney is in determining the type of business structure. Any business structure has both legal and tax ramifications. A business attorney should help the entrepreneur select the legal structure that is best for the business, the industry, and the entrepreneur. Each legal structure—sole proprietorship, partnership, or corporation—has its advantages and disadvantages. The attorney, in collaboration with the accountant, should help advise the entrepreneur about which legal form the business should take and why, not only for tax purposes but also for liability protection for the entrepreneur's personal assets and for ease of operations.

Other issues may arise during the startup stage that would require legal advice. These include branding, patents, trademark registration, and contracts. Will the entrepreneur be leasing a space or purchasing a stand-alone building? If leasing, who is responsible for the safety and well-being of employees and for protection of the equipment and inventory? In the excitement of getting started and making money, entrepreneurs may consider such questions to be unimportant. However, discussing these issues and making decisions before an adverse incident occurs can save the new business a lot of time and money. A good attorney will help keep the focus on important issues before they become catastrophic ones.

Another volatile area for new businesses involves employees and employment law. New business owners may also be new to management. Ignorance of employment laws can be very costly, especially if a disgruntled ex-employee seeks protection from state and federal agencies. Formulating company and employee policies is very important. Having an attorney help develop and use appropriate phrases will be a blessing that you will recognize long after the attorney has cashed your check.

LINK TO LEARNING

Visit the Society of Human Resource Management website with extensive resources for small business owners on many topics related to employment law, including their Workplace Compliance Newsletter and articles on current news at their site.

Attorneys are professionally trained and educated to argue for their clients and to destroy the arguments of their opponents. Having a good attorney who confronts and debunks the naive beliefs and behaviors of the nascent entrepreneur can help that entrepreneur mature into a professional. As a new entrepreneur, you may not find it easy to leave behind the "employee" mentality and enter the "owner" mindset. The entrepreneurial lifestyle, responsibility, position, status, authority, and so on are foreign to the employee population. Therefore, you may need to undergo a trial by fire. A good attorney, like a good marine drill sergeant, has to destroy the old mindset and develop a new mindset within the new entrepreneur: It's all mine.

Although a good attorney is necessary to many aspects of a business, the entrepreneur also needs to set limits and not allow the attorney to tread into the owner's domain. Attorneys should focus on legal issues, not operational, strategic, or—under any circumstances—financial issues. Attorneys may be tempted to go beyond their realm to help out a client, but in reality, they should stay within the areas of law and regulation, and out of operational or strategic decisions. A good attorney will provide information, insight, and recommendations for managing risks, but will not bully a client by insisting on eliminating risks. An entrepreneur should always be ready to terminate the relationship with anyone, including an attorney, who seems to be interfering in areas beyond their domain.

Hourly rates for experienced accountants and attorneys can be frightening. Even if you readily acknowledge that the information and guidance provided by these two professionals is valuable, having the funds to pay for their work in the pre-startup stage of the

business can be impractical. Successful entrepreneurs are known for solving problems, and at the very beginning of your own business, you can start solving your own business problems. The question is: How can I get professional advice at discounted rates?

Often, young lawyers and accountants who have just completed their education or received their license to practice will have very few clients. Likewise, those individuals who have been junior partners in larger firms and are branching out to start their own business will have limited clients. Those two scenarios are ripe for seeking discounted billing rates. Both the entrepreneur and the budding professional have a common need but few, if any, paying customers. Therefore, other business professionals or small business owners whose businesses are in the fledgling stage may be willing to offer special rates or payment terms.

Advisor: Banker or Financial Institution

All banks are not the same. Entrepreneurs need to select a bank or financial institution that can meet their current and future needs (Figure 14.1.3.3). Local banks that target a small geographic area are an excellent choice for small, locally centered businesses. Officers of the local bank may personally know local business owners, employees of the local businesses, and other key members of the local community. When a small business has a financial need, officers of the company may make decisions based on the reputation of the entrepreneur and the business. Sometimes a local bank will make loans and provide financial assistance with less scrutiny than an entrepreneur would face at a larger bank. For the small entrepreneurial business, banking is personal. Bankers like to see businesses in their backyard succeed.



Figure 14.1.3.3: Selecting the right financial institution for your venture will help create a path for security and growth. (Credit: “Money Coin Investment Business” by “nattanan23”/Pixabay, CC0)

Large banks with multiple branches in numerous cities, states, or countries may be a better choice for banking services if your company will have broad geographic and financial needs. With employees, customers, and vendors scattered over a large market, a large company is better off having a bank that mirrors that broad reach. For example, if an entrepreneur starts a business in Hutchinson, Kansas, and banks with a local bank in Hutchinson, that intimate relationship between the business and its employees in Hutchinson probably works great. However, as the business grows into the Wichita and Kansas City markets, its banking services should expand too. Likewise, expanding a business across state lines should initiate a thorough review of banking arrangements to ensure that banking services will match the needs of the expanded business.

Large companies with multiple branches or employees over a larger area have bigger demands in banking products and services. They will be better off with larger banks that can respond faster and more effectively to market shifts or individual needs.

Advisor: Insurance Agent

Having insurance is a necessity for every business. Entrepreneurs, however, should not overlook the advantages of an insurance agent’s knowledge and industry insight. Insurance agents ought to be in the entrepreneur’s portfolio of industry professionals. Furthermore, insurance agents likely have other clients who have been successful business owners for many years and may well introduce a new entrepreneur to seasoned veterans.

The insurance industry is a trove of data regarding almost every aspect of any industry or profession. All of that information is at the fingertips of your insurance agent. Agents can obtain information about any industry by running liability reports according to numbers compiled by the **North American Industry Classification System (NAICS)**, a standard used by US federal agencies to collect, analyze, and report statistical information about businesses; the government provides a searchable database related to the codes as well (https://www.census.gov/eos/www/naics/). Every business in the United States is assigned a NAICS number, and insurance premiums are determined by the risk associated within each classification. You can obtain your NAICS number from

your federal income tax return form 1120S or 1040 Schedule C. Knowing your business classification and the risks associated with it, your agent can assist you in reclassifying your business and lowering your insurance premiums, a potentially big financial savings.

Advisor: Industry Expert

Studies show industry expertise and skills are vital to successfully launching and operating one's own business. However, a lack of industry skills is not an impenetrable barrier to entrepreneurship. In fact, about 15 percent to 20 percent of successful entrepreneurs have no industry experience or have limited knowledge about an industry before entering entrepreneurship. In the service professions, the entrepreneur's lack of skill is hardly noticeable, but technical industries have a higher success rate for entrepreneurs who already possess the skills needed in the industry. Even if you do have those skills, you are more likely to succeed if you select industry experts who know the ins and outs of your profession (Figure 14.1.3.4).

Figure 14.1.3.4: An industry expert can advise you and your team. (Credit: "woman standing in front of sitting people" by Unknown/Pexels, CC0)

With the industry professional doing the work, the new entrepreneur can focus on the business aspects of the operation while gaining industry experience and insight through hands-on exposure. As many first-time entrepreneurs find out in their first year, they will spend less time on the technical aspects of working in the business and more time managing and working on the business itself. Good collaboration between a technician and an entrepreneur increases the chances of long-term success.

As you begin searching for and interviewing professional advisors such as attorneys, accountants, or industry experts to make your team (Figure 14.1.3.5), you should follow a few fundamental principles. First and most important, you—the business owner—are the decision-maker. Business owners, not members of the advisory team, reap the benefits of good decisions and bear the cost of poor decisions. Advisors inform, explain options and risks, share knowledge about others with similar situations and their outcomes, and make recommendations. An advisor's role is neither to make decisions nor to "sell" one particular viewpoint. Second, expectations and fees should be discussed before any actual work is done. Often though, a brief visit with a professional may be conducted at no charge so that each party can determine what is needed, whether the professional has the time and skills to meet the client's needs, and whether the client can afford the fees.

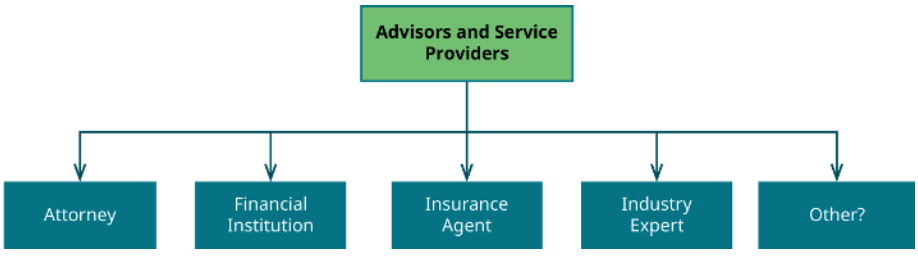


Figure 14.1.3.5: Your team should include advisors and professional service providers. (CC BY 4.0; Rice University & OpenStax)

Another consideration is that all professionals have limitations. Licensed professionals such as attorneys and accountants are experts in their respective fields, but they are not necessarily experts in general business operations or strategy. Industry experts may be very knowledgeable in many aspects of the business, but they too have boundaries. Last, shopping for experts to advise you on crucial matters should be based mostly on competence and compatibility, not strictly on fees. Securing the services of a professional is a serious matter and should be treated as such. Yet, it is a business arrangement subject to traditional market factors such as service quality, affordability, accessibility, and change over time.

ARE YOU READY?

Who Am I? Who Am I Not?

Knowing what type of person you are can help you make good career choices. Knowing what type of person your potential employee is can help you make a good hiring decision. Create a list of personality traits that you think you possess. Ask close friends, family members, instructors, or others in your life who will give you their input about your personality. People with all types of personalities and traits can be successful entrepreneurs. The difference is in how you manage yourself and what you do to compensate for areas of weakness.

A reliable tool to identify certain personalities traits is the Sixteen Personality Factor Questionnaire (16PF) developed by Raymond B. Cattell. Visit the Sixteen Personality Factors Questionnaire site to take the 16PF questionnaire.

1. What factors are reflected that you expected?
2. What factors are revealed that you did not expect?
3. If your results show that you are timid, what might you do to overcome that when you become an entrepreneur?
4. If you tend to be a perfectionist, how might you manage the uncertainties of entrepreneurship?
5. Which traits or skills on your list match or are similar to those listed by your acquaintances? Which responses do not match?

Research the functional skills that you will need to start a business. Create a list of functional skills that you believe you possess. Ask close friends, family members, instructors, or others in your life who will give you their input about your business knowledge and skill. Then:

- Make a list of the functional skills you need for your new business. Add your name next to the functional skills that you have.
- Make a list of people you know who have different functional skills than you. Add their names next to the functional skills you do not have.
- Which of your friends and acquaintances appear on both the personality and functional lists? What do you think this means?

Building a Cross-Disciplinary Team

Rarely does an entrepreneurial venture start or function due to the effort of only one person. “Birds of a feather flock together” may be a popular saying, but it is a very poor organizational strategy for building a team to start a successful business. Diversity is a key feature of successfully managed organizations. Compatibility and collaboration are also important, as each employee is duty-bound to work with, support, and assist other employees when necessary. Having staff with complementary skills and who get along improves the likelihood of success for a new business.

A new restaurant provides a great example of how employees with assorted talents, expertise, and responsibilities are assembled to make a bustling organization profitable. For a new owner, the first hire is a manager. Hiring a good manager with experience means a larger payroll expense but produces better financial dividends over the long term. A good manager oversees all staff as well as all operational functions such as scheduling, buying, pricing, marketing, health code compliance, and business support functions. Perhaps the second key hire is the chef, who is responsible for creating the menu, distinguishing the restaurant from its competitors, and creating repeat customers who want high-quality, tasteful meals.

Front-house employees—the hosts/hostesses, servers, and bussers—play critical roles as the faces and voices of a restaurant. The first experience in a restaurant will leave a lasting impression, so those at the front are obliged to appear and act professional at all times. Servers, who have the most direct contact with customers, are the sales force of the business and the liaison with the chef.

Servers' incomes depend on tips and turning tables, so it is essential for them to have tables cleared quickly and properly prepared for the next group. Servers, therefore, rely heavily on the bussers for those important tasks. In many restaurants, bussers receive a portion of the tips left for the servers, establishing a codependency between those two key positions.

Other positions in a restaurant are the bartender, dishwasher, custodian, payroll clerk, bookkeeper, and so on who must perform their duties accurately and efficiently. Subpar service in any one of these functions jeopardizes the viability of the restaurant. Every employee at each and every level is crucial, ind**ividually as well as collectively.**

WHAT CAN YOU DO?

Make a List, Check It Twice

Building a team is a skill that you can learn. One of the first steps is to identify what tasks need to be completed and what skills are necessary to complete those tasks. People in all types of leadership positions build teams. Whether they are in government, large businesses, individual retail stores, small businesses, local athletic teams, or schools, leaders go through the same process of identifying tasks and the skills necessary to accomplish those tasks and then searching for people with those skills.

A key to learning is practice. You can practice building a team and then checking with people in charge of various organizations on how well you did. For example, select a local organization that you are somewhat familiar with—a local school, a community athletic league, a church, or a scout group. List the tasks and skills you think are needed to run the organization successfully. Then observe the organization in action. Make adjustments to your list. Ask to consult the manager in charge to see how well you did. How does your list compare with the actual operational structure? How is your list different? What did you overlook? How many people are doing more than one task?

After doing this a few times, you will begin to see organizations from a functional viewpoint. This is a skill any entrepreneur needs to have. What does my business do? What skills are needed to do those activities? Which person will I select to do those activities? If my first choice declines, who will be the backup?

Not only does a business need people to perform functional activities and day-to-day operations, but it also needs people to advise in other areas such as strategy, finances, management, staff, or legal. Should I have sales? Special promotions? Expand my product lines? Raise my prices? Get another investor for expansion? What are your long-term objectives? How will you achieve them? Having individuals you can talk to about your long-term goals is important. Surrounding yourself with those who can ask the right questions, confront you on weak areas, make you consider topics that you had not considered—all without judging you—is important if you have any plans to grow your business.

Create a second list of people you know and trust, a list solely for advising purposes. Members on this list can be from any industry as these are strategic questions, relevant across all industries and markets. They will help with your business strategy and structure, not operations.

A very common organizational structure for a new venture is the flat organization, consisting of family members, friends, or professional colleagues who take responsibility for different tasks. The bond that brings this group together in launching this new business is unlikely to bring to the table all of the skills, talents, personalities, perspectives, and viewpoints that can lead to long-term success. Therefore, expanding the team's human resources beyond the founding members who also manage the business is crucial. Although they do not have to become employees, access to them is as vital as having key personnel on your payroll.

An entrepreneur with a creative or big-picture mindset may not want to be bothered by day-to-day activities. If that is the case, then someone else in the business needs to be the analytical, linear-thinking individual who can process information and data to make sound decisions. After carefully considering a situation, collecting information, and studying all relevant facts affecting the business, a *problem solver* can recommend what action the entrepreneur should take, to whom should the tasks be assigned, when to implement the solution, and how much money to dedicate to solving the problem. In other words, the problem solver becomes a lead advisor to the entrepreneur, the manager. If the creative entrepreneur is one side of the coin, the problem solver is the other side. When those two minds work in tandem, good things can happen.

In contrast, an entrepreneur may be a functional expert or licensed professional who is obliged to perform the tasks personally—for example, an HVAC technician, dentist, or professional driver. In that case, a business manager is needed to run the business side of the company. Rules, regulations, and deadlines for business activities are beyond the functional entrepreneur's scope of interest, but

they must be complied with accurately and in a timely manner, or the business may close. Like the creative founder who hires a day-to-day manager, a performance entrepreneur needs to hire someone dedicated to business functions.

Successful business owners keep careful track of metrics. They categorize and track expenses and analyze profit margins, production performance improvements or declines, employee attendance, and other measurable activities. Accurately interpreting the financial and operational performance of the company by the numbers provides the management team the information they need to make sound decisions. Having someone on the team with an aptitude for working with numbers is critical. The numbers must speak for themselves. Personnel must remain inside the box when they draw conclusions from data.

However, solutions to problems are not always inside the box. Nonlinear thinking, also known as creativity, or "thinking outside of the box," is sometimes needed to solve problems. Creativity is the source of many new ideas, products, and processes. With companies facing shorter times of competitive advantage, the entrepreneur needs to be constantly reinventing both self and company.

Over time, as the business grows, the entrepreneur makes the transition from owner-operator of a startup through the small-business phase to being the owner-operator of a mature business. Entrepreneurs eventually need to make the cognitive shift from working in a state of ambiguity to performing methodically in a predictable environment. A business model where routine, repetitiveness, and predictability occur is more appropriate for established businesses because it brings stability and confidence to employees, customers, lenders, and investors alike. Using time-tested business methods and learning from previous experiences, an entrepreneur may avoid pitfalls that could doom a startup company in the early stages.

Every organization—whether for-profit, not-for-profit, political, religious, or social organization—relies on revenue. For-profit businesses rely on sales as their main source of revenue. Nonprofit organizations, such as community organizations, political groups, or religious groups, depend upon donations, contributions, gifts, and grants. Some nonprofits, such as youth sports leagues, community performing arts groups, or scouting groups, bring in cash through fundraisers or through ticket sales for events. Governments customarily depend on various taxes as sources of revenue. Some local governments receive funds through block grants from their state and federal governments. Having multiple revenue streams improves cash flow and increases the prospects of long-term success.

Recruiting the person who will generate income for the organization should be a high priority during the earliest stages, perhaps even before formal operations, of the business. For a salesperson, grant writer, donor coordinator, or any other title referring to an income-generating position, a startup organization may have to offer a sweeter-than-normal compensation package. If the person can produce revenue and generate cash flow in excess of their total cost of employment, then he or she is worth the costs of higher commissions and bigger bonuses.

Trying to improve short-term financial performance and increase profits by reducing a key employee's compensation is likely to be detrimental over the long term. Losing a good sales rep may make the company vulnerable to losing very important and profitable customers. Failing to retain an effective grant writer could be the beginning of the demise, or at least a major downfall, for a nonprofit. Smart entrepreneurs pay their revenue producers appropriately, even if it means paying them more than the entrepreneurs pay themselves. As the old proverb states, "Never bite the hand that feeds you."

WORK IT OUT

Design the Business? Build the Product!

Stan enjoys building wooden patio furniture. He started his craft while in high school and worked with a cabinet maker during his college years. For the past twenty-five years, he has been a marketing and sales representative and sales division manager for a restaurant equipment manufacturer. Recently, his company was bought by an international company, and Stan's entire division was eliminated.

Stan was offered a new position with his current employer, but he would have to move to a new city. His family is against moving. His wife would have to quit her job teaching art in elementary school, his son does not want to miss his senior year of playing baseball, and his daughter has just started a new job at a nearby restaurant.

Stan decided to start his own business making customized outdoor patio furniture. He already owns most of the equipment and tools needed to make the furniture. He has long-term relationships with his suppliers. However, his workshop in the backyard

is not large enough to store raw materials or support an assistant. Besides, if he wants to make a living wage, he has to have a large place to handle the volume necessary to be successful yet safe.

Stan is comfortable with the technical aspects of making furniture. He knows how to do marketing and sales, including pricing and financing. What he is not comfortable with is everything else he needs to get the business started. Stan does not want to spend a lot of his retirement funds, so getting started with minimal expense is his goal.

What does Stan need to start his business? What type of professional help does he need and why? Who can help him?

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14.1.4: Designing a Startup Operational Plan

Learning Objectives

By the end of this section, you will be able to:

- Identify the major areas of operations management (money, methods, machines, people, and leadership)
- Develop a checklist of operational needs

From the start, every entrepreneur needs a business plan. Your business plan will keep you focused on the very early stages of the business, when it is easy to be distracted. A written business plan can help redirect you back to your original idea.

Business plans can be divided into four different types: operational, strategic, tactical, and contingency. In this section, the focus will be on the operational plan, the activities that an entrepreneur-owner absolutely needs to do. The core business activities and how those activities interface with customers are key to a business's long-term success.

Operational Business Plan

In the early 1900s, the mechanical engineer and management consultant Frederick Taylor introduced *scientific management* techniques into manufacturing industries. Since then, operational planning has evolved into a major component of successfully managing a business. An operational business plan details the what, when, who, how long, with what, and how much of company activities. This type of plan may list specific functions: What the activities of the business are, when those activities occur, who is responsible for various tasks, how long each activity will occur, what tools or equipment are required, and how much time and funding are needed.

Operational business plans should be flexible enough to allow for challenges that will occur. Some changes must be made on a daily or even an hourly basis. Other changes may be necessary only occasionally throughout the year. However, the purpose of the operational plan is to provide direction and guidance. This way, everyone in the business knows their specific assignments, who is responsible for individual tasks, and when major events occur.

Creating a table or chart in an Excel or other spreadsheet format can help your planning and scheduling. Figure 14.1.4.1 illustrates how workstation scheduling for a grocery store can be displayed in an Excel spreadsheet. Functional activities, specific job tasks, work shifts, or workstations are listed as column headings. Hours of operations are listed as row headings. Employees' names are entered into individual cells, showing who is assigned to each specific task or station. The table doesn't show every position, but enough positions are listed to give you an idea of how to use the same format for your own business.

Time	Manager	Front Counter	Produce	Dairy	Register #1	Register #2	Register #3
6:00	Keith	Jamal	Lewis	Justin	Gabriela		
7:00	Keith	Jamal	Lewis	Justin	Gabriela		
8:00	Keith	Jamal	Lewis	Justin	Gabriela		
9:00	Keith	Jamal	Lewis	Justin	Gabriela		
10:00	Keith	Jamal	Lewis	Justin		Shelby	
11:00	Monica	Eleanor	Lewis/Kate	Matt	Gabriela	Shelby	
12:00	Monica	Eleanor	Lewis/Kate	Justin/ Matt	Gabriela	Shelby	
1:00			Lewis/Kate	Justin/ Matt	Gabriela	Shelby	Eleanor
2:00			Lewis/Kate	Justin	Gabriela		Eleanor
3:00				Matt		Shelby	
4:00				Matt	Emily	Shelby	
5:00				Matt	Emily	Parvati	Jesse
6:00				Matt	Emily	Parvati	Jesse
7:00				Matt	Emily	Parvati	Jesse
8:00					Emily	Parvati	Jesse
9:00						Parvati	Kate
10:00					Carol		Kate

Figure 14.1.4.1: The table shows a schedule of work stations by hour. (CC BY 4.0; Rice University & OpenStax)

This type of schedule displays every functional position, the hours that each position has to be covered, and which employee is assigned to that function at what time. The manager can look at this schedule and know that each function has been assigned to an employee during a definite time period. If the work is not being completed, this type of schedule can help a manager make an informed decision about whether to hire more employees. Furthermore, if a problem occurs, the manager knows which employee(s) were working at that station when the problem occurred and can go directly to the employee(s) for information. When an employee is unable to fulfill a shift, the manager can change the schedule quickly to ensure that every task is being completed and every position is attended to.

Individual schedules and assigned workstations can also be displayed in a worksheet (Figure 14.1.4.2). This allows the manager to schedule an employee for the proper number of hours per week and helps budget payroll expenses. Employees know where they are expected to be and when they are scheduled to take lunch or dinner breaks, and the manager knows where the employee should be. When operational questions arise, the manager knows who was scheduled to be at the site and can go directly to that employee.

Time	Keith	Eleanor	Jamal	Lewis	Shelby	Jesse	Emily	Carol
6:00	Floor		FC	Produce				
7:00	Floor		FC	Produce				
8:00	Floor		FC	Produce				
9:00	Floor		FC	Produce				
10:00	Floor		FC	Break	R#2			
11:00	Floor	FC	Break	Produce	R#2			
12:00	Floor	FC	Break	Produce	R#2			
1:00	Floor	R #3	FC	Produce	R#2			
2:00	Floor	R #3	FC	Produce	Break			
3:00	Floor	FC	FC		R#2			
4:00	Floor	FC			R#2		R#1	
5:00		FC				R#3	R#1	
6:00		FC				R#3	R#1	
7:00		FC				R#3	R#1	
8:00						R#3	R#1	
9:00								
10:00								R#1

Figure 14.1.4.2: This table shows a schedule of employees by hour. (CC BY 4.0; Rice University & OpenStax)

Using tools such as spreadsheets for scheduling and managing day-to-day operations brings organization and stability to daily operations. Managers know that each task has a person assigned to it, and employees know where they should be or what they should be doing throughout the day. Complex businesses with many employees and many functions need more planning and structure. Businesses with very few employees can be less structured. However, a written plan should list most tasks and activities that need to be accomplished, who will do them, and when.

LINK TO LEARNING

Many templates and spreadsheets are available online that small employers can use to organize and schedule employees. Using key terms—for example, *employee*, *schedule*, *work station*, *template*—in popular search engines can produce multiple results.

ENTREPRENEUR IN ACTION

Scheduling Sounds Simple

Scheduling materials and parts for a fixed operation can be difficult. However, it can be even more challenging to coordinate your personal schedule with on-demand childcare needs near your workplace. Avni Patel Thompson undertook this massive challenge when she started Poppy, an on-demand childcare service, in 2015.

Recruiting customers and employees for any business can be challenging, but when a company business model is centered around customers who have unscheduled demands and employees who want consistent income, the company needs a high-tech solution. Poppy was an app where parents could submit their request for a caregiver. The app's algorithm would then scan all available caregivers who were available during the window of time requested and were located reasonably nearby. After the app did its work, a staff member would make the final decision and confirm the caregiver with the family.

Unfortunately, Poppy succumbed to the overall market and economic conditions plaguing the child care profession and closed in December 2018, but the business model is an example of one way to solve complex scheduling issues.

Questions about Poppy and its scheduling procedures:

- How is an app better suited for this type of scheduling requirements than a full-time employee?
- What requirements are mandated for the customer? Employee? Company?
- Will a new application of technology overcome other economic and marketing factors?
- How reliable is the technology? What potential threats to the "established" method of scheduling are possible when technology is updated?

For tasks requiring attention on a monthly, quarterly, or annual basis, a simple organizer/calendar can be an excellent tool to help organize and remind you of what needs to be done and when. Tasks that you must complete on time throughout the year include payroll tax deposits and reports, insurance renewal applications, permits and license renewals, employee training and recertification requirements, and account billing to certain customers. A calendar also can help you schedule advertising and marketing activities. Some events occur regularly each year at the same time or within a known time frame. This can help remind you when to start your advertising and marketing campaigns.

You can plan for major maintenance and repair in advance or keep track of scheduled price increases, pay raises, adding or removing menu items, rearranging shelving for seasonal products, and major cleaning or maintenance activities.

As you start your business, you may need to make some adjustments to your operational plan. An entrepreneur might overlook factors that occur regularly. Or a new entrepreneur may have considered some factors to be minimally influential when in fact they may be significant. Entrepreneurs might give high priority to influences that never materialize. Once the business is open, customers and competitors may not behave as expected. Employees may have skill sets that were omitted from the written plan, or they may lack needed skill sets. Even a well-written operational plan will most likely need to be tweaked shortly after operations start. But if you formulate your plan correctly at the beginning, your functional operational plan should rarely need a complete overhaul.

Control

One element that should be included in every operational plan is control. In an operational plan, a marketing plan, an employee development plan, or any other type of plan used in business, control refers to the measurement of outcomes and an evaluation of the activities that led to those outcomes. The control element of a business plans answers the questions, “Have we accomplished what we wanted to accomplish?” and “Have we met our goals within the time frame that we wanted?” Without measuring performance outcomes, the entrepreneur does not know if the business is operating as expected, worse than expected, or better than expected.

If a business performs better than expected, the entrepreneur must consider if the original expectations were too low or if some other factor contributed to the better-than-expected performance. On the other hand, if the business performed worse than expected, two reviews must be conducted. First, why are outcomes less than expected and what can be changed to improve performance? Second, how do lower outcomes affect the viability of the business?

Comparing actual outcomes with expected outcomes is a form of internal comparison called **baselining**. Baselining is important because the entrepreneur must conduct a self-evaluation on what the business has done versus what it can or should do. An entrepreneur can decide to adjust a business’s capability after conducting a baseline study. However, internal comparisons should be coupled with an external analysis, called benchmarking. By comparing your business with a close competitor’s or with the industry average, you can get a better idea of how your business fits into the larger market.

Industry Benchmarks

If a basketball team scores sixty-eight points, do they win? If a baseball team scores four runs, do they win? If a soccer team scores five goals, have they lost? The answer to all three questions is simple: We need more information. Without knowing the other team’s score, we don’t know if a team has won or lost. There must be some other score for comparison; otherwise, the points scored are meaningless.

Similarly, businesses need to compare their individual performances with some external performance measurement. The comparison with an industry average, a leader within the industry, or a market segment is called **benchmarking**. Benchmarking allows a direct comparison of your company with the collective whole of the industry or market, or with an industry leader. By looking at several performance measurements, you can see if your company is performing at a level that will sustain itself over the long term or if your company’s local market is atypical compared with another company’s market. If the performance level of a startup company does not match the industry average or the industry leader, that does not mean that the company is poorly managed or cannot be profitable. Underperforming industry leaders indicates only that your company is not the same as those leaders. Frequently, benchmarking against a local market area is better than benchmarking against national leaders or the industry as a whole.

Operations Management

Operations management can be summed up in three words: Get it done! The foundation of operations management is the theory of scientific management. As we have seen, Frederick Taylor developed scientific management to introduce organization, scheduling, coordination, standardization, and cooperation among workers into the production process. Taylor saw a production plant as a large, multifaceted organization with many interrelated activities that should function as one large machine. The activities of each worker within one group had to be coordinated with other workers’ activities within that same group. Each worker group had to be coordinated with other worker groups. Worker groups were clustered into larger cohorts. To keep materials moving through the manufacturing process, activities had to be planned, scheduled, and monitored.

Whether you are working in a manufacturing environment in which raw materials are converted into finished products or in a service environment in which customers receive experiences, these five components of operations management—organization, scheduling, coordination, standardization, and cooperation—must be the foundation your firm’s activities. To have productive outcomes, the firm must have important inputs: money, methods, machines, people, and leadership (Figure 14.1.4.3). If any of these essential management elements are deficient or lacking, the company is probably functioning inefficiently and could be at a higher risk of failure.

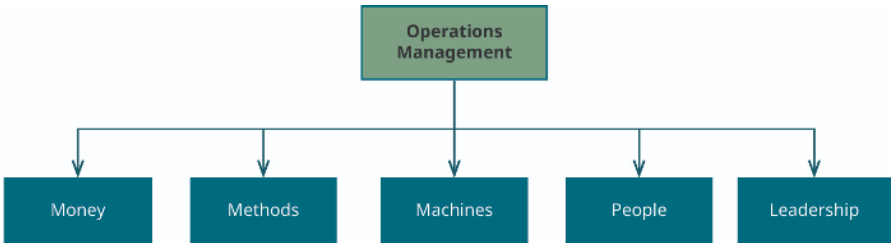


Figure 14.1.4.3: Money, methods, machines, people, and leadership form the foundation of operations management. (CC BY 4.0; Rice University & OpenStax)

Money

Three terms—money, cash, and currency—are often used interchangeably, but each has its own distinct meaning and application. Money is any legal instrument that can be used in the exchange of goods and services. Money includes paper money or coins, but it also includes checks or money orders. In developing countries, money might be any physical item that is considered valuable to people wanting to exchange some goods or services. Most money, though, is in the form of cash.

Cash typically refers to physical money or currency, but it also includes deposits in an account (checking, savings, or certificate of deposit) at a financial institution. For example, customers can pay for their purchases with paper money, coins, checks, debit cards, or credit cards. The paper money and coins are taken to the bank for deposit. The debit card and credit card transactions are debited to the business's checking account by its bank. The cash balance of the business increases by the amount of the deposits, regardless of the form of the deposit. The cash balance is shown on the company's balance sheet and is the amount of money the company has available to pay its debts and obligations.

Currency is paper money or coins printed or minted, issued, and backed by a national government. Currency is divided into denominations or units in both paper and coin formats. With the expansion of international trade, along with the expansive movement of people among countries, it is important for an entrepreneur to know how global markets affect the value of money. Each national government decides what denominations of currency to produce. The value of a national currency is determined by the ability to exchange it for another national currency. Raw materials and supplies that originate in another country may increase in price significantly because of a decline in value of the US dollar or an increase in value of the country of origin's money. Likewise, raw materials and supplies may have a price decrease because of shifts in the value of money.

Knowing and understanding how international monetary policies and activities affect a local entrepreneur can be critical to long-term growth and survivability. You must have a clear understanding of projected costs of materials as well as enough funds available at the right time to meet your financial obligations.

Liquidity is a measure of a company's ability to meet its immediate and short-term (i.e., due within one year) debts and obligations. It's a way of describing how well you can cover your current liabilities using your current assets. When a company is liquid, it can meet its financial obligations on time, typically on a very short timeline. If the company pays its bills on time, the risk to lenders is lower, so lenders charge lower interest rates; insurance companies may set lower premiums; and vendors may offer cash discounts for early payments. Maintaining liquidity is vital to the success of a small business, as it may have limited access to other financial options.

Other sources of cash include credit accounts such as a line of credit, a company credit card, accounts payable, loans, or your own reputation and goodwill. A **line of credit (LOC)** is an agreement between a bank and a depositor in which the bank makes available a maximum amount of money the depositor can borrow at any time during the term of the loan. The borrower pays a fee during the term, whether or not there is an outstanding balance, and also pays interest when there is a balance on the loan. All of these sources of cash are more cumbersome and involve more planning and preparation than liquid accounts. However, these nontraditional money sources are typically necessary for a new business owner in order to pay for business activities before the company begins collecting money from its own paying customers. Mismanaging these short-term debt accounts can easily become a burden on a small business. To better manage the financial obligations of the business, the entrepreneur needs to know which financial tools are available, how to use them, and which tool to use for which purpose. Financing is the use of money to conduct company activities. Payment sources for business activities and resources should match the life expectancy of the resource. Long-term debts—such as for land, buildings, equipment, and machinery—should be paid off through long-term financial instruments that are known as secured debt. Ordinarily, a loan used to purchase long-term assets will have a shorter life than the assets. For

example, a machine that is expected to be useful for ten years should be financed with a loan that is paid in full in less than 120 months (ten years × twelve months). The purpose of long-term debt is to create revenue that exceeds the loan payment and interest. In this arrangement, the asset pays for itself by generating more cash than is needed to pay the principal of the loan, interest on the balance, costs to operate the equipment, and any additional insurance required or taxes assessed against the equipment.

Short-term or current liabilities, such as payroll, taxes, insurance, and all other operational activities, should be paid for through short-term cash resources. Most short-term payment obligations occur each week (payroll) or at least each month (insurance, rent). Short-term cash resources include sales, accounts receivables, down payments, and line of credit. Confusing long- and short-term financing strategies jeopardizes the financial stability of the company. Mismanagement of finances could create a situation in which the company is unable to pay its bills on time. When a company cannot pay its short-term obligations, it may not be able to operate much longer.

Managing cash collected and spent is one of the two most important responsibilities of the entrepreneur. A positive cash flow exists when cash received exceeds cash spent. A negative cash flow occurs when cash received is less than cash disbursed. All companies and organizations will experience a negative cash flow at some time. However, good managers will have a savings account or access to other cash in order to meet current financial obligations. What is important, though, is to have a positive cash flow over the long term.

Paying bills is not fun, especially when you have little cash to work with. Three popular methods of paying bills include credit, cash on delivery, and deposits on account. An entrepreneur's vendors may use all three payment methods. Likewise, the entrepreneur can use all three to collect monies from customers.

When bills are due and the company does not have enough cash to pay the bills or the timing is inconvenient, the company must use credit. Credit is the promise to pay later for something already acquired. Short-term credit may come with no interest charges or fees, such as accounts payable. Vendors will routinely allow established customers to take possession of inventory or products without paying for them at the time of delivery. Payment for products is due on a specific day or after a defined period of time.

Often, a vendor will offer terms of payment at the end of the billing cycle. For example, if the terms are net thirty, purchases that a small business makes during one month are expected to be paid for in full at the end of the next month. Payments made after the due date are subject to a penalty and interest. Sometimes a vendor will offer an incentive to pay early, such as a 2 percent discount if the payment is made in less than fifteen days.

Many startup businesses must make payments at the time of delivery, a form of transaction known as cash on delivery (COD). When the delivery is made, the delivery driver or the online agent will release the product to the customer once payment has been received. This payment method can burden a startup that does not have liquidity. On the other hand, a startup business can reduce its losses by requiring COD payments from its new customers, as it receives payments and has the funds to pay its own obligations.

For unique or specialized products, some vendors will require a deposit from the customer before the product is made. This deposit reduces the financial risk to the vendor for a custom product that may be difficult to resell if the original customer backs out of the purchase. It also provides cash to the producer, who needs to buy raw materials to make the finished product. For the startup entrepreneur, paying for products beforehand could strain the cash available for ongoing operations. However, if the entrepreneur's customers provide a down payment before the product is produced, the entrepreneur secures a noninterest loan from the customer.

All three of these payment methods are used in business transactions. Cash generated during each financial cycle must equal to or exceed the expenses paid during each cycle. Otherwise, the company may find itself without any money and be unable to afford to stay in business.

Methods

The study of how work is performed is called **ergonomics**. It involves designing, arranging, and coordinating tools and equipment so that the movement of workers who use them is safe and efficient, and products flow through the appropriate workstations in a timely and efficient manner.

Work methods are perhaps most important when complex machinery and equipment are involved. A progressive movement of products from one stage to the next should reduce the employees' time and effort, which reduces costs. Raw materials should be delivered to the location nearest where it will be used. Moving and storing large inventories at each point of assembly is easier and more efficient than storing parts at another location and moving them to workstations when they are needed. Timely delivery of

inventory is equally important. Delivery of materials at the moment they are needed is called the just-in-time strategy. If component failure is detected, the point at which the part was assembled can be identified, and the deficiency quickly corrected.

LINK TO LEARNING

The just-in-time inventory system, developed in Japan during the 1960s and 1970s by the Toyota Motor Corporation, significantly changed production management. To develop a new system, Toyota took advantage of three crucial factors affecting post-war Japan: (1) limited resources, including cash; (2) value-added activities; and (3) reliance on business relationships that are mutually beneficial. They were able to avoid wasted investment and to effectively manage workloads. Watch this video on other common factors between startup entrepreneurs and Toyota to learn more.

Service industries also apply the assembly line approach. When workers become proficient at their tasks, they can perform the minimum actions needed to complete a task without sacrificing quality. The assembly line approach has given birth to another ergonomic philosophy, lean project management.

Many fast-food restaurants, such as McDonald's and Subway, use the assembly line approach to prepare food quickly and correctly. For example, in making hamburgers, one employee selects the bun, puts the appropriate meat patty on it, and then pushes it to the next worker, who may add onions, cheese, tomato, and lettuce before passing the order to the next station. Once the hamburger is complete, it is passed along to the last worker, who wraps the food and places it in a bag or on a tray.

When employees' tasks are limited to very few functions, repetition of movement makes their work quicker. This specialization results in higher quality. Specialization allows each worker to increase productivity, improve efficiency, and reduce mistakes. This division of labor has become a major component in Western economic models. Adam Smith first explained it in his work *The Wealth of Nations* (1776), using pin makers as his illustration. Smith theorized that reducing the number of tasks required of each pin maker would enable each worker to improve his efficiency of motion, resulting in both uniformity in quality and higher production levels.

This increase in quality and quantity of work increases the productivity and profitability of the worker. Collaboration among workers who work in close proximity occurs naturally. A weakness that materializes with one worker may be canceled out by an increase in another worker's efforts. However, human labor continues to be replaced by machinery and electronic instruments developed during the Industrial Revolution and the modern technology revolution. Nevertheless, human labor is essential on the production line, whether in creating or assembling products or performing services.

Machines

Beginning in the late eighteenth century, the Industrial Revolution shifted work from muscular power to mechanical power. Ever since, humans have used machinery to perform tasks greater than what they could achieve by themselves or using large animals. Machines provide consistency of work and higher volumes than human workers at lower costs per unit made. However, the initial outlay of cash for machinery can be large.

For a startup entrepreneur, purchasing machinery can be a difficult, time-consuming, and complicated task. First, one must look at the **total costs of ownership (TCO)**, which is the comprehensive cost of owning large capital items, including initial direct costs, operating direct costs, and indirect costs. Maintaining and repairing operational equipment is difficult, especially when production schedules demand the machine to be operational. Poor planning can be very costly, especially for a startup business, because your ability to produce and deliver products on time reflects on your reliability to both your customers and your employees.

When making equipment purchase decisions, you should consider all the costs associated with the purchase plus the machine's ability to produce income or lower costs. Such expenses include not only the purchase price but also delivery, installation and setup, calibration, and operational expenses. You should also consider the interest paid on the loan as part of the cost of acquiring the equipment, a factor that many new business owners overlook, but one that a good accountant should be aware of.

Hidden costs to major purchases periodically involve certain operating costs. Too often, new business owners focus on the purchase price, sometimes referred to as the sticker price, rather than on the total costs associated with equipment. Major equipment may require special delivery methods and other shipping costs. Once it is delivered to the site, it may have to be installed by skilled technicians. In some situations, the site flooring may need reinforcing to carry the new weight load, or the electrical supply may need to be upgraded to handle the necessary current. Local, state, or federal inspections may be required to obtain a permit to

operate the equipment. Sometimes, liability insurance policies require inspections and permits in addition to government permits. All of these extra expenses add to the overall costs of acquiring the equipment. Many times, these expenses are considered sunk costs, never to be recovered in resale of the equipment or in producing more units.

Purchasing machinery and other major equipment is classified as a capital purchase or capital expense. A **capital expense** is a major purchase of a functional asset that is expected to last longer than three years or that still has financial value after being fully depreciated. Capital items, which include buildings, equipment, machines, and furnishings, are best purchased using borrowed funds so that the business can use its cash to pay for **operational expenses**, which are those associated with daily, ongoing activities of the business, such as inventory, office supplies, wages, insurance, and utilities. When an asset is used as collateral for a debt, the lender places a lien on the asset. The debt then becomes a secured debt, backed by the resale value of the asset. To ease the financial burden of major purchases, depreciation, a reduction in the value of an asset, is calculated as an expense on the income statement, which reduces taxable income and lowers taxable liability.

As a general practice, the payment schedule of a capital expense should be equal to or less than the life expectancy of the equipment. For example, a business may purchase an offset printer that is expected to last twenty years and then finance it through a loan to be paid off before the twenty years are up. Although having the debt paid off before an asset is fully depreciated is ideal, in some instances terms of the loan may extend beyond the depreciation schedule.

Machines have limits to their performance. **Absolute capacity** is the highest volume of units that a machine can produce within a specified time period. **Operational capacity** is the number of units you can reasonably expect to be produced within a specified time period. The difference between the two is **operational reserve**. Because machines may need to be warmed up, materials loaded and unloaded, moving joints lubricated, belts and hoses checked and repaired, or other operational functions performed, machines cannot operate at absolute capacity for an extended length of time.

In calculating production levels, it is easy to overestimate the number of units produced. For an offset printer to work properly, paper has to be loaded, the rollers must be inked, feeder clamps may need adjusting, and one or two test sheets need to be printed to check for ink coverage and crispness of the image. All of these necessary activities take time, but they actually are unproductive. Because each business will have unique requirements and influences upon capacity, the best method is to track your own performance over time and calculate the average. Otherwise, getting input from one of your advisors or a friendly competitor would be sufficient for planning and budgetary purposes.

Machines cost money to operate. Improvement in efficiencies and in production volume is a major motivation in purchasing new equipment. You should consider the increase in units produced, operational costs per unit, decrease in waste, and improvement in quality of products. A grocery store owner who has an old freezer that still keeps food at the required temperature may decide it is worth replacing. Buying a new freezer, with all of the associated costs and improvements in efficiency, has no impact on the number of food items taken out of it and sold. Only the difference in actual cost of electricity between the two units can be considered. However, a die machine that reduces waste and improves the number of molded pieces produced per hour may be worth the investment.

All machines break down, usually at an inconvenient time and place. Trying to repair equipment when it is needed is like a road crew trying to fix potholes without shutting down traffic. Therefore, scheduling **production time**, the amount of time that a machine is actually producing products that are to be sold (also called *up time*), and **down time**, the time when production is not occurring due to repair, restocking inventory, or unscheduled work, are critical areas for management. A schedule of regularly planned maintenance that includes preventive repairs and inspections will reduce unexpected down time and equipment failures. Scheduling repairs before they are necessary keeps equipment running efficiently and smoothly, helps reduce costs over the long term, and allows for better management of expenses. Unexpected equipment failures not only interrupt operations but can delay delivery of products and services to customers. This can diminish your reliability and negatively affect customers' confidence in your trustworthiness, potentially affecting future sales.

Every machine will become obsolete at some time and will need to be replaced. Having the latest, greatest piece of equipment may be a temptation that your bank account cannot afford. Replacing equipment, whether major industrial equipment that needs professional installation or office equipment that can be set up by employees, is a critical decision. Too often, the criteria for selecting new equipment are the same criteria used to describe the old equipment's ability. Using old job requirements for new

equipment may be acceptable in an industry that undergoes very few changes over a very long time. However, most industries change drastically and need up-to-date equipment.

WORK IT OUT

Generating Interest at Home

Going green is a popular trend today. One way in which power companies are going green is with wind-generated electricity. As of now, almost all wind energy programs are on a large scale, with wind farms consisting of hundreds of towers in rural areas. Stationing wind turbines at individual houses is currently impractical. Zoning restrictions limit the height of structures, costs exceed the benefits for homeowners, and potential sound and sight pollution are a concern for neighbors.

Those concerns apply to the current options for wind turbines. Can you think of other options that would be beneficial, cost effective, and socially acceptable in urban, residential areas? What physical properties would you need to consider? What type of functional capacity is needed? Can a household have more than one type of electrical circuitry for different types of needs? Do we need a product to generate electricity for today's household purposes? Or should we simply rethink household electrical systems entirely?

Entrepreneurs not only create new products and services, but also redefine the problem. They may need to make adjustments to resolve other environmental factors. For example, there was no need for paved roads before the advent of cars. Businesses that provide gasoline and repair work for automobiles were not necessary before the automobile became popular. The mass-produced automobile changed more than how a product was manufactured—it changed the way people moved.

Consider what happed with Avni Patel Thompson and her childcare business Poppy. What lessons can you learn from her experience as you look at home wind turbines? What similarities are there between a service-oriented company and a product-oriented company? What differences are there between the two? Do homeowners really want a new way to power their homes? What are the similarities of purchasing a major piece of equipment for a home and for a business? What differences are there?

Customer demands within an industry also may change significantly over time, just as a company's specific needs may shift appreciably. To meet external customers' new wants and the company's new internal needs, machinery with new technology and more advanced construction may be mandatory. You should plan three to five years into the future for major purchases of equipment, machinery, tools, facilities, and skill levels. The question is not "What do I need today?" but "What will I need five years from today?"

Trading in outdated equipment may have value that is not always recognized in financial documents. When sales representatives of major manufacturers need to meet quotas, they may be willing to offer a very positive financing plan to place their equipment in your business while removing a competitor's machine. But you should avoid making the mistake of ignoring your current vendor. Your current machine supplier may be very eager to keep customers and may offer to take your old equipment as a trade-in, which lowers the purchasing price of new equipment. Or your current supplier may be able to offer better terms than competitors or provide supplies as a reward for loyalty. All of these choices eventually lower both purchase and operating costs of new equipment.

To upgrade or keep the old machinery, to buy or lease, to sell or trade-in, these are just a few of the questions that business owners contend with in making major purchases. Paying for big-ticket items through vendor financing might be easier than borrowing from traditional banks. But when making major equipment purchases, always keep the professional sales representatives close. Their industry insight and knowledge could be more beneficial to you than the equipment itself. People are more flexible, more knowledgeable, and especially more valuable than machines.

People

Searching, recruiting, hiring, and supporting a workforce can be some of the most rewarding and frustrating interactions that a new business owner deals with. Selecting the right people at the beginning can be the difference between succeeding or failing in the early years of a business. Many experienced business owners will say that waiting to hire the right person is better than hiring the wrong person now.

For the new entrepreneur, hiring people you know is appealing because it is easy, they are typically very amenable in the startup stages, and they share in the excitement of the new business. **Nepotism** is the hiring of family members and close friends, usually

based on their relationship to the entrepreneur rather than on their ability to perform the job. Spousal support and involvement are important in the early stages of a business. Spouses routinely become employees of the new business. Many times, the wife is an unpaid employee if her husband starts the new company. Her commitment may vary from a sporadic involvement to a few hours per month or per week. Women entrepreneurs, however, are less likely to have their husbands participate in the business, especially if the husband is unpaid.

Hiring other family members or friends because of their availability and personal commitment is enticing. Yet hiring family and friends just because they are willing and available can backfire and may produce more long-term harm than good. Sometimes hiring people close to you may discourage qualified candidates from seriously pursuing employment with your new business. Seeing that previous hiring decisions were based upon personal relationships is a discouragement to skilled personnel. Terminating employment of a family member can be truly difficult, especially if that family member is an immediate family member such as parent, spouse, child, or sibling. Difficulties within the family and the business are possible if the situation occurs. Moreover, failing to terminate a family member for cause will predictably destroy morale among nonfamily employees, especially skilled employees.

As a business is getting started, having someone is sometimes better than having no one. At other times, having no one is better than having the wrong one. Eventually, however, the ability to do a job supersedes who the employee is. Furthermore, traditional employees hired from the marketplace eventually will resent seeing more favoritism and leniency granted to family members than to nonfamily members. There is a stark difference between the integration of family and non-family members in a startup environment. The career path is usually short, with favoritism towards family members or longtime friends. A delicate balance between family and nonfamily employees is difficulty to achieve, and new entrepreneurs do not need the additional distractions caused by rifts between family and nonfamily staff members.

Friends from previous employment, college, high school, or the old neighborhood are also popular sources for employees. In the early stages, the entrepreneur has so many issues to tackle and tasks to complete that hiring people they know seems like an easy solution. People build personal relationships through social and personal interactions, outside the needs of the new business. They establish friendships along personal commonalities such as attending the same school or being in the same club or on the same team, not along the subordinate-supervisor spectrum. A sure way to end a good friendship is to hire a friend who is unqualified for the job and place them in a supervisory role. Hiring a friend as a subordinate could lead to a confrontation that could cost the new entrepreneur the support of friends and family.

Every new owner must be willing to move past the startup phase and into the growth stage, where skills become more important than personal relationships. This natural progression in business maturity requires skilled workers to perform their tasks effectively. Those skills come at a price that may be difficult to match in the early stages of the business, but in the long run, skilled workers will produce more revenue than it costs to employ them. Also, customers expect more from established businesses than they do from an initial startup business.

Entrepreneurs must hire employees who complement them, not only in skills but also in personalities. In all of its various phases—from inception through startup, growth, and expansion—every business faces situations and obstacles that require an assortment of skills and talents to resolve. Some situations demand a strong, direct, or even confrontational approach, which can be comfortable for an extrovert. Other situations may need to be handled more softly and indirectly. An introverted employee who naturally is slow to react may take a passive approach that would be more appropriate in some settings.

A small business can strengthen its staff by hiring people with an assortment of backgrounds and experiences. The collective experiences of the whole staff benefit the business in ways that may not always be easily identifiable. Employees who fit together make a nice place to work and an enjoyable experience for customers.

Sales Force

Earlier the sales rep was discussed in the context of the value and importance of generating revenue and cash flow for the business. In this section, the discussion will be focused on the sales force as a component of the personnel working in a for-profit business. However, nonprofit organizations that are also dependent upon sales revenue, as discussed earlier, could apply the concepts as described as well.

Decisions involving a sales force may be some of the most critical decisions made, perhaps even more important than organizational structure and tax status. The sales force triggers the activities that generate revenue, which brings the business to life and sustains it. Without the sales spark, the business becomes a lifeless organization doomed to closure.

A sales force must fit within the overall operational and marketing strategy of the business. The product must be fully developed, its benefits to the customers clearly defined, and the primary target market selected before a sales force is needed. Furthermore, company goals of minimum production levels must be established, and a target revenue high enough to cover expenses needs to be calculated. It is imperative that each of these goals is patently understood and achievable for both the sales force and the company before the sales force is assembled.

The first consideration is identifying the stage of the company. Some entrepreneurs have a true startup business beginning from scratch, whereas others enter entrepreneurship through the purchase of an existing business with established customers and cash flow. The organization, structure, and role of the sales force will depend upon whether the business is in the startup, growth, mature, or decline stage). As the business progresses through each stage, requirements and abilities of the company change as does the external environment of the market.

Deciding whether to self-perform sales or outsource the sales function should be done very carefully and should include research into the tax implications and benefits of using employees versus independent contractors. **Self-performing** involves the employees doing most of the work in a business. **Outsourcing** is the hiring of an outside company or third party to perform a specific task, job, or process, or to manufacture goods. Each option has benefits and limitations. The entrepreneur must consider many factors, ranging from financial strength to market knowledge to sales support capabilities. Hiring sales personnel as employees means the entrepreneur must use time and money to recruit, hire, train, supply with equipment and office materials, and regularly pay the sales force. Outsourcing the sales function to independent contractors may be a viable option, as the entrepreneur would have minimal upfront investment and they would be paid a commission only when they make a sale. Outsourcing is a preferred selection for businesses that are financially straining under cash flow, while self-performing sales is preferred for established, growing companies.

Pay is always a touchy topic. Determining a person's compensation and income gives the entrepreneur a great deal of power and control over the sales force. It is a very important responsibility that ought to be handled with great care. Issues regarding pay affect not only the employees' or contractors' livelihood, but also the company's financial health and reputation. Furthermore, there are numerous laws and regulations, at both federal and state levels, that place the burden of doing it right upon the employer.

Sales force personnel who are employees must be paid with regular wages. Sometimes, a commission or bonus is paid if sales quotas are met. Regular wages, along with employer-matching payroll taxes and employee benefits, increase fixed expenses to the business. This arrangement may not be sustainable for a startup business. Yet the entrepreneur-employer can benefit from this arrangement by retaining control over employees' schedules and routines, earning loyalty from staff, and receiving immediate market feedback from the employee.

Outsourced or independent contractor sales reps are paid on commission. This arrangement adds a variable expense to the business, an expense that should only be recognized after a sale is made. In most situations involving outsourced independent contractors, the employer is not responsible for payroll taxes. A word of caution, though, to all beginning entrepreneurs: Determining whether someone is an employee or an independent contractor can become complicated. The burden of doing it right is on the employer. And not doing it correctly can add significant expenses to the business in the form of fines and penalties.

An important factor to contemplate when deciding what type of sales force to have is knowing your position in the market and your market's characteristics (Figure 14.1.4.4). If you are selling to other businesses, business to business, you will have to understand their decision-making processes and buying criteria if you expect to make any sales. On the other hand, selling direct to the consumer, business to customer, has a wholly different marketing strategy. For the non-marketing entrepreneur, learning about marketing basics ought to be placed on the "to do" list so that conversations with sales force personnel will be productive.



Figure 14.1.4.4: (a) In a business-to-business transaction, a farmer may sell his produce to a grocery store that in turn processes the food for consumer sale. (b) In a business-to-customer transaction, the producer sells his wares directly to consumers. (credit (a): modification of "spectacular salad bar at wholefoods HQ in Austin" by Kevin Krejci/Flickr, CC BY 2.0; credit (b): modification of "Honey" by Phil Whitehouse/Flickr, CC BY 2.0)

An additional market consideration is the sales territory. If you define territories by geographic markers, does each territory have the same potential number of customers? What is the variance in size and the distance from the home office? A similar set of questions arises if the sales force is established along product lines. How are the product lines alike? How are they different? When sketching out the sales force organization and responsibilities, it would be highly advantageous to receive input from potential sales reps or more experienced entrepreneurs who already know how to setup this division of your business.

Agreements made with the sales force must be honored, so make any agreement only after very carefully thinking through scenarios and obtaining insight from trusted advisors. The reputation of the business with employees and customers alike is at stake when employers do not honor agreements with employees, especially those employees who are the face and voice of the business to the market. If a sales rep, employee, or independent contractor decides to separate from your business, they could take their customers' business with them to their next place of employment. Although you could take legal action against a former employee who does this, the bottom line is that you have lost a sales rep and a customer. Avoiding that situation is best for everyone, especially you, the entrepreneur.

Getting the right salespeople in place is critical. Having them work in a positive and effective environment is a necessity that cannot be ignored.

Leadership

Terms commonly associated with a leadership position include *owner*, *manager*, *supervisor*, *team lead*, *leader*, and *boss*. Many of these terms are used interchangeably, even though they have some minor differences in meaning, but normally one person will function as both leader and manager in a small business. Some entrepreneurs may be able to switch between these two roles flawlessly and fluidly, so that their followers and even they themselves are unaware that the roles are being filled simultaneously. Nevertheless, some traits and behaviors are associated more closely with leadership than with management.

A key difference between leaders and managers is their role in initiating action. Management is typically concerned with administering and directing an organization's activities. This includes planning, scheduling, coordinating, overseeing, and inspecting tasks performed by staff. The manager ensures that employees who have been hired to perform duties perform those duties as expected and at a level of quality and quantity acceptable.

A leader, on the other hand, instills within others a desire to perform. This is more of an internal motivation, a psychological approach, which the leader develops via words and actions. Like the results of the manager's approach, the results of motivation will be evident in the employees' performance. The difference lies within the minds and souls of employees.

Employees will work for their manager because they are obligated to on the basis of assigned roles and positions of authority. Employees will work for a leader because they want to achieve the same goals and accomplish tasks to satisfy themselves as well as their leader.

You can find many lists that describe either characteristics or qualities of a good leader. Only a few have been included here. Descriptions of good leadership can be divided into the following categories: personality, competencies, locus of control, and style.

Personality describes the characteristics of a person as shown by their actions and words. Effective leaders typically are easy to get along with, have a positive attitude, engage others, and display self-confidence in their skills. When entrepreneurs begin looking for employees, working very closely together necessitates that they get along and enjoy each other's company.

Working for someone who does not know what they are doing can be very difficult, if not impossible. Therefore, good leaders know what their competencies are and are very good at what they do. Employees as well as competitors and regulators recognize high job-performance skills. Sometimes, a very skilled leader becomes an industry expert with a reputation throughout the industry and gives training at conventions, conferences, and trade shows. Good leaders are also keenly aware of the skills they lack and readily admit their incompetence in those areas. Hiring a skilled employee who compensates for your shortcomings is a high priority.

Locus of control is the belief that you have or do not have control over events that occur in your life. If you have an internal locus of control, you believe you have significant control and influence over events that occur in your life. An external locus of control—the opposing view—means you believe you have very little control, if any, over events that occur in your daily life. Effective leaders have an internal locus of control and feel certain that they influence and control events, situations, and people in their lives and, specifically, in their business. When crises arise, effective leaders take charge and begin making decisions to get control of events. Employees, customers, and others connected to your business will rally around you if they are confident that you can take control of the situation and directly deal with the challenges.

The three common leadership styles are autocratic, democratic, and laissez-faire. Each of these approaches to leadership is effective but can also be ineffective. The approach that works is best determined by the industry, structure, environment, and requirements of the job.

Autocratic leaders make decisions by themselves and view employees as subordinates who must follow instructions without hesitating or questioning. Autocratic leaders are necessary in situations where decisions are needed quickly, the leader is highly trained and skilled in the work requirements, and the outcomes can be very serious. Democratic leaders engage their staff and seek input before making decisions. This approach works well if the organization or industry is complex, many different departments or employees are affected by the decisions, and a broad range of information is needed to make good decisions. Laissez-faire leadership allows staff to work independently, mostly without supervision or direct input from the leader. This approach works best when the employees are highly educated and skilled, tasks among employees are not closely interrelated, and staff are self-motivated.

Leadership has been studied for many centuries, and the debate continues. You can find examples of good and bad leadership in many organizations including the military, sports, government, and business. Leadership traits are like hands in a poker game—they are all good and bad. The difference is the situation. For an entrepreneur, knowing the industry, the market, the competitive environment, the customer base, and the employee pool are starters for determining which leadership traits and style would be effective. If you decide you are not matched to the environment or situation, then you could engage someone who does possess the traits and skills that better match your current needs.

Operational Needs

When starting your business, the first question you need to ask is whether anyone wants to buy your product or service. Creating a new product or service is easy. In fact, 70 percent to over 95 percent of new products introduced every year are classified as failures. With more than 30,000 new products introduced every year, you could reasonable guess that between 21,000 and 27,000 are failures. On the contrary, only 5 percent to 30 percent of new products are successful. So the question is valid: Will anyone buy my product or service?

With such a low success rate, you will need to conduct careful research and small trial runs to determine the viability of your new products. You need to know not only whether anyone will buy your products but whether customers will pay your price, so that the business can make a profit, or at least break even. You need to ask these two very important questions upfront, because if the answer to either one is "No," you have no need to do anything else.

A second series of questions that you need to address focus on the location of the company's operations. Where will you locate your business? Will you rent or buy a building or facility? Does your facility need to have easy access in a high-traffic area? Or can it be in a quieter area, where costs are lower? In addition to access and costs, will your business be located within a competitor's influence? It would be unfortunate if you negated all the positive factors of your great product and viable business plan by selecting the wrong location.

Besides deciding on a proper location, you also need to consider the size of your facility. Selecting a structure that is too small from the very beginning may handicap any growth in the early stages of your business. Having to move to a larger facility soon after beginning operations could be detrimental to your operations. On the other hand, selecting a facility that is too large puts pressure on cash flow, as you will pay rent or a mortgage for an unproductive building space. Finding the balance between "big enough to grow into" and "small enough to afford with low sales" is a predicament faced by many business owners, whether new entrepreneurs or seasoned veterans.

You will need to make similar decisions about furniture, equipment, and furnishings. These items are available for purchase or lease. Sometimes a lease is better, as the initial payments may be lower but over time, buying equipment and furniture can help improve cash flow once the items are paid for. However, deciding on how much, what quality, and what size can be difficult. Good equipment sales representatives can be a big help in making equipment decisions.

To get started, you will need to determine the proper inventory levels. How long is the shelf-life of your inventory? Some products have a long shelf-life, whereas others may perish quickly. Ask yourself "How much do I need?" and "When will I need it?"

Before beginning a business, you may need licenses and permits. Buildings must be inspected and approved prior to occupation for business activities. Building permits may require electrical, plumbing, HVAC, and structural inspections of building systems and physical features. Accounts for water, gas, and trash pickup must be made prior to occupying a facility. Table 14.1.4.1 summarizes the operational needs you should consider when launching a venture.

Table 14.1.4.1: Checklist of Operational Needs

☐ Item 1	Determine the legal organization of your business for tax purposes (sole proprietorship, partnership, or corporation). Select the legal structure of your business for operations and management control [limited liability company (LLC), general partnership or limited partnership, C-corporation, or S-corporation].
☐ Item 2	Decide on a name for your company. The company name becomes its official legal name for federal and state purposes. A corporate name can be anything that is currently not in use by another company. A trade name may be different from the official name. The trade name should reflect the product or industry.
☐ Item 3	You and any other principals of your business write and approve articles of incorporation, bylaws, or management agreements.
☐ Item 4	File organizational papers with the secretary of state (SOS) or its corresponding office in the state in which the company is founded. The SOS returns the registration or charter documents to the company.
☐ Item 5	You and other principals make cash payments to the company for starting the bank account.
☐ Item 6	Obtain a federal employers identification number (FEIN) from the Internal Revenue Service. This is the company's federal tax number for income and payroll taxes and filings.
☐ Item 7	Obtain a state employer's identification number from your state's employment commission. This is the company's state tax number for filing unemployment and sales tax reports and payments.
☐ Item 8	Be sure your trade name or assumed name certificate is filed and approved by the appropriate county and state offices if it is different from the corporate name.
☐ Item 9	Secure your business phone number, website, email, and domain name. Order your business cards.
☐ Item 10	Open a bank checking account with the appropriate corporate and trade name, authorized signers on the signature card, and all other documents that your bank requires to open a business account. Order debit cards or credit cards as necessary. Deposit your startup funds. Set up and test your business deposit processes.
☐ Item 11	Both you and your officers and partners sign agreements regarding the business.
☐ Item 12	Buy or lease your office space. Your local or city government will grant you a certificate of occupancy to occupy the building. You may need additional inspections before final approval: building, fire, health, and plumbing.
☐ Item 13	Open utilities, water, electric, gas, garbage, and phone accounts.
☐ Item 14	Post required notices in a prominent place according to regulations. Common locations are near the timeclock, break

	rooms, front cash register, or other public location.
☐ Item 15	Apply for and post as required your license for business, either by federal, state, county, or municipal government.
☐ Item 16	Apply for and post as required your license and permits for employees or specific types of products or services.
☐ Item 17	Obtain insurance for your building, liability for business, and worker's insurance. Some states allow businesses to exempt themselves from workers' compensation with proper notice to employees.
☐ Item 18	Order and install furniture, office equipment, shelving, and so on.
☐ Item 19	Order your inventory and make your product list with pricing, price sheets, or menu boards.
☐ Item 20	Recruit and hire your employees. Training and certification may be required for specific functions such as bartenders, cooks, drivers, forklift operators, or first aid personnel. Be sure employees' training in specific job functions is completed before opening. The first day of operations is typically a low-key event to ensure that everything is working as planned and that your staff know their roles and responsibilities. This gives you time to correct any weaknesses or shortcomings before the general public is aware that your business is open.

Set the grand opening several days to a few weeks after the actual opening of business. Invited guests may include investors, city officials, family members, special customers, former employers, business neighbors, and competitors.

LINK TO LEARNING

Forbes magazine has various resources such as this step-by-step guide for entrepreneurs and this list of eight steps for entrepreneurs on starting a new business. The federal SBA list of steps is also available. Review each list. Which one best matches your entrepreneurial situation?

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14.1.5: Key Terms

absolute capacity
highest volume of units that a machine can produce within a specified time period

baselining
internal comparison of actual outcomes with expected outcomes

benchmarking
comparing one's own company's performance with an industry average, a leader within the industry, or a market segment

business accelerator
organization formed by an alliance of business professionals who assist entrepreneurs in their startup or early stage businesses in exchange for an equity investment in the entrepreneur's company

business incubator
organization formed by a consortium of established professionals or organizations assisting startup or early stage businesses that provides office space, financial support, technical support, or advisors whose specialized skills in management and marketing complement the technical talents of the entrepreneur

capital expense
major purchase of a functional asset that is expected to last longer than three years or that still has financial value after being fully depreciated

capital improvements
major repairs or improvements that add to the life of an asset by improving its longevity, increasing its value or productivity, or extending its usefulness

cash flow
money collected by the business through revenue and funding versus money disbursed by the business through expenses

closed group
formal, structured group of individuals who have a strict process or specific criteria that applicants must meet before being accepted as members

creditworthiness
lender's assessment of how reliable a company is in repaying a debt

debt service
repayment of a loan, including principal and interest

down time
time when production is not occurring due to repair, restocking inventory, or unscheduled work

ergonomics
study of how work is performed

flat organization
organizational structure where owners, executives, or key decision makers interact directly with staff at all levels, with very few if any mid-level managers

hybrid group

group of individuals who have a loose and flexible set of criteria for membership and function within a very broad set of guidelines; certain criteria may be required of regular members, but guests are frequently accepted with no long-term commitment expected

inventory management
business operations that include managing the quantity of inventory units in stock, scheduling and cataloguing replacement inventory, organizing shelf location for unit storage, paying for inventory received, and processing, fulfilling, packaging, and shipping customer orders

line of credit (LOC)
agreement between a bank and a depositor in which the bank makes available a maximum amount of money the depositor can borrow at any time during the term of the loan; the borrower pays a fee during the term, whether or not there is an outstanding balance, and also pays interest when there is a balance on the loan

liquidity
measure of a company's ability to cover its immediate and short-term (i.e., due within one year) debts and obligations

nepotism
hiring family and close friends because of personal relationships rather than for their skill sets

networking
process of establishing and maintaining bilateral relationship with other people to exchange information, ideas, products or services, and money

North American Industry Classification System (NAICS)
standard used by US federal agencies to collect, analyze, and report statistical information about businesses

open group
informal, loosely organized group of individuals who have no formal process for joining or leaving the group, and who focus on a specific activity or social cause

operational capacity
number of units that can reasonably be expected to be produced within a specified time period

operational expenses
expenses associated with daily, ongoing activities of the business, such as inventory, office supplies, wages, insurance, and utilities

operational reserve
difference in unit capacity between absolute capacity and operational capacity

outsourcing
hiring an outside company or third party to perform a specific task, job, or process, or to manufacture goods

pro forma
financial statement that shows how much and where monies will be collected and spent in the early stages of business creation

production time
amount of time that a machine is actually producing products that are to be sold; also called *up time*

self-performing
when employees do most of the work in a business

total cost of ownership

comprehensive cost of owning large capital items, including initial direct costs, operating direct costs, and indirect costs

trade association

group of companies or employees of companies in a specific industry, business structure, or social cause

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14.1.7: Review Questions

1. What is “networking”?
2. What types of networks are created in a business relationship?
3. What types of organizations on college campuses can provide opportunities for building social networks?
4. What are some opportunities for you to develop the skills you need to establish personal relationships with people that you do not know?
5. What is most likely the largest social group connected with a university? Why is being a member of this group valuable?
6. How do government agencies at all levels support entrepreneurship?
7. Who selects the entrepreneur’s team? Why is this important?
8. Why is selecting an accountant a critical decision?
9. For the startup entrepreneur, what finances are considered relevant?
10. What are some differences between large banks and small banks as they relate to an entrepreneurial startup business?
11. What resources do insurance agents have to gain industry-specific information, especially about liability, operations, and challenges?
12. What relationships are possible for sales reps and small, startup businesses? What are the benefits to each?
13. Why is a functional or operational business plan necessary?
14. Many operational business plans provide some very specific steps to take and sometimes are very detailed. What are some situations in which rigid schedules can be a hindrance or a deterrent to effective operations?
15. What simple tools can an entrepreneur use to get organized and do what is necessary throughout the month or year?
16. What is benchmarking? Why is it important? What are some limitations of benchmarking?
17. What is cash flow?
18. What is credit? What are some “instruments” of debt?
19. What are some differences between “absolute capacity” and “operational capacity”? Why do they need to be distinguished?
20. Explain nepotism. Why might it be beneficial to an entrepreneur? Why may nepotism be detrimental to an entrepreneur?

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14.1.8: Discussion Questions

1. How are social connections made in early life the same as those made on the college campus? How are they different?
2. What are some benefits of professional associations that are not available from government agencies or departments?
3. How is the role of government agencies with regard to entrepreneurship different from the roles of industry and trade associations?
4. How does the SBA help aspiring entrepreneurs?
5. Why is it important for government programs to offer grants to organizations, both public and private, to educate and assist entrepreneurs at no charge?
6. What are some risks associated with surrounding yourself with others who are similar to you in background? Industry experience? Education? Age? Personality? Ability to process information?
7. If the figures on a pro forma are hypothetical, then why go through the exercise of creating a document with fake numbers?
8. What are some disadvantages of having licensed professionals such as accountants and attorneys offering advice to an entrepreneur?
9. A young, very creative, artistic woman wants to start her own graphic design business. If she is out of the office looking for new clients, she is not producing any work that generates income. What are her options?
10. What can happen if a new business does not have any kind of business plan? What if the business plan that was originally written is not effective after the business starts?
11. Why are schedules important? If the new business owner keeps a schedule only in their head and does not write it down, what might be some weaknesses of that idea?
12. Why is benchmarking relevant? What are some conditions in which benchmarking against national figures would be less accurate? How would you find information regarding benchmarking?
13. Why is cash flow more important than profit? If a company does not have enough cash, what are possible ways for it to get more cash?
14. Why is money management so important to a business? What are the consequences if money is mismanaged?
15. When is the assembly-line approach appropriate in service-oriented businesses? What are the benefits of using the assembly-line approach in this type of work?
16. How does the term “division of labor” apply to the concepts of “jack of all trades” and “specialist”?
17. What is the difference between capital expenses and operational expenses? What type of financing should be used for capital expenses? Operational expenses? Why?
18. Why should hiring the right people take precedence over buying the right equipment?
19. How do the needs of a small business and its founder change from the startup stage to the growth stage?

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14.1.9: Case Questions

1. Smartphones are everywhere today. You probably have one nearby right now. However, access to landline phone service has not been complete for very long, and wireless service is not as widespread as many people might think. The first phone lines (landlines) connected Boston and Somerville, Massachusetts in 1877. The last town in the United States to receive landline service was Mink, Louisiana, a small community 100 miles south of Shreveport, which received landline service in early 2005. Check any major US wireless carrier, and its maps have gaps in service. Building networks of any kind takes planning, money, and time.
    a. What are some similarities between an entrepreneur starting a new business in a new profession in a new market and a telephone service network?
    b. How are the requirements for a telephone network infrastructure like those for a new entrepreneur?
    c. What are some estimated costs, not necessarily monetary ones?
    d. What are some benefits to an entrepreneur who enters a market with established networks?
    e. How do established networks save the entrepreneur valuable money and time?
    f. With limited resources, what criteria should an entrepreneur use to determine priorities of spending time, effort, and money in developing networks?
    g. Does each criterion have equal weight? Why or why not?
2. The Internet Association (IA, https://internetassociation.org/) was founded in 2012 as a trade association devoted to Internet-based companies. Founding companies included Google, Amazon, eBay, and Facebook. These Internet-based companies founded this new trade group because they did not have a voice in Washington, DC, with respect to potential regulations and laws. The IA has synergy—more influence as a group than each company would have individually.
    a. What prompted the formation of the IA?
    b. Was it for marketing purposes?
    c. Management support?
    d. Industry advancement?
    e. Regulatory influence?
    f. What are some secondary purposes for the IA?
    g. How might the original purpose of the organization shift as the industry matures?
    h. Will small companies enjoy the same benefits of the larger founding organization?
    i. Any new venture involves substantial risks and costs. How might a new Internet startup benefit from joining the IA?
    j. How else do the large corporations benefit besides having a say in the political discussion in Washington, DC?
    k. What time commitment should a new business make before expecting any positive return on investing time and money in a trade association?
    l. If joining the IA requires a membership fee, what determinants should you use to place a value on the amount spent for dues?
    m. What benefits of a trade association may be not easily linked to membership expenses?
3. In 1989, the new NFL owner of the Dallas Cowboys, Jerry Jones, fired the legendary coach Tom Landry and hired one of his former college football teammates, Jimmy Johnson, as the new head coach. Johnson faced the same problems that a new entrepreneur has: Who should be on my leadership team? What should be their responsibility? Out of twelve key coaching positions, Johnson kept only three coaches from Landry's staff in the same positions and moved one coach to a different position. Within four years (1993), the Dallas Cowboys, under head coach Jimmy Johnson, won Super Bowl XXVII with six of the original coaches Johnson hired his first year still in the same positions.
    a. How is a startup similar to an existing organization that needs to be turned around? How are they different?
    b. What are some reasons to surround yourself with others instead of taking the attitude that "I can do it myself?"
    c. For any leader, what are some reasons that skills in identifying and recruiting key people are more important than technical skills?
4. Every four years, the United States elects a president. Although the incumbent might be reelected, the United States is guaranteed to have a new president at least every eight years. On winning the election, the new president must identify candidates for cabinet positions. Some potential candidates decline the invitation and voluntarily withdraw themselves from

consideration. Those who accept the invitation are put through an intensive screening process. The president then submits cabinet-level nominees to the US Senate for confirmation. As in any close group, recruiting and selecting individuals to join the presidential cabinet is critical for the president to achieve any objectives or goals.

a. What kind of experience is beneficial to members of a board of directors for a local performing arts group? Should they be experienced in industry? Government? Fundraising? Management? Marketing? The arts?
b. Besides experience, what other type of backgrounds should be considered? What about board members' ages? Education? Gender? Residency? Financial Status? Connections to local or regional major employers?
c. What can a new entrepreneur learn from an executive director of a nonprofit about selecting candidates to build a winning team? How important is it that some candidates decline to join the board? How long should members be on the board?
d. How important is diversity in building a winning team? What skills must the entrepreneur perfect? What skills can be learned and developed later by the entrepreneur? Why is a variety of backgrounds, in the technical field and outside of the industry, important?
e. Who is the actual team leader? (1) Entrepreneur? (2) Strongest personality? (3) Smartest? (4) Most technically skilled? (5) Financier? (6) Most experienced in management?

5. Narciso Gómez has worked in the service department at an auto dealership for about twenty-five years and has served as the service manager for the past seven years. He is qualified for retirement through the dealership but wants to open his own business. He is looking at buying a franchise, either a Jiffy Lube quick oil-change franchise that is for sale or a new SuperGlass Windshield Repair franchise. Both are automotive service and repair-related, where he has plenty of experience.

a. Besides his technical skills, what does Narciso need to consider before purchasing a franchise business?
b. How might the estimated volume of work required to generate enough sales to cover his financial obligations affect his decision?
c. The Jiffy Lube business model requires a four-bay facility. What does Narciso need to calculate in developing his business plan?
d. The SuperGlass Windshield Repair is an on-site repair model whereby the technicians drive to the vehicle's location for work. What should Narciso's main concerns be in developing a business plan for this business model?

6. Han Jia-ying was an office manager for a construction company until she decided to be a stay-at-home mother with her kids. Her former employer has called her to take over some administrative work at home, such as payroll processing, payroll tax filings, bookkeeping, and other general administrative work. Her employer has said that some of his customers probably could employ her for their general administrative tasks.

a. If she works from home, what type of scheduling issues does Jia-ying face? What might be some interruptions to her ability to meet specific deadlines, such as processing paychecks each week?
b. If Jia-ying needs additional help, what options does she have? Would she be wise to hire an employee or seek some support from someone else? Who might that be? What problems might Jia-ying encounter when seeking a nonregular employee?
c. Jia-ying will need new office equipment, including a new computer, a new scanner/printer, phone service, Internet connections, and so on. However, she is not tech savvy. How might she best manage working from home by herself, especially is something goes wrong or does not work?

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SECTION OVERVIEW

14.2: Managing Human Resources and Labor Relations

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14.2.2: Achieving High Performance Through Human Resources Management

14.2.3: Employee Recruitment

14.2.4: Employee Selection

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14.2.6: Performance Planning and Evaluation

14.2.7: Employee Compensation and Benefits

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14.2.11: Trends in Human Resource Management and Labor Relations

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14.2.1: Introduction

Learning Objectives

After reading this chapter, you should be able to answer these questions:

- What is the human resource management process, and how are human resource needs determined?
- How do firms recruit applicants?
- How do firms select qualified applicants?
- What types of training and development do organizations offer their employees?
- How are performance appraisals used to evaluate employee performance?
- What are the types of compensation and methods for paying workers?
- What is a labor union and how is it organized, what is collective bargaining, and what are some of the key negotiation issues?
- How are grievances between management and labor resolved, and what tactics are used to force a contract settlement?
- What are the key laws and federal agencies affecting human resource management and labor relations?
- What trends and issues are affecting human resource management and labor relations?

EXPLORING BUSINESS CAREERS

Andrea Herran, Human Resources Consultant

In college, Andrea Herran studied business administration and minored in psychology. Always interested in a business career, she initially took psychology simply because it was interesting. Little did she know how applicable that minor would become. As a human resources (HR) consultant, she often benefits from her psychology background. “Studying human behavior really gave me the background necessary to put myself in the position of others, to see things from their point of view, which has definitely been helpful in my career in human resources.”

Herran started out as an administrative assistant in the HR department of a hotel, and her career has run the gamut of human resources over the 25 years since she graduated from college. She has been an employment coordinator, focusing on employee recruitment and selection, and a personnel manager, where she learned the skills necessary to maintain and evaluate employees. As a training manager, she sharpened her talent for developing, coordinating, and even administering staff training. Eventually, she became the director of human resources for companies both in the United States and abroad. Indeed, beyond the United States, she has worked in Mexico, Argentina, and South Africa.

Andrea worked her way up in the corporate world, but entrepreneurship was more consistent with her desire for a fast-paced, changing environment, both in terms of what she does and who she works with, so she made the move to consulting. “Consulting allows me to draw upon all my human resources skills. I have opened five HR departments in my career, so I bring my full experience to bear on the challenges each company has.”

Today, Andrea’s passion is working with small businesses, entrepreneurs, managers, and owners as an advisor to “uncomplicate the people side of your business.” As the principal of Focus HR Consulting, she advises firms how to set up human resource programs and ensure legal compliance. She also provides leadership coaching and training and mentors employees. She has worked in several industries, including hospitality (hotels and restaurants), advertising, professional services, logistics, technology, and manufacturing.

When Andrea was hired by Aquion Water Treatment Products, she was tasked with updating the company’s HR policies and procedures. The company’s performance reviews were very task-oriented versus behavior-oriented. Instead of determining whether a task was completed, behavior-oriented reviews seek to evaluate not only whether the person completed the task but also how he or she did so, especially examining the interactions involved in the task. Is an employee punctual at returning consumer request calls? How does he or she relate to customers? As a manager, does he or she express thoughts clearly? “By evaluating specific behaviors, you create an environment with clearly set qualifications for advancement and opportunities for targeted employee development. Without this, the *human* aspect of human resources can be overlooked.”

> Andrea has never looked back on her choice to become an entrepreneur, and she believes her varied employment history was a key to her success. “Anyone interested in this field should experience as many possibilities within human resources as possible. You leave school with the theory, but only through experience do you really get to see what the potential of such a career is.”

This chapter looks at the role of human resources within an organization, from the general processes of developing and planning to the more specific tasks of employee evaluation and compensation.

Human resource management and labor relations involve acquisition, development, use, and maintenance of a human resource mix (people and positions) to achieve strategic organizational goals and objectives. Successful human resource management is based on a company’s ability to attract and hire the best employees, equip them with the knowledge and skills they need to excel, compensate them fairly, and motivate them to reach their full potential and perform at high levels. Today’s business environment presents numerous challenges to effectively managing employees:

- Technology continues to advance, which places great importance on knowledge workers, especially when demand outstrips the supply of high-talent individuals.
- Global business operations involve rapid data transfer and necessitate accelerated decision-making by executive and technical employees.
- The workforce is increasingly more diversified and multicultural, which places increased emphasis on communication and cultural understanding.
- Work, life, and family priorities are more difficult to balance as dual-worker families populate the labor force.
- Employment and labor laws continue to greatly influence employee recruitment and hiring, compensation decisions, and employee retention and turnover in both union and non-union organizations.

Each day, human resource experts and front-line supervisors deal with these challenges while sharing responsibility for attracting and retaining skilled, motivated employees. Whether faced with a large or small human resources problem, supervisors need some understanding of difficult employee-relations issues, especially if there are legal implications.

In this chapter, you will learn about the elements of the human resource management process, including human resource planning and job analysis and design, employee recruitment and selection, training and development of employees, performance planning and evaluation, and compensation of the workforce. The chapter also describes labor unions and their representation of millions of American workers in construction, manufacturing, transportation, and service-based industries.

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14.2.2: Achieving High Performance Through Human Resources Management

What is the Human Resource Management Process, and How are Human Resource Needs Determined?

Human resource (HR) management is the process of hiring, developing, motivating, and evaluating employees to achieve organizational goals. The goals and strategies of the firm's business model form the basis for making human resource management decisions. HR practices and systems comprise the firm's human resource decision support system that is intended to make employees a key element for gaining competitive advantage. To this end, the HR management process contains the following sequenced activities:

- Job analysis and design
- Human resource planning and forecasting
- Employee recruitment
- Employee selection
- Training and development
- Performance planning and evaluation
- Compensation and benefits

The human resource management process shown in Figure 14.2.2.1 encourages the development of high-performance employees. The process is sequential because employees can't be trained and paid until selected and placed in jobs, which follows recruitment, which is preceded by human resource planning and job analysis and design. Good HR practices used along this sequence foster performance improvement, knowledge and skill development, and loyal employees who desire to remain with the organization.

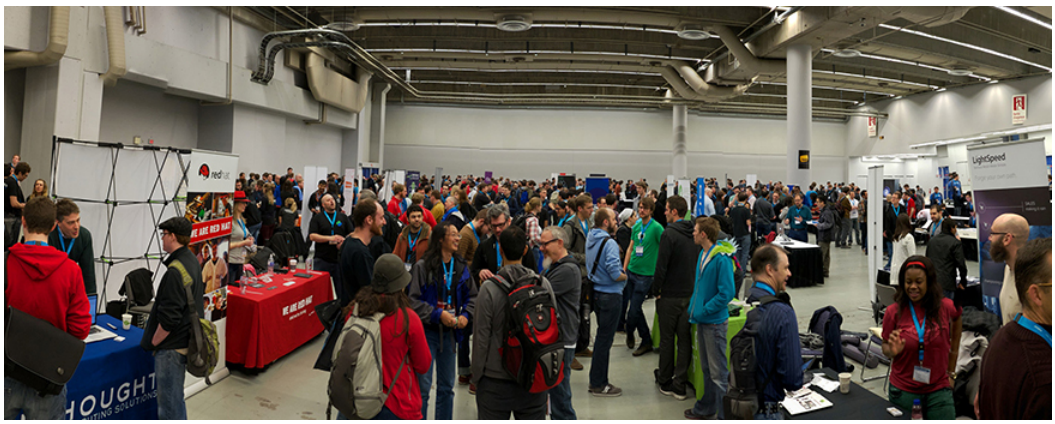


Figure 14.2.2.1: A job fair, career fair or career expo, are events in which employers, recruiters, and schools give information to potential employees and job seekers attend hoping to make a good impression to potential employers. They also interact with potential coworkers by speaking face-to-face, exchanging résumés, and asking questions in an attempt to get a good feel on the work needed. Likewise, online job fairs are held, giving job seekers another way to get in contact with probable employers using the internet. *How do you plan on using events like this in seeking your job? How can utilize the courses that you are taking to illustrate your skills that you can discuss at job fairs.* (Credit: Taavi Burns/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

HR Planning and Job Analysis and Design

Two important, and somewhat parallel, aspects of the human resource management process are determining employee needs of the firm and the jobs to be filled. When Alcon Labs gained approval from the Food and Drug Administration for sales of a new contact lens disinfectant solution in its Opti-Free product line, it had to determine if additional sales representatives were needed and whether new sales positions with different knowledge and skill requirements should be established. **Human resource planning** at Alcon means having the right number of people, with the right training, in the right jobs, to meet its sales goals for the new product. Once the need for sales representatives is determined, human resource specialists assess the skills of the firm's existing employees to see whether new people must be hired or current people can be trained. See Figure 14.2.2.2 for a representation of the human resource management process.

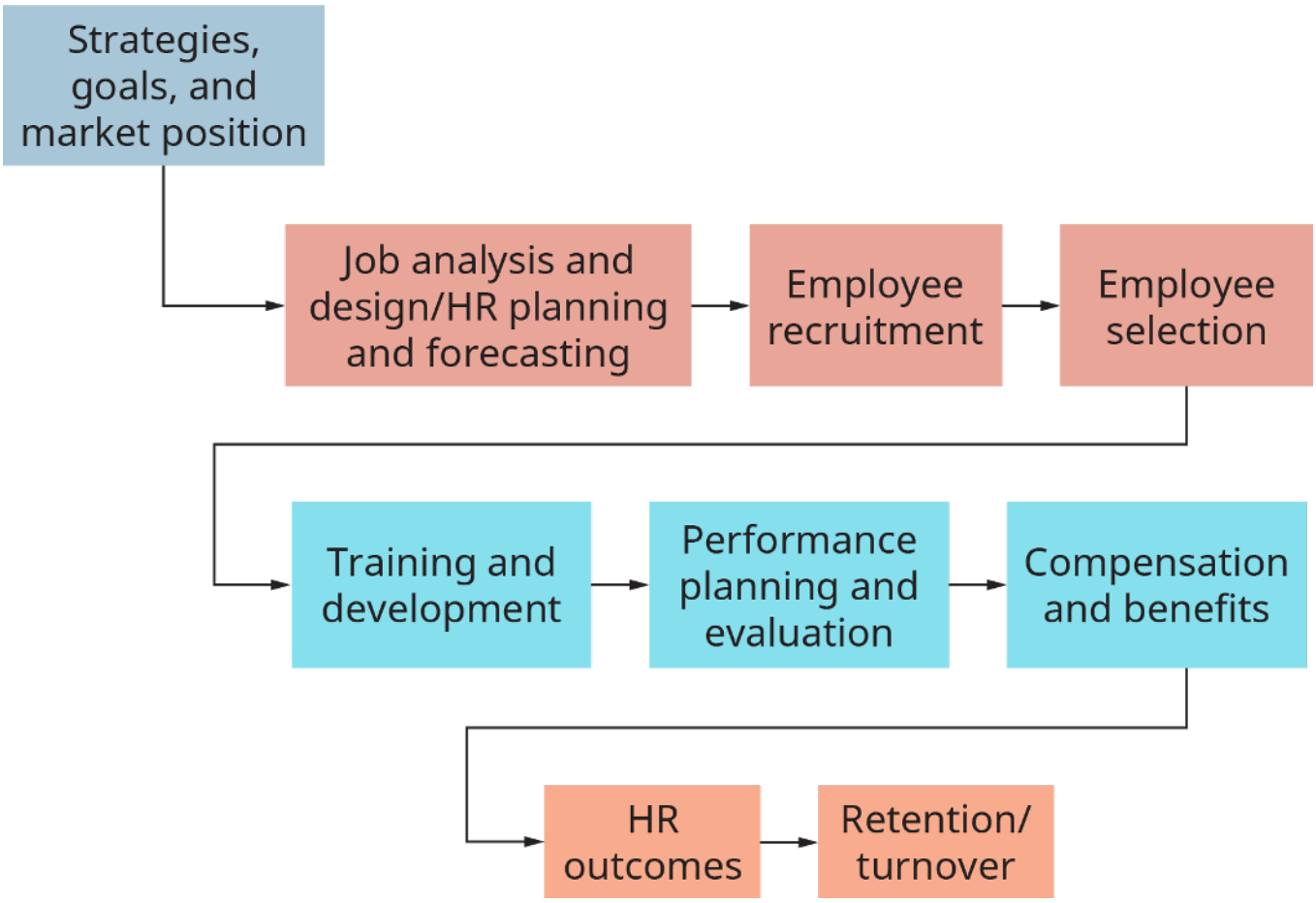


Figure 14.2.2.2: Human Resource Management Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Human resource planners must know what skills different jobs require. Information about a specific job typically begins with a **job analysis**, which is a study of the tasks required to do a job well. This information is used to specify the essential skills, knowledge, and abilities required for the job. When Hubert Joly started as the CEO at Best Buy, the retailer was facing serious financial pressures. The threat of online competition from Amazon was real. Joly was also facing a staffing issue with a lot of turnover. He and his team instituted a plan to keep and promote staff as a core competency that would differentiate Best Buy from online retailers. Also, a key HR responsibility is that jobs are examined to make any changes in job duty and task responsibilities. The tasks and responsibilities of a job are listed in a **job description**. The skills, knowledge, and abilities a person must have to fill a job are spelled out in a **job specification**. These two documents help human resource planners find the right people for specific jobs. A sample job description and specification is shown in Table 14.2.2.1.

HR Planning and Forecasting

Forecasting an organization's human resource needs, known as an HR *demand forecast*, is an essential aspect of HR planning. This process involves two forecasts: (1) determining the number of people needed by some future time (in one year, for example) and (2) estimating the number of people currently employed by the organization who will be available to fill various jobs at some future time; this is an *internal supply forecast*.

Table 14.2.2.1: Job Description and Specification

Position: College Recruiter Reports to: Vice President of Human	Location: Corporate Offices Resources Classification: Salaried/Exempt
Job Summary:	
Member of HR corporate team. Interacts with managers and department heads to determine hiring needs for college graduates. Visits 20 to 30 college and university campuses each year to conduct preliminary interviews of graduating students in all academic disciplines. Following initial interviews, works with corporate staffing specialists to determine persons who will be interviewed a second time. Makes recommendations to hiring managers concerning best-qualified applicants.	
Job Duties and Responsibilities:	
Estimated time spent and importance:	
15%	Working with managers and department heads, determines college recruiting needs.
10%	Determines colleges and universities with degree programs appropriate to hiring needs to be visited.
15%	Performs college relations activities with numerous colleges and universities.
25%	Visits campuses to conduct interviews of graduating seniors.
15%	Develops applicant files and performs initial applicant evaluations.
10%	Assists staffing specialists and line managers in determining who to schedule for second interviews.
5%	Prepares annual college recruiting report containing information and data about campuses, number interviewed, number hired, and related information.
5%	Participates in tracking college graduates who are hired to aid in determining campuses that provide the most outstanding employees.
Job Specification (Qualifications):	
Bachelor's degree in human resource management or a related field. Minimum of two years of work experience in HR or department that annually hires college graduates. Ability to perform in a team environment, especially with line managers and department heads. Very effective oral and written communication skills. Reasonably proficient in Excel, Word, and Windows computer environment and familiar with PeopleSoft software.	

The Advancement Planning process at Best Buy involved reducing the turnover that occurs in most retail environments. The company has achieved a second-place ranking, behind only Costco, and its general managers' tenure at a store averages five years. The performance of managers at Best Buy is reviewed to identify people who can fill vacancies and be promoted, a process known as **succession planning**. If Best Buy has a temporary shortage of sales professionals, at the holiday shopping season, for example, they can hire an experienced contractor or interim executive as a temporary or **contingent worker**, someone who wants to work but not on a permanent, continuous basis. Figure 14.2.2.3 summarizes the process of planning and forecasting an organization's personnel needs.

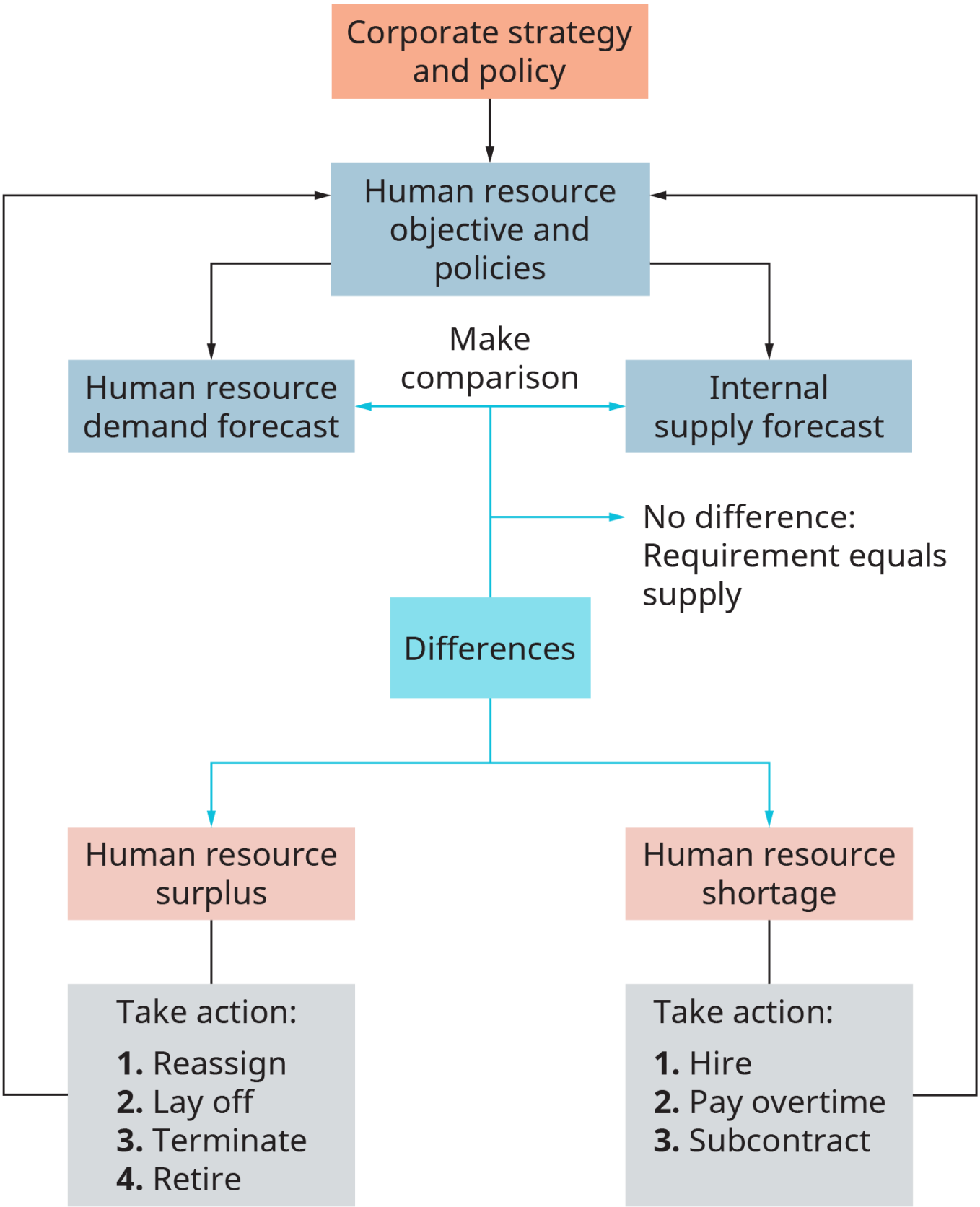


Figure 14.2.2.3: Human Resource Planning Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

CONCEPT CHECK

1. Define human resource management.
2. Distinguish between job analysis, job description, and job specification.
3. Describe the human resource management process.

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14.2.3: Employee Recruitment

How Do Firms Recruit Applicants?

When a firm creates a new position or an existing one becomes vacant, the firm starts looking for people with qualifications that meet the requirements of the job. Two sources of job applicants are the internal and external labor markets. The internal labor market consists of employees currently employed by the firm; the external labor market is the pool of potential applicants outside the firm.

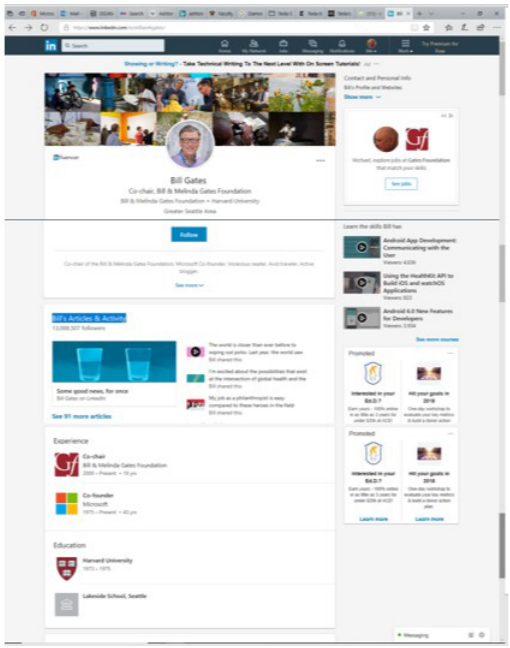


Figure 14.2.3.1: Online recruiting is among the top internet success stories of the past decade. LinkedIn, Monster, and CareerBuilder are hot spots for job hunters and recruiters seeking to establish a working relationship. *What are the advantages and disadvantages of online recruiting compared to traditional forms of recruitment?* (Credit: Bill Gates LinkedIn Profile screen capture, 3/23/2018)

Internal Labor Market

Internal recruitment can be greatly facilitated by using a human resource information system that contains an employee database with information about each employee's previous work experience, skills, education and certifications, job and career preferences, performance, and attendance. Promotions and job transfers are the most common results of internal recruiting. BNSF Railway, Walmart, Boeing, Ritz-Carlton Hotels, and most other firms, large and small, promote from within and manage the upward mobility of their employees.

External Labor Market

The external labor market consists of prospects to fill positions that cannot be filled from within the organization. **Recruitment** is the process of attracting qualified people to form an applicant pool. Numerous methods are used to attract applicants, including print, radio, web, and television advertising. Hospitality and entertainment firms, such as Ritz-Carlton Hotels and Six Flags, frequently use job fairs to attract applicants. A **job fair**, or *corporate open house*, is usually a one- or two-day event at which applicants are briefed about job opportunities, given tours, and encouraged to apply for jobs. For firms needing accountants, engineers, sales managers, and others for professional and scientific positions, college recruiting is very common. These firms (Deloitte, Cisco Systems, Salesforce.com, and thousands of others) schedule job fairs and on-campus interviews with graduating seniors.

Online Recruiting and Job Search

The internet, social media, and specialized software have completely changed the employee recruitment process. Dozens of companies such as Monster.com, Indeed, StartWire, and Glassdoor enable applicants to search for job openings, post their résumés,

and apply for jobs that companies have posted. Most companies provide links to their company website and to the career page on their site so applicants can learn about the company culture, listen to or read testimonials from employees about what it is like to work for the company, and search for additional openings that may interest them.

Large firms may receive thousands of online applications per month. To review and evaluate thousands of online résumés and job applications, firms depend on software to scan and track applicant materials using keywords to match skills or other requirements for a particular job. Social media has also changed how companies search for applicants and verify applicant information.

MANAGING CHANGE

Social Networking and Employee Recruitment

Referrals and professional networking are commonly used methods of identifying job prospects, particularity for managerial, professional, and technical positions. Several software applications and social networks facilitate employee referrals, reference checking, and hiring based on networks of personal relationships. ExecuNet and ExecRank are just two of the many career sites that allow members to search for contacts and network with other professionals in their fields.

LinkedIn is the most popular social network for professionals. It is a giant database of contacts with profiles that provide an overview of a person's past and present professional experience, skills, professional referrals, and affiliations with business and professional associations. A member can search through an extended network of contacts based on his or her professional acquaintances. The basis for a search can be job, job title, company, geography, zip code, or membership in a professional organization. LinkedIn uses the concept that there are no more than six degrees of separation between two people, or one person can be linked to any other individual through no more than six other people. With more than 530 million members worldwide, LinkedIn's extensive platform is an ideal network for both recruiters and those looking to make their next career move.

LinkedIn, like other social networks, is based on voluntary participation, and members consent to being networked. Nevertheless, important questions can be raised regarding privacy concerns and use of one's social network.

Critical Thinking Questions

1. Social networks can easily generate a name for an HR recruiting target, but how can the hiring firm convert the target into a candidate who is interested in the job?
2. A social network like LinkedIn is an excellent tool that can be used to build a personal brand and find a new job. In what ways could a job seeker potentially *harm* their career opportunities on a social networking site?

Recruitment Branding

Recruitment branding involves presenting an accurate and positive image of the firm to those being recruited. Carbone Smolan Agency (CSA) is a New York–based image consulting firm that assists in developing a recruitment branding strategy. The materials developed by CSA comprise a *realistic job preview*, which informs job candidates about organizational realities of the job and the firm so they can more accurately evaluate jobs and firm expectations concerning work assignments, performance standards, promotional opportunities, company culture, and many other characteristics of the job.

CONCEPT CHECK

1. What are the two sources of job applicants?
2. What are some methods firms use to recruit applicants?
3. What is meant by recruitment branding?

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14.2.5: Employee Training and Development

What Types of Training and Development Do Organizations Offer Their Employees?

To ensure that both new and experienced employees have the knowledge and skills to perform their jobs successfully, organizations invest in training and development activities. **Training and development** involves learning situations in which the employee acquires additional knowledge or skills to increase job performance. Training objectives specify performance improvements, reductions in errors, job knowledge to be gained, and/or other positive organizational results. The process of creating and implementing training and development activities is shown in Figure 14.2.5.1. Training is done either on the job or off the job.



Figure 14.2.5.1: Here is the final assembly process on an Airbus 787-10 for Singapore Airlines. This plant is one of Airbus's largest and most technologically advanced manufacturing facilities. *How is technology helping companies develop skilled workers both on and off the job?* (Credit: airbus777/Flickr/ Attribution 2.0 Generic (CC BY 2.0))

On-the-Job Training

New-employee training is essential and usually begins with **orientation**, which entails getting the new employee ready to perform on the job. Formal orientation (often a half-day classroom program) provides information about the company history, company values and expectations, policies, and the customers the company serves, as well as an overview of products and services. More important, however, is the specific job orientation by the new employee's supervisor concerning work rules, equipment, and performance expectations. This second briefing tends to be more informal and may last for several days or even weeks.

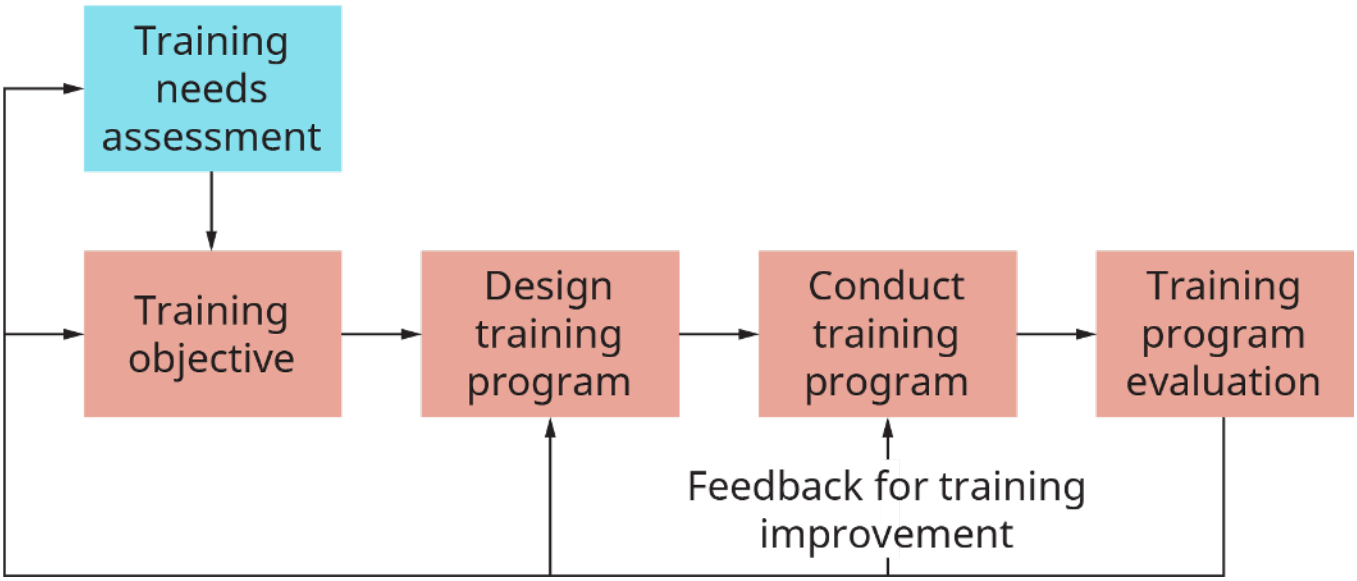


Figure 14.2.5.2: Employee Training and Development Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Beyond employee orientation, job training takes place at the job site or workstation and is directly related to the job. This training involves specific job instruction, coaching (guidance given to new employees by experienced ones), special project assignments, or job rotation. **Job rotation** is the reassignment of workers to several different jobs over time. At Walmart, management trainees rotate through three or more merchandising departments, customer service, credit, and even the human resource department during the first year or two on the job.

Two other forms of on-the-job training are apprenticeship and mentoring. An **apprenticeship** usually combines specific on-the-job instruction with classroom training. It may last as long as four years and can be found in the skilled trades of carpentry, plumbing, and electrical work. **Mentoring** involves a senior manager or other experienced employee providing job- and career-related information to a mentee. Inexpensive and providing instantaneous feedback, mentoring is becoming increasingly popular with many firms, including FedEx, Merrill Lynch, Dow Chemical, and Bank of America. Whereas mentoring is typically conducted through ongoing face-to-face interactions between mentor and mentee, technology now allows for a long-distance mentoring relationship. Dow Chemical uses e-mail and video conferencing to facilitate long-distance mentoring between persons who are working in different countries. For a mentee whose second language is English, writing e-mail messages in English helps the individual become fluent in English, which is a requirement of all Dow Chemical employees regardless of location and country of origin.

EXPANDING AROUND THE GLOBE

Employees on the (International) Move

Working abroad at one of the thousands of American or foreign multinational firms can be exciting and look good on your résumé. But is an international job assignment a step up the ladder to a more rewarding career path or a potential minefield of professional and family risk? The answer depends as much on an employee's family situation as his or her ambition, as well as how well the company supports and handles a transfer to an international location.

International job experience is increasingly seen as an essential leadership competency; therefore, many companies have developed robust rotational programs designed to give individuals critical global experience. According to the BGRS 2016 Global Mobility Trends Survey, providing high levels of service to relocating employees and their families is a fundamental expectation.

Brookfield Global Relocation Services (BGRS) is a talent mobility and relocation services firm that manages more than 60,000 relocations in 140 countries each year for its corporate and government clients. With 15 offices around the world, the company's staff (that speaks 40 languages) can tap into their network of 1,900 trusted suppliers to help employees and families acclimate to their new work and home environments.

Increasing numbers of recent college graduates and experienced professionals are offered opportunities for overseas work assignments ranging from a few days to 24 months or longer. But acclimating to a new country and culture, as well as a new work environment, can be daunting and involves some unique challenges.

Challenges face expatriates aside from the demands of work include:

- Choosing schools for children
- Securing housing
- Finding medical facilities
- Opening bank accounts
- Finding transportation and obtaining a driver's license
- Completing government forms
- Locating food stores
- Learning about community and entertainment offerings

With 189,000 worldwide staff and partners, KPMG International is one of the world's largest professional services and accounting firms, with a presence in 152 countries. Through programs like the KPMG Global Opportunities (GO) program, the professionals at KPMG can explore job rotation assignments, transfer to a new location, or change to a new job function or group. The company's Career Mobility Connection tool allows employees to evaluate opportunities based on their interests and to seek guidance from a transition advisor on potential career opportunities.

KPMG has developed several programs and standards to guide employees and establish consistency, whether they work in the United States or abroad. One of the most important is the KPMG Code of Conduct, which defines the values and standards by which KPMG conducts business and is intended to help guide actions and behaviors of its global workforce.

Every year, all KPMG employees and partners are required to affirm their agreement to comply with the Code of Conduct. In addition, all partners and employees are required to complete mandatory training that reinforces the principles of the Code and further builds understanding of the firm's expectations.

Critical Thinking Questions

1. How is KPMG's Global Code of Conduct intended to influence and guide the personal values and behaviors of its employees and partners?
2. Why must the Code of Conduct be affirmed by employees and partners every year? Why does KPMG include their partners in this program?
3. What are the top four or five job qualifications an employee should have to be considered for an overseas assignment?

Off-the-Job Training

Even with the advantages of on-the-job training, many firms recognize that it is often necessary to train employees away from the workplace. With off-the-job training, employees learn the job away from the job. There are numerous popular methods of off-the-job training. It frequently takes place in a classroom, where cases, role-play exercises, films, videos, lectures, and computer demonstrations are used to develop workplace skills.

Web-based technology is increasingly being used along with more traditional off-the-job training methods. E-learning and e-training involve online computer presentation of information for learning new job tasks. Union Pacific Railroad has tens of thousands of its employees widely dispersed across much of the United States, so it delivers training materials online to save time and travel costs. Technical and safety training at Union Pacific are made available as **programmed instruction**, an online, self-paced, and highly structured training method that presents trainees with concepts and problems using a modular format. Software provided can make sure that employees receive, undergo, and complete, as well as sign off on, various training modules.

Web-based training can also be done using a **simulation**, for example, a scaled-down version of a manufacturing process or even a mock cockpit of a jet airplane. American Airlines uses a training simulator for pilots to practice hazardous flight maneuvers or learn the controls of a new aircraft in a safe, controlled environment with no passengers. The simulator allows for more direct transfer of learning to the job.

CONCEPT CHECK

1. Describe several types of on-the-job training.
2. What are the advantages of simulation training?
3. How is technology impacting off-the-job training?

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14.2.7: Employee Compensation and Benefits

What are the Types of Compensation and Methods for Paying Workers?

Compensation, which includes both pay and benefits, is closely connected to performance appraisals. Employees who perform better tend to get bigger pay raises. Several factors affect an employee's pay:

1. *Pay structure and internal influences.* Wages, salaries, and benefits are based on skills, experience, and the level of the job. The most important high-level positions, such as president, chief information officer, and chief financial officer, are compensated at the highest rates. Likewise, different jobs of equal importance to the firm are compensated at similar rates. As the level of management responsibility increases, so does pay. For instance, if a drill-press operator and a lathe operator are considered of equal importance, they may both be paid $21 per hour.
2. *Pay level and external influences.* In deciding how much to pay workers, the firm must also be concerned with the salaries paid by competitors. If competitors are paying higher wages, a firm may lose its best employees. HR professionals regularly evaluate salaries by geography, job position, and competitor and market wages. Wage and salary surveys conducted by the U.S. Chamber of Commerce and the U.S. Department of Labor can also be useful. There are also several websites such as Glassdoor that post salaries for jobs by company.

An employer can decide to pay at, above, or below the going rate. Most firms try to offer competitive wages and salaries within a geographic area or an industry. If a company pays below-market wages, it may not be able to hire skilled people. The level of a firm's compensation is determined by the firm's financial condition (or profitability), efficiency, and employee productivity, as well as the going rates paid by competitors. For example, MillerCoors Brewing Co. is considered a high-paying firm ($29–$33 per hour for production employees).

Types of Compensation or Pay

There are two basic types of compensation: direct and indirect. Direct pay is the wage or salary received by the employee; indirect pay consists of various employee benefits and services. Employees are usually paid directly on the basis of the amount of time they work, the amount they produce, the type of work performed, or some combination of skill, time, and output. An hourly rate of pay or a monthly salary is considered base pay, or an amount of pay received by the employee regardless of output level. In many jobs, such as sales and manufacturing, an employee can earn additional pay as a result of a commission or an **incentive pay** arrangement. The accelerated commission schedule for a salesperson shown below indicates that as sales increase the incentive becomes increasingly more attractive and rewarding; therefore, pay can function as a powerful motivator. In this example, a salesperson receives a base monthly salary of $1,000, then earns 3 percent on the first $50,000 of product sold, 4 percent on the next $30,000, and 5 percent on any sales beyond $80,000.

Base pay	$1,000 per month
3% of 50,000	1,500
4% of 30,000	1,200
5% of 20,000	1,000
	$4,700

Two other incentive pay arrangements are bonuses and profit-sharing. Employees may be paid bonuses for reaching certain monthly or annual performance goals or achieving a specific cost-saving objective. In this instance, employees are rewarded based on achieving certain goals.

In a profit-sharing plan, employees may receive some portion of the firm's profit. Employee profit shares are usually based on annual company financial performance and therefore are paid once a year. With either a bonus or a profit share, an important incentive pay consideration is whether the bonus or profit share is the same for all employees or whether it is differentiated by level

in the organization, base pay, or some other criterion. Choice Homes, a large-scale builder of starter homes, pays an annual incentive share that is the same for everyone; the president receives the same profit share or bonus as the lowest-paid employee.

Indirect pay includes pensions, health insurance, vacation time, and many others. Some forms of indirect pay are required by law: unemployment compensation, worker's compensation, and Social Security, which are all paid in part by employers. **Unemployment compensation** provides former employees with money for a certain period while they are unemployed. To be eligible, the employee must have worked a minimum number of weeks, be without a job, and be willing to accept a suitable position offered by the state Unemployment Compensation Commission. Some state laws permit payments to strikers. **Worker's compensation** pays employees for lost work time caused by work-related injuries and may also cover rehabilitation after a serious injury. Social Security is mainly a government pension plan, but it also provides disability and survivor benefits and benefits for people undergoing kidney dialysis and transplants. Medicare (health care for seniors) and Medicaid (health care for the poor) are also part of Social Security.

Many employers also offer benefits not required by law. Among these are paid time off (vacations, holidays, sick days, even pay for jury duty), health insurance (including dental and vision), supplemental benefits (disability, life, pet insurance, legal benefits), 401K contributions, pensions and retirement savings accounts, and stock purchase options.

Some firms with numerous benefits allow employees to mix and match benefit items or select items based on individual needs. A younger employee with a family may desire to purchase medical, disability, and life insurance, whereas an older employee may want to put more benefit dollars into a retirement savings plan. Pay and benefits are obviously important elements of human resource management and are frequently studied as aspects of employee job satisfaction. Pay can be perceived as very satisfactory, or it can be a point of job dissatisfaction. In a study of job satisfaction conducted by SAP, direct compensation was the most important element of job satisfaction by employees from various companies. As the cost of health insurance and other benefits has risen sharply over the past few years, benefits have become increasingly important to workers.

CATCHING THE ENTREPRENEURIAL SPIRIT

Starbucks Perks More Than Coffee

At Starbucks, CEO Howard Schultz understood that the single most important aspect of creating an enduring brand is its people. Schultz wanted to set Starbucks apart from other coffee shops and service businesses, and he did this by offering health benefits and stock ownership for people who work part-time. It had never been done before, and it came with a cost.

In addition to employee benefits, funding to build the brand was funneled into operations to create an experience that would enable the brand to endure and be sold profitably for many years to come. So instead of expensive marketing and advertising campaigns, the company focused on experiential marketing.

Scott Bedbury, the president of marketing of Starbucks at the time, explains. "The stores were once four white walls. There was no comfortable furniture or fireplaces or music. So we set out to create an experience in the stores and a level of brand equity that most traditionally marketed brands couldn't touch. That meant constant creative development of products, and the look and feel in the stores. It wasn't cheap. The first year, we spent $100 million building out stores, which is a significant marketing budget for anyone."

But the defining moment for the brand was the stock option and employee benefit plan. This laid the foundation for the company's internal brand, and was Schultz's mission from the very beginning, explains Bedbury. "When Howard took over the company, he was not a rich man and he didn't own a house or even a car. Howard grew up poor in Brooklyn and was influenced strongly by his dad, who never got health benefits from any of his employers. This fueled Howard's drive to create a company that put employees first. He is passionate that when it comes to customers versus employees, employees will always come first."

But it wasn't easy, and it took a lot of courage to present this idea to investors. Bedbury said, "When Howard tried to raise $2.8 million to buy the company from the three founders, he made 220 presentations and he got shut down in all but 12 of them. He was seen as an idealist who was going to put an unnecessary burden on the bottom line by offering benefits to part-time employees who viewed this as a temporary job. But Howard convinced them that turnover would drop, which it did. Store manager attrition was 15 percent, part-time hourly employees was 65 percent, compared to McDonalds and Taco Bell, which were about 200–300 percent a year. That's turning over your work force every four months, and when you do that, your service

suffers and there are all kinds of problems. I don’t know why more people don’t do it. If you give up some equity to employees, they’ll reward you for that.”

Critical Thinking Questions

1. How can a company like Starbucks sustain its strong employee culture while continuing to grow rapidly?
2. Can a firm give its employees too much in terms of benefits and services? Explain.

CONCEPT CHECK

1. How does a firm establish a pay scale for its employees?
2. What is the difference between direct and indirect pay?
3. Why are health insurance and benefits so important to employees?

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14.2.8: The Labor Relations Process

What is a Labor Union and How is it Organized, What is Collective Bargaining, and What are Some of the Key Negotiation Issues?

Tens of thousands of American firms are unionized, and millions of U.S. workers belong to unions. Historically, the mining, manufacturing, construction, and transportation industries have been significantly unionized, but in recent years, service-based firms, including health care organizations, have been unionized.

A **labor union**, such as the International Brotherhood of Teamsters, is an organization that represents workers in dealing with management over disputes involving wages, hours, and working conditions. The labor relations process that produces a union-management relationship consists of three phases: union organizing, negotiating a labor agreement, and administering the agreement. In phase one, a group of employees within a firm may form a union on their own, or an established union (United Auto Workers, for example) may target an employer and organize many of the firm's workers into a local labor union. The second phase constitutes **collective bargaining**, which is the process of negotiating a labor agreement that provides for compensation and working arrangements mutually acceptable to the union and to management. Finally, the third phase of the labor relations process involves the daily administering of the labor agreement. This is done primarily through handling worker grievances and other workforce management problems that require interaction between managers and labor union officials.

The Modern Labor Movement

The basic structure of the modern labor movement consists of three parts: local unions, national and international unions, and union federations. There are approximately 60,000 local unions, 75 national and international unions, and two federations. Union membership has been declining over the past three decades and is now half what it once was. The number of employed union members has declined by 2.9 million since 1983, the first-year union statistics were reported. In 1983, union membership was 20.1 percent of workers, with 17.7 million union workers. In 2017, membership declined to 10.7 percent of workers, with 14.8 million members.

A **local union** is a branch or unit of a national union that represents workers at a specific plant or over a specific geographic area. Local 276 of the United Auto Workers represents assembly employees at the General Motors plant in Arlington, Texas. A local union (in conformance with its national union rules) determines the number of local union officers, procedures for electing officers, the schedule of local meetings, financial arrangements with the national organization, and the local's role in negotiating labor agreements.

The three main functions of the local union are collective bargaining, worker relations and membership services, and community and political activities. Collective bargaining takes place every three or four years. Local union officers and shop stewards in the plant oversee labor relations on a day-to-day basis. A **shop steward** is an elected union official who represents union members to management when workers have complaints. For most union members, his or her primary contact with the union is through union officials at the local level.

A national union can range in size from a few thousand members (Screen Actors Guild) to more than a million members (Teamsters). A national union may have a few to as many as several hundred local unions. The number of national unions has steadily declined since the early twentieth century. Much of this decline has resulted from union mergers. In 1999, for example, the United Papermakers International Union (UPICU) and the Oil, Chemical and Atomic Workers Union (OCAW) agreed to merge under the new name of PACE, or Paper, Allied-Industrial, Chemical and Energy International Union. PACE has about 245,000 members.

For 50 years, one union federation (the American Federation of Labor-Congress of Industrial Organization, or AFL-CIO) dominated the American labor movement. A **federation** is a collection of unions banded together to further organizing, public relations, political, and other mutually-agreed-upon purposes of the member unions. In the summer of 2005, several unions (Teamsters, Service Employees International Union, Laborers' International Union, United Farm Workers, Carpenters and Joiners, Unite Here, and the United Food and Commercial Workers Union) split from the AFL-CIO and formed a new federation named the Change to Win Coalition. The new federation and its member unions represent more than 5.5 million union members. Change to

Win Coalition member unions left the AFL-CIO over leadership disagreements and ineffective organizing strategies of the AFL-CIO; one of its primary goals is to strengthen union-organizing drives and reverse the decline in union membership.

Union Organizing

A nonunion employer becomes unionized through an organizing campaign. The campaign is started either from within, by unhappy employees, or from outside, by a union that has picked the employer for an organizing drive. Once workers and the union have made contact, a union organizer tries to convince all the workers to sign authorization cards. These cards prove the worker's interest in having the union represent them. In most cases, employers resist this card-signing campaign by speaking out against unions in letters, posters, and employee assemblies. However, it is illegal for employers to interfere directly with the card-signing campaign or to coerce employees into not joining the union.

Once the union gets signed authorization cards from at least 30 percent of the employees, it can ask National Labor Relations Board (NLRB) for a union certification election. This election, by secret ballot, determines whether the workers want to be represented by the union. The NLRB posts an election notice and defines the bargaining unit—employees who are eligible to vote and who will be represented by the particular union if it is certified. Supervisors and managers cannot vote. The union and the employer then engage in a pre-election campaign conducted through speeches, memos, and meetings. Both try to convince workers to vote in their favor. Table 14.2.8.1 lists benefits usually emphasized by the union during a campaign and common arguments employers make to convince employees a union is unnecessary.

The election itself is conducted by the NLRB. If a majority vote for the union, the NLRB certifies the union as the exclusive bargaining agent for all employees who had been designated as eligible voters. The employer then has to bargain with the union over wages, hours, and other terms of employment.

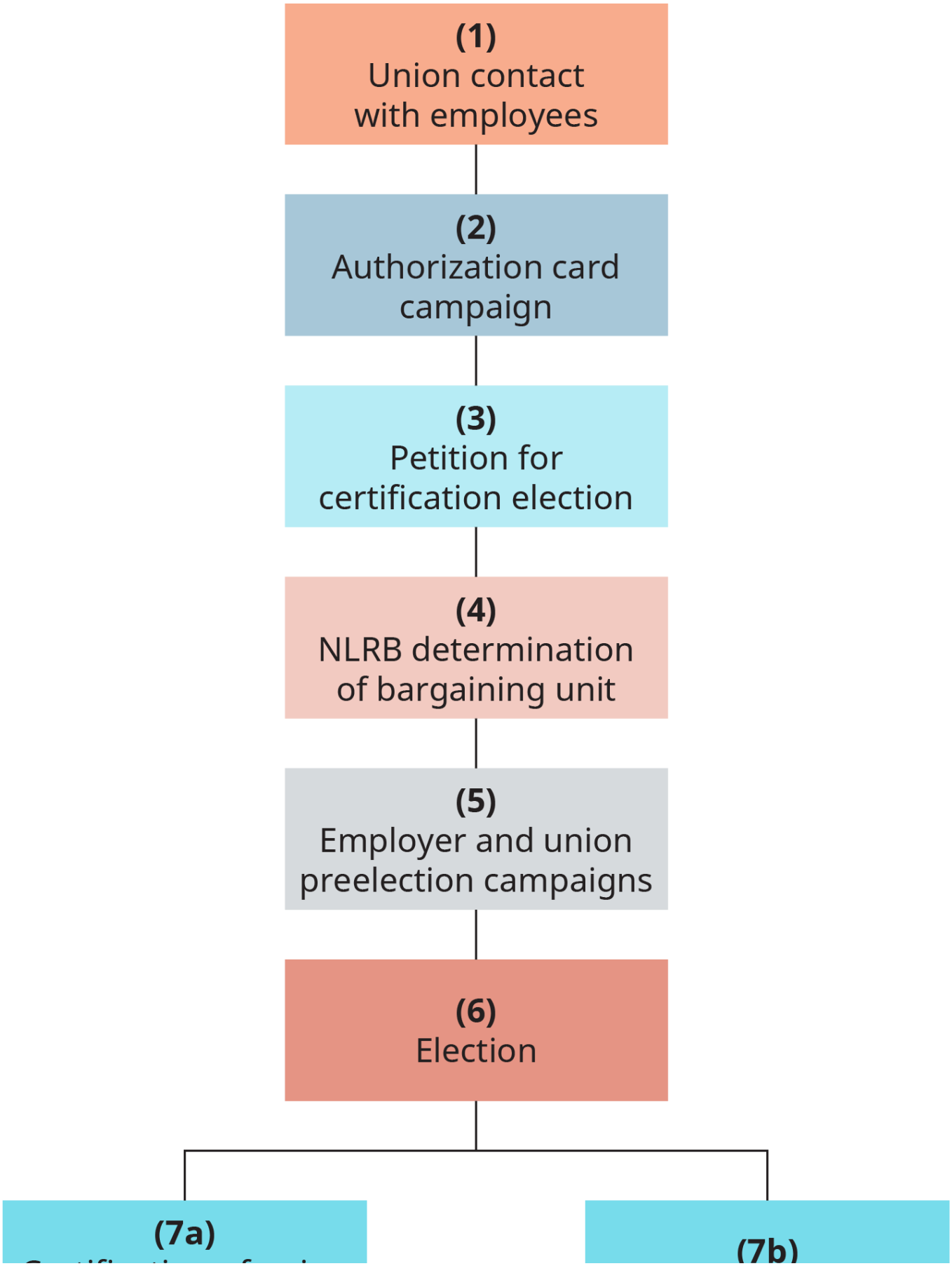
In some situations, after one year, if the union and employer don't reach an agreement, the workers petition for a decertification election, which is similar to the certification election but allows workers to vote out the union. Decertification elections are also held when workers become dissatisfied with a union that has represented them for a longer time. In recent years, the number of decertification elections has increased to several hundred per year.

Table 14.2.8.1: Benefits Stressed by Unions in Organizing Campaigns and Common Arguments Against Unions

Almost Always Stressed	Often Stressed	Seldom Stressed
Grievance procedures	More influence in decision-making	Higher-quality products
Job security	Better working conditions	Technical training
Improved benefits	Lobbying opportunities	More job satisfaction
Higher pay		Increased production

Employer Arguments Against Unionization:

- An employee can always come directly to management with a problem; a third party (the union) isn't necessary.
- As a union member, you will pay monthly union dues of $15 to $40.
- Merit-based decisions (promotions) are better than seniority-based decisions.
- Pay and benefits are very similar to the leading firms in the industry.
- We meet all health and safety standards of the Federal Occupational Safety and Health Administration.
- Performance and productivity are more important than union representation in determining pay raises.


(1)
Union contact with employees
(2)
Authorization card campaign
(3)
Petition for certification election
(4)
NLRB determination of bargaining unit
(5)
Employer and union preelection campaigns
(6)
Election
(7a)
(7b)

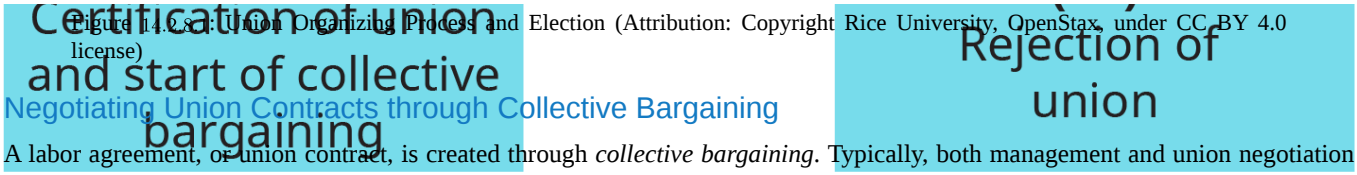


Figure 14.2.8.1: Union Organizing Process and Election (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Negotiating Union Contracts through Collective Bargaining

A labor agreement, or union contract, is created through *collective bargaining*. Typically, both management and union negotiation teams are made up of a few people. One person on each side is the chief spokesperson. Bargaining begins with union and management negotiators setting a list of contract issues that will be discussed. Much of the bargaining over specific details takes place through face-to-face meetings and the exchange of written proposals. Demands, proposals, and counterproposals are exchanged during several rounds of bargaining. The resulting contract must be approved by top management and ratified by the union members. Once both sides approve, the contract is a legally binding agreement that typically covers such issues as union security, management rights, wages, benefits, and job security. The collective bargaining process is shown in Figure 14.2.8.2. We will now explore some of the bargaining issues.

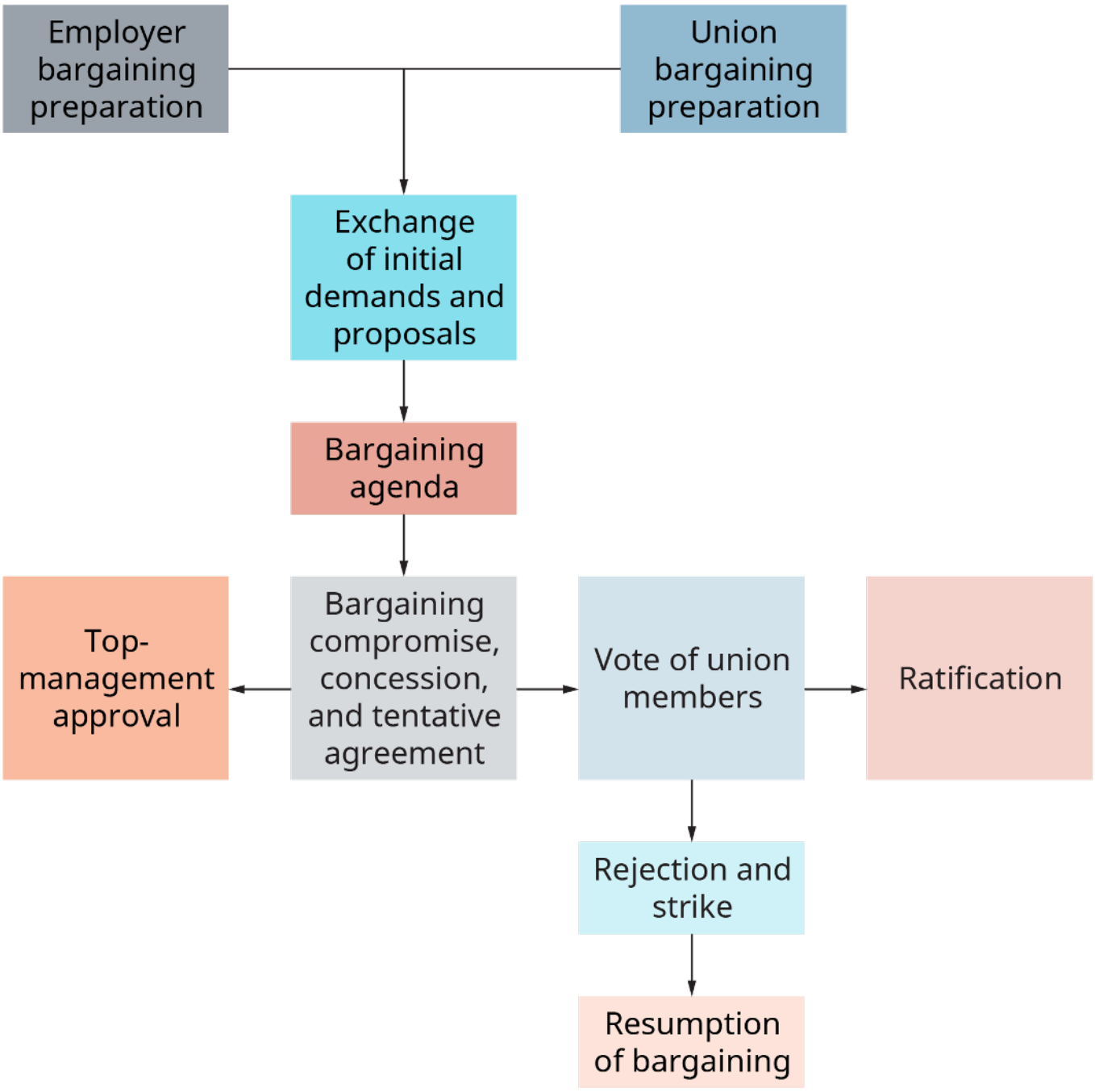


Figure 14.2.8.2: The Process of Negotiating Labor Agreements (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Union Security

A union wants all employees to be union members. This can be accomplished by negotiating a union security clause. The most common union security arrangement is the **union shop**, whereby nonunion workers can be hired by the firm, but then they must join the union, normally within 30 to 60 days. An **agency shop** does not require employees to join the union, but to remain employees, workers must pay the union a fee (known as the agency fee) to cover the union's expenses in representing them. The union must fairly represent all workers, including those in the bargaining unit who do not become members.

Under the Taft-Hartley Act of 1947, a state can make any and all forms of union security illegal by enacting a **right-to-work law**. In the 28 states that have these laws, employees can work at a unionized company without having to join the union. This arrangement is commonly known as an **open shop**. Workers don't have to join the union or pay dues or fees to the union.

Management Rights

When a company becomes unionized, management loses some of its decision-making abilities. But management still has certain rights that can be negotiated in collective bargaining. One way to resist union involvement in management matters is to put a **management rights clause** in the labor agreement. Most union contracts have one. A typical clause gives the employer all rights to manage the business except as specified in the contract. For instance, if the contract does not specify the criteria for promotions, with a management rights clause, managers will have the right to use any criteria they wish. Another way to preserve management rights is to list areas that are not subject to collective bargaining. This list might secure management's right to schedule work hours; hire and fire workers; set production standards; determine the number of supervisors in each department; and promote, demote, and transfer workers.

Wage and Benefits

Much bargaining effort focuses on wage adjustments and changes in benefits. Once agreed to, they remain in effect for the length of the contract. For example, in 2015, the United Auto Workers negotiated a four-year contract containing modest hourly wage increases with U.S. car manufacturers; pay hikes were about 3 percent for first and third years and 4 percent in year four. Hourly rates of pay can also increase under some agreements when the cost of living increases above a certain level each year, say 4 percent. No cost-of-living adjustment is made when annual living cost increases are under 4 percent, which has been the case for the early years of the twenty-first century.

In addition to requests for wage increases, unions usually want better benefits. In some industries, such as steel and auto manufacturing, benefits are 40 percent of the total cost of compensation. Benefits may include higher wages for overtime work, holiday work, and less desirable shifts; insurance programs (life, health and hospitalization, dental care); payment for certain non-work time (rest periods, vacations, holiday, sick time); pensions; and income-maintenance plans. Supplementary unemployment benefits (income-maintenance) found in the auto industry are provided by the employer and are in addition to state unemployment compensation given to laid-off workers. The unemployment compensation from the state and supplementary unemployment pay from the employer together maintain as much as 80 percent of an employee's normal pay.

Job Security and Seniority

Wage adjustments, cost-of-living increases, supplementary unemployment pay, and certain other benefits give employees under union contracts some financial security. But most financial security is directly related to job security—the assurance, to some degree, that workers will keep their jobs. Of course, job security depends primarily on the continued success and financial well-being of the company. For example, thousands of airline employees lost their jobs after the 9/11 terrorist attack in 2001; these were employees with the least seniority.

Seniority, the length of an employee's continuous service with a firm, is discussed in about 90 percent of all labor contracts. Seniority is a factor in job security; usually, unions want the workers with the most seniority to have the most job security.

CONCEPT CHECK

1. Discuss the modern labor movement.
2. What are the various topics that may be covered during collective bargaining?
3. Explain the differences among a union shop, agency shop, and an open shop.

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14.2.10: Legal Environment of Human Resources and Labor Relations

What are the Key Laws and Federal Agencies Affecting Human Resource Management and Labor Relations?

Federal laws help ensure that job applicants and employees are treated fairly and not discriminated against. Hiring, training, and job placement must be unbiased. Promotion and compensation decisions must be based on performance. These laws help all Americans who have talent, training, and the desire to get ahead. The key laws that currently impact human resource management and labor relations are listed in Table 14.2.10.1.

Several laws govern wages, pensions, and unemployment compensation. For instance, the Fair Labor Standards Act sets the federal minimum wage, which is periodically raised by Congress. Many minimum-wage jobs are found in service firms, such as fast-food chains and retail stores. The Pension Reform Act protects the retirement income of employees and retirees. Federal tax laws also affect compensation, including employee profit-sharing and stock purchase plans. When John F. Kennedy signed the Equal Pay Act into law in 1963, the goal was to stop the practice of paying women lower wages for the same job based on their gender. At the time, women with full-time jobs earned between 59 and 64 cents for every dollar their male counterparts earned in the same jobs. Although this law has been in place for several decades, progress has been slow. On April 17, 2012, President Barack Obama proclaimed National Equal Pay Day, noting that women who work full time earn only 77 cents for every dollar their male counterparts make. In 2016, the wage gap changed slightly, with women making 80.5 percent of what men earn.

Table 14.2.10.1: Laws Impacting Human Resource Management

Law	Purpose	Agency of Enforcement
Social Security Act (1935)	Provides for retirement income and old-age health care	Social Security Administration
Wagner Act (1935)	Gives workers the right to unionize and prohibits employer unfair labor practices	National Labor Relations Board
Fair Labor Standards Act (1938)	Sets minimum wage, restricts child labor, sets overtime pay	Wage and Hour Division, Department of Labor
Taft-Hartley Act (1947)	Obligates the union to bargain in good faith and prohibits union unfair labor practices	Federal Mediation and Conciliation Service
Equal Pay Act (1963)	Eliminates pay differentials based on gender	Equal Employment Opportunity Commission
Civil Rights Act (1964), Title VII	Prohibits employment discrimination based on race, color, religion, gender, or national origin	Equal Employment Opportunity Commission
Age Discrimination Act (1967)	Prohibits age discrimination against those over 40 years of age	Equal Employment Opportunity Commission
Occupational Safety and Health Act (1970)	Protects worker health and safety, provides for hazard-free workplace	Occupational Safety and Health Administration
Vietnam Veterans' Readjustment Act (1974)	Requires affirmative employment of Vietnam War veterans	Veterans Employment Service, Department of Labor
Employee Retirement Income Security Act (1974)—also called Pension Reform Act	Establishes minimum requirements for private pension plans	Internal Revenue Service, Department of Labor, and Pension Benefit Guaranty Corporation
Pregnancy Discrimination Act (1978)	Treats pregnancy as a disability, prevents employment discrimination based on pregnancy	Equal Employment Opportunity Commission
Immigration Reform and Control Act (1986)	Verifies employment eligibility, prevents employment of illegal aliens	Employment Verification Systems, Immigration and Naturalization Service
Americans with Disabilities Act (1990)	Prohibits employment discrimination based on mental or physical disabilities	Department of Labor
Family and Medical Leave Act (1993)	Requires employers to provide unpaid leave for childbirth, adoption, or illness	Equal Employment Opportunity Commission

Employers must also be aware of changes to laws concerning employee safety, health, and privacy. The Occupational Safety and Health Act (OSH Act) requires employers to provide a workplace free of health and safety hazards. For instance, manufacturers must require their employees working on loading docks to wear steel-toed shoes so their feet won't be injured if materials are dropped. Drug and AIDS testing are also governed by federal laws.

Another employee law that continues to affect the workplace is the Americans with Disabilities Act. To be considered disabled, a person must have a physical or mental impairment that greatly limits one or more major life activities. More than 40 million Americans, 12.6 percent of the population, were disabled in 2015, according to the U.S. Census Bureau. Employers may not discriminate against disabled persons. They must make "reasonable accommodations" so that qualified employees can perform the job, unless doing so would cause "undue hardship" for the business. Altering work schedules, modifying equipment so a

wheelchair-bound person can use it, and making buildings accessible by ramps and elevators are considered reasonable. Two companies often praised for their efforts to hire the disabled are McDonald's and DuPont.

The Family and Medical Leave Act went into effect in 1993. The law guarantees continuation of paid health benefits, plus a return to the same or equivalent job, and applies to employers with 50 or more employees. It requires these employers to provide unpaid leave of up to 12 weeks during any 12-month period to workers who have been employed for at least a year and worked at least 1,250 hours during the past year. The reasons for the leave include the birth or adoption of a child; the serious illness of a child, spouse, or parent; or a serious illness that prevents the worker from doing the job.

According to the Bureau of Labor Statistics, only 11 percent of all private industry workers have access to paid family leave. Low-wage earners fare even worse. Only 5 percent of low-wage earners get any paid maternity leave, and nearly half will not take time off because they cannot afford to go without income. The United States continues to be one of only four countries in the world (along with Liberia, Suriname, and Papua New Guinea) that do not guarantee paid parental leave.

The Wagner and Taft-Hartley Acts govern the relationship between an employer and union. Employees have the right to unionize and bargain collectively with the company. The employer must deal with the union fairly, bargain in good faith, and not discriminate against an employee who belongs to the union. The union must also represent all employees covered by a labor agreement fairly and deal with the employer in good faith.

Several federal agencies oversee employment, safety, compensation, and related areas. The **Occupational Safety and Health Administration** (OSHA) sets workplace safety and health standards, provides safety training, and inspects places of work (assembly plants, construction sites, and warehouse facilities, for example) to determine employer compliance with safety regulations.



Figure 14.2.10.1: For some occupations, danger is part of the job description. Tallies of work-related casualties routinely identify miners, loggers, pilots, commercial fishermen, and steelworkers as holding the most deadly jobs. Job fatalities are often linked to the use of heavy or outdated equipment. However, many work-related deaths also happen in common highway accidents or as homicides. Pictured here are miners at the Coal Miner's Memorial and Pennsylvania Welcome Center. *What laws and agencies are designated to improve occupational safety?* (Credit: Mike Steele/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

The Wage and Hour division of the Department of Labor enforces the federal minimum-wage law and overtime provisions of the Fair Labor Standards Act. Employers covered by this law must pay certain employees a premium rate of pay (or time and one-half) for all hours worked beyond 40 in one week.

The **Equal Employment Opportunity Commission** (EEOC) was created by the 1964 Civil Rights Act. It is one of the most influential agencies responsible for enforcing employment laws. The EEOC has three basic functions: processing discrimination complaints, issuing written regulations, and gathering and disseminating information. An employment discrimination complaint can be filed by an individual or a group of employees who work for a company. The group may comprise a **protected class**, such

as women, African Americans, or Hispanic Americans. The protected group may pursue a class-action complaint that may eventually become a lawsuit. As a measure to prevent employment discrimination, many employers set up **affirmative action programs** to expand job opportunities for women and minorities

Even with affirmative action and other company efforts to follow the law, each year the EEOC receives tens of thousands of complaints from current or former employees. The monetary benefits that the EEOC wins for employees has grown substantially during the past 10 years. Large monetary settlements often occur when the EEOC files a class-action suit against an employer. For example, the Ford Motor Company settled sexual and racial harassment claims by more than 30 women for more than $10 million at two Chicago-area manufacturing plants in 2017. Also, Sears, Motorola, and AT&T have had to make large back-pay awards and to offer special training to minority employees after the court found they had been discriminated against.

The NLRB was established to enforce the Wagner Act. Its five members are appointed by the president; the agency's main office is in Washington, DC, and regional and field offices are scattered throughout the United States. NLRB field agents investigate charges of employer and union wrongdoing (or unfair labor practices) and supervise elections held to decide union representation. Judges conduct hearings to determine whether employers and unions have violated the law.

The Federal Mediation and Conciliation Service helps unions and employers negotiate labor agreements. Agency specialists, who serve as impartial third parties between the union and company, use two processes: conciliation and mediation, both of which require expert communication and persuasion. In **conciliation**, the specialist assists management and the union with focusing on the issues in dispute and acts as a go-between, or communication channel through which the union and employer send messages to and share information with each other. The specialist takes a stronger role in **mediation** by suggesting compromises to the disputing organizations.

CONCEPT CHECK

1. Discuss the laws that govern wages, pensions, and employee compensation.
2. Describe the Americans with Disabilities Act.
3. How do the Wagner and Taft-Hartley Acts impact labor-management relations?

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14.2.11: Trends in Human Resource Management and Labor Relations

What Trends and Issues Are Affecting Human Resource Management and Labor Relations?

Some of today's most important trends in human resource management are using employee diversity as a competitive advantage, improving efficiency through outsourcing and technology, and hiring employees who fit the organizational culture. Although overall labor union enrollment continues to decline, a possible surge in membership in service unions is anticipated.

Employee Diversity and Competitive Advantage

American society and its workforce are becoming increasingly more diverse in terms of racial and ethnic status, age, educational background, work experience, and gender. A company with a demographic employee profile that looks like its customers may be in a position to gain a **competitive advantage**, which is a set of unique features of a company and its product or service that are perceived by the target market as superior to those of the competition. Competitive advantage is the factor that causes customers to patronize a firm and not the competition. Many things can be a source of competitive advantage: for Southwest Airlines it is route structure and high asset utilization; for Ritz-Carlton hotels it is very high-quality guest services; for Toyota it is manufacturing efficiency and product durability; and for Starbucks it is location, service, and outstanding coffee products. For these firms, a competitive advantage is also created by their HR practices. Many firms are successful because of employee diversity, which can produce more effective problem-solving, a stronger reputation for hiring women and minorities, greater employee diversity, quicker adaptation to change, and more robust product solutions because a diverse team can generate more options for improvement.

In order for an organization to use employee diversity for competitive advantage, top management must be fully committed to hiring and developing women and minority individuals. An organization that highly values employee diversity is the United States Postal Service (USPS). In 1992 the Postal Service launched a diversity development program to serve as the organization's "social conscience and to increase employees' awareness of and appreciation for ethnic and cultural diversity both in the postal workplace and among customers." Twenty-five years later, 39 percent of postal service employees are minority persons: 21 percent African-American, 8 percent Hispanic, and more than 8.0 percent other minorities. In addition, women make up 40 percent of the organization's workforce.

Outsourcing HR and Technology

The role of the HR professional has changed noticeably over the past 20 years. One significant change has been the use of technology in handling relatively routine HR tasks, such as payroll processing, initial screening of applicants, and benefits enrollments. Large firms such as Nokia and Lockheed Martin purchase specialized software (SAP and Oracle/PeopleSoft) to perform the information-processing aspects of many HR tasks. Other firms, such as Jacobs Engineering Group (a large professional services firm), outsource—or contract out—these tasks to HR service providers such as Aon Hewitt and Workforce Solutions.

HR outsourcing is done when another firm can perform a task better and more efficiently, thus saving costs. Sometimes HR activities are outsourced because HR requirements are extraordinary and too overwhelming to execute in-house in a timely fashion. Frequently, HR activities are outsourced simply because a provider has greater expertise. For example, media conglomerate CBS Corp. recently announced that it hired Fidelity Investments to manage its 401(k) plan, which has more than $4 billion in assets.

Organizational Culture and Hiring for Fit

Regardless of general business and economic conditions, many firms are expanding operations and hiring additional employees. For many growing firms, corporate culture can be a key aspect of developing employees into a competitive advantage for the firm. Corporate culture refers to the core values and beliefs that support the mission and business model of the firm and guide employee behavior. Companies such as JetBlue, Ritz-Carlton, and Cypress frequently hire for fit with their corporate cultures. This necessitates recruitment and selection of employees who exhibit the values of the firm. Ritz-Carlton and Cypress use carefully crafted applicant questionnaires to screen for values and behaviors that support the corporate culture. JetBlue uses behavioral-based interview questions derived from its corporate values of safety, integrity, caring, fun, and passion. Southwest Airlines has non-HR employees (flight attendants, gate agents, and pilots) and even frequent flyer passengers interview applicants to screen for cultural fit as well as strong customer-service orientation.

In addition to cultural fit, firms are increasingly hiring for technical knowledge and skills fit to the job. Tech companies such as IBM, Amazon, and Microsoft receive thousands of résumés and job applications each year and continue to look for the best and the brightest when it comes to technical knowledge and skills. For example, IBM is now focusing on a skills-based approach rather than a candidate's education level and number of academic degrees. Amazon is all about the customer and looks for employees who continue to be "relentlessly curious." Microsoft continues to raise the talent bar by embracing job applicants who have demonstrated leadership, achieved concrete results, and can prove that they love to learn.

More Service Workers Joining Labor Unions

Organized labor has faced tumultuous times during the last several decades due to declining union membership, loss of factory jobs, dwindling political clout, and the shifting of jobs outside the United States. With union membership now down to a little more than 10 percent of the U.S. workforce, some wonder if labor unions, who organize as a united front against poor working conditions, still have a place in the country. Mary Kay Henry, international president of Service Employees International Union (SEIU), is optimistic that unions are capable of resurgence by organizing the growing number of service workers into labor unions. The SEIU is the fastest-growing union in the nation, having jumped to 2 million members from 1.1 million a decade ago.

Henry's goal is to focus on recruiting the country's millions of low-wage service workers, positions that are primarily filled by the working poor. These workers are disproportionately women, immigrants, and members of minority groups, which have all been traditionally more open to unionization. If these workers are successfully recruited into the SEIU, Henry believes that their wages and benefits would increase in much the same way unions brought factory workers into the middle class in the 1930s.

The SEIU believes that the service industry provides a target of opportunity, with the largest expected employment growth through 2026 in low-paid local services:

Job	Projected Growth
Home health aides	47%
Personal care aides	39%
Food preparation	17%
Janitorial	10%

Many believe that the future of labor lies primarily in the success of recruitment efforts and in enrolling the massive numbers of employees who are in fast-growing, low-wage service jobs. For example, the SEIU was successful recently in unionizing hundreds of workers who provide services to people with disabilities in California, with an eye toward raising standards for their work and increasing hourly wages and benefits. Reversing labor's decline will be challenging, but the SEIU looks positively toward the future.

CONCEPT CHECK

1. How can employee diversity give a company a competitive advantage?
2. Explain the concept of hiring for fit.
3. Why does the service industry provide an opportunity for labor union growth?

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SECTION OVERVIEW

14.3: Supply Chain Management - You Better Get It Right

14.3.1: Introduction

14.3.2: The Supply Chain and a Firm's Role in It

14.3.3: Firm's Role in the Supply Chain

14.3.4: The Benefits and the Risks of Participating in a Supply Chain

14.3.5: The Three Threads

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14.3.3: Firm's Role in the Supply Chain

Learning Objectives

- Learn about the importance of developing new types of relationships with suppliers and customers.
- Businesses need to strive toward win-win scenarios with their supplier partners.
- Understand the need for accurate metrics to evaluate the performance of the supply chain management system.

Developing New Relationships

Game theory is a branch of mathematics. Broadly stated, game theory examines competitive situations in which one's outcomes may be influenced or dictated by the decisions of other players. It has been applied to a variety of worldwide domains, including economics, military operations, political science, and business strategy. It has its own very large literature base, and work in this field has been recognized by several Nobel prizes in economics. To better understand some of the risk associated for small businesses participating in supply chain management, we will briefly look at two types of games: zero-sum games and non-zero-sum games.

Zero-sum games are those in which the total benefits for all participants total zero. Baseball can be seen as a zero-sum game. If one is told that the New York Yankees and the New York Mets played an exhibition game and the Yankees won, then one also knows that the New York Mets lost. Basketball and most games in professional football are also zero-sum games because there is a winner and a loser. Poker can also be seen as a zero-sum game. If your five friends have a Friday night game of poker and one player is up $100, then you also know that the other four players have suffered a cumulative loss of $100.

Non-zero-sum games, on the other hand, are those that potentially have net results other than zero. This simply means that the loss of one player does not directly correspond to the game of another player. In a non-zero-sum game, it is possible for all the players to win or for all the players to lose. The classic illustration of a non-zero-sum game is known as the prisoner's dilemma. The prisoner's dilemma hypothesizes that two criminals (prisoner A and prisoner B) are arrested and charged with the same crime. At the police station, they are separated, and each is given the following option: if you inform on the other prisoner, you will be set free, while the other prisoner will receive a five-year sentence. Both prisoners would instinctively recognize that if they both remained silent, the police would have insufficient evidence to convict both of the crime. At worst, they would be held in the jail for several months. If, however, both prisoners informed on each other, they would probably receive a two-year sentence. Assuming that both prisoners wish to serve the minimal amount of time, their individual decisions will be dictated by what they believe will be the other prisoner's decision. There are four possible outcomes to this scenario:

1. Prisoner A informs on prisoner B while prisoner B remains silent. This is a win for prisoner A and a loss for prisoner B. This is a win-lose outcome.
2. Prisoner B informs on prisoner A while prisoner A remains silent. This is a win for prisoner B and a loss for prisoner A. This is a win-lose outcome.
3. Both prisoner A and prisoner B inform on each other. This situation essentially represents a loss for both prisoner A and prisoner B. This is a lose-lose outcome.
4. Both prisoner A and prisoner B trust each other and remain silent. This results in both prisoners doing a minimal amount of time. In effect, this is a win-win for both individuals.

The point of this brief introduction to game theory is to highlight the possibility of creating a **win-win scenario**. In the prisoner's dilemma, the key to achieving a win-win outcome is that both parties must have complete trust in each other. This concept of mutual trust plays a critical role in successful supply chain management. Far too often, both the supplier and the customer perceive the relationship as a win-lose outcome only. Customers want suppliers to provide items at the lowest possible cost, with the highest quality, delivered exactly when needed. Customers often use multiple suppliers and play them off against each other to guarantee the lowest possible price. Suppliers want to provide customers with items of the highest possible price, with acceptable quality, and delivered when it is convenient for the supplier. These attitudes produce a "dance" between the customer and the supplier, where both are trying to win even if that means that the other loses. These attitudes often stem from the fact that there is no trust between the customer and the supplier.

W. Edwards Deming, the famous management guru who was most commonly associated with the quality movement, had several interesting insights into areas that would be associated with supply chain management. As one of the few management theorists whose ideas were comprehensive enough to be synthesized into a coherent business philosophy, Deming summarized his approach to management in fourteen points. One of these points is as follows: “End the practice of awarding business on the basis of price. Instead, minimize total cost. Move toward a single supplier for any one item, with a long-term relationship of loyalty and trust.”

Deming argued that the move toward a single supplier for a particular part could yield significant advantages. Using a single supplier requires that a customer must sign a multi-year agreement with the supplier. This enables both the supplier and the customer to better understand each other’s needs and capabilities. As this knowledge grows, the supplier can better serve the customer by improving quality, design, and service. From these improvements, one can easily anticipate that there will be lower costs and higher profits. A multi-year contract with a supplier guaranteeing particular sales is invaluable to many suppliers because of the benefit of such a contract when that supplier must deal with its bank. Deming counters the argument for the need for multiple suppliers, in case a catastrophe or a disaster strikes that single supplier, by suggesting that a tight and trusting relationship will lead the supplier to develop sufficient contingency plans. Deming argues that a sense of joint responsibility comparable to a marriage comes from such trust.

Building such trust between two organizations is not easy. It will often require significant changes in one or both parties. Such change is best induced when it is clear to all participants that there is top-level management support for the new ways of doing business. Top management must articulate the shared vision between the two organizations. Top management must clearly identify the objectives and metrics to be used by both the supplier and the customer. People need to clearly understand the joint benefits from adopting the new way of business. In addition, even with electronic communication, it is highly advisable that members of both organizations meet on a regular basis and perhaps tour each other’s facilities.

The new relationships that are required for the success of any supply chain management program are not easy to implement, but they are vital. Every effort must be made to adopt this win-win perspective.

Video Clip: Supply Chain Integration

How elements of a supply chain must be brought together.

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Video Clip: Global Supply Chain Management

An examination of global operations.

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Video Clip: Socially Responsible Supply Chain Management

Social responsibility and sustainability are important concepts.

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Video Clip: Business Processes

The moment a customer places an order through delivery.

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Video Clip: Quality Management

Supply chains are tasked with producing high-quality products.

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Managing Information in New Ways

Cost, profits, and financial ratios can provide useful insights into the overall efficiency and effectiveness of any business. However, they do not always tell the full story. A sudden spike in the price of oil, a flood that destroys a low-cost supplier, an increase in interest rates, the closing of a large plant in a small town, or a national banking crisis are all external factors that can cripple the financial viability of any business. These external factors lie beyond the control of even the best management team. Sometimes we

need to be very careful about what we measure and how we should measure. Although it adds a layer of complexity to a basic accounting system, measurements that are useful for evaluating processes that serve customers can be provided.

When evaluating the supply chain of a business, there is a great need to carefully consider what metrics should be employed. Such a consideration should include at least some of the following factors:

- **Total supply chain cost.** All the operational expenditures of a cost associated with the requisite information systems.
- **Cash-to-cash cycle time.** The time between when an organization purchases raw materials and when they are paid by the customer.
- **Delivery.** The percentage of orders delivered on or before customer due dates.
- **Flexibility.** The amount of time required to handle a significant ramp up in production.

For those who are seriously committed to maximizing the benefits from successful supply chain management, study the **supply chain operations reference (SCOR) model**. This model enables businesses to benchmark their supply chain management systems. Developed in 1996 by the Supply Chain Council in conjunction with AMR Research and Pittiglio Rabin Todd and McGrath, the purpose of the SCOR model is to provide methods to measure and benchmark the performance of the supply chain management system of a business. Currently, one thousand firms, universities, and government agencies participate in the continuing evolution of the SCOR model. It is predicated on three major components: process modeling, performance measurement, and the determination of best practices.

The process-modeling component begins with five essential elements that link together the supply chain: plan, source, make, deliver, and return. Plan refers to those processes associated with the design of the supply chain, planning activities associated with the other four processes, and the implementation of all these plans. These plans should enable management to identify any significant gaps and determine how these gaps will be closed. Source refers to the ordering and the acquisition of goods and services to meet anticipated demand, including purchase orders, scheduling, receipts, and storage. Make refers to those processes used to create the product or the service, including, for example, make to stock, make to order, or engineer to order. Deliver refers to those processes associated with the development and the fulfillment of customer orders, including scheduling, packaging, and shipping all orders. Lastly, return refers to those processes associated with the return of finished products by a customer. The SCOR model attempts to be as inclusive as possible with respect to these five major processes. Each process can be broken down into sub-components. Currently, there are thirty sub-components for the plan element, twenty-seven sub-components for the source element, thirty-one sub-components for the make element, sixty-one sub-components for the deliver element, and thirty-six sub-components for the return element. This program then goes on to identify specific metrics for nearly every sub-component. It is the most comprehensive system of evaluation for supply chain management.

Video Clip: Walmart Logistics

A Walmart logistics commercial.

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Video Clip: Ford Manufacturing Supply Chain

A Cisco promotional video on supply chain management.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Measuring Performance

Supply chains are tasked with being effective, efficient, and adaptable.

A YouTube element has been excluded from this version of the text. You can view it online here.

WEB RESOURCES

Game Theory

A comprehensive set of materials from a professor's course on game theory.

Prisoner's Dilemma

A computer application that allows individuals to play a game based on the prisoner's dilemma.

SCOR Frameworks

An overview of SCOR from the Supply Chain Council.

The SCOR Model for Supply Chain Strategic Decisions

An article describing SCOR.

KEY TAKEAWAYS

- In game theory's non-zero-sum model, it is possible to produce win-win scenarios for multiple players.
- Win-win scenarios require mutual trust.
- Supply chain management success needs new levels of trust and respect for it to function properly in the long run.
- Supply chain management needs metrics to evaluate its performance.
- Existing models of supply chain metrics (SCOR) can handle the most complicated of supply chains.

EXERCISES

1. Identify some examples in your life and in business of win-win scenarios.
2. How were these scenarios achieved?
3. What were the greatest threats to these scenarios?
4. Interview five small business owners and ask them if they have had any experiences with win-win scenarios and how were they achieved.
5. Ask the same five small business owners how they measure (if they do) the effectiveness of the performance of their supply chain.
6. Imagine a local bakery that produces goods for a regional supermarket chain. Examine the SCOR model and determine if it is appropriate for evaluating the bakery's supply chain.

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14.3.4: The Benefits and the Risks of Participating in a Supply Chain

Learning Objectives

- Understand the major benefits to be derived from adopting a supply chain management system.
- Understand the challenges of creating such a system.
- Understand the technical and managerial risks associated with supply chain management.
- Recognize the benefits for a small business in adopting supply chain management.

The Benefits of Successful Supply Chain Management

For any small business, a commitment to developing a supply chain management system is not a small undertaking. It involves the commitment of significant financial resources for the acquisition of appropriate software. Policies and procedures must be changed in accordance with the needs of the new system. Personnel must be trained in not only using the new software but also adapting to new ways of doing business. Small businesses accept these challenges of adopting supply chain management systems because such systems are viewed as being important for long-term survival and because businesses anticipate substantial management and economic benefits.

The management benefits of supply chain management system include the following:

- **Silo busting.** By their very nature, supply chain management systems improve communication across all functions within a business. This leads to employees having a better understanding of the entire operations of a business and how their work relates to the overall benefits of the business.
- **Improve communications with suppliers and customers.** Improved communications with customers enhance the overall value provided to those customers. The improvement in customer satisfaction leads to longtime relationships, which yields significant economic benefits. Improved communications with suppliers improve the overall operational efficiency of both participants, reduce costs, and improve profits.
- **Supplier selection.** Supply chain management systems can help businesses evaluate prospective suppliers and monitor the performance of current suppliers. This capability can lead to strategic sourcing and significant cost savings plus improvement of the when- and where-needed variables.
- **Improvements in purchasing.** The automation of purchasing reduces errors and improves the economic efficiency of the purchasing function. Disciplined purchasing can allow for the full exploitation of available discounts.
- **Reduction of inventory costs.** Supply chain management systems can produce significant cost savings across all levels of inventory. Improved forecasting and scheduling will lead to increases in inventory turns and a corresponding reduction of costs.
- **Improvements in operations.** Improved quality control reduces the scrap rate, which in turn can have significant cost savings. Better production scheduling translates into producing what is needed when it is needed. The business does not have to spend additional money trying to expedite the production of particular orders to customers. The cost of goods sold is reduced in this manner. An additional benefit of supply chain management systems is that they lead to better utilization of plant and equipment. Great utilization translates into less likelihood that unneeded assets will be acquired, which has major financial benefits.
- **Error reduction.** By automating processes, billing errors and errors associated with purchasing and shipping quantities can be reduced. This not only saves money but also improves satisfaction with both suppliers and customers.
- **Improvements in transportation operations.** Accurate deliveries reduce returns and their associated costs. Sophisticated shipping models can reduce the overall cost of transportation.
- **Additional financial benefits.** Such systems can improve the collections process, which impacts customer relations, reduces bad debts, and improves cash flow.

The Risks Associated with Supply Chain Management

The major risks associated with a supply chain management system fall into two categories: technical and managerial.

Michael Porter’s five forces model is a model of the major factors that contribute to an industry’s overall structure. It also points to factors that might affect the overall profitability of the particular business within that industry. The greater the strength of these forces, the greater the challenge to make above-average return profits for businesses in that industry. It is useful to review two of

those forces—the power of suppliers and the power of buyers—and reexamine how they might influence the profitability of any business in the supply chain.

Porter identifies the following factors that might contribute to the overall strength of each force. He argued that suppliers are powerful when the following occurs:

- **They are concentrated.** When an industry is dominated by only a few suppliers, these suppliers generally have a greater ability to dictate terms to their customers. The mining company DeBeers, which controls more than 50 percent of the world's diamond production, is able to set the selling price of diamonds for most of the world's jewelers. It should be pointed out, however, that in some cases concentration, particularly a duopoly, provides an opportunity for customers to force the two competing firms to compete more readily against each other. Think of the situation of Boeing and Airbus and their relationship to their customers—various airlines. At present, there are only two major producers of commercial aircraft, and airlines sometimes obtain better deals from one manufacturer because of their desire to maintain parity in market share.
- **The size of the suppliers is large relative to the buyers.** Suppliers are powerful when they are large and sell to a set of fragmented buyers. Think of the largest oil companies that sell gasoline to independent stations. The power in this scenario lies with the large oil companies.
- **Switching costs are high.** Suppliers have power when the cost of switching to an alternative supplier is expensive. Many businesses stay with Microsoft products because to do otherwise means that they would have to repurchase new hardware and software for the entire organization.

Problems may also arise from a heavier reliance on one customer in the supply chain. Even large companies need to be aware of their relative strength in the supply chain. Rubbermaid is the most admired corporation in America, as voted by *Fortune* magazine in 1993 and 1994, yet it had significant difficulties when dealing with one of its major customers—Walmart. In the early 1990s, Rubbermaid found that the cost for a key ingredient—resin—had increased by 80 percent. Walmart's almost total focus on lowering its prices led it to drop many of Rubbermaid's products. This began a downward spiral for Rubbermaid, which led to its acquisition by Newell Inc. Rubbermaid went from the status of the most admired corporation to being a basket case because it failed to recognize its excessive dependence on one customer.

WEB RESOURCES

The Benefits of Supply Chain Management

A list of benefits from SAP, a software company.

The Risks of Supply Chain Management

A Forbes article on the risks associated with supply chain management.

Risk and Rewards in Supply Chain Management

A Harvard working paper.

KEY TAKEAWAYS

- There are significant benefits for businesses that adopt supply chain management systems.
- The benefits stem from improved customer relations, cost-cutting, and increased operational efficiencies.
- The adoption of a supply chain management perspective can pose risks.
- Businesses must consider the relative power of both their suppliers and their customers.

EXERCISES

1. Interview the owners of local businesses who say they have some form of a supply chain management system and ask them if they believe they have benefited from the system.
2. Ask them how they have benefited.
3. Ask them to identify the major problems they had with implementing and using the system.
4. Ask them if they believe they have the "power" in their supply chain or if the "power" is in the hands of their suppliers.

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14.3.5: The Three Threads

Learning Objectives

- Understand how customer value is enhanced by supply chain management.
- Understand how cash flow can be increased, in the long term, by using supply chain management.
- Understand the various computer programs that make up a supply chain management program.
- Recognize the risks that can stem from adopting a single supplier program.

Customer Value Implications

Throughout this text, we have emphasized the importance for small businesses to constantly focus on the notion of improving value for their customers. Successfully implementing a supply chain management system offers tremendous possibilities for not only improving value to customers but also significantly enhancing the capabilities and profitability of the small business itself. Supply chain management improves customer value in the following ways:

- **Reduced inventory.** A well-executed supply chain management system means that customers receive orders when they need them. Further, this does not necessarily imply that the supplier will be holding the inventory for the customer—although that might occur. It refers to the fact that better communication and better scheduling may enable the supplier to produce the item exactly when it is needed.
- **Improvement in the order accuracy.** Supply chain management should guarantee that when orders are shipped, the right items are shipped in the right quantity. This does not disrupt the production of the customer and eliminates product returns, which results in economic benefits for both the customer and the supplier.
- **Reduced cycle time for product development.** To ensure success, the customer and the supplier must develop new levels of trust. This trust will evolve into a long-term relationship. Both parties begin to know each other better, including each other's needs and capabilities. As this evolves, the supplier is in a better position to help the customer develop new products far more rapidly. It greatly reduces the product cycle time.
- **Financial benefits.** These value improvements all translate into significant cost savings. Cost savings experienced by the supplier can be transferred into cost savings for the customer. Relatively modest improvements in inventory reduction, reduced safety stock size, reduce stockouts, improved order fill rates, and reduced transit time can yield surprisingly large financial benefits to both parties.
- **Peace of mind.** Having a supplier that one can trust to accurately deliver items in a timely low-cost fashion, which has also developed contingency plans to cope with potential problems, is relatively unique and provides the customer with a high level of comfort. One may be unable to place an economic price on such peace of mind.

Cash-Flow Implications

It must be recognized that committing to a supply chain management system from scratch will entail a major investment. New approaches to software can reduce both the cost and the risk of such a commitment. However, businesses will want to recoup most of the investment as quickly as possible—perhaps six months or less. Given the potential for cost savings, the impact on increasing cash flow should be obvious.

What is not obvious is the potential for significant improvements in cash flow from minor improvements generated by supply chain management systems. To illustrate this, let us look at an example adapted from Coyle et al. (2009). Assume that a firm is in the following situation: It ships orders to customers; if the orders are incomplete or inaccurate, the firm assumes the full cost of the return and follow-up shipping. When an incorrect shipment is made, to ameliorate their upset customers, the firm takes $100 off the

bill. However, when some customers find that the order is incomplete or inaccurate, they are so upset that they cancel the order. Here are the data:

Number of orders per year	50,000
Number of items per order	25
Profit per unit ($)	30
Price reduction for incorrect order ($)	100
Backorder cost per order ($)	200
Percentage of totally correct orders	90
Percentage of incorrect orders canceled	25

It can be readily seen that the profit per order is $750 (25 × $30). We now examine the lost cash flow from the situation. The lost cash flow has several components. The first component is the backorder cost, which is composed of the number of orders that will have to be backfilled. The second component is associated with the losses from the incorrect orders that were canceled. The last component is the price reduction for the incorrect order.

lost cash flow = backorder costs + cancelled sales costs + price reduction costs

These can be computed as follows:

lost cash flow = [number of orders × (1 − percentage of totally correct orders) × backordered cost per order][number of orders × (1 − percentage of totally correct orders) × percentage of incorrect orders canceled × profit per order] + [number of orders × (1 − percentage of totally correct orders) × price reduction for incorrect order]

Now let us substitute the correct values into this equation.

$$\text{lost cash flow} = [50{,}000 \times (1 - .90) \times \$200] + [50{,}000 \times (1 - .90) \times (.25) \times \$750] + [50{,}000 \times (1 - .90) \times \$100]$$

$$\text{lost cash flow} = \$1{,}000{,}000 + \$937{,}500 + \$500{,}000 = \$2{,}437{,}500$$

We now assume that an “improved” supply chain management system has been installed. The percentage of correctly filled orders increases from 90 percent to 96 percent. If we substitute 96 percent into these equations, we find that the *new* lost cash flow would decrease to *$975,000*. This means that a 6 percent increase in order accuracy leads to a 60 percent decrease in the loss of cash flow.

Implications of Technology and the E-Environment

It should be obvious that contemporary supply chain management cannot be conducted through paper and pencil procedures. The backbone of today’s supply chain management is software. Initially, it would be impossible to think of developing such systems without **electronic data interchange**. Today, the Internet serves as the basis for sharing communication between suppliers and customers. However, there is more to the technology behind supply chain management system than merely the exchange of data.

Supply chain management requires several types of software packages and the need to successfully integrate them. One can identify several major software components of a supply chain management system. One section would be **supplier relationship management** programs. These programs involve planning and controlling the actions with upstream suppliers. Such programs would cover many aspects of procurement—supplier analysis, order execution, payment, and performance monitoring. There would also be customer relationship management (CRM) software that would handle all interactions with customers. Enterprise resource planning (ERP) would handle the necessary integration of all data. ERP coordinates data flows from finance, accounting, and operations to provide management with a seamless overview of the performance of a business. It may also have a **decision support system**, which allows for data manipulation or the use of analytical modeling tools to provide a better decision-making environment. It may involve using mathematical programming models to optimize decisions. Another set of modules dedicated to logistics would focus on the optimal use of warehousing and shipping. These functions are sometimes handled externally by either a third- or fourth-party logistics provider.

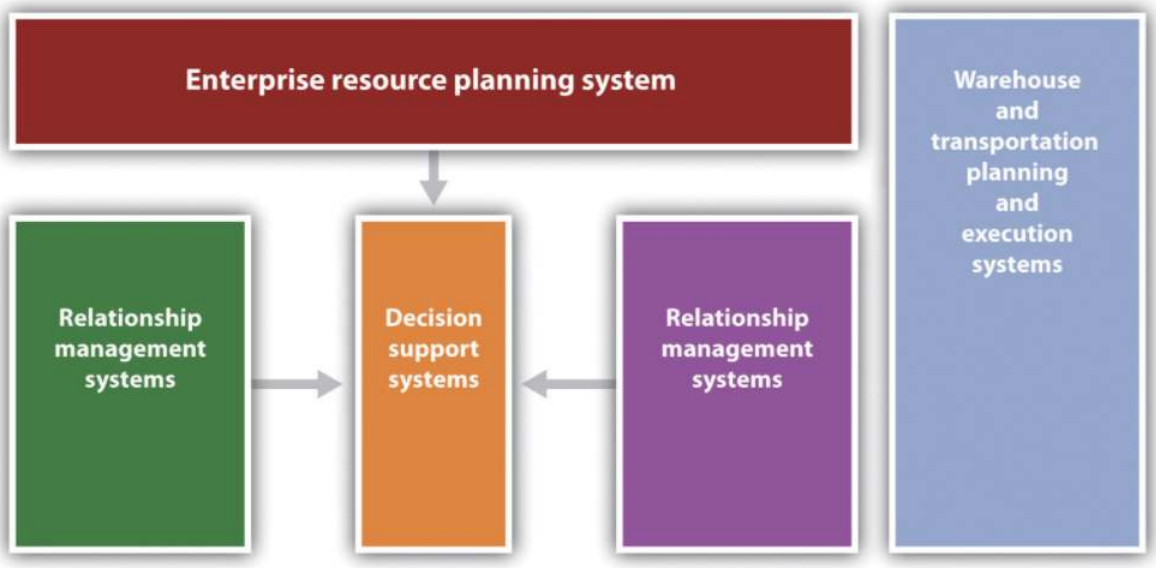


Figure 14.3.5.1: Schematic for a Supply Chain Management Information System

Not too long ago, the acquisition and the operation of these software packages would have been prohibitive for most small businesses from both a cost standpoint and a technical standpoint. Fortunately, software providers now recognize that small and midsize businesses represent a tremendous market for supply chain management software. It was estimated in 2008 that the demand for business enterprise software applications for small and mid-sized businesses would grow at a nearly 11 percent annualized growth rate until 2012. Microsoft, Oracle, and SAP have developed systems that enable small to midsize companies to handle all the complexities of global supply chain management. Large software vendors such as Oracle estimated that the mid-market clientele was approximately 4,500 out of their total client base of 7,000 customers. Several factors can be attributed to this rapid growth in small to midsize businesses. The first was that many software providers were willing to offer in-house installation at a predictable cost. Second and perhaps the most important factor is the increasing move to **cloud-based software**, where software resides on an external server to which the businesses are connected to via the Internet. It provides several substantial benefits to small businesses: lowers software and hardware costs, installation is significantly easier, maintenance and training costs are lower, and free upgrades may sometimes be available. The use of Internet-based systems also makes it easier to maintain lines of communications with one's suppliers and customers. Robert LaGarde, president of LaGarde E-business Solution, has stated that "using Internet technology to provide customers with online demand access to supply chain systems is critical to nurturing and growing relationships with customers." What initially appeared to be a remarkably complex system of programs has now been made available to even very small businesses.

Video Clip: Impact of RFID Technology on Supply Chain Management

The impact of RFID technology on supply chains.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Supply Chains and Information Technology

Modern-day supply chains are tasked with responding at lightning speed.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Japan - The Business Aftershocks

Japan is a small country with a supersized role in the global supply chain (a short ad precedes the video clip).

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WEB RESOURCES

List of Supply Chain Management Software

A comprehensive list of SCM software with links.

About.com SCM Software

Supply chain management software with links to other sites.

The Benefits of Supply Chain Management Software

Identifies benefits and includes the option to download a report on the top fifteen ERP providers.

KEY TAKEAWAYS

- Supply chain management can enhance customer value in many ways.
- Cost savings brought about by supply chain management systems can produce amplified improvements in cash flow.
- Supply chain management systems can be seen as a collection of interconnected software packages.
- The advent of cloud computing can make supply chain management systems available for small businesses.

EXERCISES

1. Interview the owners of five local businesses and ask them how supply chain management has or could enhance their customers' value.
2. For those small business owners who have a functioning supply chain management system, ask them if they have noticed improvements in cash flow attributable to the system.
3. Ask them what system(s) they use and why they went with these computer packages.
4. Ask them if they have contingency plans for the loss of key suppliers.

Disaster Watch

This chapter has emphasized that successful supply chain management requires successful integration across the supply chain. It has been argued that businesses should actively seek to have a single source supplier for particular parts and components. Having a single source supplier may result in a closer relationship that should yield significant economic benefit. Many businesses, both large and small, have moved toward, if not a single supplier, then a significantly reduced number of suppliers for particular parts. This, however, may have some serious negative consequences.

Apple introduced its new iPad 2 tablet on March 2, 2011. Little more than a week later, on March 11, Japan was struck by a major earthquake and damage from the resulting tsunami. Although the two events may seem to be unrelated, there were several connections. It was estimated that Japanese firms manufactured at least five major components in the iPad 2. Although some of these firms were not damaged by either the earthquake or the tsunami, they found that maintaining production schedules was a challenge due to curtailment and available electricity, the movement of supplies, and employees being unable to arrive at work. "These factors are having a major impact on 'delicate processes, such as semiconductor lithography,' said the report, especially as the country continues to experience aftershocks." Apple was not the only firm affected by the Japanese disaster. The port of Sendai was heavily damaged, and many goods could not be shipped out. As one commentator put it, "It is a nuclear winter for the economy."

Further exacerbating the situation for Apple was an explosion at Foxconn Technology Group's plant in Chengdu, China. The explosion killed three workers and injured many more. In addition, the initial estimate was that Apple might lose production of more than half a million iPad 2 units while the plant was closed for repairs.

Disruptions in the supply chain need not be caused by natural disasters. They can occur because of human failings and can have significant consequences. Toys "R" Us was severely damaged in 1999 when its online customer order system proved to be inadequate for demand at Christmastime. In the same time frame, The Hershey Company, which expended approximately $100 million on developing software for its supply chain, found that attempting to develop an order system, a CRM system, and a supply chain planning system proved to be too much of a technical challenge. Because of failures in the system, Hershey

missed at least $150 million in orders. Hershey was guilty of trying to implement these systems simultaneously. They had gone a “bridge too far.”

There is actually a field called supply chain sensitivity analysis that attempts to identify the extent of disruptions in the supply chain caused by external factors. It relies on computer simulation analysis. Obviously, such an approach is beyond the capability of most small businesses.

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14.4.1: Introduction

Unnamed Publisher

The idea for Unnamed Publisher, the publisher of this book, started on a business trip to Chicago in 2006. Co-founders Jeff Shelstad and Eric Frank, who were both working at a large educational publisher at the time, decided they wanted to move away from the limitations and the frustrations of the traditional publishing industry. Veterans of the higher education publishing industry. Their vision was to create a new publishing company that offered a lot more choices to students, professors, and authors.

“Students can’t afford to pay $200 for a textbook. The old business model wasn’t adapting fast enough to the Internet, where so much information was available for free or low-cost,” says Jeff, referring to traditional publishers. “We knew there had to be a better way to publish high-quality material *and* eliminate price and access barriers.”

Since its beginning in 2007, more than thirty employees have joined this fast-growing start-up, located just north of New York City, in Irvington, New York. The company has become a recognized pioneer in transforming higher educational publishing and textbook affordability.

FWK is upending the $8 billion college textbook industry with a new business model that focuses on affordability and personalization. Professors who assign FWK books are free to revise and edit the material to match their course and help improve student success. Students have a choice of affordable print and digital formats that they can access online or on a laptop, tablet, e-reader or smartphone for a fraction of the price that most traditional publishers charge.

Rather than hamper the company’s growth, the economic downturn has actually highlighted the value of its products and the viability of its business model. Despite the bad economy, FWK has been able to raise over $30 million in venture capital. Clearly, they are doing something right.

The numbers tell the story. Since the launch of their first ten books in spring 2009 (there are more than one hundred fifteen books to date), faculty at more than two thousand institutions in forty-four countries have adopted FWK books. As a result, more than 600,000 students have benefited from affordable textbook choices that lower costs, increase access and personalize learning.

In 2010, 2011, and 2012, *EContent* magazine named FWK as one of the top one hundred companies that matter most in the digital content industry. FWK was also named 2010 Best Discount Textbook Provider by the Education Resources People’s Choice Awards.

What is particularly refreshing is Jeff’s philosophy about people and work. “Give talented people an opportunity to build something meaningful, the tools to do it, and the freedom to do one’s best.” He believes in flexibility with people and their jobs, and, to that end, employees have the option to work remotely. There is no question that FWK is an innovator in the educational publishing industry, but it also knows how to treat people well and provide a challenging environment that fosters personal growth.

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14.4.2: Principles of Management and Organization

Learning Objectives

- Understand the functions of management.
- Explain the three basic leadership styles.
- Explain the three basic levels of management.
- Understand the management skills that are important for a successful small business.
- Understand the steps in ethical decision-making.

All small businesses need to be concerned about management principles. Management decisions will impact the success of a business, the health of its work environment, its growth if growth is an objective, and customer value and satisfaction. Seat-of-the-pants management may work temporarily, but its folly will inevitably take a toll on a business. This section discusses management principles, levels, and skills—all areas that small business owners should understand so that they can make informed and effective choices for their businesses.

What is Management?

There is no universally accepted definition for management. The definitions run the gamut from very simple to very complex. For our purposes, we define **management** as "the application of planning, organizing, staffing, directing, and controlling functions in the most efficient manner possible to accomplish meaningful organizational objectives." Put more simply, management is all about achieving organizational objectives through people and other resources.

Management principles apply to all organizations—large or small, for-profit or not-for-profit. Even one-person small businesses need to be concerned about management principles because without a fundamental understanding of how businesses are managed, there can be no realistic expectation of success. Remember that the most common reason attributed to small business failure is failure on the part of management.

Management Functions

On any given day, small business owners and managers will engage in a mix of many different kinds of activities—for example, deal with crises as they arise, read, think, write, talk to people, arrange for things to be done, have meetings, send e-mails, conduct performance evaluations, and plan. Although the amount of time that is spent on each activity will vary, all the activities can be assigned to one or more of the five management functions: planning, organizing, staffing, directing, and controlling.



Figure 14.4.2.1: Management Functions

Planning

Planning "is the process of anticipating future events and conditions and determining courses of action for achieving organizational objectives." It is the one step in running a small business that is most commonly skipped, but it is the one thing that can keep a business on track and keep it there. Planning helps a business realize its vision, get things done, show when things cannot get done and why they may not have been done right, avoid costly mistakes, and determine the resources that will be needed to get things done.

Organizing

Contrary to what some people may believe, the principle of organizing is not dead. Rather, it is clearly important "to both the organization and its workers because both the effectiveness of organizations and worker satisfaction require that there be clear and decisive direction from leadership; clarity of responsibilities, authorities, and accountabilities; authority that is commensurate with responsibility and accountability; unified command (each employee has one boss); a clear approval process; and, rules governing acceptable employee behavior." Except for a small business run solely by its owner, every small business needs a management hierarchy—no matter how small. Each person in the business should know who is responsible for what, have the authority to carry out his or her responsibilities, and not get conflicting instructions from different bosses. The absence of these things can have debilitating consequences for the employees in particular and the business in general.

The organizational design and structure of a small business are important parts of organizing.

Video Clip: Glassblowing Business Thrives

Lesson learned: Everyone should know his or her role in the business.

A YouTube element has been excluded from this version of the text. You can view it online here.

Staffing

The **staffing** function involves selecting, placing, training, developing, compensating, and evaluating (the performance appraisal) employees. Small businesses need to be staffed with competent people who can do the work that is necessary to make the business a success. It would also be extremely helpful if these people could be retained.

Directing

Directing is the managerial function that initiates action: issuing directives, assignments, and instructions; building an effective group of subordinates who are motivated to do what must be done; explaining procedures; issuing orders; and making sure that mistakes are corrected. Directing is part of the job for every small business owner or manager. **Leading** and **motivating** work together in the directing function. Leading "is the process of influencing people to work toward a common goal [and] motivating is the process of providing reasons for people to work in the best interests of an organization."

Different situations call for different leadership styles. In a very influential research study, Kurt Lewin established three major leadership styles: autocratic, democratic, and laissez-faire. Although good leaders will use all three styles depending on the situation, with one style normally dominant, bad leaders tend to stick with only one style.

Autocratic leadership occurs when a leader makes decisions without involving others; the leader tells the employees what is to be done and how it should be accomplished. Lewin et al. found that this style creates the most discontent. However, this style works when all the information needed for a decision is present, there is little time to make a decision, the decision would not change as a result of the participation of others, the employees are well motivated, and the motivation of the people who will carry out subsequent actions would not be affected by whether they are involved in the decision or not. This leadership style should not be used very often.

Democratic leadership involves other people in the decision-making—for example, subordinates, peers, superiors, and other stakeholders—but the leader makes the final decision. Rather than being a sign of weakness, this participative form of leadership is a sign of strength because it demonstrates respect for the opinions of others. The extent of participation will vary depending on the leader's strengths, preferences, beliefs, and the decision to be made, but it can be as extreme as fully delegating a decision to the team. This leadership style works well when the leader has only part of the information and the employees have the other part. The participation is a win-win situation, where the benefits are mutual. Others usually appreciate this leadership style, but it can be problematic if there is a wide range of opinions and no clear path for making an equitable, final decision. In experiments that Lewin et al. conducted with others, the democratic leadership style was revealed as the most effective.

Laissez-faire leadership (or delegative or free-reign leadership) minimizes the leader's involvement in decision-making. Employees are allowed to make decisions, but the leader still has responsibility for the decisions that are made. The leader's role is that of a contact person who provides helpful guidance to accomplish objectives. This style works best when employees are self-motivated and competent in making their own decisions, and there is no need for central coordination; it presumes full trust and confidence in the people below the leader in the hierarchy. However, this is not the style to use if the leader wants to blame others when things go wrong. This style can be problematic because people may tend not to be coherent in their work and not inclined to put in the energy they did when having more visible and active leadership.

Good leadership is necessary for all small businesses. Employees need someone to look up to, inspire and motivate them to do their best, and perhaps emulate. In the final analysis, leadership is necessary for success. Without leadership, "the ship that is your small business will aimlessly circle and eventually run out of power or run aground."

Don't Be This Kind of Leader or Manager

Here are some examples of common leadership styles that should be avoided:

- **Post-hoc management.** As judge and jury, management is always right and never to blame. This approach ensures security in the leader's job. This style is very common in small companies where there are few formal systems and a general autocratic leadership style.
- **Micromanagement.** Alive and well in businesses of all sizes, this style assumes that the subordinate is incapable of doing the job, so close instruction is provided, and everything is checked. Subordinates are often criticized and seldom praised; nothing is ever good enough. It is really the opposite of leadership.
- **Seagull management.** This humorous term is used to describe a management style whereby a person flies in, poops on you, and then flies away. When present, such people like to give criticism and direction in equal quantities—with no real understanding of what the job entails. Before anyone can object or ask what the manager really wants, he or she is off to an important meeting. Everyone is actively discouraged from saying anything, and eye contact is avoided.

- **Mushroom management.** This manager plants you knee-deep (or worse) in the smelly stuff and keeps you in the dark. Mushroom managers tend to be more concerned about their own careers and images. Anyone who is seen as a threat may be deliberately held back. These managers have their favorites on whom they lavish attention and give the best jobs. Everyone else is swept away and given the unpopular work. Oftentimes, mushroom managers are incompetent and do not know any better. We have all seen at least one manager of this type.
- **Kipper management.** This is the manager who is, like a fish, two-faced because employees can see only one face at a time. To senior managers, this person is typically a model employee who puts business first and himself last. To subordinates, however, the reverse is often the case. The subordinates will work hard to get things done in time, but they are blamed when things go wrong—even if it is not their fault. The kipper will be a friend when things need to get done and then stab the subordinates in the back when glory or reward is to be gained. We have all seen this kind of manager, perhaps even worked for one.

Controlling

Controlling is about keeping an eye on things. It is "the process of evaluating and regulating ongoing activities to ensure that goals are achieved." Controlling provides feedback for future planning activities and aims to modify behavior and performance when deviations from plans are discovered. There are four commonly identified steps in the controlling process. **Setting performance standards** is the first step. Standards let employees know what to expect in terms of time, quality, quantity, and so forth. The second step is **measuring performance**, where the actual performance or results are determined. **Comparing performance** is step three. This is when the actual performance is compared to the standard. The fourth and last step, **taking corrective action**, involves making whatever actions are necessary to get things back on track. The controlling functions should be circular in motion, so all the steps will be repeated periodically until the goal is achieved.

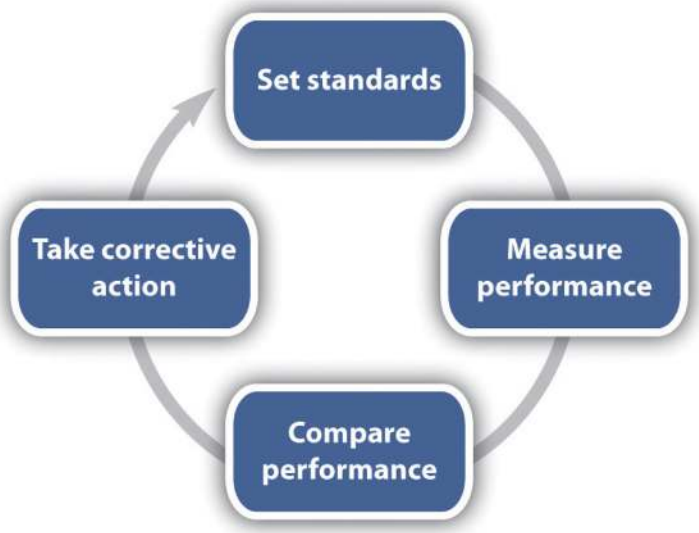


Figure 14.4.2.2: The Controlling Function

Levels of Management

As a small business grows, it should be concerned about the levels or the layers of management. Also referred to as the **management hierarchy**, there are typically three levels of management: top or executive, middle, and first-line or supervisory. To meet a company's goals, there should be coordination of all three levels.



Figure 14.4.2.3: The Management Hierarchy

Top management, also referred to as the executive level, guides and controls the overall fortunes of a business. This level includes such positions as the president or CEO, the chief financial officer, the chief marketing officer, and executive vice presidents. Top managers devote most of their time to developing the mission, long-range plans, and strategy of a business—thus setting its direction. They are often asked to represent the business in events at educational institutions, community activities, dealings with the government, and seminars and sometimes as a spokesperson for the business in advertisements. It has been estimated that top managers spend 55 percent of their time planning.

Middle management is probably the largest group of managers. This level includes such positions as regional manager, plant manager, division head, branch manager, marketing manager, and project director. Middle managers, a conduit between top management and first-line management, focus on specific operations, products, or customer groups within a business. They have responsibility for developing detailed plans and procedures to implement a firm's strategic plans.

First-line or supervisory management is the group that works directly with the people who produce and sell the goods and/or the services of a business; they implement the plans of middle management. They coordinate and supervise the activities of operating employees, spending most of their time working with and motivating their employees, answering questions, and solving day-to-day problems. Examples of first-line positions include supervisor, section chief, office manager, foreman, and team leader.

In many small businesses, people often wear multiple hats. This happens with management as well. One person may wear hats at each management level, and this can be confusing for both the person wearing the different hats and other employees. It is common for the small business owner to do mostly first-level management work, with middle or top management performed only in response to a problem or a crisis, and top-level strategic work rarely performed. This is not a good situation. If the small business is large enough to have three levels of management, it is important that there be clear distinctions among them—and among the people who are in those positions. The small business owner should be top management only. This will eliminate confusion about responsibilities and accountabilities.

Management Skills

Management skill "is the ability to carry out the process of reaching organizational goals by working with and through people and other organizational resources." Possessing management skill is generally considered a requirement for success. An effective manager is a manager who is able to master four basic types of skills: technical, conceptual, interpersonal, and decision making.

Technical skills "are the manager's ability to understand and use the techniques, knowledge, and tools and equipment of a specific discipline or department." These skills are mostly related to working with processes or physical objects. Engineering, accounting, and computer programming are examples of technical skills. Technical skills are particularly important for first-line managers and

are much less important at the top management level. The need for technical skills by the small business owner will depend on the nature and the size of the business.

Conceptual skills "determine a manager's ability to see the organization as a unified whole and to understand how each part of the overall organization interacts with other parts." These skills are of greatest importance to top management because it is this level that must develop long-range plans for the future direction of a business. Conceptual skills are not of much relevance to the first-line manager but are of great importance to the middle manager. All small business owners need such skills.

Interpersonal skills "include the ability to communicate with, motivate, and lead employees to complete assigned activities," hopefully building cooperation within the manager's team. Managers without these skills will have a tough time succeeding. Interpersonal skills are of greatest importance to middle managers and are somewhat less important for first-line managers. They are of least importance to top management, but they are still very important. They are critical for all small business owners.

The fourth basic management skill is **decision-making**, the ability to identify a problem or an opportunity, creatively develop alternative solutions, select an alternative, delegate authority to implement a solution, and evaluate the solution.

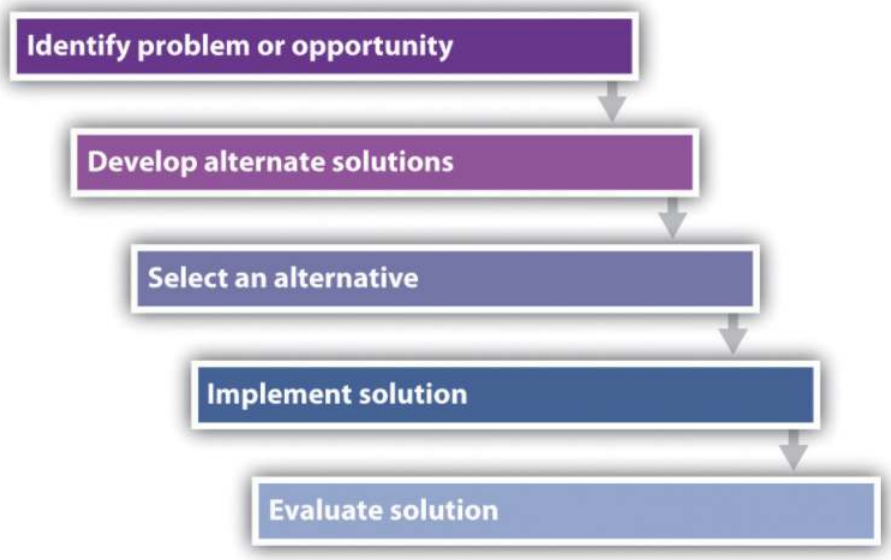


Figure 14.4.2.4: Management Decision Making

Making good decisions is never easy, but doing so is clearly related to small business success. "Decisions that are based on a foundation of knowledge and sound reasoning can lead the company into long-term prosperity; conversely, decisions that are made on the basis of flawed logic, emotionalism, or incomplete information can quickly put a small business out of commission."

A Framework for Ethical Decision Making

Small business decisions should be ethical decisions. Making ethical decisions requires that the decision-maker(s) be sensitive to ethical issues. In addition, it is helpful to have a method for making ethical decisions that, when practiced regularly, becomes so familiar that it is automatic. The Markkula Center for Applied Ethics recommends the following framework for exploring ethical dilemmas and identifying ethical courses of action. However, in many, if not most instances, a small business owner or manager and an employee will usually know instinctively whether a particular decision is unethical.

Recognize an Ethical Issue

- Could this decision or situation be damaging to someone or some group? Does this decision involve a choice between a good and a bad alternative or perhaps between two "goods" or between two "bads"?
- Is this issue about more than what is legal or most efficient? If so, how?

Get the Facts

- What are the relevant facts of the case? What facts are not known? Can I learn more about the situation? Do I know enough to make a decision?
- What individuals and groups have an important stake in the outcome? Are some concerns more important? Why?
- What are the options for acting? Have all the relevant persons and groups been consulted? Have I identified creative options?

Evaluate Alternative Actions

- Which option will produce the most good and do the least harm?
- Which option best respects the rights of all who have a stake?
- Which option treats people equally or proportionately?
- Which option best serves the community as a whole, not just some members?
- Which option leads me to act as the sort of person I want to be?

Make a Decision and Test It

- Considering all these approaches, which option best addresses the situation?
- If I told someone I respect—or told a television audience—which option I have chosen, what would they say?

Act and Reflect on the Outcome

- How can my decision be implemented with the greatest care and attention to the concerns of all stakeholders?
- How did my decision turn out, and what have I learned from this specific situation?

KEY TAKEAWAYS

- Management principles are important to all small businesses.
- Management decisions will impact the success of a business, the health of its work environment, its growth if growth is an objective, and customer value and satisfaction.
- Management is about achieving organizational objectives through people.
- The most common reason attributed to small business failure is failure on the part of management.
- On any given day, a typical small business owner or manager will be engaged in some mix of planning, organizing, staffing, directing, and controlling.
- Different situations call for different leadership styles. The three major styles are autocratic, democratic, and laissez-faire. Bad leaders typically stick with one style.
- The management hierarchy is typically composed of three levels: top or executive, middle, and first-line or supervisory. If a small business is large enough to have these three levels, it is important that there be a clear distinction between them.
- Management skills are required for success. Technical, conceptual, interpersonal, and decision-making skills will be of differing importance depending on the management level.

EXERCISE

Apply the four steps in the controlling function for Frank's BarBeQue. Identify and discuss examples of performance standards that Frank might use. Indicate which standards should be numerically based. How could he measure performance? What corrective action should he take if performance does not meet the established performance standards?

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14.4.3: Organizational Design

Learning Objectives

- Understand why an organizational structure is necessary.
- Understand organizational principles.
- Explain the guidelines for organizing a small business.
- Describe the different forms of organizational structure and how they apply to small businesses.

Organizing consists of grouping people and assigning activities so that job tasks and the mission of a business can be properly carried out. The result of the organizing process should be an overall structure that permits interactions among individuals and departments needed to achieve the goals and objectives of a business. Although small business owners may believe that they do not need to adhere to the organizing principles of management, nothing could be farther from the truth.

Principles represent guidelines that managers can use in making decisions. They are not laws etched in stone. At times, principles can be used exactly as the way they are stated; at other times they should be modified or even completely ignored. **Small business owners must learn through experience when and where to use [the] principles or to modify them** [emphasis added]. Principles when used effectively and in the right context often bring organizational efficiencies and thus result in the growth of the business. Some organizing principles…would apply to small businesses as well as they would to large enterprises and would lead to similar benefits.

There is no single best way to organize. Rather, the organization decision is based on a multitude of factors, including business size, market, product mix, competition, the number of employees, history, objectives and goals, and available financial resources. Each small business must decide what organizational design best fits the business.

Fundamentals of Organization

Ivancevich and Duening maintain that there are several fundamental issues that managers need to consider when making any kind of organizational decision: clear objectives, coordination, formal and informal organization, the organization chart, formal authority, and centralization versus decentralization. Understanding these fundamentals can facilitate the creation of an organizational structure that is a good fit for a small business.

Clear Objectives

Objectives "give meaning to the business—and to the work done by employees—by determining what it is attempting to accomplish." Objectives provide direction for organizing a firm, helping to identify the work that must be done to accomplish the objectives. This work, in turn, serves as the basis on which to make staffing decisions.

Coordination

The resources of a small business and its employees must be coordinated to minimize duplication and maximize effectiveness. Coordination requires informal communication with and among employees every day. All businesses must continually coordinate the activities of others—an effort that should never be underestimated. Business leaders must make sure that employees have the answers to six fundamental questions:

- What is my job?
- How am I doing?
- Does anyone care?
- How are we doing?
- What are our vision, mission, and values?
- How can I help?

Formal and Informal Organization

When a one-person small business adds employees, some kind of hierarchy will be needed to indicate who does what. This hierarchy often becomes the **formal organization**—that is, the details of the roles and responsibilities of all employees. Formal

organization tends to be static, but it does indicate who is in charge of what. This helps to prevent chaos. The formal organizational structure helps employees feel safe and secure because they know exactly what their chain of command is. The downside of a formal organizational structure is that it typically results in a slower decision-making process because of the numerous groups and people who have to be involved and consulted.

The **informal organization** is almost never explicitly stated. It consists of all the connections and relationships that relate to how people throughout the organization actually network to get a job done. The informal organization fills the gaps that are created by the formal organization. Although the informal organization is not written down anywhere, it has a tremendous impact on the success of a small business because it is "composed of natural leaders who get things done primarily through the power granted to them by their peers." Informal groups and the infamous grapevine are firmly embedded in the informal organization. The **grapevine (or water cooler)** "is the informal communications network within an organization,…completely separate from—and sometimes much faster than—the organization's formal channels of communication." Small business owners must acknowledge the existence of the grapevine and figure out how to use it constructively.

Video Clip: Leading Outside the Lines

The formal and informal organizations need to work together to sustain peak performance over time.

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Organization Chart

The **organization chart** is a visual representation of the formal organization of a business. The chart shows the structure of the organization and the relationships and relative ranks of its positions; it helps organize the workplace while outlining the direction of management control for subordinates. Even the one-person small business can use some kind of organization chart to see what functions need to be performed; this will help ensure that everything that should be done is getting done. Figure 14.4.3.1 illustrates a simple organization chart for a one-person retail business.

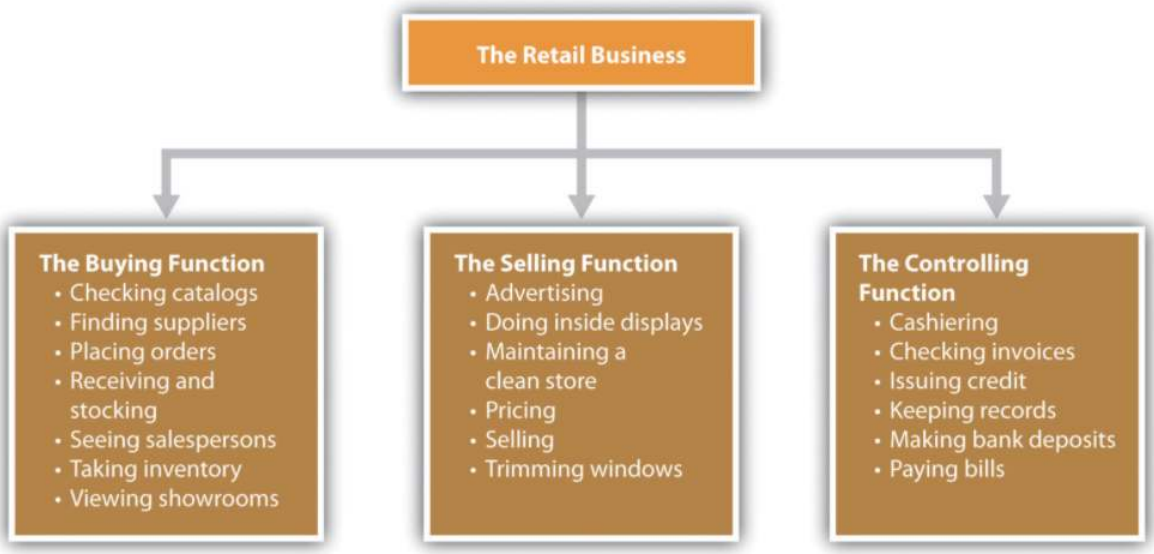


Figure 14.4.3.1: Copy and Paste Caption here. (Copyright; author via source)

Organization charts offer the following benefits:

- Effectively communicate organizational, employee, and enterprise information
- Allow managers to make decisions about resources, provide a framework for managing change, and communicate operational information across the organization
- Are transparent and predictable about what should happen in a business
- Provide a quick snapshot about the formal hierarchy in a business
- Tell everyone in the organization who is in charge of what and who reports to whom

There are, of course, several limitations to organization charts:

- They are static and inflexible, often being out of date as organizations change and go through growth phases.
- They do not aid in understanding what actually happens within the informal organization. The reality is that organizations are often quite chaotic.
- They cannot cope with changing boundaries of firms due to outsourcing, information technology, strategic alliances, and the network economy.

In its early stages, a small business may choose not to create a formal organization chart. However, organization must exist even without a chart so that the business can be successful. Most small businesses find organization charts to be useful because they help the owner or the manager track growth and change in the organizational structure. The real challenge is to create an organizational chart that reflects the real world. Small businesses have a definite advantage here because their size allows for more flexibility and manageability.

Video Clip: Burn Your Org Chart

Not all organizational charts reflect the real world.

A YouTube element has been excluded from this version of the text. You can view it online here.

Formal authority is "the right to give orders and set policy." It is organized according to a hierarchy, typically expressed in the organization chart, where one manager may have authority over some employees while being subject to the formal authority of a superior at the same time. Formal authority also encompasses the allocation of an organization's resources to achieve its objectives. The position on the organization chart will be indicative of the amount of authority and formal power held by a particular individual.

Two major types of authority that the small business owner should understand are line and staff. These authorities reflect the existing relationships between superiors and subordinates. **Line authority** refers to having direct authority over lower positions in the hierarchy. "A manager with line authority is the unquestioned superior for all activities of his or her subordinates." The day-to-day tasks of those with line authority involve working directly toward accomplishing an organization's mission, goals, and objectives. Examples of positions with line authority are the president, the vice president of operations, and the marketing manager. In a small business, the owner or the top manager will have line authority over his or her subordinates. The extent of line authority beyond the owner or the top manager will depend on the size of the business and the organizational vision of the owner.

Staff authority is advisory only. There is no authority to take action (except when someone is a manager of a staff function, e.g., human resources), and there is no responsibility for revenue generation. Someone with staff authority assists those with line authority as well as others who have staff authority. Examples of staff authority are human resources, legal, and accounting, each of which is relevant to a small business. Staff personnel can be extremely helpful in improving the effectiveness of line personnel. Unfortunately, staff personnel are often the first to go when cutbacks occur. As a small business grows, a decision may be made to add staff personnel because the most significant factor in determining whether or not to add personnel is the size of a business. The larger the organization, the greater the need and the ability to hire staff personnel to provide specialized expertise. Small businesses, however, may prefer to hire outside service providers for staff functions such as legal and accounting services because it would be difficult to keep such people busy full time. Remember, cash flow is king.

Centralization and Decentralization

Centralization and decentralization are about the amount of authority to delegate. **Centralization** means that little or no authority and job activities are delegated to subordinates. A relatively small number of line managers make the decisions and hold most of the authority and power. **Decentralization** is the opposite. Authority and job activities are delegated rather than being held by a small management group.

Depending on various factors, organizations move back and forth on the centralization-decentralization continuum. For example, managing a crisis requires more centralized decision-making because decisions need to be made quickly. A non-crisis or a normal work situation would favor decentralized decision-making and encourages employee empowerment and delegated authority. There are no universally accepted guidelines for determining whether a centralized or a decentralized approach should be used. It has been noted, however, that, "the best organizations are those that are able to shift flexibly from one level of centralization to another

in response to changing external conditions." Given the flexibility and the responsiveness of small businesses that originate from their size, any movement that is needed along the centralization-decentralization continuum will be much easier and quicker.

Guidelines for Organizing

Several management principles can be used as guidelines when designing an organizational structure. Although there are many principles to consider, the focus here is on unity of command, division of work, span of control, and the scalar principle. These principles are applicable to small businesses although, as has been said earlier, they should not be seen as etched in stone. They can be modified or ignored altogether depending on the business, the situation at hand, and the experience of management.

Unity of Command

Unity of command means that no subordinate has more than one boss. Each person in a business should know who gives him or her the authority to make decisions and do the job. Having conflicting orders from multiple bosses will create confusion and frustration about which order to follow and result in contradictory instructions. In addition, violating the unity of command will undermine authority, divide loyalty, and create a situation in which responsibilities can be evaded and work efforts will be duplicated and overlapping. Abiding by the unity of command will provide discipline, stability, and order, with a harmonious relationship—relatively speaking, of course—between superior and subordinate. Unity of command makes the most sense for everyone, but it is violated on a regular basis.

Division of Labor

The **division of labor** is a basic principle of organizing that maintains that a job can be performed much more efficiently if the work is divided among individuals and groups so that attention and effort are focused on discrete portions of the task—that is, the jobholder is allowed to specialize. The result is a more efficient use of resources and greater productivity. As mentioned earlier, small businesses are commonly staffed with people who wear multiple hats, including the owner. However, the larger the business, the more desirable it will be to have people specialize to improve efficiency and productivity. To do otherwise will be to slow down processes and use more resources than should be necessary. This will have a negative impact on the bottom line.

Span of Control

Span of control (span of management) refers to the number of people or subordinates that a manager supervises. The span of control typically becomes smaller as a person moves up the management hierarchy. There is no magic number for every manager. Instead, the number will vary based on "the abilities of both the manager and the subordinates, the nature of the work being done, the location of the employees, and the need for planning and coordination." The growing trend is to use wider spans of control. Companies are flattening their structures by reducing their layers of management, particularly middle management. This process has increased the decision-making responsibilities that are given to employees. As a small business grows, there will likely be more management hierarchy unless the small business owner is committed to a flatter organization. Either approach will have implications for span of control.

Scalar Principle

The **scalar principle** maintains "that authority and responsibility should flow in a clear, unbroken line from the highest to the lowest manager." Abiding by this principle will result in more effective decision-making and communication at various levels in the organization. Breaking the chain would result in confusion about relationships and employee frustration. Following this principle is particularly important to small businesses because the tendency may otherwise be to operate on a more informal basis because of the size of the business. This would be a mistake. Even a two-person business should pay attention to the scalar principle.

Types of Organization Structures

Knowledge about organization structures is important for a small business that is already up and running as well as a small business in its early stages. Organizations are changing every day, so small business owners should be flexible enough to change the structure over time as the situation demands, perhaps by using the **contingency approach**. "The contingency approach to the structure of current organizations suggests there is no 'one best' structure appropriate for every organization. Rather, this approach

contends the ‘best’ structure for an organization fits its needs for the situation at the time.” If a small business employs fewer than fifteen people, it may not be necessary to worry too much about its organizational structure. However, if the plans for the business include hiring more than fifteen people, having an organizational structure makes good sense because it will benefit a company’s owner, managers, employees, investors, and lenders. There are many structure options. Functional, divisional, matrix, and network or virtual structures are discussed here.

Functional Structure

The **functional structure** is overwhelmingly the choice of business start-ups and is probably the most common structure used today. This structure organizes a business according to job or purpose in the organization and is most easily recognized by departments that focus on a single function or goal. (See Figure 14.4.3.2 for an example of a functional structure.) A start-up business is not likely to have an organization that looks like this. There may be only one or two boxes on it, representing the founder and his or her partner (if applicable). As a small business grows, the need for additional departments will grow as well.

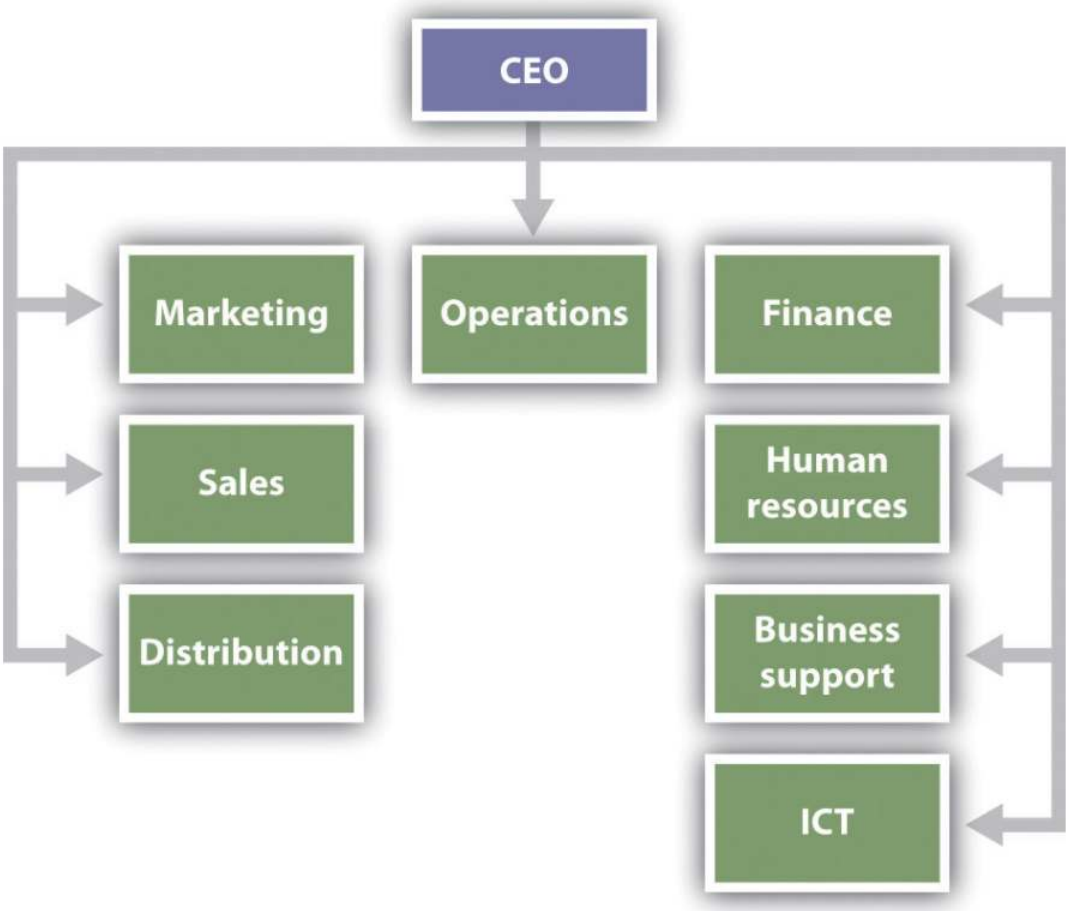


Figure 14.4.3.2: An Example of a Functional Structure. *Source: “Small Business Management Skills,” How to Start a Business, accessed February 2, 2012.*

The functional structure gives employees and their respective departments clear objectives and purpose for their work. People in accounting can focus on improving their knowledge and skills to perform that work. This structure has also been shown to work well for businesses that operate in a relatively stable environment.

At the same time, the functional structure can create divisions between departments if conflict occurs, and it can become an obstruction if the objectives and the environment of the business require coordination across departments.

Divisional Structure

The **divisional structure** can be seen as a decentralized version of the functional structure. The functions still exist in the organization, but they are based on product, geographic area or territory, or customer. Each division will then have its own functional department(s). (See Figure 14.4.3.3 for an example of a divisional structure.)

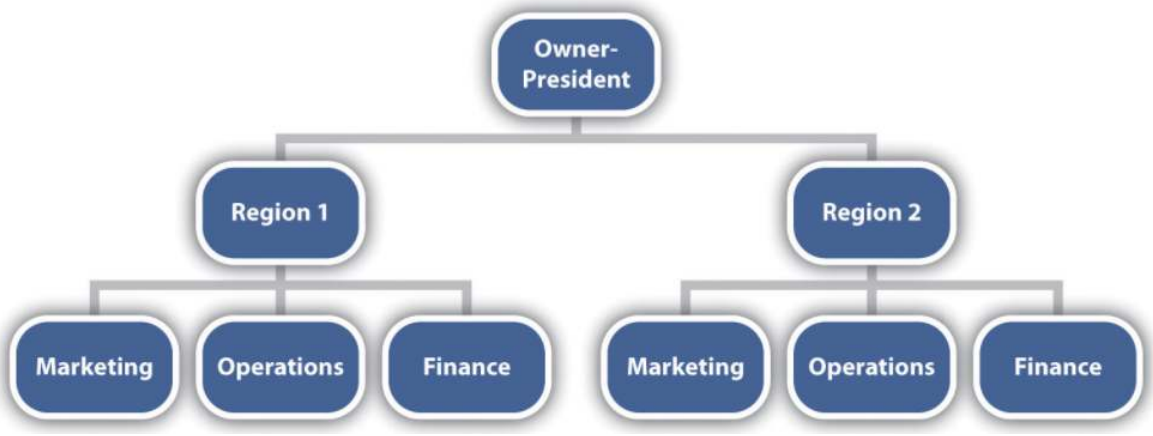


Figure 14.4.3.3: An Example of a Divisional Structure

The divisional structure can work well because it focuses on individual geographic regions, customers, or products. This focus will enable greater efficiencies of operation and the building of "a common culture and esprit de corps that contributes both to higher morale and a better knowledge of the division's portfolio." There are, of course, disadvantages to this structure. Competing divisions may turn to office politics, rather than strategic thinking, to guide their decision-making, and divisions may become so compartmentalized as to lead to product incompatibilities.

As a small business starts to grow in the diversity of its products, in the geographic reach of its markets, or in its customer bases, there is an evolution away from the functional structure to the divisional structure. However, significant growth would be needed before the divisional structure should be put into place.

Matrix Structure

The **matrix structure** combines elements of the functional and the divisional structures, bringing together specialists from different areas of a business to work on different projects on a short-term basis. Each person on the project team reports to two bosses: a line manager and a project manager. (See Figure 14.4.3.4: for an example of a matrix structure.) The matrix structure, popular in high-technology, multinational, consulting, and aerospace firms and hospitals, offers several key advantages, including the following: flexibility in assigning specialists, flexibility in adapting quickly to rapid environmental changes, the ability to focus resources on major products and problems, and creating an environment where there is a higher level of motivation and satisfaction for employees. The disadvantages include the following: the violation of the "one boss" principle (unity of command) because of the dual lines of authority, responsibility, and accountability; employee confusion and frustration from reporting to two bosses; power struggles between the first-line and the project managers; too much group decision making; too much time spent in meetings; personality clashes; and undefined personal roles. The disadvantages notwithstanding, many companies with multiple business units, operations in multiple countries, and distribution through multiple channels have discovered that the effective use of a matrix structure is their only choice.

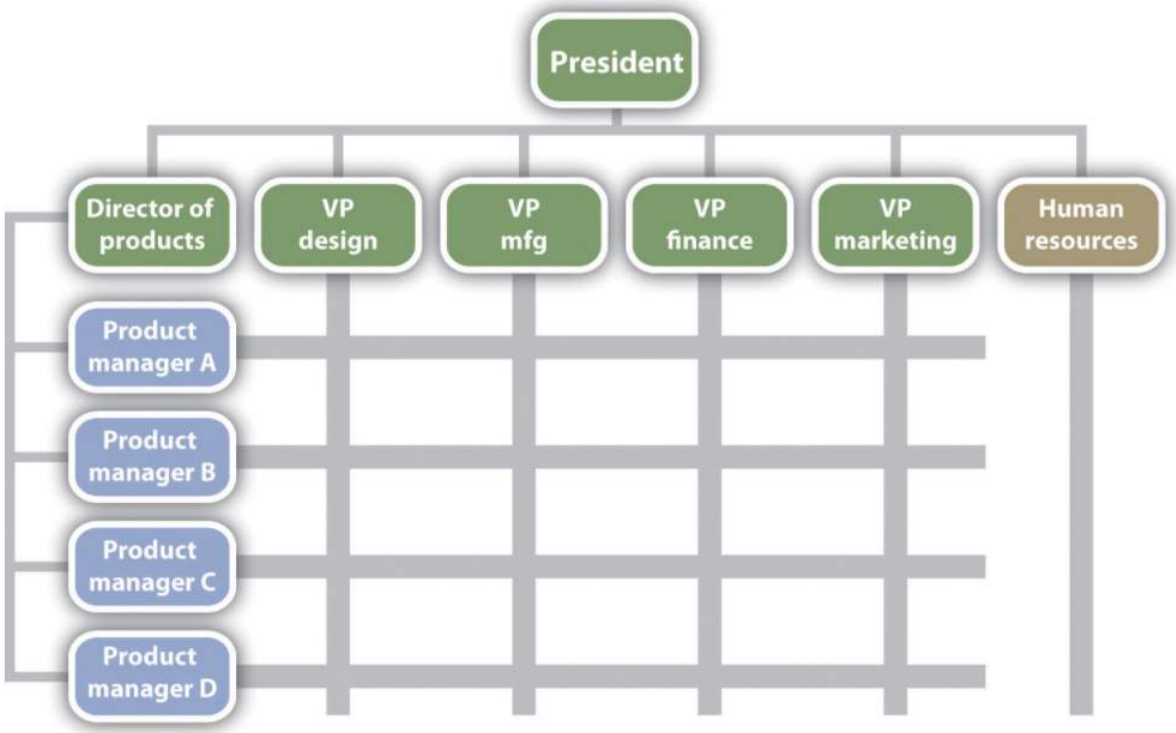


Figure 14.4.3.4: An Example of a Matrix Structure *"Sample Organization Charts: Matrix Organizational Structure," Vertex41.com, accessed February 2, 2012.*

The matrix structure is for project-oriented businesses, such as aerospace, construction, or small manufacturers of the job-shop variety (producers of a wide diversity of products made in small batches).

Virtual Organization

The **virtual organization (or network organization)** is becoming an increasingly popular business structure as a means of addressing critical resource, personnel, and logistical issues. (See Figure 14.4.3.5 for an example of a virtual organization.) Administration is the primary function performed; other functions—such as marketing, engineering, production, and finance—are outsourced to other organizations or individuals. Individual professionals may or may not share office space, the organization is geographically distributed, the members of the organization communicate and coordinate their work through information technology, and there is a high degree of informal communication. The barriers of time and location are removed.

Figure 14.4.3.5: An Example of a Virtual Organization. *Source: "Supporting Skills," Eviton, Inc., accessed February 2, 2012, http://eviton.com/organizations.htm.*

The positives associated with a virtual organization include reduced real-estate expenses, increased productivity, higher profits, improved customer service, access to global markets, environmental benefits (such as reduced gas mileage for employees, which contributes to reduced auto emissions), a wider pool of potential employees, and not needing to have all or some of the relevant employees in the same place at the same time for meetings or delivering services. The negatives include setup costs; some loss of cost efficiencies; cultural issues (particularly when working in the global arena); traditional managers not feeling secure when their employees are working remotely, particularly in a crisis; feelings of isolation because of the loss of the camaraderie of the traditional office environment; and a lack of trust.

The virtual organization can be quite attractive to small businesses and start-ups. By outsourcing much of the operations of a business, costs and capital requirements will be significantly reduced and flexibility enhanced. Given the lower capital requirements of a virtual business, some measures of profitability (e.g., return on investment [ROI] and return on assets [ROA]), would be significantly increased. This makes a business much more financially attractive to potential investors or banks, which might provide funding for future growth. **ROI** "is a performance measure used to evaluate the efficiency of an investment or to

compare the efficiency of a number of investments." **ROA** is "an indicator of how profitable a company is relative to its assets… [giving] an idea as to how efficient management is at using its assets to generate earnings."

Creating an Effective Business Organization Structure

Thinking and rethinking the business organization structure is important for all businesses—large or small. Conditions, products, and markets change. It is important to be flexible in creating a business structure that will best allow a business to operate effectively and efficiently. Each of the following should be considered:

- **Competitors.** Make an educated guess of the structure of competitors. Try to find out what works for them. Look at their reporting line structures and their procurement, production, marketing, and management systems. Perhaps there are some good ideas to be had.
- **Industry.** Is there a standard in an industry? Perhaps an industry lends itself to flexible organization structures, or perhaps more hierarchical structures are the norm. For example, auto manufacturers are usually set up regionally.
- **Compliance or legal requirements.** If an industry is regulated, certain elements may be required in the business structure. Even if an industry is not regulated, there may be compliance issues associated with employing a certain number of employees.
- **Investors and lending sources.** Having a business organization structure will give potential investors and funding institutions a window into how the business organizes its operations. The structure also lets investors and lenders know what kind of talent is needed, how soon they will be needed, and how the business will find and attract them.

KEY TAKEAWAYS

- Organizations are changing every day, so small business owners should be flexible enough to change their structure over time as the situation demands.
- The functional structure is overwhelmingly the choice of business start-ups and is probably the most commonly used structure today.
- The functional structure organizes a business according to the job or the purpose in the organization and is most easily recognized by departments that focus on a single function or goal.
- The divisional structure is a decentralized version of the functional structure. The functions still exist, but they are based on product, geographic area or territory, or customer.
- As a small business starts to grow, there is an evolution away from the functional to the divisional structure. However, significant growth is required before the divisional structure is put into place.
- The matrix structure brings specialists from different areas of a business together to work on different projects for a short-term basis. This structure is for project-oriented businesses, such as aerospace, construction, or small manufacturers.
- In the virtual structure, administration is the primary function performed, with other functions—such as marketing, engineering, production, and finance—outsourced to other companies or individuals. This structure can be quite attractive to small businesses and start-ups.
- Creating an effective business organization structure should take the competition, the industry, compliance or legal requirements, investors, and lending sources into consideration.

EXERCISES

1. Select two small businesses that market two very different products, for example, a small manufacturer and a restaurant. Contact the manager of each business and conduct a fifteen-minute interview about the organizational structure that has been chosen. Ask each manager to describe the existing organizational structure (drawing an organization chart), explain why that structure was chosen, and reflect on the effectiveness and efficiency of the structure. Also ask each manager whether any thoughts have been given to changing the existing structure.
2. Frank Rainsford has been, in effect, the CEO of Frank's All-American BarBeQue since its inception. His major role has been that of restaurant manager, receiving support from his assistant manager Ed Tobor for the last fourteen years. Frank has two children, a son and daughter, who both worked in the restaurant as teenagers. His daughter has worked periodically at the restaurant since she graduated from high school. Frank's son, who recently lost his job, has returned to work for his father. The son produced several plans to expand the business, including the opening of a second restaurant and the extensive use of social media. After careful consideration, Frank has decided to open a second restaurant, but this has

presented him with a major problem—how to assign responsibilities to personnel. His son wants to be designated the restaurant manager of the second restaurant and made the vice president of marketing. Ed Tobor also wants to be the manager of the new restaurant. His daughter has expressed an interest in being the manager of either restaurant. How should Frank resolve this problem?

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14.4.4: Legal Forms of Organization for the Small Business

Learning Objectives

- Understand the different legal forms that a small business can take.
- Explain the factors that should be considered when choosing a legal form.
- Understand the advantages and disadvantages of each legal form.
- Explain why the limited liability company may be the best legal structure for many small businesses.

Every small business must select a legal form of ownership. The most common forms are sole proprietorship, partnership, and corporation. A limited liability company (LLC) is a relatively new business structure that is now allowed by all fifty states. Before a legal form is selected, however, several factors must be considered, not the least of which are legal and tax options.

Factors to Consider

The legal form of the business is one of the first decisions that a small business owner will have to make. Because this decision will have long-term implications, it is important to consult an attorney and an accountant to help make the right choice. The following are some factors the small business owner should consider before making the choice:

- **The owner's vision.** Where does the owner see the business in the future (size, nature, etc.)?
- **The desired level of control.** Does the owner want to own the business personally or share ownership with others? Does the owner want to share responsibility for operating the business with others?
- **The level of structure.** What is desired—a very structured organization or something more informal?
- **The acceptable liability exposure.** Is the owner willing to risk personal assets? Is the owner willing to accept liability for the actions of others?
- **Tax implications.** Does the owner want to pay business income taxes and then pay personal income taxes on the profits earned?
- **Sharing profits.** Does the owner want to share the profits with others or personally keep them?
- **Financing needs.** Can the owner provide all the financing needs or will outside investors be needed? If outside investors are needed, how easy will it be to get them?
- **The need for cash.** Does the owner want to be able to take cash out of the business?

The final selection of a legal form will require consideration of these factors and tradeoffs between the advantages and disadvantages of each form. No choice will be perfect. Even after a business structure is determined, the favorability of that choice over another will always be subject to changes in the laws.

Sole Proprietorship

A **sole proprietorship** is a business that is owned and usually operated by one person. It is the oldest, simplest, and cheapest form of business ownership because there is no legal distinction made between the owner and the business (see Table 14.4.4.1). Sole proprietorships are very popular, comprising 72 percent of all businesses and nearly $1.3 trillion in total revenue. Sole proprietorships are common in a variety of industries, but the typical sole proprietorship owns a small service or retail operation, such as a dry cleaner, accounting services, insurance services, a roadside produce stand, a bakery, a repair shop, a gift shop, painters, plumbers, electricians, and landscaping services. Clearly, the sole proprietorship is the choice for most small businesses.

Table 14.4.4.1: Sole Proprietorships: A Summary of Characteristics

Liability	Taxes	Advantages	Disadvantages
Unlimited: owner is responsible for all the debts of the business.	No special taxes; owner pays taxes on profits; not subject to corporate taxes	• Tax breaks • Owner retains all profits • Easy to start and dissolve • Flexibility of being own boss • No need to disclose business information • Pride of ownership	• Owner absorbs all losses • Unlimited liability • Difficult to get financing • Management deficiencies • Lack of stability in case of injury, death, or illness • Time demands • Difficult to hire and keep highly motivated employees

Partnership

A **partnership** is two or more people voluntarily operating a business as co-owners for profit. Partnerships make up more than 8 percent of all businesses in the United States and more than 11 percent of the total revenue. Like the sole proprietorship, the partnership does not distinguish between the business and its owners. There should be a legal agreement that "sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, and what steps will be taken to dissolve the partnership when needed."

There are two types of partnerships. In the **general partnership**, all the partners have unlimited liability, and each partner can enter into contracts on behalf of the other partners. A **limited partnership** has at least one general partner and one or more limited partners whose liability is limited to the cash or property invested in the partnership. Limited partnerships are usually found in professional firms, such as dentists, lawyers, and physicians, as well as in oil and gas, motion-picture, and real-estate companies. However, many medical and legal partnerships have switched to other forms to limit personal liability.

Before creating a partnership, the partners should get to know each other. According to Michael Lee Stallard, co-founder and president of E Pluribis Partners, a consulting firm in Greenwich, Connecticut, "The biggest mistake business partners make is jumping into business before getting to know each other…You must be able to connect to feel comfortable expressing your opinions, ideas and expectations."

Table 14.4.4.2: Partnerships: A Summary of Characteristics

Liability	Taxes	Advantages	Disadvantages
Unlimited for general partner; limited partners risk only their original investment.	Individual taxes on business earnings; no income taxes as a business	• Owner(s) retain all profits • Unlimited for general partner; limited partners risk only their original investment. Individual taxes on business earnings; no income taxes as a business • Easy to form and dissolve • Greater access to capital • No special taxes • Clear legal status • Combined managerial skills • Prospective employees may be attracted to a company if given incentive to become a partner	• Unlimited financial liability for general partners • Interpersonal conflicts • Financing limitations • Management deficiencies • Partnership terminated if one partner dies, withdraws, or is declared legally incompetent • Shared decisions may lead to disagreements

Corporation

A **corporation** "is an artificial person created by law, with most of the legal rights of a real person. These include the rights to start and operate a business, to buy or sell property, to borrow money, to sue or be sued, and to enter into binding

contracts.” Corporations make up 20 percent of all businesses in the United States, but they account for almost 90 percent of the revenue. Although some small businesses are incorporated, many corporations are extremely large businesses—for example, Walmart, General Electric, Procter & Gamble, and Home Depot. Recent data show that only about one-half of the small business owners in the United States run incorporated businesses.

Scott Shane, author of *The Illusions of Entrepreneurship* (Yale University Press, 2010), argues that small businesses that are incorporated have a much higher rate of success than sole proprietorships, outperforming unincorporated small businesses in terms of profitability, employment growth, sales growth, and other measures. Shane maintains that being incorporated may not make sense for “tiny little businesses” because the small amount of risk may not be worth the complexity. However, Deborah Sweeney, incorporation expert for Intuit, disagrees, saying that “even the smallest eBay business has a risk of being sued” because shipping products around the country or the world can create legal problems if a shipment is lost. Ultimately, it is the small business being successful that may be the biggest factor for the owner to move from a sole proprietorship to a corporation.

Table 14.4.4.3: Corporations: A Summary of Characteristics

Liability	Taxes	Advantages	Disadvantages
Limited;	multiple taxation	• Limited liability • Skilled management team • Ease of raising capital • Easy to transfer ownership by selling stock • Perpetual life • Legal-entity status • Economies of large-scale operations	• Double taxation • Difficult and expensive to start • Individual stockholder has little control over operations • Financial disclosure • Lack of personal interest unless managers are also stockholders • Credit limitations • Government regulation and increased paperwork

Limited Liability Company

The **limited liability company** is a relatively new form of business ownership that is now permitted in all fifty states, although the laws of each state may differ. The LLC is a blend of a sole proprietorship and a corporation: the owners of the LLC have limited liability and are taxed only once for the business. The LLC provides all the benefits of a partnership but limits the liability of each investor to the amount of his or her investment (see Table 14.4.4.4). “LLCs were created to provide business owners with the liability protection that corporations enjoy without the double taxation.”

According to Carter Bishop, a professor at Suffolk University Law School, who helped draft the uniform LLC laws for several states, “There’s virtually no reason why a small business should file as a corporation, unless the owners plan to take the business public in the near future.” In the final analysis, the LLC business structure is the best choice for most small businesses. The owners will have the greatest flexibility, and there is a liability shield that protects all owners.

Table 14.4.4.4: Limited Liability Companies: A Summary of Characteristics

Liability	Taxes	Advantages	Disadvantages
Limited;	owners taxed at individual income tax rate	• Limited liability • Taxed at individual tax rate • Shareholders can participate fully in managing company • No limit on number of shareholders • Easy to organize • LLC members can agree to share profits and losses disproportionately	• Difficult to raise money • No perpetual life • Is dissolved at death, withdrawal, resignation, expulsion, or bankruptcy of one member unless there is a vote to continue • No transferability of membership without the majority consent of other members

KEY TAKEAWAYS

- Every small business must select a legal form of ownership. It is one of the first decisions that a small business owner must make.
- The most common forms of legal structure are the sole proprietorship, the partnership, and the corporation. An LLC is a relatively new business structure.
- When deciding on a legal structure, every small business owner must consider several important factors before making the choice.
- The sole proprietorship is the oldest, simplest, and cheapest form of business ownership. This business structure accounts for the largest number of businesses but the lowest amount of revenue. This is the choice for most small businesses.
- A partnership is two or more people voluntarily operating a business as co-owners for profit. There are general partnerships and limited partnerships.
- A corporation is an artificial person with most of the legal rights of a real person. Corporations make up about 20 percent of all businesses in the United States, but they account for almost 90 percent of the revenue.
- Small businesses that are incorporated outperform unincorporated small businesses in terms of profitability, employment growth, sales growth, and other measures.
- The LLC is a hybrid of a sole proprietorship and a corporation. It is the best choice for most small businesses.

EXERCISES

1. Select three small businesses of different sizes: small, medium, and large. Interview the owners, asking each about the legal structure that the owner chose and why. If any of the businesses are sole proprietorships, ask the owner if an LLC was considered. If not, try to find out why it was not considered.
2. Frank's BarBeQue is currently a sole proprietorship. Frank's son, Robert, is trying to persuade his father to either incorporate or become an LLC. Assume that you are Robert. Make a case for each legal structure and then make a recommendation to Frank. It is expected that you will go beyond the textbook in researching your response to this assignment.

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14.4.5: People

Learning Objectives

- Understand the complexities of hiring, retaining, and terminating employees.
- Be aware of the laws that apply to businesses of all sizes and specifically to small businesses of certain sizes.
- Understand outsourcing: what it is; when it is a good idea; and when it is a bad idea.
- Describe ways to improve office productivity.

The term *human resources* has been deliberately avoided in this section. This term is more appropriate for large bureaucratic organizations that tend to view their personnel as a problem to be managed. Smaller and midsize enterprise personnel, however, are not mere resources to be managed. They should not be seen as cogs in a machine that are easily replaceable. Rather, they are people to be cultivated because they are the true lifeblood of the organization.

Many small businesses operate with no employees. The sole proprietor handles the whole business individually, perhaps with help from family or friends from time to time. Deciding to hire someone will always be a big leap because there will be an immediate need to worry about payroll, benefits, unemployment, and numerous other details. A small business that looks to grow will face the hiring decision again and again, and additional decisions about compensation, benefits, retention, training, and termination will become necessary. Other issues of concern to a growing small business or a small business that wants to stay pretty much where it is include things such as outsourcing, how to enhance and improve productivity, and legal matters.

Hiring New People

All businesses want to attract, develop, and retain enough qualified employees to perform the activities necessary to accomplish the organizational objectives of the business. Although most small businesses will not have a department dedicated to performing these functions, these functions must be performed just the same. The hiring of the first few people may end up being pretty simple, but as the hiring continues, there should be a more formal hiring process in place.

Figure 14.4.5.1 illustrates the basics of any hiring process, whether for a sole proprietorship or a large multinational corporation.

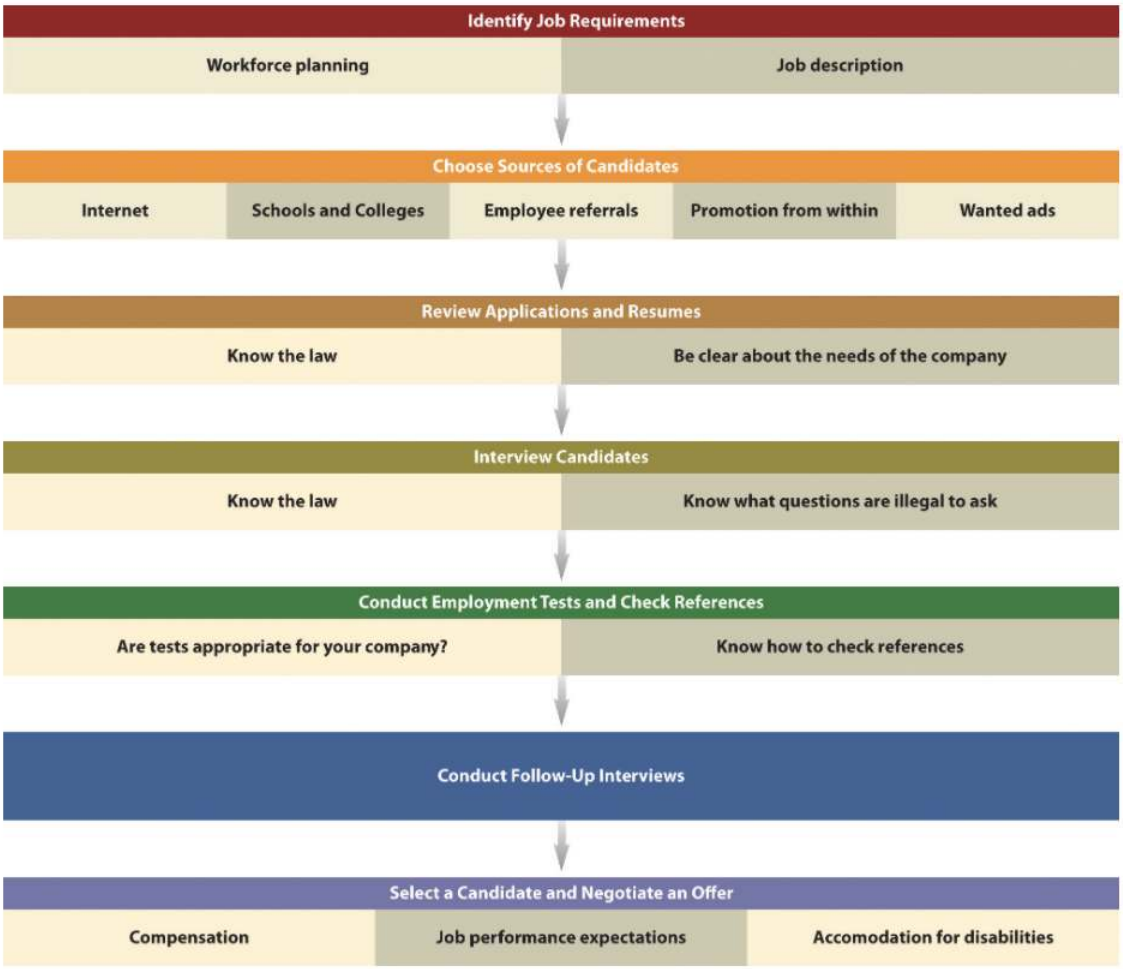


Figure 14.4.5.1: Steps in the Hiring Process. *Adapted from David L. Kurtz, Contemporary Business, 13th Edition Update (Hoboken, NJ: John Wiley & Sons, 2011), 289.*

Identify Job Requirements

A small business owner should not proceed with hiring anyone until he or she has a clear idea of what the new hire will do and how that new hire will help attain the objectives of the business. **Workforce planning**, the "process of placing the right number of people with the right skills, experiences, and competencies in the right jobs at the right time," is a way to do that. The scope of this planning will be very limited when a business is very small, but as a business grows, it will take on much greater importance. Doing things right with the first new hire will establish a strong foundation for hiring in the future. Forecasting needs for new people, both current and future, is part of workforce planning. No forecast is perfect, but it will provide a basis on which to make hiring decisions.

As an employer, every small business should prepare a **job description** before initiating the recruitment process. A good job description describes the major areas of an employee's job or position: the duties to be performed, who the employee will report to, the working conditions, responsibilities, and the tools and equipment that must be used on the job. It is important not to create an inflexible job description because it will prevent the small business owner and the employees from trying anything new and learning how to perform their jobs more productively.

Choose Sources of Candidates

Because hiring a new employee is an expensive process, it is important to choose sources that have the greatest potential for reaching the people who will most likely be interested in what a small business has to offer. Unfortunately, it is not always possible to know what those sources are, so selecting a mix of sources makes good sense.

- **Internet.** The Internet offers a wealth of places to advertise a job opportunity. Monster.com, CareerBuilder.com, and LinkedIn.com are among the largest and most well-known sites, but there may be local or regional job sites that might work better, particularly if a business is very small. A business will not have the resources to bring people in from great distances. If a business has a Facebook or a Twitter presence, this is another great place to let people know about job openings. There may also be websites that specialize in particular occupations.
- **Schools and colleges.** Depending on the nature of the job, local schools and colleges are great sources for job candidates, particularly if the job is part-time. Full-time opportunities may be perfect for the new high school or college graduate. It would be worth checking out college alumni offices as well because they often offer job services.
- **Employee referrals.** Referrals are always worth consideration, if only on a preliminary basis. The employee making the referral knows the business and the person being referred. Going this route can significantly shorten the search process…if there is a fit.
- **Promotion from within.** Promoting from within is a time-honored practice. The owner sends a positive signal to employees that there is room for advancement and management cares about its employees. It is significantly less costly and quicker than recruiting outside, candidates are easier to assess because more information is available, and it improves morale and organization loyalty. On the downside, there may be problems between the person who is promoted and former coworkers, and the organization will not benefit from the fresh ideas of someone hired from the outside.
- **Want ads.** Want ads can be very effective for a small business, especially if a business is looking locally or regionally. The more dynamic the want ad, the more likely it will attract good candidates. Newspapers and local-reach magazines might be a business's first thoughts but also consider advertising in the newsletters of relevant professional organizations and at the career services offices of local colleges, universities, and technical colleges.

Review Applications and Résumés

When looking for the best qualified candidates, be very clear about the objectives of the business and the associated reason(s) for hiring someone new. It is also critical to know the law. Some examples are provided here. This would be a good time to consult with a lawyer to make sure that everything is done properly.

1. **Employee registration requirement.** All US employers must complete and retain Form I-9 for each individual, whether a citizen or a noncitizen, hired for employment in the United States. The employer must verify employment eligibility and identity documents presented by the employee.
2. **The Civil Rights Act of 1964, the Civil Rights Act of 1991, and the Equal Employment Opportunity Act of 1972.** Attempt to provide equal opportunities for employment with regard to race, religion, age, creed, gender, national origin, or disability. The closest Equal Employment Opportunity Commission (EEOC) district office should be contacted for specific information.
3. **Immigration Reform and Control Act of 1986.** This law places a major responsibility on employers for stopping illegal immigration.

Labor Laws Governing Employers

The following is a brief synopsis of some of the federal statutes governing employers that may apply to a small business. In many instances, they are related to the size of the business. There are definite advantages to staying small.

The following laws apply no matter the size of the business:

- Fair Labor Standards Act
- Social Security
- Federal Insurance Contributions Act
- Medicare
- Equal Pay Act
- Immigration Reform and Control Act
- Federal Unemployment Tax Act

This additional law applies if a business has more than ten employees:

- Occupational Safety and Health Administration Act

The following additional laws apply if a business has more than fourteen employees:

- Title VII Civil Rights Act
- Americans with Disabilities Act (ADA)
- Pregnancy Discrimination Act

The following additional laws apply if a business has more than nineteen employees:

- Age Discrimination in Employment Act
- Older Worker Benefit Protection Act
- Consolidated Omnibus Budget Reconciliation Act

This additional law applies if a business has more than forty-nine employees:

- Family Medical Leave Act

The following additional laws apply if a business has more than ninety-nine employees:

- Worker Adjustment and Retraining Notification Act
- Employee Retirement Income Security Act

Interview Candidates

Just as knowing the law is important when reviewing applications and résumés, it is also important when interviewing candidates. Several interview questions are illegal to ask—for example, "Do you have dependable child care in place?" and "Do you rent or own your own home?" In general, the off-limit topics in most employment interviews include religion, national origin, race, marital status, parental status, age, disability, gender, political affiliation, criminal records, and other personal information such as financial and credit history. In short, keep the interview focused on the job, its requirements, and the qualifications of the candidate.

Conduct Employment Tests and Check References

Selection tests have been used to screen applicants for more than one hundred years. An effective testing program can improve accuracy in selecting employees; provide an objective means for comparing candidates; and provide information about training, development, or counseling needs. These advantages must be carefully weighed against the disadvantages: the fallibility of tests, the fact that tests can never measure everything, and many tests discriminate against minorities. Each small business owner must decide whether employment tests make sense for his or her business. However, Daniel Kehrer of Work.com claims that employee testing is essential to reducing employee turnover for small businesses because pre-employment screens are four times greater at predicting employee success than interviews. He notes further that high turnover rates are much more expensive for small businesses than large companies. Just be sure that all employment tests can be linked to a business necessity.

Checking references is a much more difficult proposition. It is a good idea to check references after the interview to objectively evaluate the candidate's qualifications, experience, and other information presented during the interview. Not checking references can result in poor hiring choices.

Unfortunately, many former employers are reluctant to reveal anything other than an employee's date of hire and departure and job title, but others may be willing to discuss an employee's job performance, work ethic, attendance, attitude, and other things that may be important to the prospective employer.

As important as it is to check references, it is a process that is fraught with legal risk, so check with an attorney before moving forward.

Select a Candidate and Negotiate an Offer

After any desired follow-up interviews are conducted, it is time to select a candidate and negotiate an offer. There are three main issues to consider: compensation, job performance and expectations, and accommodations for disabilities.

Compensation includes wages, salaries, and benefits. Although wages and salaries are often used interchangeably, they are different. **Wages** are payments based on an hourly pay rate or the amount of output. Production employees, maintenance workers, retail salespeople (sometimes), and part-time workers are examples of employees who are paid wages. **Salaries** are typically calculated weekly, biweekly, or monthly. They are usually paid to office personnel, executives, and professional employees. Every

small business should do its best to offer competitive wages and salaries, but a small business will generally not be able to offer wages and salaries that are comparable to those offered by large corporations and government. **Employee benefits**, such as health and disability insurance, sick leave, vacation time, child and elder care, and retirement plans, are paid entirely or in part by the company; they represent a large component of each employee's compensation. Most employees have come to expect a good benefits program, even in a small business, so "the absence of a program or an inadequate program can seriously hinder a company's ability to attract and keep good personnel." Not surprisingly, small businesses are also not in a position to offer the same level of benefits that can be offered by large corporations and the government. However, small businesses can still offer a good benefits program if it includes some or all the following elements: health insurance, disability insurance, life insurance, a retirement plan, flexible compensation, leave, and perks. In addition, small businesses can offer benefits that only a small business can offer—for example, the flexibility to dress casually, half days on Friday, and bringing one's pet to work. Other ideas include gym memberships or lunch programs. These things have proven to increase employee loyalty, and they will fit the budget of even the smallest business.

Set Performance Expectations

It is in the best interests of a business for prospective new employees to know and understand their performance expectations. This means that a business must determine what these expectations are. New employees should understand the goals of the organization and, as applicable, the department in which they will be working. It should also be made clear how the employee's work can positively impact the achievement of these goals.

Make Accommodations for Disabilities

If a business is hiring someone with a disability and has fifteen or more employees, it is required by the ADA (enacted in 1990) to make reasonable workplace accommodations for employees with disabilities. Though not required, businesses with fewer than fifteen employees should consider accommodations as well.

Reasonable accommodations are adjustments or modifications which range from making the physical work environment accessible to restructuring a job, providing assistive equipment, providing certain types of personal assistants (e.g., a reader for a person who is blind, an interpreter for a person who is deaf), transferring an employee to a different job or location, or providing flexible scheduling.

Reasonable accommodations are tools provided by employers to enable employees with disabilities to do their jobs. For example, employees are provided with desks, chairs, phones, and computers. An employee who is blind or who has a visual impairment might need a computer which operates by voice command or has a screen that enlarges print. A tax credit is available to an eligible small business, and businesses may deduct the costs (up to $15,000) of removing an architectural barrier. Small businesses should check with the appropriate government agency before making accommodations to make sure that everything is done correctly.

Is a Business Hiring and Breeding Greedy and Selfish Employees?

If a business is worried about hiring a bunch of jerks, the EGOS Survey (Evaluation Gauge for Obnoxious Superstars) from *Fast Company* will help it find out. If a business owner answers truthfully, the owner can learn whether he or she is a leader of obnoxious superstars. Hiring jerks can happen in any size business.

Retention and Termination

Acquiring skilled, talented, and motivated employees will be a continuing concern for all small businesses. But the concerns do not end there. There will be issues concerning retention and termination of employment. **Retention** refers to keeping employees, and **termination** is about ending the employment of current employees against their will.

Retention

Employee retention rates play an important role in the cost of running a business. The first few years of an employee's service are the most costly because money will be spent on recruiting and training the employee. It is only after the employee has been working for some time that he or she will start making money for the business.

Because of the costly and time-consuming nature of hiring new employees, many companies today increasingly emphasize retaining productive people. Even the smallest of businesses should be concerned about retention because high turnover will be

disruptive to the operations of the business and, as a result, may lessen the quality of the customer experience and customer satisfaction.

A good training and orientation program at the outset of employment can set the stage for increased retention. **Training** "is a continual process of providing employees with skills and knowledge they need to perform at a high level." This continuing process is important. According to *Inc.com*, "the quality of employees and the continual improvement of their skills and productivity through training, are now widely recognized as vital factors in ensuring the long-term success and profitability of small businesses." Training programs will vary greatly depending on the size and the nature of the business. However, all training programs must be based on both organizational and individual needs, spell out the problems that will be solved, and be based on sound theories of learning. Many training and management development programs are not for amateurs, but the extent to which a small business can provide professionally delivered programs will be budget and needs-related. In some instances, training is performed by someone who is currently doing the job—for example, using a particular machine, operating the cash register, stocking merchandise, and learning office procedures and protocols. Nothing additional is required.

Employee incentive programs are particularly important for small businesses because benefits satisfaction in small businesses typically lags behind benefits satisfaction in large corporations. A recent study revealed that 81 percent of employees who are satisfied with their benefits are also satisfied with their jobs, whereas 23 percent of employees who are dissatisfied with their benefits are very satisfied with their jobs (Figure 14.4.5.2).

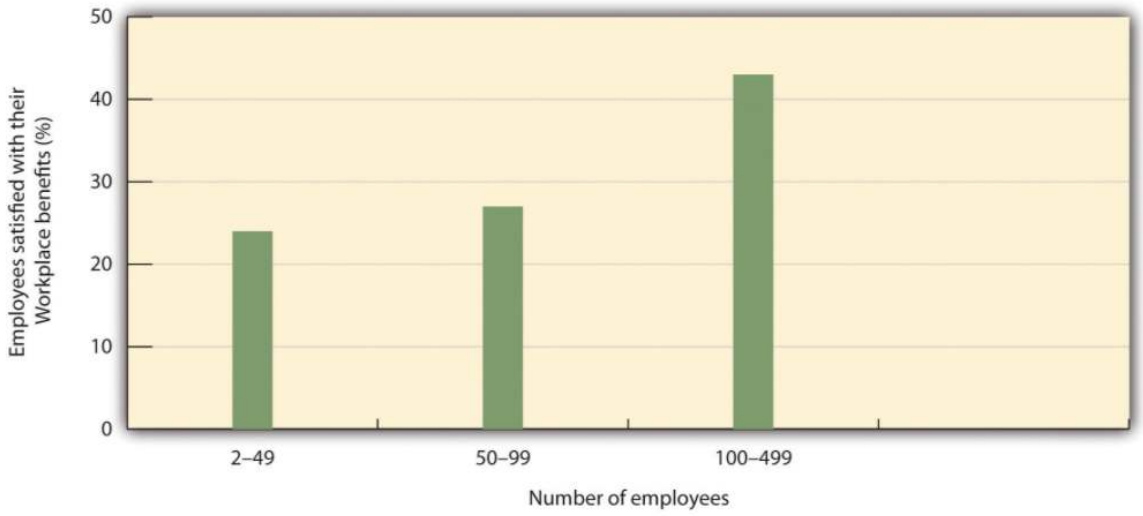


Figure 14.4.5.2: Benefits Satisfaction in Small Businesses. *"Building a Better Benefits Program without Breaking the Budget:Five Practical Steps Every Small Business Should Consider," MetLife, 2010, accessed February 3, 2012.*

Given the importance of benefits to employees, small businesses need to be very creative about what kinds of incentives are offered to their employees. One of the biggest incentives may be the flexibility and camaraderie that are not available in larger businesses, but to increase employee retention and attract the best and brightest, there will need to be more. Creating a sense of community, offering leadership opportunities, creating a culture of recognition, and constantly offering opportunity can be powerful incentives. They can be very effective at increasing employee retention, particularly when there is insufficient money to provide large raises. People want to enjoy their jobs as well as earn money, and they may care about their community and passions equally as much as their salaries. This is an opportunity for small businesses because "smaller companies may be better positioned to provide work-life balance that makes for happier, healthier employees."

Video Clip: Keeping Small Business Employees

Some ideas for keeping small business employees. They begin with a good job description.

A YouTube element has been excluded from this version of the text. You can view it online here.

Termination

Termination or firing will always be unavoidably painful, but it is a managerial duty that is sometimes necessary. In small businesses, terminations are usually carried out by the owner. They should be done promptly to preserve the health of the business. Terminations can be **termination at will** or **termination for cause**.

- **Termination at will.** Employment at will means that a person does not have an employment contract. The person is employed "at the will" of the employer for as little or as long as the owner desires. It also means that a person can stop working for an employer at any time. An employer "doesn't need to give a reason for termination of an 'at will' employee, as long as the termination isn't unlawful or discriminatory…Termination can be due to a merger, workforce reduction, change in company direction and business focus, poor company performance, or any number of other legitimate reasons."
- **Termination for cause.** When someone is terminated for cause, that person is being fired for a specific reason, one of which may be behavior. Common causes for termination include but are not limited to stealing, lying, falsifying records, embezzlement, insubordination, deliberately violating company policies or rules, absenteeism and tardiness, unsatisfactory performance, changed job requirements, sexual harassment, and failing a drug or alcohol test. Sexual harassment is a form of sex discrimination that violates Title VII of the Civil Rights Act of 1964. According to the EEOC, sexual harassment is "unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature constitutes sexual harassment when submission to or rejection of this conduct explicitly or implicitly affects an individual's employment, unreasonably interferes with an individual's work performance or creates an intimidating, hostile or offensive work environment."

When an employee has been terminated, the small business owner should inform the other employees. As a general rule, the less said to coworkers and other employees about an employee's termination, the better. People will be curious, but do not infringe on the terminated employee's privacy or say something that might leave a person open to legal action. The best approach is to inform immediate coworkers, subordinates, and clients by simply telling them that the company no longer employs the employee. Do not mention any details but do include an explanation of how the terminated employee's duties will be carried out in the future.

Outsourcing

Outsourcing is the practice of using outside firms, some of which may be offshore, to handle work that is normally performed within a company. Small business owners routinely outsource a range of services, such as landscaping; building, utility, and furniture maintenance; distribution; and cleaning. Consistent with the trend set by larger corporations, small businesses are outsourcing a range of services, many of which were once considered fundamental internal functions.

A major reason for outsourcing is cost reduction. Other benefits of outsourcing include increasing efficiency, enabling a company to start new projects quickly, allowing a company to focus on its core business, leveling the playing field with larger companies, and reducing risk. There is no question that outsourcing can be a good idea, but outsourcing is not always a good idea.

When Is Outsourcing a Good Idea?

Outsourcing is a good idea when it allows a small business "to continue performing the functions it does best, while hiring other companies [many of which may be other small businesses] to do tasks that they can handle more competently and cost-effectively." Traditionally, payroll and personnel services have been outsourced by small businesses, but small businesses now use outside providers for a much greater range of services, including the following:

- **Accounting and bookkeeping.** A growth area here is outsourcing accounts receivable. This enables a small business to sell off its accounts receivable and invoices to a financing company. As a small business grows, the process of collecting accounts receivable may become too cumbersome to handle without collection agencies becoming involved.
- **Specialist and expert help.** Elance offers a range of services for small businesses. It has access to thousands of professionals around the world who can provide services such as graphic design, multimedia presentations, engineering, sales and marketing, writing, and translation.
- **Public relations and marketing services.** These services are costly, require specialized expertise, and are not usually full-time needs. Many service providers specialize in the needs of small businesses.
- **Virtual assistants.** These people are independent entrepreneurs who provide administrative, creative, or technical support. A growing phenomenon, they work on a contractual basis via online or electronic communications. Virtual Office Temps and

VirtualAssistants.com are examples of companies that can connect virtual assistants with any company that is interested.

- **Creating benefits package.** A tremendous amount of time and creativity would be required for a smaller company to create a benefits package that is competitive in the marketplace. Given the vast complexities of health care, including healthcare laws that differ by state, outsourcing this activity makes good sense.
- **Legal services.** A small business may need to consult an attorney for a variety of reasons, including the following:
  - Choosing the business structure
  - Constructing a partnership agreement
  - Obtaining a corporate charter
  - Registering a corporation's stock
  - Obtaining a trademark, a patent, or a copyright or intellectual property
  - Filing for licenses or permits at the local, state, and federal levels
  - Purchasing an existing business or real estate
  - Hiring employees, independent contractors, and other external suppliers (outsourcing)
  - Extending credit and collecting debts
  - Creating valid contracts
  - Initiating or defending against lawsuits
  - Keeping current on and compliant with business law and regulations (e.g., advertising, employment and labor, finance, intellectual property, online business law, privacy law, environmental regulations, and the Uniform Commercial Code)
  - Protecting intellectual property
  - Protecting ideas or inventions from others' infringement

  However, the cost of a full-time attorney would probably be prohibitive. Outsourcing these services is an appropriate choice. Some legal firms offer small businesses a flat monthly fee instead of charging them by the hour, a practice that is very helpful to the small business budget.

When Is Outsourcing a Bad Idea?

Although outsourcing has benefits, there are times when it is a bad idea. For example, sales and technology development are operations that are generally best handled in-house because they are full-time needs that are at the heart of any business. Outsourcing might actually end up being the more expensive alternative, leading to a financial loss instead of a gain. An example would be the cost of a highly specialized expert. In addition, when outsourcing overseas, the small business owner and/or managers may not be prepared to manage projects across time differences and cultural barriers and may not have clear guidelines, expectations, and processes in place to manage product or service quality.

Office Productivity

All small businesses want their employees to work better and smarter. In fact, the smaller a business is, the more efficient and effective it must be. Productivity is an issue in two places: the office and in manufacturing. Office productivity (which applies to all levels in the organization) is discussed in this section, and the role of technology is the focus. "Office" is used broadly to include, for example, physical offices, virtual offices, work situations that involve in-the-car time (e.g., realtors and salespeople), restaurant kitchens, and people who work on the sales floor in retail establishments.

Even the smallest of businesses can improve productivity by using technology, even though such use may be very limited in some instances. For example, goods and services needed to run a business can often be ordered online; e-mail can be used for customer and supplier communication; taxes can be filed online; and a simple software package like *Microsoft Communicator* allows intra- and extra-company communication via e-mail, text, and video. It will be the rare business that uses no technology.

Some have referred to technology as the road map to small business success—helping grow the business, work smarter, attract more customers, enhance customer service, and stay ahead of the competition. An important component of all this is high office productivity. Efficiency and effectiveness in the office will benefit the entire business.

With the proliferation of social networks, small businesses are implementing more Facebook-like applications into their day-to-day operations. Yammer, for example, "enables a company's employees to gather inside a private and secure social network that can be controlled and monitored by the employer. The goal is to increase productivity…[It] is about making people work more

productively using communication that's becoming very popular in the consumer space." Other similar products include Conenza and Chatter.

Some see the iPad as changing how business relationships are built—providing opportunities to connect with prospects in a more meaningful way and allowing people to collaborate with others in real-time from wherever they are. The iPad is also changing the way people can work. The SoundNote application allows note-taking and recording a meeting simultaneously; once written, the notes can be e-mailed directly to the participants. Just want to take notes? Use Evernote. The iPad can be used in the kitchen of a restaurant, a café, a hotel, or a bar for finding recipes and cooking instructions, displaying recipes as PDF files, and working on budgets and cost analyses. In retailing, the iPad can be used as a virtual sales assistant. In a dress department, coordinating accessories from a jewelry store or the shoe department can be accessed and recommended to the customer. Car dealers could customize a car by showing colors and finishes to the customer—all while standing in the parking lot. In real estate, the iPad can be used for buyer consultations, listing presentations, tracking properties, and chatting with clients—just to name a few.

Video Clip: Using the iPad for Real Estate

Some tips on how to use the iPad in real estate.

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Although every small business owner may not see an immediate need for an iPad, it is a technology worth checking out. New applications for office productivity are coming out all the time.

A **smartphone** is a device that lets a person make phone calls but has other features found on a digital assistant or a computer, such as sending and receiving e-mail and editing Microsoft Office documents. A popular brand is the Apple iPhone. Smartphones give a person access to company data that is normally not possible without a laptop; make it possible to accomplish more, faster; enable mobile workers to connect to company information while on the road; keep your calendar, address book, and task lists organized; and, perhaps most importantly, keep frustrations to a minimum because the technology is designed to work in tandem with a **server** and a **personal digital assistant (PDA)**. A server is a computer or a series of computers that link other computers or electronic devices together. A PDA is a handheld computer that acts "as an electronic organizer or day planner that is portable, easy to use and capable of sharing information with your PC." Blackberry is a popular brand of the PDA. The smartphone can be used for numerous business functions, such as tracking equipment and accounts, keeping calendars and address books, connecting to the Internet, acting as a global positioning system (GPS), and running multimedia software.

Like everyone else, small businesses have to do more with less. This means that effective collaboration is increasingly critical to success. Because collaboration is a daily requirement for all small businesses, the question becomes how to have productive collaboration without using up too much time and costing too much money. What is needed is a way to "spur employees to share ideas and increase productivity while protecting work-life balance." A recent study reported that among companies that used collaboration tools, 72 percent reported better business performance. One popular collaboration tool is web conferencing: "Web conferencing services enable users to hold collaborative meetings with interactive whiteboard tools, give sales demonstrations with real-time efficacy, stage presentations with full and select moderator control or hold enhanced, multimedia roundtable discussions…And, with recording and playback tools available in the leading Web conferencing service providers, audience members and other authorized users can access meetings, presentations and demonstrations again and again or continually reference whiteboard sessions."

Although Top Ten Reviews ranked Infinite Conferencing, Netviewer Meet, and Adobe Connect Pro as the 2011 top three web conferencing services, each small business should select the product that best serves its needs and its budget.

Virtual or Telecommuting Employees

Another boon to office productivity and adding to the bottom line is the **virtual or telecommuting employee**. This is an employee that works from a location other than the traditional office. They can work from anywhere. There is no agreement on the number of US workers that are already telecommuting. However, it has been estimated that 40 percent of the US workforce hold jobs that lend themselves to telecommuting.

The advantages of virtual employees include the following:

- Companies could save $6,500 annually per employee.

- Virtual employees tend to be happier, healthier, and less stressed compared to their office-bound coworkers.
- Virtual workers are significantly more productive than their office-bound colleagues. The differential is estimated at 15 percent.
- Virtual employees almost always give back more than 50 percent of the time they save by not commuting.
- Some virtual workers actually put in more time per week than those who commute.

From the perspective of the virtual employee, the advantages of telecommuting are as follows: no distractions from coworkers; no stress from office politics; spending more time with the family; saving money on transportation, parking, and clothing; and avoiding traffic or saving time by not commuting.

Virtual employees offer terrific advantages to the small business owner who is always looking to cut costs and attract high-quality employees. However, it is not something that works for everyone and every kind of business. For example, a restaurant cannot have a virtual waiter…at least not yet. A small business that wants to use virtual employees must create the appropriate infrastructure—that is, technology, security, policies, behavioral protocols, performance management, and so forth—to provide the best support for telecommuting workers in how, where, and when they do their jobs. For support with telecommuting challenges, small business owners can tap into The Alternative Board, an organization with three thousand small- and mid-sized business owners.

KEY TAKEAWAYS

- Deciding to hire someone will always be a big step because there will be an immediate need to worry about payroll, benefits, unemployment, and numerous other issues.
- The hiring process includes identifying job requirements, choosing sources of candidates, reviewing applications and résumés, interviewing candidates, conducting employment tests (if desired), checking references, conducting follow-up interviews if needed, selecting a candidate, and making an offer.
- It is very important to know employment law before proceeding with the hiring process. For example, several potential questions are illegal to ask.
- Whether it is required or not, small businesses should be willing to make accommodations for employees with disabilities.
- Retention is an important concern for all small businesses.
- When an employee is to be terminated, it is best to do it promptly.
- Outsourcing is about using outside firms, some of which may be offshore, to handle work that is normally performed within a company. Outsourcing can be either good or bad; it depends on the situation.
- Office productivity is about working smarter and better. Social networking, the iPad, smartphones, online collaboration tools, and virtual employees can all help increase productivity.

EXERCISES

1. As the owner of a one-hundred-employee business, you just learned that some of your employees were “dumpster diving” in the trash outside a competitor’s offices. In other words, they were looking for information that could provide your company with a competitive advantage. With investigation, you found out that the head of the espionage operation was a personal friend. You have decided to fire your friend immediately, along with his dumpster divers. How should you proceed with the termination of your friend and his operatives so that you will not be held liable in a lawsuit? Would you reconsider the firing of the operatives? Why or why not?
2. Robert is trying to convince his father, Frank of Frank’s BarBeQue, to integrate more technology into his restaurant operations because it will increase productivity. Assuming the role of Robert, select technologies that you think would be a good fit for Frank’s restaurant. Prepare your recommendations for Frank.

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14.4.6: The Three Threads

Learning Objectives

- Explain how people and organization can add to customer value.
- Explain how decisions about people and organization can impact cash flow.
- Explain how technology and the e-environment are impacting people and organization.

Customer Value Implications

By definition, a small business is small. The CEO and the top management team have a much greater understanding of the tasks and operations of the entire business and what their employees are doing. (Sometimes their employees wish they did not have such a good knowledge of the tasks they, the employees, are supposed to be performing.) In a small business, it is much more likely for the CEO and the top management team to have a personalized relationship with their customer base. Sometimes this functions on a one-to-one basis and is predicated on a true sense of personal friendship. This intimacy between those at the top of a small business and their customers or clientele can yield tremendous benefits for both the business and the customers. Knowing the true needs of the customer on a personalized level greatly enhances the value produced by a business.

Small business organizations are flatter and less bureaucratic. Sometimes they are less centralized. This enables frontline personnel to be closer to the customer, where they can better ascertain the needs of the customer and make decisions more quickly to satisfy those needs. This adds to the value of these businesses in the eyes of their customers because of a more positive customer experience.

In addition to being closer to the customers, the owner of a smaller business has a closer relationship with the employees. There generally is no need for a formal “human resources” department that bureaucratizes relationships. The owner knows the strengths and the weaknesses of the employees and will best use them in the business. The owner can develop personal relationships with employees that are impossible in larger organizations. This closeness can often translate into an intangible strength—loyalty. Employees who are happy with their employment will provide greater value to the customer.

Cash-Flow Implications

The simpler the organizational structure, the more positive will be the impact on cash flow. Having unnecessary positions will negatively impact small business operations in terms of not only costs but also efficiency and effectiveness.

Improper hiring and termination procedures will also adversely affect cash flow. Recruiting employees is an expensive process, so errors in the hiring process will be a drain on the cash flow of a business and, as a result, its profitability. Termination is a particularly sensitive process, so a careful and thoughtful procedure should be developed for carrying it out. Errors in either hiring or termination may open up a business to lawsuits, another major hit to cash flow and profitability.

Technology adoption for office productivity improvements (e.g., social networking, iPads, and smartphones) may adversely affect the cash flow in the short term, but (hopefully) the higher productivity should offset those losses in the longer term. As an example, recall Lloyd’s Construction in Eagan, Minnesota. The company switched to a **smartphone** system that allowed for integrated data entry and communication. The company reduced its routing and fuel costs by as much as 30 percent, and they estimated that they saved $1 million on a $50,000 investment.

Implications of Technology and the E-Environment

New technology solutions are being introduced every day, many of them potentially very useful for small businesses. This chapter discussed the productivity enhancement possibilities offered by social networking, the iPad, smartphones, and collaboration tools, but the discussion was only the tip of the iceberg. Technology is so pervasive in today’s workplace that ignoring it will be done at each business’s peril. Mobile technology is now even pervading the hiring process; the world of recruiting via mobile technology is moving at the speed of light. The result? More and more organizations are trying to figure out how to start using mobile devices to recruit new employees. The prospect of targeting all populations of people is an exciting—but certainly challenging—one.

Another interesting technology product is talent management software developed by Taleo, which is targeted to the small business to simplify recruiting, hiring, and performance management with “unmatched flexibility.” There are undoubtedly other similar

products available. The point is that this is an example of the small business technology solutions that are available for exploration and consideration.

The e-environment is a small business facilitator extraordinaire. The web is a fabulous place, making collaboration and communication so much better and faster. It has opened the door to enhanced productivity, and a potentially important part of that is the virtual employee. Small businesses should seriously consider the advantages of virtual employees because they can help the small business expand its reach, increase employee morale, and contribute to a much better work-life balance.

KEY TAKEAWAYS

- The less bureaucratic organizational structure of small businesses tends to open the door for more personalized relationships between the CEO and other top managers and customers. This adds considerable value to the business and the customer experience.
- The simpler the organizational structure, the more positive the impact on cash flow.
- Technology investments for increased productivity will be a drain on cash flow in the short term, but productivity improvements should offset the loss in the long term.
- New technology products are being introduced every day, many of them geared to the small business. Small businesses should make it a point to learn about what's available and keep an open mind about adopting a new solution to an old problem.
- The e-environment has opened the door to multiple ways to improve office productivity, not the least of which is the virtual employee.

EXERCISE

Select a small business with between fifty and seventy-five employees. Set up an interview with the president or one of the other members of top management. Ask the person to describe the organizational structure of the business, and then ask him or her to discuss whether the structure helps or hinders his or her relationships with customers. Lastly, ask if there is anything about the organizational structure he or she would change—and why.

Disaster Watch

John owns a very successful electronics business. He has been in business for only three years and already has several large stores. He has seventy-five part- and full-time employees. The business thrives on a sales force that must be able to close deals, particularly on high-priced items.

Jennifer is John's administrative assistant. She has been with him from the beginning, and John considers her to be a vital element in the success of the business. He had wooed her away from another large electronics chain. On Tuesday, Jennifer requested a private meeting with him. She arrived at the meeting clearly distressed. He asked her to sit down and tell him what was troubling her. She struggled not to cry but could not hold back the tears. She recounted the following story.

Ed Smith, a salesperson, had for the last five weeks been making inappropriate and suggestive comments to her. She told John that at first she tried to dismiss and deflect Ed's comments with humor, and the humor clearly indicated that she had no interest. The result was that the comments became more frequent, more aggressive, and more vulgar. At this point (last Friday), Jennifer indicated to Ed that she found his remarks offensive and harassing. He laughed and, in the intervening days, continued the remarks, which became even more progressively lewd. It was Jennifer's opinion that Ed was incapable of understanding how inappropriate his behavior was. She believes that his presence creates a significantly hostile working environment for her and other women. She thinks it would be best for the organization if Ed were fired immediately.

John expressed his profound sympathy to Jennifer and said that he would speak to Ed right away. This clearly was not what Jennifer wanted to hear. She left John's office simply stating, "It's either him or me."

Although John was extremely sympathetic to Jennifer's position, he recognized that he had to speak to Ed to protect himself. Further, John had to consider the fact that Ed was unquestionably his best salesperson. Two hours later, John called Ed into his office and related Jennifer's story. Ed laughed it off as harmless wordplay, even going as far as saying, "Could you possibly see

me being interested in a woman who looks like she does?" He then countered with, "Look. You know I'm your best salesman, and if I'm fired because of some slanderous comments, I'll sue." He then stormed out of John's office.

What should John do?

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SECTION OVERVIEW

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15.1.1: Introduction

The Notch Store

No small business, or for that matter no large business, becomes a landmark and community-gathering place overnight. It takes time along with some very sharp management skills. In the case of the Notch Store, a local legend in Cheshire, Connecticut, it took ninety years and three generations of family members.

The business began in 1921 when Pauline Salvatore recognized a business opportunity. Her husband Mike worked in the nearby quarry, and she recognized that the employees needed a location where they could buy groceries for their lunch or to bring home for dinner. She began to sell them from her living room. Soon the business located to a facility next to her home. The name Notch Store came from its use in the quarry.

A few years later, Mike left the quarry and began to work with Pauline. Over the years, the Notch Store evolved as customer needs changed. They began to expand their offerings. The physical store was enlarged. A gasoline pump was installed, and for several years, one wall of the store carried auto parts.

In 1967, Mike and Pauline's son Frank and his wife Josephine took over the operation of the business. In the 1970s, the Notch Store extended its offerings to include deli items and lunches. It even offered a homemade cider every fall. The business grew and included its third generation of Salvatores—Frank Jr.

In the early 1990s, Frank Jr. was in charge of operations. Like any business man, he was open to suggestions from others, including his employees. One woman who worked for Frank Jr. suggested that he add breakfast sandwiches to the menu. To make these sandwiches, Frank Jr. needed a restaurant-quality stove. In one of those strange twists of life, Frank Jr. had a friend who knew Joe Namath and his wife. The Namaths were building a new home, and Joe's wife did not like the stove in the home. Frank Jr. acquired it, and since then, the breakfast sandwich offerings have become a major staple in the Notch Store.

No business develops without encountering problems, and the Notch Store was no exception. Several years ago, a number of customers complained that they had become ill from the Notch's cider. This was followed by several lawsuits. For most businesses, this might have been a fatal crisis and financial ruin. Fortunately, years before, Frank Jr. had listened to his brother Robert's advice (Robert was in the insurance industry). The Notch Store had $2.3 million in insurance coverage, which was more than enough to ensure its survival. For several reasons, including recognition of the risk of serving food to the public, the Notch Store has adopted a limited liability corporation format. Even with the best of financial planning and risk reduction strategies, many businesses have to deal with factors beyond their control. The recent economic downturn has meant that there is a significant reduction in new homes being built in Cheshire. This means that there are far fewer builders buying breakfasts and lunches, but Frank Jr. is coping with a small line of credit at a local bank. The future is still bright for the Notch Store and so is the possibility of it continuing into a fourth generation. Frank Salvatore (owner), in discussion with the authors.

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15.1.2: The Importance of Financial Management in Small Business

Learning Objectives

- Understand the difference between accounting and finance for small businesses.
- Understand the major activities of finance.
- Understand how finance can affect the selection of a business form.
- Understand the various sources that can be used to finance the start-up operations of a business.
- Understand what factors might affect the extent to which a firm is financed by either debt or equity.

An earlier chapter discussed the critical importance of a small business owner understanding the fundamentals of accounting—"the language of business." This chapter examines finance and argues that the small business owner should acquire a basic understanding of some key principles in this discipline. One question that might come to someone's mind immediately is as follows: "What is the difference between accounting and finance?" As an academic discipline, finance began in the early decades of the twentieth century. We have already seen that accounting predates the formal study of finance by millennia. Yet some have argued that accounting should be seen as a subset of finance. Others have argued that both accounting and finance should be seen as subdisciplines of economics. Not surprisingly, others have argued in favor of the primacy of accounting. If we get beyond this debate, we can see that accounting is involved with the precise reporting of the financial position of a firm through the financial statements. The accounting function is expected to collect, organize, and present financial information in a systematic fashion. **Finance** can be seen as "the science of money management" and consists of three major activities: financial planning, financial control, and financial decision making. Financial planning deals with the acquisition of adequate funds to maintain the operations of a business and making sure that funds are available when needed. Control seeks to assure that assets are being efficiently used. Decision-making is associated with determining how to acquire funds, where to acquire funds, and how those funds should be used and within the context of the risk assessment of the aforementioned decisions. As an academic discipline, finance has grown tremendously over the last four decades.

Much of the work produced during this period possessed both an esoteric analytical quality and profound practical consequences. One only has to look at newspapers and the business press, during the last few years, to see how financial theory (efficient market hypothesis) and financial models (options pricing, derivatives, and arbitrage models) have played a dominant role in the global economy. Fortunately, most small businesses have no need to directly involve themselves with these analytical abstractions. But this does not mean that small business owners do not need to concern themselves with fundamental issues of financing their firms.

Impact of Organization Type on Finance Decisions

Selecting the form of business organization that is adopted by a business depends on many factors. One could begin by anticipating the eventual size and nature of the business. The complexity of a business may dictate the type of business organization that is adopted. However, many of the factors that go into this determination are either directly or indirectly financial in nature. The indirect factors are as follows: the extent to which a business owner wishes to attain control of the business, the relationship that the owner would have with partners or investors, and the perceived risk associated with the business. This last factor is tied to the question of the extent to which the owner will invest his or her own money and assets. The direct financial factors that go into selecting the type of the business organization include the following: expected profits or losses, tax issues, the vulnerability and threat from lawsuits, and the ability to extract profits from the business for the owner's use. The federal government recognizes six forms of business organizations for tax purposes: **sole proprietorship**, partnership, **C-corporation**, **S-corporation**, trust, and nonprofit. The last two are unlikely to be adopted by small businesses. It is useful to examine the financial implications of organizing along the remaining four basic formats.

Sole Proprietorship

Many small businesses operated by a single individual adopt sole proprietorship format of business organization. It is the most basic type of business organization. It is also the least expensive to create and the easiest to operate and dissolve. Sole proprietorships can be incorporated if the owner so desires. Not being a legal entity, single scratch sole proprietorships disappear after the death of the owner. This type of business is essentially a format for a single-person business (although many have between one and ten employees), where the owner makes *all* the decisions related to the business's operations. The owner can extract all

profits from the business for his or her personal use, or the owner can decide to reinvest any portion of the profits back into the business. It is interesting to know that 70 percent of all businesses in the United States are sole proprietorships yet they only produce 20 percent of all the nation's profits. Because a single proprietorship is not a legal entity, any income generated by the business goes directly on the owner's personal tax return. However, the single owner is also personally responsible for any debts that the business acquires. This means that the owner may put his or her own personal assets at risk. In addition, this business organization means unlimited liability for its owner. The format means that there is very little opportunity to raise funds from sources other than the owner's own capital or consumer loans.

Partnerships

Partnerships generally are unincorporated businesses. From a financial standpoint, partnerships offer a few advantages over sole proprietorship. By having more than one owner (investor), it is often easier to raise additional capital. In some businesses, such as law firms and accounting firms, the prospect of becoming a partner may be an attractive inducement to gain employees. There are several versions of partnerships.

The **general partnership** is composed of two or more owners who contribute the initial capital of the business and share in the profits and any losses. It is similar to a sole proprietorship in that all partners are personally responsible for all the debts and the liabilities of the business. A general partnership is comparable to a sole proprietorship in that neither is a taxable entity; therefore, the partners' profits are taxed as personal income. They can deduct any business losses from their personal income taxes. The exact proportion of ownership of the firm is generally found in a written document known as the partnership agreement.

A **limited partnership** is a business that may have several general partners and several more limited partners. The major difference with a general partnership is that the limited partners do not have unlimited liability. Their losses are limited to their original investment in the business. Common practice means that these limited partners do not play a major decision-making role in the life of the business.

C-Corporations

Selecting a C-corporation form of business entails more effort and expense in creating this format. Corporations must be chartered by the state in which they are headquartered. Corporations are viewed as legal entities, meaning that they can enter into legal agreements with individuals and other corporations. They are also subject to numerous local and state regulations. This often results in extensive paperwork that can be costly. Corporations are owned by their shareholders. The shareholders are liable only for their original investment in the business. They cannot be sued for more than that amount. One of the major advantages of adopting a corporate format is that in this type of business, it is sometimes much easier to raise capital through either debt or the issuance of stock. Profits derived from this type of business are taxed at the corporate rate. It is important to note that dividends paid to shareholders, unlike interest expenses, are not deductible. So in a real sense, this form of income is doubly taxed.

S-Corporations

The S-corporation is a special format designed to eliminate the problem of double taxation that one might find with a C-corporation format. It first differs from a C-corporation in that it is limited to a hundred shareholders, although it can be created with just one shareholder. If a shareholder is an employee of the business and contributes any service to the business, then the corporation is required to pay that individual a salary. The term that is used is "reasonable" salary. This definition may vary under several conditions. A failure to comply with this ambiguous definition of "reasonable" salary means that the IRS can reclassify the profits as wages and tax the amount at the personal income rate.

Limited Liability Company

A **limited liability company** is an organizational form that can be limited to a single individual or several other owners or shareholders. Like a general partnership, there is a requirement for documents that define the distribution of responsibilities, profits, or losses. Generally, the members of a limited liability company are liable for the debts of the company. This format may provide tax and financial benefits for the participants. This format cannot be used in the banking or insurance industries.

Acquisition of Funds

Capital is the lifeblood of all businesses. It is needed to start, operate, and expand a business. Capital comes from several sources: equity, debt, internally generated funds, and trade credits (see Figure 15.1.2.1).

Figure 15.1.2.1

Equity financing raises money by selling a certain share of the ownership of the business. It involves no explicit obligation or expectation, on the part of the investors, to be repaid their investment. The value of equity financing lies in the partial ownership of the business.

Perhaps the major source of equity financing for most small start-up businesses comes from personal savings. The term *bootstrapping* refers to using personal, family, or friends' money to start a business. The use of one's own money (or that of family and friends) is a strong indicator that a business owner has a strong commitment to and belief in the success of the business. If a business is financed totally from one's personal savings, that means the owner or the operator has total control of the business.

If a business is structured as a corporation, it may issue stock. Generally, two major types of stock may be issued: common stock and preferred stock. It should be noted that in most cases, owners of common stock have what are known as voting rights. They have a proportional vote (directly related to the number of shares they own) for members of the board of directors. Preferred stock does not carry with it voting rights, but it has a form of guaranteed dividend.

Corporations that issue stock must comply with several steps to meet both federal and state statutes, including the following: outlines to issue stock to shareholders, determining the price and number of shares to be issued, creating stock certificates; developing a record to record all stock transactions; and meeting all federal and state securities requirements. Smaller businesses may choose to issue stock only to those who were involved in the initial investment of the business. In such cases, one generally does not have to register these securities with state or federal agencies. However, one may be required to fill out all the forms.

An earlier chapter discussed two sources of capital investment: venture capitalist and angel investors. Venture capitalists are looking for substantial returns on their initial investment—five, ten, sometimes even twenty-five times their original investment. They will be looking for firms that can rapidly generate significant profits or significant growth in sales. Angel investors may be more attracted to their interest in the small business concept than in reaping significant returns. This is not to say that they are not interested in recouping their original investment with some type of significant return. It is much more likely that angel investors, as compared to venture capitalists, will play a much more active role in the decision-making process of the small business.

One area for possible capital infusion into a small business may come from a surprising source. Many students (and some adults) may find funding to start up a business through business plan competitions. These competitions are often hosted by colleges and

universities or small business associations. The capital investment may not be large, but it might be enough to start very small businesses.

Debt financing represents a legal obligation to repay the original debt plus interest. Most debt financing involves a fixed payment schedule to repay both principal and interest. A failure to meet the schedule has serious consequences, which might include the bankruptcy of the business. Those who provide debt financing expect that the principal will be repaid with interest, but they are not formal investors in the business.

There are numerous sources for debt financing. Some small businesses begin with financing by borrowing from friends and family. Some firms may choose to finance business operations by using either personal or corporate credit cards. This approach to financing can be extraordinarily expensive given the interest rates charged on credit cards and the possibility that the credit card companies may change (by a significant amount) the credit limit associated with the credit card.

The largest source of debt financing for small businesses in the United States comes from commercial banks. Bank lending can take many forms. The most common loan specifies the amount of money to be repaid within a specific time frame for a specific interest rate. These loans can be either secured or unsecured. Secured loans involve pledging some assets—such as a home, real estate, machinery, and plant—as collateral. Unsecured loans provide no such collateral. Because they are riskier for the bank, they generally have higher interest rates.

The Small Business Administration (SBA) has a large number of programs designed to help small businesses. These include the business loan programs, investment programs, and bonding programs. The SBA operates three different loan programs. It should be understood that the SBA does not make the loan itself to a small business but rather guarantees a portion of the loan to its partners that include private lenders, microlending institutions, and community development organizations. To secure one of these loans, the borrower must meet criteria set forth by the SBA. It should be recognized that these SBA loan rules and guidelines can be altered by the US Congress and are dependent on prevailing economic and political conditions. The following subsections briefly describe some of the loan programs used by the SBA.

(a) Loan Programs

This class of loans may be used for a variety of reasons, including the purchase of land, buildings, equipment, machinery, supplies, or materials. It may also be used for long-term working capital (paying accounts payable or the purchase of inventory). It may even be used to purchase an existing business. This class of loans cannot, however, be used to refinance existing debt, to pay delinquent taxes, or to change business ownership.

- **Special-purpose loans program.** These loans are designed to assist small businesses for specific purposes. They have been used to help small businesses purchase and incorporate pollution control systems, develop employee stock ownership plans, and aid companies negatively impacted by the North American Free Trade Agreement (NAFTA). It includes programs such as the CAPLines, which provide assistance to businesses for meeting their short-term working capital needs. There is also the Community Adjustment and Investment Program. This program is designed to assist businesses that might have been adversely impacted by NAFTA.
- **Express and pilot programs.** These loan programs are designed to accelerate the process of providing loans. SBA Express can respond to a loan application within thirty-six hours while also providing lower interest rates.
- **Community express programs.** These programs are designed to assist borrowers whose businesses are located in economically depressed regions of the country.
- **Patriot express loans.** These loans are designed to assist members of the US military who wish to create or expand a small business. These loans have lower interest rates and can be used for starting a business, real estate purchases, working capital, expansions, and helping the business if the owner should be deployed.
- **Export loan programs.** Given the remarkable fact that 70 percent of American exporters have less than twenty employees, it is not surprising that the SBA makes a special effort to support these businesses by providing specialized loan programs. These programs include the following:
  - **Export Express Program.** This program has a rapid turnaround time to support export-based activities. It can provide for funds up to $500,000 worth of financing. Financing can be either a term loan or a line of credit.
  - **Export Working Capital Program.** A major challenge that small exporters face is the fact that many American banks will not provide working capital advances on orders, receivables, or even letters of credit. This SBA program assures up to the 90

percent of a loan so as to enhance a business's export working capital.

- **SBA and Ex-Im Bank Coguarantee Program.** This is an extension of the Export Working Capital Program and deals with expanding a business's export working capital lines up to $2 million.
- **International Trade Loan Program.** This program, with a maximum guarantee of $1.75 million, enables small businesses to start an exporting program, enlarge an exporting program, or deal with the consequences of competition from overseas imports.

Another source of debt financing is the issuance of bonds. Bonds are promissory notes. There are many forms of bonds, and here we discuss only the most basic type. The fundamental format of the bond is that it is a debt instrument that promises to repay a fixed amount of money within a given time frame while providing interest payments on a regular basis. The issuance of bonds is generally an option available to businesses with a corporation format. It also requires extensive legal and financial preparations.

Another source of capital is the generation of internal funding. This simply means that a business plows its retained earnings back into the business. This is a viable source of capital when a business is highly profitable.

The last source of capital is trade credit. Trade credit involves purchasing supplies or equipment through financing made available by vendors. This approach may allow someone to acquire inventory of materials and supplies without having the full price at the time of purchase. Some analysts say that trade credit is the second-largest source of financing for small businesses after borrowing from banks. Trade credit is often a vital way of securing supplies.

Trade credit is often expressed in terms of three important numbers—a discount rate, the number of days for one to pay to qualify for the discount, and the number of days on which the bill must be paid. As an example, a trade credit offered by a supplier might be listed as 5/5/30. This translates into a 5 percent discount if the bill is paid within five days of the issuance. The third number means that the bill must be paid *in full* within thirty days.

Video Clip: How to Raise Capital

Describes what an entrepreneur needs to do in order to acquire capital for the firm.

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Video Clip: Getting Business Financing for a Small Business

Voice-over PowerPoint identifies where a small business owner can acquire funding.

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Video Clip: How to Get Start-Up Business Financing

Examines the use of bank financing for the small business.

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Video Clip: How to Find Government Small Business Grants

Locate places to find small business grants through search engines with ideas from a certified public accountant in this free video on new business financing.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: The Role of Credit Cards in Small Business Financing

Congressional testimony that warns of the use of using credit cards to finance small businesses.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Financial Analysis for Small-Business Owners

This excerpt from the popular video learning series at BusinessBuffet.com introduces the core concepts behind financial analysis for small business.

A YouTube element has been excluded from this version of the text. You can view it online here.

WEB RESOURCES

Credit Loans for Small Businesses

The Chase portal—one provider of loans for small businesses.

Five Ways to Finance a Business in Difficult Financial Times

Alternative ways of financing when banks are not lending.

Capital Structure: Debt versus Equity

A critical component of financial planning for any business is determining the extent to which a firm will be financed by debt and by equity. This decision determines the **financial leverage** of a business. Many factors enter into this decision, particularly for the small business. From the classic economic and finance perspective, one should evaluate the cost of both debt and equity. Debt's cost centers largely on the interest rate associated with a specific debt. Equity's cost includes ceding control to other equity partners, the cost of issuing stock, and dividend payments. One should also consider the fact that the interest payment on debt is deductible and therefore will lower a business's tax bill. Neither the cost of issuing stock nor dividend payments is tax-deductible.

Larger businesses have many more options available to them than smaller enterprises. Although this is not always true, larger businesses can often arrange for larger loans at more favorable rates than smaller businesses. Larger businesses often find it easier to raise capital through the issuance of stock (equity).

By increasing a business's proportion of debt, its financial leverage can be increased. There are many reasons for attempting to increase a business's financial leverage. First, one is growing the business with someone else's money. Second, there is the deductible nature of interest on debt. Third, increasing one's financial leverage can have a positive impact on the business's return on equity. For all these benefits, however, there is the inescapable fact that increasing a business's debt level also increases a business's overall risk. The term *financial leverage* can be seen as being comparable to the base word—lever. Levers are tools that can amplify an individual's power. A certain level of debt can amplify the "lifting" power of a business (see the upper portion of Figure 15.1.2.2). However, beyond a certain point, the debt may be out of reach, and therefore the entire lifting power of financial leverage may be lost (see the lower portion of Figure 15.1.2.2). Beyond the loss of lifting power, the assumption of too much debt may lead to an inability to pay the interest on the debt. This situation becomes the classic case of filing for bankruptcy.

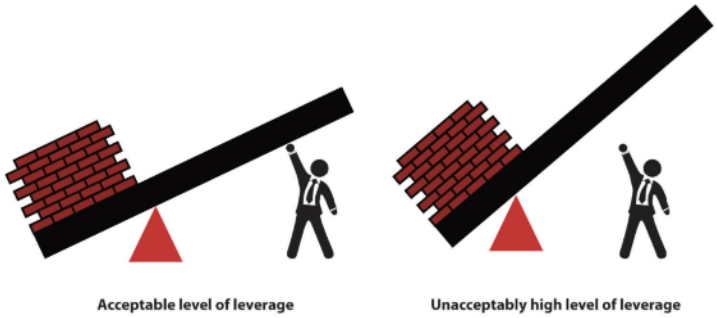


Figure 15.1.2.2: Acceptable and Unacceptable Levels of Leverage

This major issue for small businesses—determining how to raise funds through either debt or equity—often transcends economic or financial decisions. For many small business owners, the ideal way of financing business growth is through generating internal funds. This means that a business does not have to acquire debt but has generated sufficient profits from its operations. Unfortunately, many small businesses, particularly at the beginning, cannot generate sufficient internal funds to finance areas such as product development, the acquisition of new machinery, or market expansions. These businesses have to rely on securing additional capital debt, equity, or some combination of both.

Many individuals start small businesses with the express purpose of finding independence and control over their own economic and business lives. This desire for independence may make many small business owners averse to the idea of equity financing because that might mean ceding business control to equity partners. Another issue that makes some small business owners averse to acquiring additional equity partners is the simple fact that the acquisition of these partners means less profit to the business owner.

This factor in the control issue must be considered when the small business owner is looking to raise additional capital through venture capitalist and angel investors.

A recent research paper examined the relationship between profitability and sources of financing for firms that had fewer than twenty-five employees. It found several rather interesting results:

- Firms that use only equity have a low probability of being profitable compared to firms that use only business or personal debt.
- Firms owned by females and minority members relied less on personal debt than male and minority owners.
- Female owners will be more likely to rely on equity from friends and family than their male counterparts.
- Firms that rely exclusively on personal savings to finance business operations will more likely be profitable than firms using equity forms of debt.

WEB RESOURCES

Capital Structure

Definition and explanation of capital structure.

Capital Structure from an Investor's Perspective

This reviews how an investor would interpret a business's capital structure.

KEY TAKEAWAYS

- Business owner must be aware of the implications of financing their firms.
- Owners should be aware of the financial and tax implications of the various forms of business organizations.
- Business owners should be aware of the impact of financing their firms through equity, debt, internally generated funds, and trade credit.
- Small-business owners should be aware of the various loans, grants, and bond opportunities offered by the SBA. They should also be aware of the restrictions associated with these programs.

EXERCISES

1. Interview the owners of five local businesses and ask them what business organizational format they use and why they adopted that form.
2. Ask them how they initially financed the start-up of their businesses.
3. Ask these same owners how they prefer to finance the firm. (Note that most owners will probably not want to go into any detail about the financial operations of their businesses.)
4. Ask them if they have had any experience with any SBA loan program and if they have any reactions to these programs.

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15.1.3: Financial Control

Learning Objectives

- Learn about the importance of cultivating a relationship with a banker.
- Understand the elements of the CAMPARI approach to evaluating a loan.

Relationships with Bank and Bankers

One often hears the following standard complaint of small businesses: bankers lend money only to those businesses that do not need the money. The inverse of this complaint from the bank's standpoint might be that small businesses request money only when they are least likely to be able to repay it. The conflict between small businesses and bankers may stem from a misunderstanding of the respective roles of both groups. At face value, it might appear—particularly to small businesses—that bankers are investing in their companies.

Under normal conditions, bankers are extremely risk-averse. This means they are not investors anticipating a substantial return predicated on the risks associated with a particular business. Bankers lend money with the clear expectation that they will be repaid both principal and interest. It is in the interest of both parties to transcend these two conflicting perceptions of the role of bankers in the life of a small business. The key way is for the small business owner to try to foster improved communications with a banker. This communication promoted by the small business owner should become the basis of a solid working relationship with the bank. Most often, this means developing a personal relationship with the loan officer of the bank, which is sometimes a problematic proposition. Bank loan officers are often moved to different branches, or they may change jobs and work for different banks. It should be the responsibility of the small business owner to maintain frequent contact with whoever is representing the bank. This should involve more than just providing quarterly statements. It should include face-to-face discussions and even asking the officer to tour a business's facilities. The point is to personalize the working relationship between the two parties. "Ideally, it's a human relationship as well as a business relationship," says Bill Byne, an entrepreneur and author of *Habits of Wealth*.

Although bankers and loan officers will rely heavily on data related to the creditworthiness of a small business, they will also consider the trustworthiness and integrity of the business owner. This intangible sense that a business owner is a worthy credit risk may play a determinant role in whether a loan is approved with the extension of a credit line. This notion of integrity has to be built over time. It is predicated on projecting an image that you can be counted on to honor what you say, know the right thing to do to make the business a success, and be able to execute the correct decisions.

It is sometimes said that bankers, when reviewing a perspective loan applicant, think of the drink "**CAMPARI**," which stands for the following:

- **Character.** As previously stated, bankers will consider the issue of personal integrity. Part of that definition of integrity will include a sense of professionalism, which can be reflected in one's attitude and dress. Bankers will also review one's history as a business leader, namely one's track record of success. This notion of character may also be extended to the upper echelon of the management team of a small business.
- **Ability.** The bank's prime concern is with repayment of the principal and the interest of a loan. The loan application should clearly demonstrate a business's ability to repay the loan. All support materials should be brought to bear to prove to the banker that the loan will not be defaulted on and will be paid in a timely fashion.
- **Means.** This refers to a business's ability to function in a way so that it can repay the loan. Bankers must be convinced of this crucial point. The best way to do this is by providing a comprehensive business plan with detailed numbers that indicate the business's ability to repay the loan. The business plan should also include the business strategy and the business model that will be employed to convince the banker of the validity of the overall plan.
- **Purpose.** Bankers want to know for what purpose the borrowed money will be used. You should never request a loan with the argument that having more money is better for the business than having less money. You should clearly identify how the money will be used, such as purchasing a piece of capital equipment. Having done that, you should also indicate how the acquisition of the capital equipment will positively affect the bottom line of the business.
- **Amount.** It would be extraordinarily inadvisable to begin a request for a business loan by saying "I need some money." It is very important that you specify the exact amount of the loan and also justify how you determined this amount of money. As an

example, you might want to identify a particular piece of capital equipment that you plan to acquire. How did you determine its price? You should be able to address what additional expenditures might be required—such as training on the use of the equipment. The greater the degree of precision that is brought to this proposal, the greater the confidence the bank might have in granting the loan.

- **Repayment.** This refers to demonstrating an ability to repay both the interest and the principal. Again, detailed documentation, such as sales projections, profit margins, and projected cash flows, is essential if you wish to secure the loan. It is important when generating these data that you try to be as honest as possible. Extremely positive projections may be misleading. Worse still, if they are misleading and inaccurate, it may result in the business defaulting on the loan and perhaps losing the business.
- **Insurance.** Even the most scrupulously developed sales and profit projections might not pan out. It would be extraordinarily useful to show contingency plans to the bank that would indicate how you would repay the loan in the event that the scenarios that you have identified do not come to fruition.

One should recognize that a good relationship with the bank can yield benefits above and beyond credit lines and business loans. Bankers can serve as interlocutors, connecting you to potential customers, suppliers, and other investors. A good working relationship with a bank can be the best reference a business could have. This is particularly true in the current business climate where bankers have significantly restricted lending to small businesses.

KEY TAKEAWAYS

- Any business owner must be aware that bankers consider several factors when considering a loan decision.
- Business owners should be aware of their own and their business's creditworthiness.
- Business owners should be aware that bankers appreciate precision, particularly when it comes to the exact size of the loan, its purpose, and how it will be repaid.

EXERCISES

1. Arrange an interview with a loan officer at a local bank. Ask him or her what factors are considered when evaluating a small business loan for
   - A start-up business
   - A line-of-credit
   - An equipment purchase
   - A real estate purchase
2. Ask him or her how the bank evaluates the risk associated with these loans.
3. Ask the loan officer what might constitute a "red flag" that would mean that the loan would not be approved.

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15.1.4: Financial Decision Making

Learning Objectives

- Learn the importance of a breakeven analysis.
- Understand how to conduct a breakeven analysis.
- Understand the potential power and danger of financial leverage.
- Learn how changing financial leverage can affect measures of profitability, such as ROA and ROE.
- Learn how to use scenarios to evaluate the impact of various levels of financial leverage.

Breakeven Analysis

A **breakeven analysis** is remarkably useful to someone considering starting up a business. It examines a business's potential costs—both fixed and variable—and then determines the sales volume necessary to produce a profit for given selling price. This information enables one to determine if the entire concept is feasible. After all, if one has to sell five million shoes in a small town to turn a profit, one would immediately recognize that there may be a severe problem with the proposed business model.

A breakeven analysis begins with several simplifying assumptions. In its most basic form, it assumes that you are selling only one product at a particular price, and the production cost per unit is constant over a wide range of values. The purpose of a breakeven analysis is to determine the sales volume that is required so that you neither lose money nor make a profit. This translates into a situation in which the profit level is zero. Put in equation form, this simply means:

$$\text{total revenue} - \text{total costs} = \$0$$

By moving terms, we can see that the break-even point occurs when total revenues equal total costs:

$$\text{total revenue} = \text{total costs}$$

We can define total revenue as the selling price of the product times the number of units sold, which can be represented as follows:

$$\text{total revenue (TR)} = \text{selling price (SP)} \times \text{sales volume (Q)} TR = SP \times Q$$

Total costs are seen as being composed of two parts: fixed costs and total variable costs. Fixed costs exist whether or not a firm produces any product or has any sales and consist of rent, insurance, property taxes, administrative salaries, and depreciation. Total variable costs are those costs that change across the volume of production. As part of the simplifying assumptions of the breakeven analysis, it is assumed that there is a constant unit cost of production. This would be based on the labor input and the amount of materials required to make one unit of product. As production increases, the total variable cost will likewise increase, which can be represented as follows:

$$\text{total variable costs (TVC)} = \text{variable cost per unit (VC)} \times \text{sales quantity (Q)} TVC = VC \times Q$$

Total costs are simply the summation of fixed costs plus the total variable costs:

$$\text{total costs (TC)} = [\text{fixed costs (FC)} + \text{total variable cost (TVC)}] TC = FC + TVC$$

The original equation for the break-even point can now be rewritten as follows:

$$[\text{selling price (SP)} \times \text{sales volume (Q)}] - \text{total costs (TC)} = \$0 (SP \times Q) - TC = \$0$$

At the break-even point, revenues equal total costs, so this equation can be rewritten as:

$$SP \times Q = TC$$

Given that the total costs equal the fixed costs plus the total variable costs, this equation can now be extended as follows:

$$\text{selling price (SP)} \times \text{sales volume (Q)} = [\text{fixed costs (FC)} + \text{total variable costs (TVC)}] SP \times Q = FC + TVC$$

This equation can be expanded by incorporating the definition of total variable costs as a function of sales volume:

$$SP \times Q = FC + (VC \times Q)$$

This equation can now be rewritten to solve for the sales value:

$$(SP \times Q) - (VC \times Q) = FC$$

Because the term *sales volume* is present in both terms on the left-hand side of the equation, it can be factored to produce:

$$Q \times (SP - VC) = FC$$

The sales value to produce the break-even point can now be solved for in the following equation:

$$Q = FC / (SP - VC)$$

The utility of the concept of break-even point can be illustrated with the following example.

Carl Jacobs, a retired engineer, was a lifelong enthusiast of making plastic aircraft models. Over thirty years, he entered many regional and national competitions and received many awards for the quality of his model building. Part of this success was due to his ability to cast precision resin parts to enhance the look of his aircraft models. During the last ten years, he acquired a reputation as being an expert in this field of creating these resin parts. A friend of his, who started several businesses, suggested that Carl look at turning this hobby into a small business opportunity in his retirement. This opportunity stemmed from the fact that Carl had created a mold into which he could cast the resin part for a particular aircraft model; this same mold could be used to produce several hundred or several thousand copies of the part, all at relatively low cost.

Carl had experience only with sculpturing and casting parts in extremely low volumes—one to five parts at a time. If he were to create a business format for this hobby, he would have to have a significant investment in equipment. There would be a need to create multiple metal molds of the same part so that they could be cast in volume. In addition, there would be a need for equipment for mixing and melting the chemicals that are required to produce the resin. After researching, he could buy top-of-the-line equipment for a total of $33,000. He also found secondhand but somewhat less efficient equipment. Carl estimated that the total cost of acquiring all the necessary secondhand equipment would be close to $15,000. After reviewing the equipment specifications, he concluded that with new equipment, the unit cost of producing a set of resin parts for a model would run $9.25, whereas the unit cost for using the secondhand equipment would be $11.00. After doing some market research, Carl determined that the maximum price he could set for his resin sets would be $23.00. This would be true whether the resin sets were produced with new or secondhand equipment.

Carl wanted to determine how many resin sets would have to be sold to break even with each set of equipment. For simplicity's sake, he assumed that the initial purchase price of both options would be his fixed cost. His analysis is presented in Table 15.1.4.1.

Table 15.1.4.1: Breakeven Point Analysis

Option	Fixed Costs	Variable Cost	Selling Price	break-even point
New equipment	$33,000	$9.25/unit	$23.00	Q = $33,000 / ($23.00 − $9.25) Q = $33,000 / $13.75 Q = 2,400 units
Secondhand equipment	$15.000	$11.00/unit	$23.00	Q = $15,000 / ($23.00 − $11.00) Q = $15,000 / $12.00 Q = 1,250 units

From this analysis, he could see that although the secondhand equipment is not as efficient (hence the higher variable cost per unit), it will break even at a significantly lower level of sales than the new equipment. Carl was still curious about the profitability of the two sets of equipment at different levels of sales. So he ran the numbers to calculate the profitability for both sets of equipment at sales levels of 1,000 units, 3,000 units, 5,000 units, 7,500 units, and 10,000 units. The results are presented in Table 15.1.4.2.

Table 15.1.4.2: Sales Level versus Profit Breakdown

	Secondhand Equipment				New Equipment			
Sales Level	**Revenue**	**Fixed Cost**	**Total Variable Costs**	**Profit**	**Revenue**	**Fixed Cost**	**Total Variable Costs**	**Profit**
1,000	$23,000	$15,000	$11,000	$(3,000)	$23,000	$33,000	$9,250	$(19,250)
3,000	$69,000	$15,000	$33,000	$21,000	$69,000	$33,000	$27,750	$8,250
5,000	$115,000	$15,000	$55,000	$45,000	$115,000	$33,000	$46,250	$35,750
7,500	$172,500	$15,000	$82,500	$75,000	$172,500	$33,000	$69,375	$70,125
10,000	$230,000	$15,000	$110,000	$105,000	$230,000	$33,000	$92,500	$104,500

From these results, it is clear that the secondhand equipment is preferable to the new equipment. At 10,000 units, the highest annual sales that Carl anticipated, the overall profits would be greater with secondhand equipment.

Video Clip: Economics for Managers

A slide show showing breakeven calculations.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Breakeven Analysis

A breakeven tutorial with voice-over.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Perform a Breakeven Analysis with Excel's Goal Seek Tool

Shows how Excel can be used to conduct sophisticated breakeven analyses.

A YouTube element has been excluded from this version of the text. You can view it online here.

Breakeven Analysis

This site provides a straightforward description of breakeven analysis with an example.

Capital Structure Issues in Practice

In an earlier chapter, the need to balance debt and equity, with respect to financing a firm's operations, was briefly discussed. A critical financial decision for any business owner is determining the extent of financial leverage a firm should acquire. Building a firm using debt amplifies a return of equity to the owners; however, the acquisition of too much debt, which cannot be repaid, may lead to bankruptcy, which represents a complete failure of the firm.

In the early 1950s, the field of finance tried to describe the effect of financial leverage on the valuation of a firm and its cost of capital. A major breakthrough occurred with the works of Franco Modigliani and Merton Miller. Reduced to simplest form, their works hypothesized that the valuation of a firm increases as the financial leverage increases. This is true but only *up to a point*. When a firm exceeds a particular value of financial leverage—namely, it has assumed too much debt—the overall value of the firm begins to decline. The point at which the valuation of a firm is maximized determines the optimal capital structure of the business. The model defined valuation as a firm's earnings before interest and taxes (EBIT) divided by its cost of capital. **Cost of capital** is a weighted average of a firm's debt and equity, where equity directly relates to a firm's stock. The reality is that this model is far more closely attuned, from a mathematical standpoint, to the corporate entity. It cannot be directly applied to most small businesses. However, the basic notion that there is some desired level of debt to equity, a level that yields maximum economic benefit, is germane, as we will now illustrate.

Let us envision a small family-based manufacturing firm that until now has been able to grow through the generation of internal funds and the equity that has been invested by the original owners. Presently, the firm has no long-term debt. It has a revolving line

of credit, but in the last few years, it has not had to tap into this line of credit to any great extent. The income statement for the year 2010 and the projected income statement for 2011 are given in Table 15.1.4.3. In preparing the projected income statement for 2011, the firm assumed that sales would grow by 7.5 percent due to a rapidly rising market. In fact, the sales force indicated that sales could grow at a much higher rate if the firm can significantly increase its productive capacity. The projected income statement estimates the cost of goods sold to be 65 percent of the firm's revenue. This estimate is predicated on the past five years' worth of data. Table 15.1.4.4 shows an abbreviated balance sheet for 2010 and a projection for 2011. The return on assets (ROA) and the return on equity (ROE) for 2010 and the projected values for 2011 are provided in Table 15.1.4.5.

Table 15.1.4.3: Income Statement for 2010 and Projections for 2011

	2010	2011
Revenue	$475,000	$510,625
Cost of goods sold	$308,750	$331,906
Gross profit	$166,250	$178,719
General sales and administrative	$95,000	$102,125
EBIT	$71,250	$76,594
Interest	—	—
Taxes	$21,375	$22,978
Net profit	$49,875	$53,616

Table 15.1.4.4: Abbreviated Balance Sheet

	2010	2011
Total assets	$750,000	$765,000
Long-term debt	—	—
Owners' equity	$750,000	$765,000
Total debt and equity	$750,000	$765,000

Table 15.1.4.5: ROA and ROE Values for 2010 and Projections for 2011

	2010 (%)	2011 (%)
Return on assets	6.65	7.01
Return on equity	6.65	7.01

After preparing these projections, the owners were approached by a company that manufactures computer-controlled machinery. The owners were presented with a series of machines that will not significantly raise the productive capacity of their business while also reducing the unit cost of production. The owners examined in detail the productive increase in improved efficiency that this computer-controlled machinery would provide. They estimated that demand in the market would increase if they had this new equipment, and sales could increase by 25 percent in 2011, rather than 7.5 percent as they had originally estimated. Further, the efficiencies brought about by the computer-controlled equipment would significantly reduce their operating costs. A rough estimate indicated that with this new equipment the cost of goods sold would decrease from 65 percent of revenue to 55 percent of revenue. These were remarkably attractive figures. The only reservation that the owners had was the cost of this new equipment. The sales price was $200,000, but the business did not have this amount of cash available. To raise this amount of money, they would either have to bring in a new equity partner who would supply the entire amount, borrow the $200,000 as a long-term loan, or have some combination of equity partnership and debt. They first approached a distant relative who has successfully invested in several businesses. This individual was willing to invest $50,000, $100,000, $150,000, or the entire $200,000 for taking an equity position

in the firm. The owners also went to the bank where they had line of credit and asked about their lending options. The bank was impressed with the improved productivity and efficiency of the proposed new machinery. The bank was also willing to lend the business $50,000, $100,000, $150,000, or the entire $200,000 to purchase the computer-controlled equipment. The bank, however, stipulated that the lending rate would depend on the amount that was borrowed. If the firm borrowed $50,000, the interest rate would be 7.5 percent; if the amount borrowed was $100,000, the interest rate would increase to 10 percent; if $150,000 was the amount of the loan, the interest rate would be 12.5 percent; and if the firm borrowed the entire $200,000, the bank would charge an interest rate of 15 percent.

To correctly analyze this investment opportunity, the owners could employ several financial tools and methods, such as **net present value (NPV)**. This approach examines a lifetime stream of additional earnings and cost savings for an investment. The cash flow that might exist is then discounted by the cost of borrowing that money. If the NPV is positive, then the firm should undertake the investment; if it is negative, the firm should not undertake the investment. This approach is too complex—for the needs of this text—to be examined in any detail. For the purpose of illustration, it will be assumed that the owners began by looking at the impact of alternative investment schemes on the projected results for 2011. Obviously, any in-depth analysis of this investment would have to entail multi-year projections.

They examined five scenarios:

1. Their relative provides the entire $200,000 for an equity position in the business.
2. They borrow $50,000 from the bank at an interest rate of 7.5 percent, and their relative provides the remaining $150,000 for a smaller equity position in the business.
3. They borrow $100,000 from the bank at an interest rate of 10 percent, and their relative provides the remaining $100,000 for a smaller equity position in the business.
4. They borrow $150,000 from the bank at an interest rate of 12.5 percent, and their relative provides the remaining $50,000 for an even smaller equity position in the business.
5. They borrow the entire $200,000 from the bank at an interest rate of 15 percent.

Table 15.1.4.6 presents the income statement for these five scenarios. (An abbreviated balance sheet for the five scenarios is given in Table 15.1.4.7.) All five scenarios begin with the assumption that the new equipment would improve productive capacity and allow sales to increase, in 2011, by 25 percent, rather than the 7.5 percent that had been previously forecasted. Likewise, all five scenarios have the same cost of goods sold, which in this case is 55 percent of the revenues rather than the anticipated 65 percent if the new equipment is not purchased. All five scenarios have the same EBIT. The scenarios differ, however, in the interest payments. The first scenario assumes that all $200,000 would be provided by a relative who is taking an equity position in the firm. This is not a loan, so there are no interest payments. In the remaining four scenarios, the interest payments are a function of the amount borrowed and the corresponding interest rate. The payment of interest obviously impacts the earnings before taxes (EBT) and the amount of taxes that have to be paid. Although the tax bill for those scenarios where money has been borrowed is less than the scenario where the $200,000 is provided by equity, the net profit also declines as the amount borrowed increases.

Table 15.1.4.6: Income Statement for the Five Scenarios

	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
Revenue	$593,750	$593,750	$593,750	$593,750	$593,750
Cost of goods sold	$326,563	$326,563	$326,563	$326,563	$326,563
Gross profit	$267,188	$267,188	$267,188	$267,188	$267,188
General sales and administrative	$118,750	$118,750	$118,750	$118,750	$118,750
EBIT	$148,438	$148,438	$148,438	$148,438	$148,438
Interest	—	$3,750	$10,000	$18,750	$30,000
Taxes	$44,531	$43,406	$41,531	$38,906	$35,531
Net profit	$103,906	$101,281	$96,906	$90,781	$82,906

Table 15.1.4.7: Abbreviated Balance Sheet for the Five Scenarios

	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
Total assets	$965,000	$965,000	$965,000	$965,000	$965,000
Long-term debt	—	$50,000	$100,000	$150,000	$200,000
Owners' equity	$965,000	$915,000	$865,000	$815,000	$765,000
Total debt and equity	$965,000	$965,000	$965,000	$965,000	$965,000

The owners then calculated the ROA and the ROE for the five scenarios (see Table 15.1.4.8). When they examined these results, they noticed that the greatest ROA occurred when the new machinery was financed exclusively by equity capital. The ROA declined as they began to fund new machinery with debt: the greater the debt, the lower the ROA. However, they saw a different situation when they looked at the ROE for each scenario. The ROE was greater in each scenario where the machinery was financed either exclusively or to some extent by debt. In fact, the lowest ROE (the firm borrowed the entire $200,000) was 50 percent higher than if the firm did not acquire the new equipment. A further examination of the ROE results provides a very interesting insight. The ROE increases as the firm borrows up to $100,000 of debt. When the firm borrows more money ($150,000 or $200,000), the ROE declines. This is a highly simplified example of optimal capital structure. There is a level of debt beyond which the benefits measured by ROE begins to decline. Small businesses must be able to identify their "ideal" debt-to-equity ratio.

Table 15.1.4.8: ROA and ROE for the Five Scenarios

	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
ROA	10.77%	10.50%	10.04%	9.41%	8.59%
ROE	10.77%	11.07%	11.20%	11.14%	10.84%

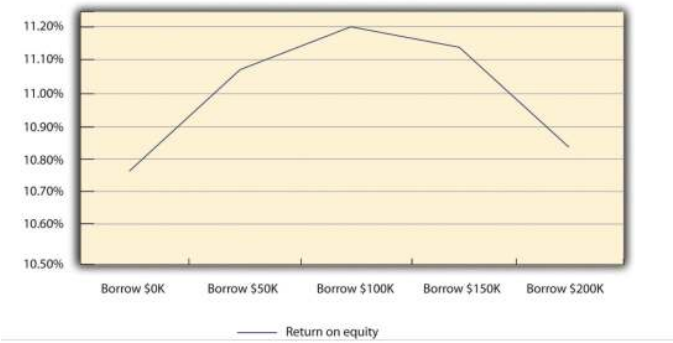


Figure 15.1.4.1: ROE for the Five Scenarios

The owners decided to carry their analysis one step further; they wondered if the sales projections were too enthusiastic. They were concerned about the firm's ability to repay any loan should there be a drop in sales. Therefore, they decided to examine a worst-case scenario. Such analyses are absolutely critical if one is to fully evaluate the risk of undertaking debt. They ran the numbers to see what the results would be if there was a 25 percent decrease in sales in 2011 rather than a 25 percent increase in sales compared to 2010. The results of this set of analyses are in Table 15.1.4.9. Even with a heavy debt burden for the five scenarios, the firm is able to generate a profit, although it is a substantially lower profit compared to if sales increased by 25 percent. They examined the impact of this proposed declining sales on ROA and ROE. These results are found in Table 15.1.4.10.

Table 15.1.4.9: Income Statement for the Five Scenarios Assuming a 25 Percent Decrease in Sales

	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
Revenue	$356,250	$356,250	$356,250	$356,250	$356,250
Cost of goods sold	$195,938	$195,938	$195,938	$195,938	$195,938
Gross profit	$160,313	$160,313	$160,313	$160,313	$160,313
General sales and administrative	$71,250	$71,250	$71,250	$71,250	$71,250
EBIT	$89,063	$89,063	$89,063	$89,063	$89,063
Interest	—	$3,750	$10,000	$18,750	$30,000
Taxes	$26,719	$25,594	$23,719	$21,094	$17,719
Net profit	$62,344	$59,719	$55,344	$49,219	$41,344

Table 15.1.4.10: ROA and ROE for the Five Scenarios under the Condition of Declining Sales

	Borrow $0	Borrow $50,000	Borrow $100,000	Borrow $150,000	Borrow $200,000
ROA	6.46%	6.19%	5.74%	5.10%	4.28%
ROE	6.46%	6.53%	6.40%	6.04%	5.40%

Video Clip: Debt Financing Versus Equity Financing - Which is Best for Us?

Overview of the benefits and dangers associated with debt financing and equity financing.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Capital Structure

Compares capital structure to a commercial aircraft.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: Lecture in Capital Structure

Explains why capital structure matters.

A YouTube element has been excluded from this version of the text. You can view it online here.

Video Clip: The Capital Structure of a Company

Discusses the issue of long-term and short-term debt in capital structure.

A YouTube element has been excluded from this version of the text. You can view it online here.

KEY TAKEAWAYS

- A relatively simple model—breakeven analysis—can indicate what sales level is required to start making a profit.
- Financial leverage—the ratio of debt to equity—can improve the economic performance of a business as measured by ROE.
- Excessive financial leverage—too much debt—can begin to reduce the economic performance of a business.
- There is an ideal level of debt for a firm, which is its optimal capital structure.

EXERCISES

1. A new start-up business will have fixed costs of $750,000 per year. It plans on selling one product that will have a variable cost of $20 per unit. What is the product's selling price to break even?

2. Using data from the business in Exercise 1, in its second year of operation, it adds a second selling facility, which increases the fixed cost by $250,000. The variable cost has now decreased by $2.50 per unit. What is the new selling price to break even?
3. Using the example in "Capital Structure Issues in Practice", how would the ROA and the ROE change if economic conditions made borrowing money more expensive? Specifically, what would be the impact if the interest rate on $50,000 was 10 percent; $100,000, 15 percent; $150,000, 17.5 percent; and $200,000, 20 percent?
4. Again using the example in "Capital Structure Issues in Practice", how much would sales have to decrease to threaten the business's ability to repay its interest on a $100,000 loan?

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15.1.5: The Three Threads

Learning Objectives

- Understand that effective and efficient financial management can enhance value provided to customers.
- Appreciate that effective financial management can improve the firm's cash-flow position.
- Understand that the use of technologies can significantly reduce cost of operations and improve profitability.

Customer Value

In earlier chapters, there has been extensive discussion of the notion of market segmentation. By segmenting the market, one improves the probability that a business will be able to better serve particular customers' needs and thus provide better customer value. From a financial perspective, there may be an equivalent notion of segmentation. Earlier discussions on market segmentation were centered on how a business could provide value to particular sets of customers. A subsequent stage of this analysis would be to examine how and if these customers can provide value to a business. No one is served if the business provides significant value to its customers but the business goes broke in the process. The financial equivalent of customer segmentation examines the profitability of different groups of customers. Some customer groups may be extremely profitable to a firm, while others produce nothing but losses. Identifying these different groups requires a commitment to accounting and a financial analysis of each customer base. The first step is to determine the margin provided by each customer group. In many cases, this is a bit of a challenge. It may require more extensive record keeping. The business may have to use **activity-based costing systems**. (Activity-based costing systems were developed in the late 1970s and the early 1980s.) This approach to accounting "is a process where costs are assigned due to the cause and effect relationship between costs and the activity that drives the cost."

Done properly, activity-based accounting can help a business identify the true costs for serving particular customer groups and therefore identify their real profit margins. A business may discover that some customer groups are actually a source of losses for the firm.

It should be pointed out that activity-based accounting is complex, difficult to implement, and, in some instances, does not conform to the requirements of generally accepted accounting principles. This might mean that a business would have to have two coexisting accounting systems, which may be too much of a burden for the small business.

Cash-Flow Implications

It should not be too surprising to find that good financial management can benefit tremendously when a firm's cash flow is improved. Two areas where good financial management can help would be e-procurement and factoring. **E-procurement** involves managing the timing of invoices to customers and from suppliers to improve the cash flow of the firm. The electronic handling of orders and their associated invoices assures that customers will receive their orders in a more timely fashion. E-procurement means that fewer personnel are required to take and handle orders. This can be a tremendous source of cash saving in and of itself. E-procurement should be on any supply chain management program of a business.

Another area where good financial management can improve cash flow is factoring. The most common form of factoring is associated with a business's accounts receivable. Trade credits involve purchasing and taking delivery of supplies now while planning to pay for it later. Three key numbers often identify trade credits: a discount rate for early payment, the time to pay to take advantage of the discount rate, and the date by which the entire bill must be paid. We underscore the kinds of the factoring with the following example.

A firm makes a large sale of supplies—$200,000. The trade credit program is 2/10/60. This means that the firm will give a 2 percent discount if the customer pays the entire $200,000 within 10 days and expects the payment of the entire $200,000 within the next 60 days. The firm knows that its customer never exercises the discount opportunity and always pays on the last possible date. Further, let us assume that this firm is having a problem with its cash flow. It would like to expedite payment as quickly as possible but does not expect that the customer will obtain a 2 percent discount by paying within 10 days. This firm could exercise the factoring option. This business goes to another firm that would provide as much as 80 percent of the cash receivable invoice immediately for small fee. In other words, the firm would receive $160,000 immediately rather than waiting 60 days. When its

customer pays the bill, the firm would receive, in total, slightly less than the $200,000 but would have expedited the payment and thus aided its cash flow. Factoring can be an important element in improving the overall cash flow of any firm.

Digital Technology and E-Environment Implications

We identify four sources of capital, one of which is internally generated funds. Businesses can increase the supply of capital money by becoming more operationally efficient. Improved operational efficiency can save any organization considerable amounts of money. Many start-ups, particularly those with some technological savvy, use technology to produce significant cost savings. This recognition of the vital role of technology as a cost-saving tool came to the forefront at a recent GeeknRolla conference in London. This conference brings together new business start-ups and potential investors. There is a heavy emphasis on how new businesses (and established businesses) can successfully integrate a variety of technologies and improve their operational efficiencies. As one participant in the conference, Michael Jackson, an investor, said, “Companies that are cottoning on quickly to these tools are doing very well, and they are taking business away from those who are too slow to adapt.”

The 2011 conference paid special attention to the concept of **cloud computing**. This term refers to having software programs and databases located on an outsourced site. As an example, rather than buying Microsoft’s Office Suite for every computer in a business, one could access a word-processing program, a spreadsheet program, or a database as needed. The firm would be charged for each use or a monthly fee rather than having to purchase an entire package. One can even access an entire accounting system as a part of a cloud computing option. As Sharif Sakr said, “In addition to being ‘pay-as-you-go,’ cloud computing has the advantage of reducing the number of computers, servers and network connections that a small business needs.”

In addition to reducing a small business’s initial commitment to an information technology (IT) infrastructure—computers, software, network systems, and IT staff—cloud computing provides some of the following additional benefits:

- **Scalability.** Many cloud applications allow for the growth of a business. As an example, some cloud accounting packages charge on the basis of the number of users; therefore, a company could purchase as much capability as it needed.
- **Updates.** Businesses do not have to worry about purchasing the latest version of the software, uninstalling the old version, and installing the latest version. This is done automatically by the vendor.
- **Access.** Cloud programs can be accessed wherever one has a connection to the Internet. A business is not tied to its own computer or the network where the software resides. This results in tremendous flexibility; as an example, one can access the program and the data while on the road with a client.
- **Integration.** Having programs and databases on the cloud facilitates multiple members of an organization successfully working together. No one has to worry whether he or she is working with the latest version of the spreadsheet or the client list.
- **Security.** Cloud providers recognize that securing their client’s data is a core issue for business survival. They will bring into play the required technology to ensure that everyone’s data are secure and safe. They have a much greater capability of assuring this than almost any small business.
- **Customization.** Businesses can acquire the software that they need.
- **Extensions into the world of social media.** More and more businesses are using various forms of social media—Facebook, Twitter, LinkedIn, and so forth—yet many small businesses lack the technological savvy to fully exploit these new avenues of marketing. Cloud providers can assist these businesses in this vital area.

So how can smaller businesses aspire to efficiencies that much larger organizations have achieved through the use of IT while achieving it at a fraction of the cost? Entire accounting systems can be placed on the cloud. FreshBooks, which is free for solo location businesses, provides an accounting system that can be extended to allow business operators to submit invoices via the iPhone. Shoeboxed, another cloud-based company, allows small businesses to take digitalized receipts and turn them into invoices.

Owners and employees can more productively manage their time by using a variety of scheduling programs. TimeTrade is an effective personal scheduling assistant. It can show prospective clients available times and assist in arranging a scheduled appointment. Major companies, such as Microsoft and Google, provide cloud-based applications that can be employed by both large corporations and the smallest of businesses. Microsoft has an e-mail system—Exchange—that can be used by smaller businesses for fees as low as $50 per month. Google Voice can translate voice mail and e-mail messages and forward them anywhere in the world. Programs such as Mail-Chimp can send information packages to any or all of a business’s clients and then automatically post the same information on the company’s Facebook and Twitter sites.

KEY TAKEAWAYS

- Just as a business must identify what is of value to its customers, it should also determine how valuable its customers are to the business.
- It may not “pay” to attract and keep all customers.
- Techniques such as factoring accounts receivable may improve the cash flow of a firm.
- The use of cloud computing can significantly reduce costs and improve the financial position of a firm.
- Local, national, and international economic conditions can affect any firm. Businesses should plan on how to deal with major economic upheavals.

EXERCISES

1. Search the Internet to find out about the availability and price of activity-based accounting software.
2. Imagine your boss has asked you to prepare a small report on using factoring as an option in her auto parts business. Search the Internet to find out about the economics of factoring.
3. Prepare a report on accounting and finance software packages available through cloud computing. Discuss their pros, cons, and pricing structures.

Disaster Watch

Earlier, it was stated that a major cause of failure in small businesses is inadequate financial management. If one looks at that statement at face value, the only conclusion one can come to is that failure solely rests on the shoulders of the small business owner. This is far from the full story. Small businesses can face disastrous financial situations over which they have absolutely no control. This simple fact has been brought to the forefront in the last few years with the economic downturn.

For most small businesses, the major source of external financing comes from banks. Anything that affects the banks’ ability or desire to lend to small businesses can have a profound effect. One of the first responses on the part of commercial banks to the crisis of 2008 was a severe restriction of credit. At the height of the crisis in October 2008, nearly 72 percent of large banks and 78 percent of small banks stated that they were tightening their credit standards for small businesses. This slightly more restrictive approach on the part of smaller banks represented a change from some prior recessions. Berger and Udell (1994) found that during the credit crunch of 1990–92 smaller banks were more willing to lend than larger banks.

The current credit crunch has even more significance for small businesses. The originator of current economic difficulties was in the US real estate industry. The result has been a significantly depressed real estate market. Many small businesses use either personal residences or business property (real estate) as the basis for collateral to secure loans. A depressed real estate market reduces the viability of this option. Other negative consequences for small businesses in this current economic environment revolve around its impact on alternatives of raising capital via commercial bank loans. In earlier credit crunches, many small businesses turned to commercial finance companies. These types of companies would lend money to small businesses that pledged assets as collateral. Since the early 1990s, many of these firms either disappeared or have been absorbed by larger commercial banking institutions. Today, many of the largest firms in the United States are holding onto cash (some estimate it in the neighborhood of $2 trillion to $3 trillion). Their unwillingness to spend or invest is impacting smaller businesses that operate further down the supply chain. Another impact of the current economic crisis has been that many banks have changed their lending practices for credit cards. They have raised rates, raised fees, and lowered credit limits. Many small businesses are sometimes reduced to using credit cards as a basis for attaining short-term financing for purchases or meeting bills. This sudden change in the “rules of the game” for credit cards has presented many small businesses with an unexpected challenge.

None of these changes in the financial landscape were brought about by the decision-making or the knowledge of entrepreneurs and small business operators. Only an extraordinarily small number of financial experts saw the crisis coming. Nonetheless, entrepreneurs and small business owners have found that they must learn to rapidly adapt to what is simply a disastrous situation. The financial lesson to be learned from the current crisis is that any business, particularly small businesses, must prepare to have alternative sources of financing available for the continued operations.

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SECTION OVERVIEW

15.2: Icebergs and Escapes

15.2.1: Introduction

15.2.2: Icebergs

15.2.3: Disaster Assistance

15.2.4: Getting Out of the Business

15.2.5: Exit Strategies

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15.2.2: Icebergs

Learning Objectives

- Understand the kinds of disasters that can face a small business.
- Understand why disaster planning is important to a small business.
- Describe the process of disaster planning.
- Describe the sources of disaster assistance for small businesses.

A natural or a man-made disaster is but the tip of the iceberg. Planning for the complexity of what lies below the tip is important for every small business. Small- to medium-sized businesses are the most vulnerable in the event of a disaster. It has been estimated by the US Department of Labor that 40 percent of businesses never reopen following a disaster. At least 25 percent of the remaining companies will close within two years. The Association of Records Managers and Administrators estimated that over 60 percent of small businesses that experience a major disaster close by the end of two years.

Given these odds, planning for disaster recovery makes great sense—even if, in the end, walking away makes the most sense. If a small business owner decides to rebuild, the process can begin after human health and safety are restored, the electricity is back on, and transportation is up and running. Everyone will want life to return to normal following the destruction, but that may not be possible for every small business. The market may change. Conditions may change, and a business must change to succeed in disaster recovery.

Disaster Planning

In the film *Apollo 13*, astronauts and engineers went through seemingly endless simulations of what might go wrong on a flight to the moon. The astronauts complained that some of the scenarios were unrealistic and almost impossible to occur. But when a near disaster occurred on Apollo 13, the engineers and astronauts were confronted with a problem that had never been considered; however, because of their prior experience with disaster training, they were able to develop a solution.

Rather than being negative, anticipating what can go wrong can be profoundly positive through either prevention or quickly responding to a crisis. The wise small business owner should appreciate Murphy's Law ("Anything that can go wrong will go wrong") and Murphy's first corollary ("And it will go wrong at the worst possible moment"). The most pragmatic small business owner will also realize that Murphy was an optimist.

The Federal Emergency Management Agency declared 741 natural disasters in the United States for the period 2000 to 2011. Of that number, 66 percent were declared across the following six states: Texas (#1), California, Oklahoma, New York, Florida, and Louisiana (#6). However, every state and territory was represented. Planning for the aftermath of severe storms, flooding (e.g., perhaps snow melts too fast), fire, a hurricane or a tornado, a terrorist attack, or—in some areas—an earthquake is the key to getting back to business with a minimum of disruption. Not all businesses will face the same likelihood of these disasters occurring, but everyone faces the possibility of fire, severe storms, and flooding. Every situation will be unique, with the complexity of issues depending on the particular industry, size, location, and scope of a business. The widespread nature of a the typical disaster means that public services, such as police, firefighters, and medical assistance, will be unable to reach everyone right away. A business might be going it alone for a while.

According to a recent poll conducted by the National Federation of Independent Business, man-made disasters affect 10 percent of small businesses, and natural disasters have impacted more than 30 percent of all small businesses in the United States. **Man-made disasters** are disastrous events caused directly and principally by one or more identifiable deliberate or negligent human actions. They include such things as arson, radiation contamination, terrorism, structural collapse due to engineering failures, civil disorder, and industrial hazards. The better prepared a business is, the faster it will be able to recover and resume operations… if that is the decision. Having a disaster plan can mean the difference between being shut down for a few days and going out of business entirely.

A Disaster Planning Success Story

Joe Bogner of Dodge City, Kansas, learned the importance of disaster planning firsthand. He owns Western Beverage, Inc., a beverage distribution company serving twenty-nine counties in western Kansas. In 2002, Western Beverage sustained millions of

dollars in fire damage. Yet the company resumed deliveries after just three days. Bogner was named the Kansas City Small Businessperson of the Year for 2006, partially because of his company's ability to respond to adversity. As his nomination package stated, "Setting up plans of action and following through are Joe's way of life. He has proven and is continuing to prove that dreams can come true."

Four key facts about disaster planning must be kept in mind: (1) disasters will occur, (2) an owner must have a plan *before* the disaster occurs, (3) react with urgency but do not panic, and (4) ride it out. If an owner is committed to having a disaster plan for a business, the plan and process can be structured in a variety of ways. For this section, however, the recommendations on Ready.gov serve as the structure for our discussion. These recommendations reflect the Emergency Preparedness Business Continuity Standard (NFPA 1600) developed by the National Fire Protection Association and endorsed by the American National Standards Institute and the Department of Homeland Security. The recommendations are divided into three areas: plan to stay in business, talk to the people, and protect the investment. The topics discussed here are presented in Figure 15.2.2.1. They have the greatest immediacy for a small business.



Figure 15.2.2.1: Disaster Planning. *Source:* http://www.ready.gov/business.

Plan to Stay in Business

A business owner has invested a tremendous amount of time, money, resources, and emotions into building a business, so he or she will want to be able to survive a natural or man-made disaster. This requires taking a proactive approach so that the chances of the business surviving are increased. Unfortunately, nothing can be done to guarantee the survival of a business because there is no way to know what kind of disaster may occur—or when. There is also no way to know what kind of business environment the owner will face after the disaster. There are, however, several things can be done to increase those chances of survival. Resist the temptation to put emergency planning on the back burner.

Be Informed

It is important to look realistically at the types of disasters that might affect a business internally and externally and prepare a risk assessment. Consider the natural disasters that are most common in the areas where the business operates and think about the business's vulnerability to man-made disasters. Fires are the most common disasters in the United States, and they are extremely destructive to businesses, but an owner may not be aware that a community is very vulnerable to flooding from snow melt or that the proximity to a chemical plant makes a business vulnerable to the results of explosions. This is why it is important to prepare a risk assessment so that the business can plan accordingly.

Make a Continuity Plan

It is said that a business continuity plan is the least expensive insurance any business can have—especially a small business—because it costs virtually nothing to produce. The better the continuity planning is before a disaster, the greater the chances that a business will survive and recover. There are many things that can be done. The following is not an exhaustive list:

1. Carefully assess how the business functions. Document internal key personnel and backups (i.e., the personnel without whom a business absolutely cannot function). The list should be as large as necessary but as small as possible.

2. Identify suppliers, shippers, resources, and other businesses that are interacted with on a daily basis. Document these and other external contacts, such as bankers, attorneys, information technology (IT) consultants, utilities, and municipal and community offices (police, fire, etc.) that may be needed for assistance.
3. Identify people who can telecommute. Take steps to ensure that critical staff can telecommute if necessary.
4. Plan for payroll continuity.
5. Document critical equipment. Personal computers, fax machines, special printers and scanners, and software are critical to most businesses. An accurate inventory will help a business restore critical equipment.
6. Make sure that all data and critical documents are protected. Critical documents include articles of incorporation and other legal papers, utility bills, banking information, and human resources documents; all these will be required to start over again. The Small Business Administration (SBA) recommends that vital business records—information stored on paper and computer—should be copied and saved at an offsite location at least fifty miles away from the main business site. Companies such as Carbonite can store records "on the cloud."
7. Identify a contingency location where business can be conducted while the primary office is unavailable. Many hotels have well-equipped business facilities that can be used, but remember that other businesses may need to do the same thing. It is good to have a contingency plan for a contingency location.
8. Put all the information together. The continuity plan is an important document, a copy of which should be given to all key personnel. Do not distribute the plan to people who do not need to have it. The plan will contain sensitive and secure information that could be used by a disgruntled employee for inappropriate purposes.
9. Plan to change the plan. There will always be events that could not have been factored into the plan. For example, the contingency site is damaged beyond use or the business's bank is in an area that will be without power for days. Situations such as these will require immediate changes to the plan.
10. Review and revise the plan.

Talk to People

Without good communication, the internal and external structure of a business—and its daily operations—will face challenges that may ultimately lead to its downfall. Strong communication skills are, therefore, a vital part of business success. When first starting out, the owner will need good communication skills to attract and keep new customers. As the business grows and new employees are required, these skills will be needed to hire, motivate, and retain good staff. It is for this reason that the employees of a business should play a central role in creating a disaster plan.

Involve Coworkers

Providing for the well-being of all employees is one of the best ways to ensure that a business will recover from a disaster. A business must be able to communicate with them before, during, and after a disaster. There are several recommendations for doing this, including the following:

- Employees from all levels in the organization should be involved.
- Internal communications tools, such as newsletters and intranets, should be used to communicate emergency plans and procedures.
- Set up procedures to warn people, being sure to plan how to warn employees who are hearing impaired, are otherwise disabled, or do not speak English.
- Encourage employees to find an alternate way of getting to and from work in case their usual way of transportation is interrupted.
- Keep a record of employee emergency contact information with other important documents.

Write a Crisis Communication Plan

The owner must decide how the business will contact suppliers, creditors, other employees, local authorities, customers, media, and utility companies during and after the disaster. One easy way to do this is to assign key employees to make designated contacts. Provide a list of these key employees and contacts to each affected employee and keep a copy with other protected contacts. Each key employee should also keep a copy of the list at home. In addition, do the following:

- Make sure that top executives have all the relevant information needed to protect employees, customers, vendors, and nearby facilities.
- Update customers on whether and when products will be received and services rendered.
- Let public officials know what the business is prepared to do to help in the recovery effort.
- Let public officials know whether the business will need emergency assistance to conduct essential business activity.

Support Employee Health—and the Owner's Health

Disasters often result in business disorientation and environmental detachment, with the psychological trauma of key decision-makers leading to company inflexibility (perhaps inability) to deal with the change required to move forward. If the owner or other key personnel experience posttraumatic stress disorder, it can cripple a business's decision-making ability.

No matter the disaster, there will be psychological effects (e.g., fear, stress, depression, anxiety, and difficulty in making decisions) as well as—depending on the nature of the disaster—physical effects such as injuries, burns, exposure to toxins, and prolonged pain. As a result, the owner and the employees may have special recovery needs. To support those needs, do the following:

- Provide for time at home to care for family needs, if necessary.
- Have an open-door policy that facilitates seeking care when needed.
- Reestablish routines as best as possible.
- Offer special counselors to help people address their fears and anxieties.
- Take care of yourself. Leaders tend to experience increased stress after a disaster. The leader's own health and recovery are also important to both family and the business as a whole.

Protect the Investment

Last but certainly not least, take steps to protect the business and secure its physical assets. Among the things that can be done, having appropriate insurance coverage; securing facilities, buildings, and plants; and improving cybersecurity are at the top of the list.

Insurance Coverage

Having inadequate insurance coverage can leave a business vulnerable to a major financial loss if it is damaged, destroyed, or simply interrupted for a period of time. Because insurance policies vary, meet with an insurance agent who understands the needs of a particular business.

- Review coverage for things such as physical losses, flood coverage, and business interruption. Normal hazard insurance does not cover floods, so make sure the business has the right insurance. **Business interruption insurance** protects a business in the event of a natural disaster, a fire, or other extenuating circumstances that affect the ability of a company to conduct business. Small business owners should seriously consider this type of insurance because it can provide enough money to meet overhead and other expenses while out of commission. The premiums for these policies are based on a company's income.
- Understand what the insurance policy covers and what it does not cover.
- Add coverage as necessary.
- Understand the deductible and make adjustments as appropriate.
- Think about how creditors and employees will be paid.
- Plan how to pay yourself if the business is interrupted.
- Find out what records the insurance provider will require after an emergency and store them in a safe place. It would be a good idea to take pictures of your physical facilities, equipment, buildings, and plant so that insurance claims can be processed quickly. These pictures will also provide a good basis for putting the operation back into working order.

Secure Facilities, Buildings, and Plants

One cannot predict what will happen in the case of a disaster, but there are steps that can be taken in advance to help protect a business's physical assets, including the following:

- Fire extinguishers and smoke detectors should be installed in appropriate places.

- Building and site maps with critical utility and emergency routes clearly marked should be available in multiple locations—and they should be protected with other important documents.
- Think about whether automatic fire sprinklers, alarm systems, closed-circuit television, access control, security guards, or other security measures would make sense.
- Secure the entrance and the exit for people, products, supplies, and anything else that comes into and leaves the business.
- Teach employees to quickly identify suspect packages and letters, for example, packages and letters with misspelled words, no return address, the excessive use of tape, and strange coloration or odor. Have a plan for how such packages and letters are to be handled.

Improve Cybersecurity

Many, perhaps most, small businesses will have data and IT systems that may require specialized expertise. They need to be protected. The industry, size, and scope of a business will determine the complexity of cybersecurity, but even the smallest business can be better prepared. Small businesses are the most vulnerable to cybersecurity breaches because they have the weakest security systems, thereby making them easier online targets.

Every computer can be vulnerable to attack. The consequences can range from simple inconvenience to financial catastrophe. There are several things that can be done to protect a business, its customers, and its vendors, including the following:

- **Explore cybersecurity liability insurance.** This coverage is available at reasonable rates to protect against credit card identity theft, with limits up to $5 million. This insurance will cover the loss of digital assets plus expenses for public relations, damages, and service interruption. It will also protect customers. The notification of customers whose credit was compromised is included plus any legal costs and a year of credit monitoring for each individual affected. Although other cybersecurity insurance policies can cover data loss, applicants must break down loss estimates on an hourly basis because most breaches are resolved in hours, not days. This is not an easy thing to do.
- **Use antivirus software and keep it up to date.** If an owner is not already doing this, he or she should probably have a mental examination.
- **Do not open e-mail from unknown sources.** Always be suspicious of unexpected e-mails that include attachments, whether or not they are from a known source. When in doubt, delete the file and the attachment—and then empty the computer's deleted items file. This should be a procedure that all employees know about and follow. The owner must do it as well.
- **Use hard-to-guess passwords.** An application for cyber insurance requires, among other things, answering the following question: "Are passwords required to be at least seven characters in length, alphanumeric, and free of consecutive characters?" (Check yes or no.) Whether or not a business plans to apply for cyber insurance, instituting this kind of password policy is well worth consideration.

KEY TAKEAWAYS

- Small- to medium-sized businesses are the most vulnerable in the event of a disaster.
- Some estimates claim that over 60 percent of small businesses that experience a major disaster close by the end of the second year.
- Planning for disaster recovery makes great sense for protecting a business.
- Every state and territory has experienced disasters. Planning for the aftermath is the key to getting back to business with a minimum of disruption. However, every situation will be unique.
- Man-made disasters affect 10 percent of small businesses, while natural disasters have impacted more than 30 percent of all small businesses in the United States.
- A man-made disaster is a disastrous event caused directly and principally by one or more identifiable deliberate or negligent human actions—for example, arson, terrorism, and structural collapse.
- The better prepared a business is, the faster it will recover from a disaster and resume operations. Having a disaster plan can mean the difference between being shut down for a few days and going out of business entirely.
- Even the smallest business should have a disaster plan.
- The three main areas that an owner should focus on in a disaster plan are the plan to stay in business, talk to people, and protect the investment.

EXERCISE

Frank’s BarBeQue just missed being impacted by a tornado that ripped through southwestern Connecticut. Many small businesses were lost, never to reopen, while others sustained major physical and economic damage. Frank’s son, Robert, asked his father about whether he was prepared for something like that. Frank’s response was troubling. Although he kept some important documents in a safety deposit box at the bank, there was little planning or protection. Robert explained the importance of disaster planning, but Frank was overwhelmed by the prospect of the process.

Robert contacted a local university and arranged with its school of business for a team of five students to prepare a disaster plan for Frank’s BarBeQue. He presented the project idea to his father and was relieved that his dad was willing to participate. It was clearly understood that no proprietary or confidential information would be shared with the students.

1. Assume that you are the leader of the team. Describe the approach you will take and the recommendations that you will make. It is expected that you will go beyond the information provided in the text. Creativity is strongly encouraged.

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15.2.3: Disaster Assistance

Learning Objectives

- Learn about the sources of disaster assistance for the physical and/or economic losses of small business.

Do not assume that all small businesses will qualify for disaster loan assistance or that insurance will cover the costs of all losses. A small business owner may have to depend on other forms of financial assistance—for example, savings, friends, and family. However, if a small business has sustained economic injury after a disaster, it may be eligible for financial assistance from the Small Business Administration (SBA). If a business is located in a declared disaster area, the owner may apply for a long-term, low-interest loan to repair or replace damaged property.

Physical and Economic Injury Disaster Loans

In the case of a physical disaster, a small business owner may apply for a low-interest SBA loan of up to $2 million to repair or replace damaged real estate, equipment, inventory, and fixtures: "The loan may be increased by as much as 20 percent of the total amount of disaster damage to real estate and/or leasehold improvements, as verified by SBA, to protect property against future disasters of the same type. These loans will cover uninsured and or under-insured losses." It is also possible that small business disaster relief loans may be available at the local, county, regional, or state level.

The SBA can also help small businesses that were not damaged physically but have suffered economically. An Economic Injury Disaster Loan of up to $2 million can be granted to meet necessary financial obligations—expenses the business would have paid if the disaster had not occurred.

The interest rate on both Physical and Economic Injury Disaster Loans will not exceed 4 percent if you do not have credit available elsewhere. Repayment can be up to 30 years, but this will depend on the business's ability to repay the loan. For businesses that may have credit available elsewhere, the interest rate will not exceed 8 percent. SBA determines whether the applicant has credit available elsewhere.

Disaster Assistance from the Internal Revenue Service

The Internal Revenue Service (IRS) provides some disaster assistance and emergency relief for businesses through special tax law provisions, especially when the federal government declares their location to be a major disaster area. The IRS may grant additional time to file returns and pay taxes. While doing disaster planning, check the latest special tax law provisions that may help a business recover financially from the impact of a major disaster. It would also be a good idea to check out what kind of record-keeping the IRS requires so that a business will be fully prepared should it be necessary to take advantage of what the IRS offers.

SCORE Business Advice

Disaster recovery will push the limits of a small business…and then some. Locate the closest offices of **SCORE (Service Corps of Retired Executives)**—a nonprofit association dedicated to educating entrepreneurs and helping small businesses start, grow, and succeed nationwide—and enlist their support. SCORE provides confidential business counseling services at no charge.

Online Disaster Assistance

DisasterAssistance.gov is a one-stop web portal, self-described as access to disaster help and resources, that details over sixty different forms of assistance from seventeen US government agencies where a business owner can apply for SBA loans through online applications, receive referral information on forms of assistance that do not have online applications, or check the progress and status of online applications.

Benefits.gov wants to let survivors and disaster relief workers know about the many disaster relief programs that are available. There are questions for a small business owner who has suffered damage because of a natural disaster to answer to find out which government benefits the business may be eligible to receive. The site also provides a link to DisasterAssistance.gov.

KEY TAKEAWAYS

- Do not assume that a small business will qualify for disaster loan assistance or that insurance will cover the costs of all losses. A small business owner may have to depend on others for financial assistance—for example, friends, family, and savings.
- A small business owner may apply for a low-interest SBA loan of up to $2 million to repair or replace damaged real estate. The interest rate on this loan will not exceed 4 percent if credit is not available elsewhere.
- The SBA also provides financial assistance to small businesses that were not damaged physically but suffered economic losses. The interest rate on this loan will also not exceed 4 percent if the business does not have credit available elsewhere.
- The IRS provides disaster assistance and emergency relief through special tax provisions.
- It would be worthwhile checking out SCORE for assistance.
- Online disaster assistance is available through two website portals: DisasterAssistance.gov and Benefits.gov.

EXERCISE

As part of the disaster management plan, Robert has asked the student team to prepare a specific plan for obtaining disaster assistance under the assumption that both physical and economic damages will occur. Review the various options and the material from the previous section in this chapter and then make specific recommendations. It is expected that you will go beyond the information presented in the text.

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15.2.5: Exit Strategies

Learning Objectives

- Understand the importance of an exit strategy.
- Explain the exit strategies that a small business can consider.

The most emotional topic a small business owner will face while building a business—and the hardest decision to make—is when and how to exit the business. This very personal decision should be considered while building the business because this decision will impact many other decisions made along the way. Ultimately, however, an exit strategy must be developed whether or not it is considered along the way. The strategy should be developed early in the business, and it should be reviewed and changed periodically because conditions change. Unfortunately, many small business owners have no exit strategy. This will make an already very emotional decision and process even more difficult.

There are many exit strategies that a small business owner can consider. Liquidation or walk away, family succession, selling the business, bankruptcy, and taking the company public are discussed here. Selecting an exit strategy is important because the way in which an owner exits can affect the following:

- The value that the owner and/or shareholders (if any) can realize from a business
- Whether a cash deal, deferred payments, or staged payments are received
- The future success of the business and its products or services (unless one is closing the business)
- Whether the owner wants to retain any involvement in or control of the business
- Tax liabilities



Figure 15.2.5.1: Possible Exit Strategies

The best exit strategy is the one that is the best match to a small business and the owner's personal and professional goals. The owner must first decide what he or she wants to walk away with—for example, money, management control, or intellectual property. If interested only in money, selling the business on the open market or to another business may be the best choice. If, on the other hand, one's legacy and seeing the small business continue are important, family succession or selling the business to the employees might be a better solution.

Liquidation or Walkaway

There are times when a small business owner may decide that enough is enough, so he or she simply calls it quits, closes the business doors, and calls it a day. This happens all the time, to hundreds of businesses every day—for example, a small shop, a restaurant, a small construction company, a shoe store, a gift shop, a consignment shop, a nail salon, a bakery, or a video store. This closing of the business involves **liquidation**, the selling of all assets. If all debts are paid, it can also be referred to as a **walkaway**.

To make any money with the liquidation exit strategy, a business must have valuable assets to sell—for example, land or expensive equipment. The name of the business may have some value, so it could be purchased by someone for pennies on the dollar and restarted with different owners. There is also a possibility that there may be a substantial amount of goodwill or even badwill if a business has been around for a long time. **Goodwill** is an intangible asset that reflects the value of intangible assets, such as a

strong brand name, good customer relationships, good employee relationships, patents, intellectual property, size and quality of the customer list, and market penetration. However, if a business is simply closed, the value of the goodwill will drop, and the selling price will be lower than it would have been prior to the business being closed.

Badwill is the negative effect felt by a company when it is found out that a company has done something not in accord with good business practices. Although badwill is typically not expressed in a dollar amount, it can result in such things as decreased revenue; the loss of clients, customers, and suppliers; the loss of market share; the loss of credit; federal or state indictments for crimes committed, and censure by the community. For the small business owner who wants to close under these circumstances, there will be nothing much to sell but tangible assets because the business will have very little, if any, market value.

In all instances of liquidation, the proceeds from the sale of assets must first be used to repay creditors. The remaining money is divided among the shareholders (if any), the partners (if any), and the owner. In an ideal walkaway situation, the following occurs:

- All bills are paid off (or scheduled).
- All taxes are paid, and the various levels of government are informed of the closure.
- Contracts, leases, and the like are fulfilled or formally terminated.
- Employees are let go to find other jobs.
- Assets or inventory is depleted.
- No lawsuits are consuming money and time.
- Customers are placed so that they get needed goods or services.
- If needed, insurance is continued to cover unexpected claims after the firm closes.

The walkaway is the cleanest and best way to exit, but it is not always possible for all businesses that decide to close their doors. There will, of course, always be those instances in which the owner closes the business and takes off, leaving a mess behind.

Any small business owner thinking about liquidation should consider the pros and cons, which are as follows:

- **Pros**
  - It is easy and natural. Everything comes to an end.
  - No negotiations are involved.
  - There are no worries about the transfer of control.
- **Cons**
  - Get real! It is a waste. At most, the owner will get the market value of the company's assets.
  - Things such as client lists, the owner's reputation, and business relationships may be very valuable. Liquidation destroys them without an opportunity to recover their value.
  - Other shareholders, if any, may be less than thrilled about how much is left on the table.
  - If a company's brand has any value, there is a loyal or sizeable customer base, or there is a stable core of employees, an owner would be significantly better off selling the company.

Family Succession

Many small business owners dream of passing the business to a family member. Keeping the business in the family allows the owner's legacy to live on, which is clearly an attractive option. Family succession as an exit strategy also allows the owner an opportunity to groom the successor; the owner might even retain some influence and involvement in the business if desired. However, given that very few family firms survive beyond the first generation and even fewer survive into the third generation, **succession** is the most critical issue facing family firms. Succession is the transference of leadership from one generation to the next to ensure continuity of family ownership of the business.

A sudden decision to hand over the business to a family member is unwise. The owner will be burdened with problems that will likely lead to business failure. Succession in family firms is a multistage, complex process that should begin even before the heirs enter the business, and effects extend beyond the point in time when they are named as successors. Many factors are involved, and the succession should evolve over a long period of time. Further, because succession is usually followed by changes in the organization, particularly the change in the top position, it is thought to be an indicator of the future of the business. The better prepared and committed the successor is, the greater the likelihood of a successful succession process and business. The quality of interpersonal relationships, successors' expectations, and the role of the predecessor are also relevant to success.

The ideal is for the family business to have engaged in formal **succession planning**: planning for the family business to be transferred to a family member or members. The failure to plan for succession is seen as a fundamental human resource problem as well as the primary cause for the poor survival rate of family businesses. Unfortunately, a very small percentage of family businesses plan appropriately for succession, and those that do frequently have mental, not written, plans.

Bankruptcy

Feeling the need to file for bankruptcy is a tough pill for any small business owner to swallow. **Bankruptcy** is an extreme form of business termination that uses a legal method for closing a business and paying off creditors when the business is failing and the debts are substantially greater than the assets. Because bankruptcy is a complicated legal process, it is important to get an attorney involved as soon as possible. There may be options other than bankruptcy, and consulting with an attorney will help. The owner must understand how bankruptcy works and the options that are available. It is also good to know that not all bankruptcies are voluntary; creditors can petition the court for a business to declare bankruptcy.

Chapter 7 small business bankruptcy, more commonly referred to as liquidation, is appropriate when a business is failing, has no future, and has no substantial assets. This form of bankruptcy makes sense only if the owner wants to walk away. It is particularly suited to sole proprietorships and other small businesses in which the business is essentially an extension of its owner's skills. Under Chapter 7 bankruptcy law, a trustee will take a business apart, selling assets to satisfy outstanding debts and discharging debts that cannot be satisfied with the assets that are available.

Chapter 11 small business bankruptcy allows an owner to run a business with court oversight. The owner loses control of the firm, but it continues to operate. The owner is protected from creditors in the short term because the court orders an automatic stay that prevents the creditors from seizing your assets. Unfortunately, the outcome is not pleasant. The owner is out as manager, and the creditors end up owning the business. If the owner cannot pay the $75,000+ in legal fees, the judge will probably order liquidation, so the result is the same as a Chapter 7. This form of bankruptcy applies to sole proprietorships, corporations, and partnerships.

The amount that creditors can collect will depend on how a business is structured. If a business is a sole proprietorship, the owner's personal assets may be used to pay off business debts, depending on the chosen bankruptcy option. If a business is a corporation, a limited liability company, or some form of a partnership, the owner's personal assets are protected and cannot be used to pay off business debts.

Alternatives to Bankruptcy

Instead of going the bankruptcy route, a small business owner could do the following things:

- **Negotiate debt.** This involves trying to reorganize a business's finances outside a legal proceeding. The owner can work with the creditors to renegotiate the terms of payment and the amount owed to each creditor. If a business is basically profitable but the debt situation is due to an unusual circumstance, such as a lawsuit or a temporary industry slowdown, this could be a successful solution.
- **Improve operations.** If the owner is in a position to fix the cash problem by fixing the underlying problems in the business, it may not be necessary to declare bankruptcy. An owner should look at cash-flow controls; eliminate unprofitable products, services, and divisions; and restructure into a leaner and meaner organization.
- **Turn around and restructure the business.** This alternative combines debt negotiation and operational improvement—perhaps the best choice. By doing both things at the same time, an owner will be in an even stronger position to improve the balance sheet, cash flow, and profitability—and avoid insolvency.

Taking a Company Public

An **initial public offering (IPO)** is a stock offering in which the owner or owners of equity in a formerly private company have their private holdings transferred into issues tradable in public markets, such as the New York Stock Exchange (NYSE). From the initial owners' perspective, an IPO is often seen as liquidation, but it is also a money event for a company. For this reason, an IPO makes sense only if a small business can benefit from a substantial infusion of cash.

IPOs receive lots of press, even though they are really very rare. In a typical year, there may be 200 IPOs, perhaps even less. Consider the following data:

- 2008: 32 IPOs
- 2009: 63 IPOs
- 2010: 157 IPOs
- 2011: 159 IPOs

Why are the numbers so small? The IPO process is costly, labor-intensive, and usually requires an up-front investment of more than $100,000. Detailed reports are required on a business's financials, staffing, marketing, operations, management, and so forth. Preparing these reports typically costs hundreds of thousands of dollars, sometimes millions, every year. The Sarbanes-Oxley Act alone, a product of the Enron scandal, costs even the smallest companies several hundred thousands of dollars in consulting fees. Lastly, many companies are not valued very highly on the stock market.

When thinking about an IPO, consider the following pros and cons:

- **Pros**
  - The owner will be on the cover of *Newsweek*.
  - The stock will be worth in the tens—or even hundreds—of millions of dollars.
  - Venture capitalists will finally stop bugging the owner as they frantically try to ensure their shares will retain value.
- **Cons**
  - Only a very few number of small businesses actually have this option available to them because there are so few IPOs in the United States each year.
  - A business needs financial and accounting rigor from day one that is way beyond what many small business owners put in place.
  - The owner will spend most of his or her time selling the company, not running it.
  - Investment bankers take 6 percent off the top, and the transaction costs of an IPO can run into the millions.

Stever Robbins of *Entrepreneur* paints an amusing but very dismal picture of what is actually involved in an IPO.

You start by spending millions just preparing for the roadshow, where you grovel to convince investors your stock should be worth as much as possible…Unlike an acquisition, where you craft a good fit with a single suitor, here you are romancing hundreds of Wall Street analysts. If the romance fails, you've blown millions. And if you succeed, you end up married to the analysts. You call that a life?

Once public, you bow and scrape to the analysts. These earnest 28-year-olds—who haven't produced anything of value since winning their fifth-grade limerick contest—will study your every move, soberly declaring your utter incompetence at running the business you've built over decades. It's one thing to receive this treatment from your loving spouse. It's quite another to receive it from Smith Barney.

We won't even talk about the need to conform to Sarbanes-Oxley, or the 6 percent underwriting fees you'll pay to investment bankers, or lockout periods, or how markets can tank your wealth despite having a healthy business, or how IPO-raised funds distort your income statement, or…

In short, IPOs are not only rare, they're a pain in the backside. They make the headlines in the very, very rare cases that they produce 20-year-old billionaires. But when you're founding [and running] your company, consider them just one of many exit strategies. Realize that there are a lot of ways to skin a cat, and just as many ways to get value out of your company. Think ahead, surely, but do it with sanity and gravitas. And if you find yourself tempted to start looking for more office space in preparation for your IPO in 18 months, call me first. I'll talk you down until the paramedic arrives.

For some small businesses, although not many, an IPO might make sense—and may even be necessary. For most, however, an IPO is clearly not a viable exit strategy.

Selling the Business

Another possible exit strategy is selling the business. Although the sale of a business is sometimes described as the end of entrepreneurship or as failure or defeat, selling the business can also be a relief and the beginning of the next phase of the owner's personal and professional life. As in the case of SoBe (highlighted at the beginning of this chapter), the owners sold the business because, among other things, it was becoming something they did not want it to be—and it was no longer fun. Whatever the reason,

an owner can sell a business only once, so be sure that it is the right exit strategy. The owner should address the following questions:

1. **Can the business be sold?** There are many things that make a business attractive to buyers: a solid history of profitability, a large and loyal base of customers, a good reputation, a competitive advantage (e.g., intellectual property rights, patents, long-term contracts with clients, and exclusive distributorships), opportunities for growth, a desirable location, a skilled workforce, and a loyal workforce. If a business does not have at least some of these things or others of equal value, it will not likely generate much interest in the market.
2. **Is the owner ready to sell or does the owner need to sell?** Selling a business, when it is a choice, requires emotional and financial readiness. The owner must think about what life will be like after the business is sold. What will be a source of income? How will time be spent? Has the owner "sold out" or could more have been done with the business? Does the owner love what he or she is doing? Many small business owners suffer real remorse after handing their businesses over to a new owner. Selling the business because the owner is forced to will engender very different emotional and financial challenges.
3. **What is the business worth?** The owner may have no idea. For example, the owner of a small professional services firm felt the firm was worth more than $1 million. After a lengthy search, however, the owner received less than one-half that amount from the buyer. On the other side of the coin, the owner of an information technology (IT) company planned to sell the company to an employee for $200,000. However, after advertising the business for sale nationwide, the owner sold it for one dollar shy of $1 million.

It is recommended that an owner start planning for a sale at least three to four years in advance. Sometimes, even five years is not long enough. It is very easy to become overly attached to a business, so it will be difficult to see how the business really looks to an outsider. Selling a business is an art and a science. If the asking price is too high, this may signal to potential buyers that the owner is not really interested in selling. Because there are several methods used to value a business, it is a good idea to hire a professional.

There are different ways to sell a business. Acquisition, friendly buyout, selling to the employees, and selling on the open market are discussed here. Be aware, however, that if a business is floundering and it is well known that the business is having major problems paying bills, **vulture capitalists** might start circling. A vulture capitalist is a **venture capitalist** who invests in floundering firms in the hope that they will turn around. A venture capitalist is an investor who either provides capital to start-up ventures or supports small companies to expand but does not have access to public funding. Venture capitalists typically expect higher returns because they are taking additional risks.



Figure 15.2.5.2: Four Ways to Sell a Small Business

Acquisition

When one business buys another business, as in the case of Pepsi buying SoBe, it is called an **acquisition**. Businesses buy other businesses for all kinds of reasons—for example, as a quick path to expansion or diversification or to get rid of the competition. When Pepsi was considering acquiring SoBe, their first thought was to kill the brand. But the bottlers convinced them otherwise, saying that it was a very strong brand.

Acquisition is one of the most common exit strategies for a small business. One key to success is to target the potential acquirer(s) in advance, position the business accordingly, and convince the acquirer that the small business is worth the asking price. Another way to become the target of an acquisition is to be successful in the marketplace. This happened with SoBe. Coca-Cola, Pepsi, Arizona, and Campbell's all expressed an interest after SoBe became a national brand. Pepsi ended up being the acquirer in the end.

In an acquisition, the owner negotiates the price—a good thing because public markets value a business relative to its industry, which limits the value of a business. In an acquisition, however, there is no limit on the perceived value of a company. Why? The person making the acquisition decision is rarely the owner of the acquiring company, so there is no problem with the checkbook. It is someone else's money.

When thinking about an acquisition, consider the following pros and cons:

- **Pros**
  - If a business has strategic value to an acquirer, it may pay far more than the business is worth to anyone else.
  - If multiple acquirers are in a bidding war, the owner can raise the price "to the stratosphere."
- **Cons**
  - If the owner organizes the business around a specific acquirer, the business may be unattractive to other buyers.
  - Acquisitions are messy and often difficult when cultures and systems clash in the merged company. Although not a small business example, the Warner-AOL combination was a failure largely due to a major culture clash.
  - Acquisitions are frequently accompanied by noncompete agreements and other strings that, while making the owner rich, can make life unpleasant for a while. Noncompete agreements are enforceable, but their enforcement depends on the applicable facts and circumstances—including which state's law governs.

Friendly Buyout

A **friendly buyout** occurs when ownership is transferred to family members, customers, employees, current managers, children, or friends. It is still considered selling the business, but the terms and nature of the transaction are usually very different. No matter who the "friendly" buyer may be, figure on starting to plan early—and engage a professional before, during, and after the sale.

When thinking about friendly buyout, consider the following pros and cons:

- **Pros**
  - The owner knows much more about the buyer, and the buyer knows the owner. There is less due diligence required.
  - The buyer will most likely preserve what is important about the business.
  - If management buys the business, it has a commitment to make it work.
- **Cons**
  - The owner will be less objective about the buyer and more likely to let his or her guard down in negotiations and planning. The owner leaves too much money on the table.
  - If the owner sells to a friend, the friend will be less than thrilled when discovering, for example, decades' worth of unpaid taxes.
  - Selling to family can tear a company apart with jealousies and promotions that put emotion ahead of business needs.

Selling to Employees

Selling the business to employees and/or managers is another option to consider. "Arranging an employee buyout can be a win-win situation as they get an established business they know a great deal about already and you get enthusiastic buyers that want to see your business continue to thrive." The owner can accomplish this process by setting up an employee stock option plan (ESOP), a stock equity plan that lets employees buy ownership in the business. However, because the owner is giving control of the business

to the employees, a transition plan is critical to make sure that they are ready to carry on the business after the owner leaves. It is a good idea to hire an ESOP specialist. Keep in mind, though, that only corporations are eligible to form an ESOP. An ESOP is expensive to set up and maintain, so this might not be the best choice.

If an ESOP is not appealing or the business is not eligible to have an ESOP, selling the business could be as simple as having a current employee take it over. The owner could also consider a **worker-owned cooperative**, in which interested employees become members of a cooperative that buys the business. In the case of Select Machine of Brimfield, Ohio, "[the owners] sold 30 percent of their stock to the co-op in the first of several installments. The co-op took out loans in the amount of $324,000, which were personally guaranteed by the sellers. The loans were paid off out of company profits over three years; subsequent installments have been owner-financed. Today the co-op owns 59 percent of the company's stock, and sale of an additional 10 percent is now on the table."

For a worker-owned cooperative to work, the business owner(s) must be totally committed to the sale of the business to the employees. It is a good option if the business is small (fewer than twenty-five employees), profitable, relatively debt-free, already has a culture of participatory management, and the owners are willing to stay on throughout the transition.

Selling on the Open Market

Selling a business on the open market is the most popular exit strategy for small businesses. Unfortunately, it has been estimated that 75 percent of US businesses do not sell, so if this is how the owner wants to sell the business, it must be marketed in a way that maximizes its value in the eyes of a potential buyer.

An owner also needs to spread the word. Most savvy business buyers use the Internet to research available businesses for sale, so post the sale notice on the two largest websites:

KEY TAKEAWAYS

- The most emotional topic an owner will face when building a business—and the hardest decision he or she will probably have to make—is when and how to exit.
- An exit strategy should be planned while running the business. Unfortunately, many small businesses do not have an exit plan.
- There are many exit strategies that a small business owner can consider, including liquidation or walkaway, family succession, selling the business, bankruptcy, and taking a company public.
- The best exit strategy is the one that best matches the small business and the owner's personal and professional goals.
- Liquidation is the selling of all assets. If all debts are paid, it can also be referred to as a walkaway. Walking away is the cleanest and best way to exit a business.
- Family succession is the transference of leadership from one generation to the next to ensure continuity of family ownership in the business. It is a critical issue in family businesses because few family firms survive beyond the first generation and even fewer survive into the third generation.
- The failure to plan for succession is seen as a basic human resource problem as well as the primary cause for the poor survival rate of family businesses.
- Bankruptcy is an extreme exit strategy that uses a legal method for closing a business and paying off creditors when a business is failing and the debts are substantially greater than the assets.
- Debt negotiations, operational improvements, or business turnaround and restructuring are alternatives to bankruptcy.
- An IPO is a stock offering in which the owner or owners of equity in a business have their private holdings transferred into issues tradable in public markets, such as the NYSE.
- There are several options for selling a business: acquisition, friendly buyout, selling to the employees, and selling in the open market.
- An acquisition is when another business buys a business. In an acquisition, there is no limit on the perceived value of the business.
- A friendly buyout is the transfer of ownership to family members, customers, employees, current managers, children, or friends—but it is still a sale.
- Selling to the employees can be a win-win situation because they get an established business that they know a great deal about already, and the owner gets enthusiastic buyers who want to see a business continue to thrive.

- Selling in the open market is the most popular exit strategy for small businesses.
- It has been estimated that 75 percent of small businesses do not sell, so a business must market in a way that maximizes its value in the eyes of the potential buyer.

EXERCISE

Two executives of a regional food company are regular customers and big fans of Frank's All-American BarBeQue. They recently learned that Frank has been selling his sauces in local grocery stores and have been a big hit. The executives bought jars of each flavor, took them back to their company, and talked to the people who would decide about adding products to their line. Everyone loved the sauces, and there was definite interest in acquiring the sauce-making side of Frank's business. It would fill a hole in their product line that they had been looking to fill.

The company contacted Frank about its interest, and Frank—with some urging from his son, Robert—is thinking about it. It would provide Frank with a nice retirement (when he decides to do that), money for his son and daughter, and a legacy. How should Frank proceed?

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SECTION OVERVIEW

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15.3.1: Introduction

Learning Objectives

After reading this chapter, you should be able to answer these questions:

- How do finance and the financial manager affect a firm's overall strategy?
- What types of short-term and long-term expenditures does a firm make?
- What are the main sources and costs of unsecured and secured short-term financing?
- What are the key differences between debt and equity, and what are the major types and features of long-term debt?
- When and how do firms issue equity, and what are the costs?
- How do securities markets help firms raise funding, and what securities trade in the capital markets?
- Where can investors buy and sell securities, and how are securities markets regulated?
- What are the current developments in financial management and the securities markets?

EXPLORING BUSINESS CAREERS

Vicki Saunders, Venture Capitalist & Entrepreneur

Many women dream of starting their own business. But this involves a large investment of time, dedication, creativity—and money. Even the best ideas fall flat without strong financial backing and fiscal management. Most start-ups don't have a chief financial officer, let alone an unlimited amount of cash to fund their owners' dreams.

According to a recent report, there are more than 11 million woman-owned businesses in the United States that employ close to 9 million people and generate more than $1.6 trillion in revenues. And revenues have increased for these businesses more than 35% over the last decade compared to 27% among all U.S. companies. Despite these impressive statistics, less than 4 percent of venture capital funding goes to this group of entrepreneurs. That's where Vicki Saunders and SheEO, her venture capital start-up, come into the picture.

Saunders, who describes herself as a serial entrepreneur, previously co-founded and ran four different business ventures. She believes that the funding universe for women entrepreneurs needs to be fixed and offers her plan via SheEO, a platform to enlist women "activators" to invest money to create a pool of capital distributed to select woman-owned businesses in the form of 0% interest loans that are paid back within five years. The activators are more than just investors, however. Saunders envisions these women as being a crucial part of the businesses in which they invest, by providing operational support, resources for suppliers and other vendors, and a solid networking opportunity for everything from legal support to cultivating new customers. In a recent campaign called Radical Generosity, $1,000 was raised from each of 500 women, and that pool of $500,000 was split among five woman-led businesses.

In year three of the funding venture in 2017, SheEO funded 15 companies and invested $1.5 million. SheEO has funded entrepreneurs working on a variety of businesses, including artificial intelligence, hardware for people with disabilities, food, and education. While SheEO currently operates in four regions, Canada, Los Angeles, San Francisco, and Colorado, Saunders's goals for funding woman-led businesses are lofty. By 2020, Saunders hopes to have a million investors and a billion dollars to fund 10,000 entrepreneurs. But her ultimate goal is to change the culture around how investors support businesses—all businesses. According to Saunders, activating women on behalf of other women will change the world.

In today's fast-paced global economy, managing a firm's finances is more complex than ever. For financial managers, a thorough command of traditional finance activities—financial planning, investing money, and raising funds—is only part of the job. Financial managers are more than number crunchers. As part of the top management team, chief financial officers (CFOs) need a broad understanding of their firm's business and industry, as well as leadership ability and creativity. They must never lose sight of the primary goal of the financial manager: to maximize the value of the firm to its owners.

Financial management—spending and raising a firm's money—is both a science and an art. The science part is analyzing numbers and flows of cash through the firm. The art is answering questions such as these: Is the firm using its financial resources in the best way? Aside from costs, why choose a particular form of financing? How risky is each option? Another important concern for both

business managers and investors is understanding the basics of securities markets and the securities traded on them, which affect both corporate plans and investor pocketbooks. About 52 percent of adult Americans now own stocks, compared to just 25 percent in 1981.

This chapter focuses on the financial management of a firm and the securities markets in which firms raise funds. We'll start with an overview of the role of finance and of the financial manager in the firm's overall business strategy. Discussions of short- and long-term uses of funds and investment decisions follow. Next, we'll examine key sources of short- and long-term financing. Then we'll review the function, operation, and regulation of securities markets. Finally, we'll look at key trends affecting financial management and securities markets.

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15.3.2: The Role of Finance and the Financial Manager

How Do Finance and the Financial Manager Affect the Firm's Overall Strategy?

Any company, whether it's a small-town bakery or General Motors, needs money to operate. To make money, it must first spend money—on inventory and supplies, equipment and facilities, and employee wages and salaries. Therefore, finance is critical to the success of all companies. It may not be as visible as marketing or production, but management of a firm's finances is just as much a key to the firm's success.

Financial management—the art and science of managing a firm's money so that it can meet its goals—is not just the responsibility of the finance department. All business decisions have financial consequences. Managers in all departments must work closely with financial personnel. If you are a sales representative, for example, the company's credit and collection policies will affect your ability to make sales. The head of the IT department will need to justify any requests for new computer systems or employee laptops.

Revenues from sales of the firm's products should be the chief source of funding. But money from sales doesn't always come in when it's needed to pay the bills. Financial managers must track how money is flowing into and out of the firm. They work with the firm's other department managers to determine how available funds will be used and how much money is needed. Then they choose the best sources to obtain the required funding.

For example, a financial manager will track day-to-day operational data such as cash collections and disbursements to ensure that the company has enough cash to meet its obligations. Over a longer time horizon, the manager will thoroughly study whether and when the company should open a new manufacturing facility. The manager will also suggest the most appropriate way to finance the project, raise the funds, and then monitor the project's implementation and operation.

Financial management is closely related to accounting. In most firms, both areas are the responsibility of the vice president of finance or CFO. But the accountant's main function is to collect and present financial data. Financial managers use financial statements and other information prepared by accountants to make financial decisions. Financial managers focus on **cash flows**, the inflows and outflows of cash. They plan and monitor the firm's cash flows to ensure that cash is available when needed.

The Financial Manager's Responsibilities and Activities

Financial managers have a complex and challenging job. They analyze financial data prepared by accountants, monitor the firm's financial status, and prepare and implement financial plans. One day they may be developing a better way to automate cash collections, and the next they may be analyzing a proposed acquisition. The key activities of the financial manager are:

- **Financial planning:** Preparing the financial plan, which projects revenues, expenditures, and financing needs over a given period.
- **Investment (spending money):** Investing the firm's funds in projects and securities that provide high returns in relation to their risks.
- **Financing (raising money):** Obtaining funding for the firm's operations and investments and seeking the best balance between debt (borrowed funds) and equity (funds raised through the sale of ownership in the business).

The Goal of the Financial Manager

How can financial managers make wise planning, investment, and financing decisions? The main goal of the financial manager is to maximize the value of the firm to its owners. The value of a publicly owned corporation is measured by the share price of its stock. A private company's value is the price at which it could be sold.

To maximize the firm's value, the financial manager has to consider both short- and long-term consequences of the firm's actions. Maximizing profits is one approach, but it should not be the only one. Such an approach favors making short-term gains over achieving long-term goals. What if a firm in a highly technical and competitive industry did no research and development? In the short run, profits would be high because research and development is very expensive. But in the long run, the firm might lose its ability to compete because of its lack of new products.

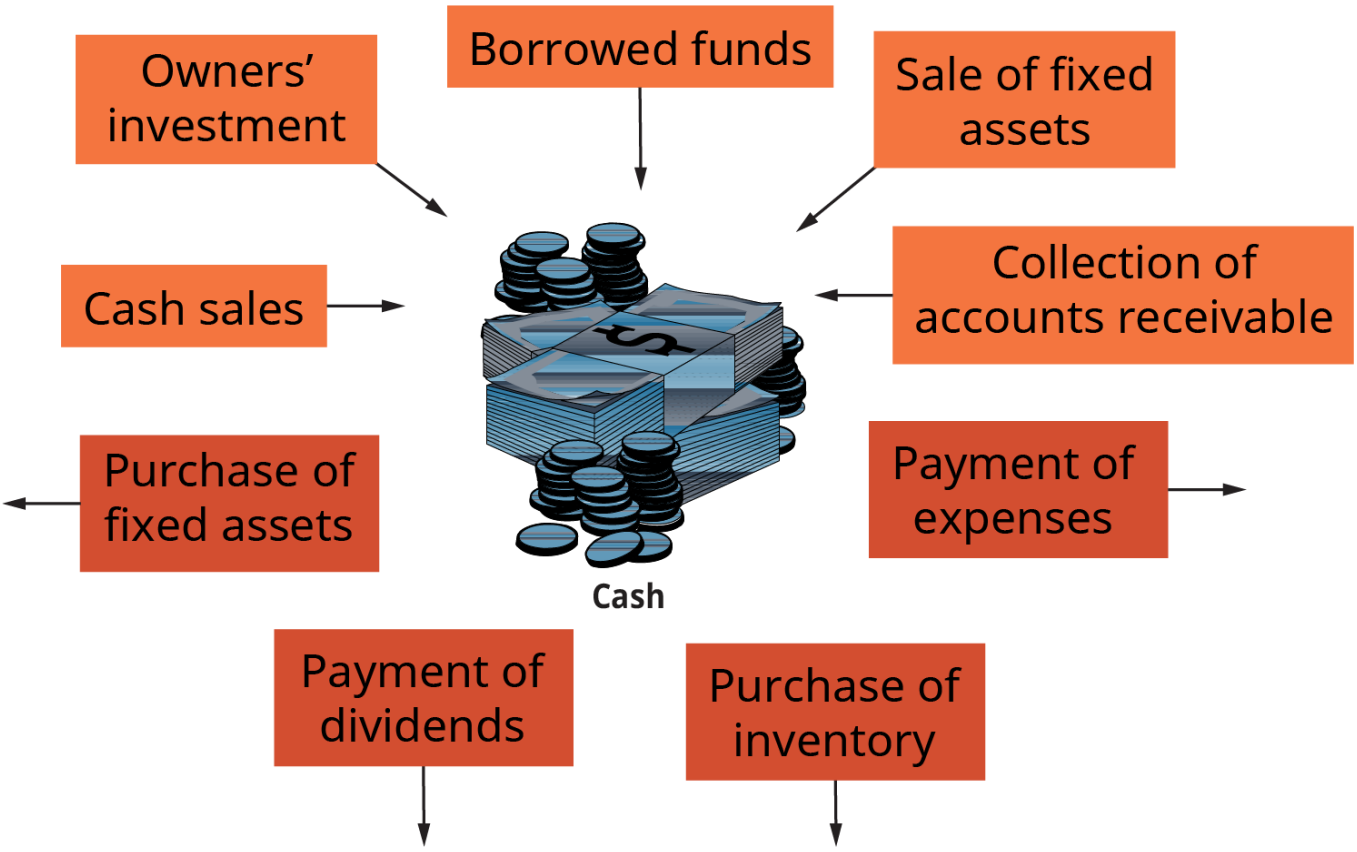


Figure 15.3.2.1: How Cash Flows through a Business (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

This is true regardless of a company's size or point in its life cycle. At Corning, a company founded more than 160 years ago, management believes in taking the long-term view and not managing for quarterly earnings to satisfy Wall Street's expectations. The company, once known to consumers mostly for kitchen products such as Corelle dinnerware and Pyrex heat-resistant glass cookware, is today a technology company that manufactures specialized glass and ceramic products. It is a leading supplier of Gorilla Glass, a special type of glass used for the screens of mobile devices, including the iPhone, the iPad, and devices powered by Google's Android operating system. The company was also the inventor of optical fiber and cable for the telecommunications industry. These product lines require large investments during their long research and development (R&D) cycles and for plant and equipment once they go into production.

This can be risky in the short term, but staying the course can pay off. In fact, Corning recently announced plans to develop a separate company division for Gorilla Glass, which now has more than 20 percent of the phone market—with over 200 million devices sold. In addition, its fiber-optic cable business is back in vogue and thriving as cable service providers such as Verizon have doubled down on upgrading the fiber-optic network across the United States. As of 2017, Corning's commitment to repurposing some of its technologies and developing new products has helped the company's bottom line, increasing revenues in a recent quarter by more than 16 percent.

As the Corning situation demonstrates, financial managers constantly strive for a balance between the opportunity for profit and the potential for loss. In finance, the opportunity for profit is termed **return**; the potential for loss, or the chance that an investment will not achieve the expected level of return, is **risk**. A basic principle in finance is that the higher the risk, the greater the return that is required. This widely accepted concept is called the **risk-return trade-off**. Financial managers consider many risk and return factors when making investment and financing decisions. Among them are changing patterns of market demand, interest rates, general economic conditions, market conditions, and social issues (such as environmental effects and equal employment opportunity policies).

CONCEPT CHECK

1. What is the role of financial management in a firm?
2. How do the three key activities of the financial manager relate?
3. What is the main goal of the financial manager? How does the risk-return trade-off relate to the financial manager's main goal?

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15.3.3: How Organizations Use Funds

What Types of Short-term and Long-term Expenditures Does a Firm Make?

To grow and prosper, a firm must keep investing money in its operations. The financial manager decides how best to use the firm's money. Short-term expenses support the firm's day-to-day activities. For instance, athletic-apparel maker Nike regularly spends money to buy such raw materials as leather and fabric and to pay employee salaries. Long-term expenses are typically for fixed assets. For Nike, these would include outlays to build a new factory, buy automated manufacturing equipment, or acquire a small manufacturer of sports apparel.

Short-Term Expenses

Short-term expenses, often called operating expenses, are outlays used to support current production and selling activities. They typically result in current assets, which include cash and any other assets (accounts receivable and inventory) that can be converted to cash within a year. The financial manager's goal is to manage current assets so the firm has enough cash to pay its bills and to support its accounts receivable and inventory.

Cash Management: Assuring Liquidity

Cash is the lifeblood of business. Without it, a firm could not operate. An important duty of the financial manager is **cash management**, or making sure that enough cash is on hand to pay bills as they come due and to meet unexpected expenses.

Businesses estimate their cash requirements for a specific period. Many companies keep a minimum cash balance to cover unexpected expenses or changes in projected cash flows. The financial manager arranges loans to cover any shortfalls. If the size and timing of cash inflows closely match the size and timing of cash outflows, the company needs to keep only a small amount of cash on hand. A company whose sales and receipts are fairly predictable and regular throughout the year needs less cash than a company with a seasonal pattern of sales and receipts. A toy company, for instance, whose sales are concentrated in the fall, spends a great deal of cash during the spring and summer to build inventory. It has excess cash during the winter and early spring, when it collects on sales from its peak selling season.

Because cash held in checking accounts earns little, if any, interest, the financial manager tries to keep cash balances low and to invest the surplus cash. Surpluses are invested temporarily in **marketable securities**, short-term investments that are easily converted into cash. The financial manager looks for low-risk investments that offer high returns. Three of the most popular marketable securities are Treasury bills, certificates of deposit, and commercial paper. (**Commercial paper** is unsecured short-term debt—an IOU—issued by a financially strong corporation.) Today's financial managers have new tools to help them find the best short-term investments, such as online trading platforms that save time and provide access to more types of investments. These have been especially useful for smaller companies who don't have large finance staffs.

Companies with overseas operations face even greater cash management challenges. Developing the systems for international cash management may sound simple in theory, but in practice, it's extremely complex. In addition to dealing with multiple foreign currencies, treasurers must understand and follow banking practices and regulatory and tax requirements in each country. Regulations may impede their ability to move funds freely across borders. Also, issuing a standard set of procedures for every office may not work because local business practices differ from country to country. In addition, local managers may resist the shift to a centralized structure because they don't want to give up control of cash generated by their units. Corporate financial managers must be sensitive to and aware of local customs and adapt the centralization strategy accordingly.

In addition to seeking the right balance between cash and marketable securities, the financial manager tries to shorten the time between the purchase of inventory or services (cash outflows) and the collection of cash from sales (cash inflows). The three key strategies are to collect money owed to the firm (accounts receivable) as quickly as possible, to pay money owed to others (accounts payable) as late as possible without damaging the firm's credit reputation, and to minimize the funds tied up in inventory.

Managing Accounts Receivable

Accounts receivable represent sales for which the firm has not yet been paid. Because the product has been sold but cash has not yet been received, an account receivable amounts to a use of funds. For the average manufacturing firm, accounts receivable represent about 15 to 20 percent of total assets.

The financial manager's goal is to collect money owed to the firm as quickly as possible, while offering customers credit terms attractive enough to increase sales. Accounts receivable management involves setting credit policies, guidelines on offering credit, credit terms, and specific repayment conditions, including how long customers have to pay their bills and whether a cash discount is given for quicker payment. Another aspect of accounts receivable management is deciding on collection policies, the procedures for collecting overdue accounts.

Setting up credit and collection policies is a balancing act for financial managers. On the one hand, easier credit policies or generous credit terms (a longer repayment period or larger cash discount) result in increased sales. On the other hand, the firm has to finance more accounts receivable. The risk of uncollectible accounts receivable also rises. Businesses consider the impact on sales, timing of cash flow, experience with bad debt, customer profiles, and industry standards when developing their credit and collection policies.

Companies that want to speed up collections actively manage their accounts receivable, rather than passively letting customers pay when they want to. According to recent statistics, more than 90 percent of businesses experience late payments from customers, and some companies write off a percentage of their bad debt, which can be expensive.

Technology plays a big role in helping companies improve their credit and collections performance. For example, many companies use some type of automated decision-making, whether that comes in the form of an ERP system or a combination of software programs and supplemental modules that help companies make informed decisions when it comes to credit and collection processes.

Other companies choose to outsource financial and accounting business processes to specialists rather than develop their own systems. The availability of cutting-edge technology and specialized electronic platforms that would be difficult and expensive to develop in-house is winning over firms of all sizes. Giving up control of finance to a third party has not been easy for CFOs. The risks are high when financial and other sensitive corporate data are transferred to an outside computer system: data could be compromised or lost, or rivals could steal corporate data. It's also harder to monitor an outside provider than your own employees. One outsourcing area that has attracted many clients is international trade, which has regulations that differ from country to country and requires huge amounts of documentation. With specialized IT systems, providers can track not only the physical location of goods, but also all the paperwork associated with shipments. Processing costs for goods purchased overseas are about twice those of domestic goods, so more efficient systems pay off.

Inventory

Another use of funds is to buy inventory needed by the firm. In a typical manufacturing firm, inventory is nearly 20 percent of total assets. The cost of inventory includes not only its purchase price, but also ordering, handling, storage, interest, and insurance costs.

Production, marketing, and finance managers usually have differing views about inventory. Production managers want lots of raw materials on hand to avoid production delays. Marketing managers want lots of finished goods on hand so customer orders can be filled quickly. But financial managers want the least inventory possible without harming production efficiency or sales. Financial managers must work closely with production and marketing to balance these conflicting goals. Techniques for reducing the investment in inventory are inventory management, the just-in-time system, and materials requirement planning.

For retail firms, inventory management is a critical area for financial managers, who closely monitor inventory turnover ratios. This ratio shows how quickly inventory moves through the firm and is turned into sales. If the inventory number is too high, it will typically affect the amount of working capital a company has on hand, forcing the company to borrow money to cover the excess inventory. If the turnover ratio number is too high, it means the company does not have enough inventory of products on hand to satisfy customer needs, which means they could take their business elsewhere.

Long-Term Expenditures

A firm also invests funds in physical assets such as land, buildings, machinery, equipment, and information systems. These are called **capital expenditures**. Unlike operating expenses, which produce benefits within a year, the benefits from capital expenditures extend beyond one year. For instance, a printer's purchase of a new printing press with a usable life of seven years is a capital expenditure and appears as a fixed asset on the firm's balance sheet. Paper, ink, and other supplies, however, are expenses. Mergers and acquisitions are also considered capital expenditures.

Firms make capital expenditures for many reasons. The most common are to expand, to replace or renew fixed assets, and to develop new products. Most manufacturing firms have a big investment in long-term assets. Boeing Company, for instance, puts billions of dollars a year into airplane-manufacturing facilities. Because capital expenditures tend to be costly and have a major effect on the firm's future, the financial manager uses a process called **capital budgeting** to analyze long-term projects and select those that offer the best returns while maximizing the firm's value. Decisions involving new products or the acquisition of another business are especially important. Managers look at project costs and forecast the future benefits the project will bring to calculate the firm's estimated return on the investment.

CONCEPT CHECK

1. Distinguish between short- and long-term expenses.
2. What is the financial manager's goal in cash management? List the three key cash management strategies.
3. Describe a firm's main motives in making capital expenditures.

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15.3.4: Obtaining Short-Term Financing

What are the Main Sources and Costs of Unsecured and Secured Short-term Financing?

How do firms raise the funding they need? They borrow money (debt), sell ownership shares (equity), and retain earnings (profits). The financial manager must assess all these sources and choose the one most likely to help maximize the firm's value.

Like expenses, borrowed funds can be divided into short- and long-term loans. A short-term loan comes due within one year; a long-term loan has a maturity greater than one year. Short-term financing is shown as a current liability on the balance sheet and is used to finance current assets and support operations. Short-term loans can be unsecured or secured.

Unsecured Short-Term Loans

Unsecured loans are made on the basis of the firm's creditworthiness and the lender's previous experience with the firm. An unsecured borrower does not have to pledge specific assets as security. The three main types of unsecured short-term loans are trade credit, bank loans, and commercial paper.

Trade Credit: Accounts Payable

When Goodyear sells tires to General Motors, GM does not have to pay cash on delivery. Instead, Goodyear regularly bills GM for its tire purchases, and GM pays at a later date. This is an example of **trade credit**: the seller extends credit to the buyer between the time the buyer receives the goods or services and when it pays for them. Trade credit is a major source of short-term business financing. The buyer enters the credit on its books as an **account payable**. In effect, the credit is a short-term loan from the seller to the buyer of the goods and services. Until GM pays Goodyear, Goodyear has an account receivable from GM, and GM has an account payable to Goodyear.

Bank Loans

Unsecured bank loans are another source of short-term business financing. Companies often use these loans to finance seasonal (cyclical) businesses. Unsecured bank loans include lines of credit and revolving credit agreements. A **line of credit** specifies the maximum amount of unsecured short-term borrowing the bank will allow the firm over a given period, typically one year. The firm either pays a fee or keeps a certain percentage of the loan amount (generally 10 to 20 percent) in a checking account at the bank. Another bank loan, the **revolving credit agreement**, is basically a guaranteed line of credit that carries an extra fee in addition to interest. Revolving credit agreements are often arranged for a period of two to five years.

Commercial Paper

As noted earlier, commercial paper is an unsecured short-term debt—an IOU—issued by a financially strong corporation. Thus, it is both a short-term investment and a financing option for major corporations. Corporations issue commercial paper in multiples of $100,000 for periods ranging from 3 to 270 days. Many big companies use commercial paper instead of short-term bank loans because the interest rate on commercial paper is usually 1 to 3 percent below bank rates.

Secured Short-term Loans

Secured loans require the borrower to pledge specific assets as collateral, or security. The secured lender can legally take the collateral if the borrower doesn't repay the loan. Commercial banks and commercial finance companies are the main sources of secured short-term loans to business. Borrowers whose credit is not strong enough to qualify for unsecured loans use these loans. Typically, the collateral for secured short-term loans is accounts receivable or inventory. Because accounts receivable are normally quite liquid (easily converted to cash), they are an attractive form of collateral. The appeal of inventory—raw materials or finished goods—as collateral depends on how easily it can be sold at a fair price.

Another form of short-term financing using accounts receivable is **factoring**. A firm sells its accounts receivable outright to a factor, a financial institution (often a commercial bank or commercial finance company) that buys accounts receivable at a discount. Factoring is widely used in the clothing, furniture, and appliance industries. Factoring is more expensive than a bank loan, however, because the factor buys the receivables at a discount from their actual value.



Figure 15.3.4.1: For businesses with steady orders but a lack of cash to make payroll or other immediate payments, factoring is a popular way to obtain financing. In factoring, a company sells its invoices to a third-party funding source for cash. The factor purchasing the invoices then collects on the due payments over time. Trucking companies with voluminous accounts receivable in the form of freight bills are good candidates for the use of short-term financing such as factoring. Why might firms choose factoring instead of loans? *(Credit: Mike's Photos/ flickr/ Creative Commons Zero (CC0) license)*

CONCEPT CHECK

1. Distinguish between unsecured and secured short-term loans.
2. Briefly describe the three main types of unsecured short-term loans.
3. Discuss the two ways that accounts receivable can be used to obtain short-term financing.

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15.3.5: Raising Long-Term Financing

What are the Key Differences Between Debt and Equity, and What are the Major Types and Features of Long-term Debt?

A basic principle of finance is to match the term of the financing to the period over which benefits are expected to be received from the associated outlay. Short-term items should be financed with short-term funds, and long-term items should be financed with long-term funds. Long-term financing sources include both debt (borrowing) and equity (ownership). Equity financing comes either from selling new ownership interests or from retaining earnings. Financial managers try to select the mix of long-term debt and equity that results in the best balance between cost and risk.

Debt Versus Equity Financing

Say that the Boeing Company plans to spend $2 billion over the next four years to build and equip new factories to make jet aircraft. Boeing's top management will assess the pros and cons of both debt and equity and then consider several possible sources of the desired form of long-term financing.

The major advantage of debt financing is the deductibility of interest expense for income tax purposes, which lowers its overall cost. In addition, there is no loss of ownership. The major drawback is **financial risk**: the chance that the firm will be unable to make scheduled interest and principal payments. The lender can force a borrower that fails to make scheduled debt payments into bankruptcy. Most loan agreements have restrictions to ensure that the borrower operates efficiently.

Equity, on the other hand, is a form of permanent financing that places few restrictions on the firm. The firm is not required to pay dividends or repay the investment. However, equity financing gives common stockholders voting rights that provide them with a voice in management. Equity is more costly than debt. Unlike the interest on debt, dividends to owners are not tax-deductible expenses. Table 15.3.5.1 summarizes the major differences between debt and equity financing.

Debt Financing

Long-term debt is used to finance long-term (capital) expenditures. The initial maturities of long-term debt typically range between 5 and 20 years. Three important forms of long-term debt are term loans, bonds, and mortgage loans.

Table 15.3.5.1: Major Differences between Debt and Equity Financing

	Debt Financing	Equity Financing
Have a say in management	Creditors typically have none, unless the borrower defaults on payments. Creditors may be able to place restraints on management in event of default.	Common stockholders have voting rights.
Have a right to income and assets	Debt holders rank ahead of equity holders. Payment of interest and principal is a contractual obligation of the firm.	Equity owners have a residual claim on income (dividends are paid only after paying interest and any scheduled principal) and no obligation to pay dividends.
Maturity (date when debt needs to be paid back)	Debt has a stated maturity and requires repayment of principal by a specified date.	The company is not required to repay equity, which has no maturity date.
Tax treatment	Interest is a tax-deductible expense.	Dividends are not tax-deductible and are paid from after-tax income.

A **term loan** is a business loan with a maturity of more than one year. Term loans generally have maturities of 5 to 12 years and can be unsecured or secured. They are available from commercial banks, insurance companies, pension funds, commercial finance companies, and manufacturers' financing subsidiaries. A contract between the borrower and the lender spells out the amount and maturity of the loan, the interest rate, payment dates, the purpose of the loan, and other provisions such as operating and financial

restrictions on the borrower to control the risk of default. The payments include both interest and principal, so the loan balance declines over time. Borrowers try to arrange a repayment schedule that matches the forecast cash flow from the project being financed.

Bonds are long-term debt obligations (liabilities) of corporations and governments. A bond certificate is issued as proof of the obligation. The issuer of a bond must pay the buyer a fixed amount of money—called **interest**, stated as the *coupon rate*—on a regular schedule, typically every six months. The issuer must also pay the bondholder the amount borrowed—called the **principal**, or *par value*—at the bond's maturity date (due date). Bonds are usually issued in units of $1,000—for instance, $1,000, $5,000, or $10,000—and have initial maturities of 10 to 30 years. They may be secured or unsecured, include special provisions for early retirement, or be convertible to common stock.

A **mortgage loan** is a long-term loan made against real estate as collateral. The lender takes a mortgage on the property, which lets the lender seize the property, sell it, and use the proceeds to pay off the loan if the borrower fails to make the scheduled payments. Long-term mortgage loans are often used to finance office buildings, factories, and warehouses. Life insurance companies are an important source of these loans. They make billions of dollars' worth of mortgage loans to businesses each year.

CONCEPT CHECK

1. Distinguish between debt and equity.
2. Identify the major types and features of long term debt.

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15.3.6: Equity Financing

When and How Do Firms Issue Equity, and What are the Costs?

Equity refers to the owners' investment in the business. In corporations, the preferred and common stockholders are the owners. A firm obtains equity financing by selling new ownership shares (external financing), by retaining earnings (internal financing), or for small and growing, typically high-tech, companies, through venture capital (external financing).

Selling New Issues of Common Stock

Common stock is a security that represents an ownership interest in a corporation. A company's first sale of stock to the public is called an *initial public offering (IPO)*. An IPO often enables existing stockholders, usually employees, family, and friends who bought the stock privately, to earn big profits on their investment. (Companies that are already public can issue and sell additional shares of common stock to raise equity funds.)

But going public has some drawbacks. For one thing, there is no guarantee an IPO will sell. It is also expensive. Big fees must be paid to investment bankers, brokers, attorneys, accountants, and printers. Once the company is public, it is closely watched by regulators, stockholders, and securities analysts. The firm must reveal such information as operating and financial data, product details, financing plans, and operating strategies. Providing this information is often costly.

Going public is the dream of many small company founders and early investors, who hope to recoup their investments and become instant millionaires. Google, which went public in 2004 at $85 a share and soared to $475 in early 2006 before settling back to trade in the high-300 range in August 2006. More than a decade later, in October 2017, Google continues to be a successful IPO, trading at more than $990 per share.

In recent years, the number of IPOs has dropped sharply, as start-ups think long and hard about going public, despite the promise of millions of dollars for investors and entrepreneurs. For example, in 2017, Blue Apron, a meal-kit delivery service, went public with an opening stock price of $10 per share. Several months later, the share price dropped more than 40 percent. Some analysts believe that Amazon's possible entry into the meal-kit delivery sector has hurt Blue Apron's value, as well as the company's high marketing costs to attract and retain monthly subscribers.

Some companies choose to remain private. Cargill, SC Johnson, Mars, Publix Super Markets, and Bloomberg are among the largest U.S. private companies.



Figure 15.3.6.1: Snap Inc., the parent company of Snapchat, went public in 2017 under the ticker symbol "SNAP." The much-anticipated IPO was popular at an opening price of $17 per share and rose that same day by more than 40 percent, which initially put the company's market capitalization at about $30 billion. What are the pros and cons of going public? *(Credit: Tim Savage/ pexels/ Creative Commons Zero (CC0) license)*

Dividends and Retained Earnings

Dividends are payments to stockholders from a corporation's profits. Dividends can be paid in cash or in stock. **Stock dividends** are payments in the form of more stock. Stock dividends may replace or supplement cash dividends. After a stock dividend has been paid, more shares have a claim on the same company, so the value of each share often declines. A company does not have to pay dividends to stockholders. But if investors buy the stock expecting to get dividends and the firm does not pay them, the investors may sell their stocks.

At their quarterly meetings, the company's board of directors (typically with the advice of its CFO) decides how much of the profits to distribute as dividends and how much to reinvest. A firm's basic approach to paying dividends can greatly affect its share price. A stable history of dividend payments indicates good financial health. For example, cable giant Comcast has increased its dividend more than 20 percent over the past five years, giving shareholders a healthy return on their investment.

If a firm that has been making regular dividend payments cuts or skips a dividend, investors start thinking it has serious financial problems. The increased uncertainty often results in lower stock prices. Thus, most firms set dividends at a level they can keep paying. They start with a relatively low dividend payout ratio so that they can maintain a steady or slightly increasing dividend over time.

Retained earnings, profits that have been reinvested in the firm, have a big advantage over other sources of equity capital: They do not incur underwriting costs. Financial managers strive to balance dividends and retained earnings to maximize the value of the firm. Often the balance reflects the nature of the firm and its industry. Well-established and stable firms and those that expect only modest growth, such as public utilities, financial services companies, and large industrial corporations, typically pay out much of

their earnings in dividends. For example, in the 2016 fiscal year, ExxonMobil paid dividends of $3.08 per share, Altria Group paid $2.64 per share, Apple paid $2.23 per share, and Costco paid $2.00 per share.

Most high-growth companies, such as those in technology-related fields, finance much of their growth through retained earnings and pay little or no dividends to stockholders. As they mature, many decide to begin paying dividends, as Apple decided to do in 2012, after 17 years of paying no annual dividends to shareholders.

Preferred Stock

Another form of equity is **preferred stock**. Unlike common stock, preferred stock usually has a dividend amount that is set at the time the stock is issued. These dividends must be paid before the company can pay any dividends to common stockholders. Also, if the firm goes bankrupt and sells its assets, preferred stockholders get their money back before common stockholders do.

Like debt, preferred stock increases the firm's financial risk because it obligates the firm to make a fixed payment. But preferred stock is more flexible. The firm can miss a dividend payment without suffering the serious results of failing to pay back a debt.

Preferred stock is more expensive than debt financing, however, because preferred dividends are not tax-deductible. Also, because the claims of preferred stockholders on income and assets are second to those of debtholders, preferred stockholders require higher returns to compensate for the greater risk.

Venture Capital

Venture capital is another source of equity capital. It is most often used by small and growing firms that aren't big enough to sell securities to the public. This type of financing is especially popular among high-tech companies that need large sums of money.

Venture capitalists invest in new businesses in return for part of the ownership, sometimes as much as 60 percent. They look for new businesses with high growth potential, and they expect a high investment return within 5 to 10 years. By getting in on the ground floor, venture capitalists buy stock at a very low price. They earn profits by selling the stock at a much higher price when the company goes public. Venture capitalists generally get a voice in management through seats on the board of directors. Getting venture capital is difficult, even though there are hundreds of private venture-capital firms in this country. Most venture capitalists finance only about 1 to 5 percent of the companies that apply. Venture-capital investors, many of whom experienced losses during recent years from their investments in failed dot-coms, are currently less willing to take risks on very early-stage companies with unproven technology. As a result, other sources of venture capital, including private foundations, states, and wealthy individuals (called *angel investors*), are helping start-up firms find equity capital. These private investors are motivated by the potential to earn a high return on their investment.

CONCEPT CHECK

1. Compare the advantages and disadvantages of debt and equity financing.
2. Discuss the costs involved in issuing common stock.
3. Briefly describe these sources of equity: retained earnings, preferred stock, venture capital.

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15.3.8: Buying and Selling at Securities Exchanges

Where Can Investors Buy and Sell Securities, and How are Securities Markets Regulated?

When we think of stock markets, we are typically referring to secondary markets, which handle most of the securities trading activity. The two segments of the secondary markets are broker markets and dealer markets, as Figure 15.3.8.1 shows. The primary difference between broker and dealer markets is the way each executes securities trades. Securities trades can also take place in alternative market systems and on non-U.S. securities exchanges.

The securities markets both in the United States and around the world are in flux and undergoing tremendous changes. We present the basics of securities exchanges in this section and discuss the latest trends in the global securities markets later in the chapter.

Broker Markets

The **broker market** consists of national and regional securities exchanges that bring buyers and sellers together through brokers on a centralized trading floor. In the broker market, the buyer purchases the securities directly from the seller through the broker. Broker markets account for about 60 percent of the total dollar volume of all shares traded in the U.S. securities markets.

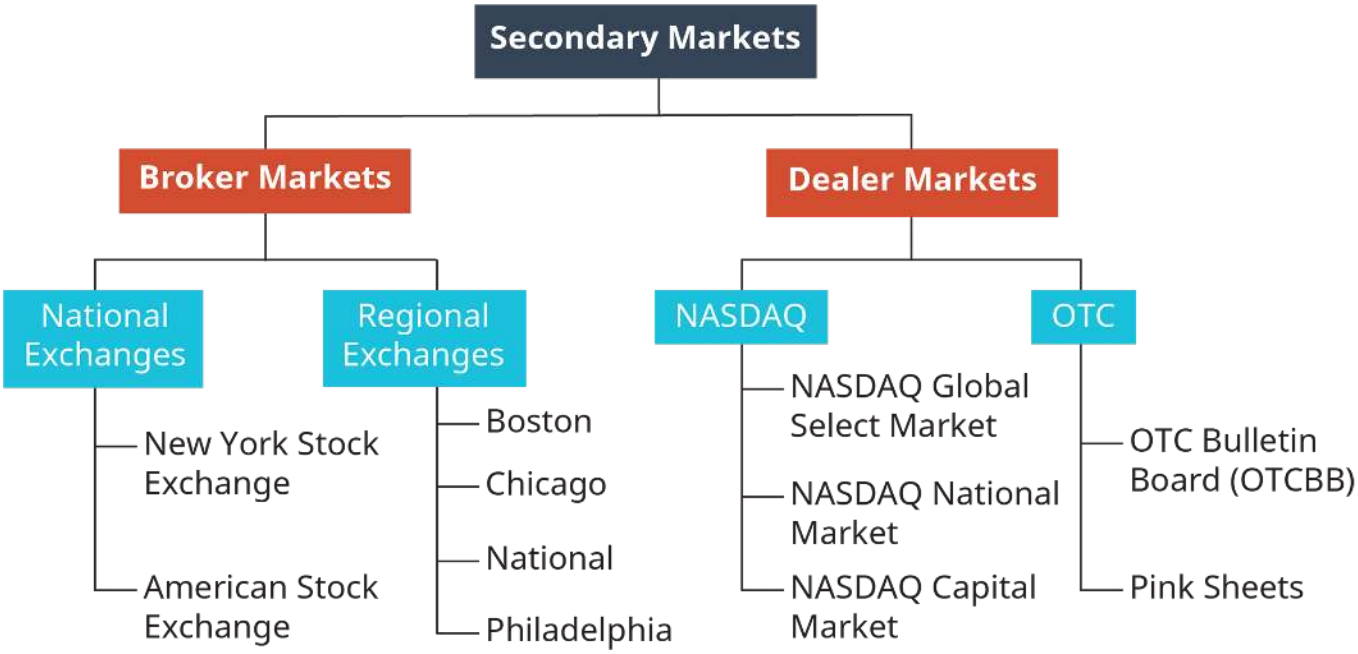


Figure 15.3.8.1: The Secondary Markets: Broker and Dealer Markets *(Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)*

New York Stock Exchange

The oldest and most prestigious broker market is the *New York Stock Exchange (NYSE)*, which has existed since 1792. Often called the Big Board, it is located on Wall Street in downtown New York City. The NYSE, which lists the shares of some 2,400 corporations, had a total market capitalization (domestic and foreign companies) of $25.8 trillion at year-end 2016. On a typical day, more than 3 billion shares of stock are traded on the NYSE. It represents 90 percent of the trading volume in the U.S. broker marketplace. Major companies such as IBM, Coca-Cola, AT&T, Procter & Gamble, Ford Motor Co., and Chevron list their shares on the NYSE. Companies that list on the NYSE must meet stringent listing requirements and annual maintenance requirements, which give them creditability.

The NYSE is also popular with non-U.S. companies. More than 490 foreign companies with a global market capitalization of almost $63 trillion now list their securities on the NYSE.

Until recently, all NYSE transactions occurred on the vast NYSE trading floor. Each of the companies traded at the NYSE is assigned to a trading post on the floor. When an exchange member receives an order to buy or sell a particular stock, the order is

transmitted to a floor broker at the company's trading post. The floor brokers then compete with other brokers on the trading floor to get the best price for their customers.

In response to competitive pressures from electronic exchanges, the NYSE created a hybrid market that combines features of the floor auction market and automated trading. Its customers now have a choice of how they execute trades. In the trends section, we'll discuss other changes the NYSE is making to maintain a leadership position among securities exchanges.

Another national stock exchange, the American Stock Exchange (AMEX), lists the securities of more than 700 corporations but handles only 4 percent of the annual share volume of shares traded on U.S. securities exchanges. Because the AMEX's rules are less strict than those of the NYSE, most AMEX firms are smaller and less well-known than NYSE-listed corporations. Some firms move up to the NYSE once they qualify for listing there. Other companies choose to remain on the AMEX. Companies cannot be listed on both exchanges at the same time. The AMEX has become a major market, however, for exchange-traded funds and in options trading.



Figure 15.3.8.2: The New York Stock Exchange (NYSE) is the largest securities market in the world. Its market capitalization dwarfs both foreign and domestic markets. Unlike other financial markets, the NYSE trades mostly through specialists, financial professionals who match up buyers and sellers of securities, while pocketing the spread between the bid and ask price on market orders. How does the NYSE's hybrid trading system differ from fully automated, electronic trading? *(Credit: Kevin Hutchison/ flickr/ Attribution 2.0 Generic (CC BY 2.0))*

Regional Exchanges

The remaining 6 percent of annual share volume takes place on several regional exchanges in the United States. These exchanges list about 100 to 500 securities of firms located in their area. Regional exchange membership rules are much less strict than for the NYSE. The top regional exchanges are the Boston, Chicago, Philadelphia, and National (formerly the Cincinnati) exchanges. An

electronic network linking the NYSE and many of the regional exchanges allows brokers to make securities transactions at the best prices.

The regional exchanges, which have struggled to compete, benefited from the passage of the Securities and Exchange Commission's (SEC's) Regulation NMS (National Market System), which became fully effective in 2007. Regulation NMS makes price the most important factor in making securities trades, and all orders must go to the trading venue with the best price.

Dealer Markets

Unlike broker markets, **dealer markets** do not operate on centralized trading floors but instead use sophisticated telecommunications networks that link dealers throughout the United States. Buyers and sellers do not trade securities directly, as they do in broker markets. They work through securities dealers called *market makers*, who make markets in one or more securities and offer to buy or sell securities at stated prices. A security transaction in the dealer market has two parts: the selling investor sells his or her securities to one dealer, and the buyer purchases the securities from another dealer (or in some cases, the same dealer).



Figure 15.3.8.3: Copy and Paste Caption here. (Copyright; author via source)

Exhibit **16.8** The New York Stock Exchange (NYSE) named Stacy Cunningham the first female head of the exchange in its 226-year history. Outside the exchange, the statue "Fearless Girl" by Kristen Virbal stared down the "bull" statue and represented the need for more female representation on the world's most important exchange. How does the naming of Stacy Cunningham as head of the NYSE demonstrate that the glass ceiling has been shattered? *(Anthony Quintano/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

NASDAQ

The largest dealer market is the **National Association of Securities Dealers Automated Quotation system**, commonly referred to as NASDAQ. The first electronic-based stock market, the NASDAQ is a sophisticated telecommunications network that links dealers throughout the United States. Founded in 1971 with origins in the over-the-counter (OTC) market, today NASDAQ is a separate securities exchange that is no longer part of the OTC market. The NASDAQ lists more companies than the NYSE, but the

NYSE still leads in total market capitalization. An average of 1.6 billion shares were exchanged daily in 2016 through NASDAQ, which is now the largest electronic stock market. It provides up-to-date bid and ask prices on about 3,700 of the most active OTC securities. Its sophisticated electronic communication system provides faster transaction speeds than traditional floor markets and is the main reason for the popularity and growth of the OTC market.

In January 2006, the SEC approved NASDAQ's application to operate as a national securities exchange. As a result, the NASDAQ Stock Market LLC began operating independently in August 2006. The securities of many well-known companies, some of which could be listed on the organized exchanges, trade on the NASDAQ. Examples include Amazon, Apple, Costco, Comcast, JetBlue, Microsoft, Qualcomm, and Starbucks. The stocks of most commercial banks and insurance companies also trade in this market, as do most government and corporate bonds. More than 400 foreign companies also trade on the NASDAQ.

More than a decade ago, the NASDAQ changed its structure to a three-tier market:

- The NASDAQ Global Select Market, a new tier with "financial and liquidity requirements that are higher than those of any other market," according to NASDAQ. More than 1,000 NASDAQ companies qualify for this group.
- The NASDAQ Global Market (formerly the NASDAQ National Market), which will list about 1,650 companies.
- The NASDAQ Capital Market will replace the NASDAQ Small Cap Market and list about 550 companies.

All three market tiers adhere to NASDAQ's rigorous listing and corporate governance standards.

The Over-the-Counter Market

The **over-the-counter (OTC) markets** refer to those other than the organized exchanges described above. There are two OTC markets: the *Over-the-Counter Bulletin Board (OTCBB)* and the *Pink Sheets*. These markets generally list small companies and have no listing or maintenance standards, making them attractive to young companies looking for funding. OTC companies do not have to file with the SEC or follow the costly provisions of Sarbanes-Oxley. Investing in OTC companies is therefore highly risky and should be for experienced investors only.

Alternative Trading Systems

In addition to broker and dealer markets, alternative trading systems such as **electronic communications networks (ECNs)** make securities transactions. ECNs are private trading networks that allow institutional traders and some individuals to make direct transactions in what is called the *fourth market*. ECNs bypass brokers and dealers to automatically match electronic buy and sell orders. They are most effective for high-volume, actively traded stocks. Money managers and institutions such as pension funds and mutual funds with large amounts of money to invest like ECNs because they cost far less than other trading venues.

Global Trading and Foreign Exchanges

Improved communications and the elimination of many legal barriers are helping the securities markets go global. The number of securities listed on exchanges in more than one country is growing. Foreign securities are now traded in the United States. Likewise, foreign investors can easily buy U.S. securities.

Stock markets also exist in foreign countries: more than 60 countries operate their own securities exchanges. NASDAQ ranks second to the NYSE, followed by the London Stock Exchange (LSE) and the Tokyo Stock Exchange. Other important foreign stock exchanges include Euronext (which merged with the NYSE but operates separately) and those in Toronto, Frankfurt, Hong Kong, Zurich, Australia, Paris, and Taiwan. The number of big U.S. corporations with listings on foreign exchanges is growing steadily, especially in Europe. For example, significant activity in NYSE-listed stocks also occurs on the LSE. The LSE also is getting a growing share of the world's IPOs. Emerging markets such as India, whose economy has been growing 6 percent or more a year, continue to attract investor attention. The Sensex, the benchmark index of the Bombay Stock Exchange, increased close to 40 percent between 2013 and 2017 as foreign investors continue to pump billions into Indian stocks.

Why should U.S. investors pay attention to international stock markets? Because the world's economies are increasingly interdependent, businesses must look beyond their own national borders to find materials to make their goods and markets for foreign goods and services. The same is true for investors, who may find that they can earn higher returns in international markets.

Regulation of Securities Markets

Both state and federal governments regulate the securities markets. The states were the first to pass laws aimed at preventing securities fraud. But most securities transactions occur across state lines, so federal securities laws are more effective. In addition to legislation, the industry has self-regulatory groups and measures.

Securities Legislation

Congress passed the Securities Act of 1933 in response to the 1929 stock market crash and subsequent problems during the Great Depression. It protects investors by requiring full disclosure of information about new securities issues. The issuer must file a *registration statement* with the SEC, which must be approved by the SEC before the security can be sold.

The *Securities Exchange Act of 1934* formally gave the SEC power to regulate securities exchanges. The act was amended in 1964 to give the SEC authority over the dealer markets as well. The amendment included rules for operating the stock exchanges and granted the SEC control over all participants (exchange members, brokers, dealers) and the securities traded in these markets.

The 1934 act also banned **insider trading**, the use of information that is not available to the general public to make profits on securities transactions. Because of lax enforcement, however, several big insider trading scandals occurred during the late 1980s. The *Insider Trading and Fraud Act of 1988* greatly increased the penalties for illegal insider trading and gave the SEC more power to investigate and prosecute claims of illegal actions. The meaning of *insider* was expanded beyond a company's directors, employees, and their relatives to include anyone who gets private information about a company.

Other important legislation includes the *Investment Company Act of 1940*, which gives the SEC the right to regulate the practices of investment companies (such as mutual funds managed by financial institutions), and the *Investment Advisers Act of 1940*, which requires investment advisers to disclose information about their background. The *Securities Investor Protection Corporation (SIPC)*was established in 1970 to protect customers if a brokerage firm fails, by insuring each customer's account for up to $500,000.

In response to corporate scandals that hurt thousands of investors, the SEC passed new regulations designed to restore public trust in the securities industry. It issued *Regulation FD* (for "fair disclosure") in October 2000. Regulation FD requires public companies to share information with all investors at the same time, leveling the information playing field. The *Sarbanes-Oxley Act of 2002* has given the SEC more power when it comes to regulating how securities are offered, sold, and marketed.

Self-Regulation

The investment community also regulates itself, developing and enforcing ethical standards to reduce the potential for abuses in the financial marketplace. The Financial Industry Regulatory Authority (FINRA) oversees the nation's more than 3,700 brokerage firms and more 600,000 registered brokers. It develops rules and regulations, provides a dispute resolution forum, and conducts regulatory reviews of member activities for the protection and benefit of investors.

In response to "Black Monday"—October 19, 1987, when the Dow Jones Industrial Average plunged 508 points and the trading activity severely overloaded the exchange's computers—the securities markets instituted corrective measures to prevent a repeat of the crisis. Now, under certain conditions, **circuit breakers** stop trading for a 15-minute cooling-off period to limit the amount the market can drop in one day. Under revised rules approved in 2012 by the SEC, market-wide circuit breakers kick in when the S&P 500 Index drops 7 percent (level 1), 13 percent (level 2), and 20 percent (level 3) from the prior day's closing numbers.

ETHICS IN PRACTICE

Blowing the Whistle on Financial Fraud

As part of the 2010 Dodd-Frank legislation passed by Congress in response to the 2008 financial crisis, the Securities and Exchange Commission (SEC) established a whistleblower-rewards program to provide employees and other individuals with the opportunity to report financial securities misconduct. More than seven years after starting the Office of the Whistleblower, the SEC reports that the rewards program has recovered almost $1 billion in financial penalties from companies that have done things to damage their own reputation as well as those of employees and other stakeholders.

According to a recent SEC report, 2016 was a banner year for individuals reporting financial wrongdoings and whistleblowers being rewarded for what they discovered. In 2016 alone, more than $57 million was awarded to whistleblowers—an amount

greater than the total amount of rewards issued since the program's inception in 2011.

The whistleblower program is based on three key components: monetary awards, prohibition of employer retaliation, and protection of the whistleblower's identity. The program requires the SEC to pay out monetary awards to eligible individuals who voluntarily provide original information about a violation of federal securities laws that has occurred, is ongoing, or is about to take place. The information supplied must lead to a successful enforcement action or monetary sanctions exceeding $1 million. No awards are paid out until the sanctions are collected from the offending firm.

A whistleblower must be an individual (not a company), and that individual does not need to be employed by a company to submit information about that specific organization. A typical award to a whistleblower is between 10 and 30 percent of the monetary sanctions the SEC and others (for example, the U.S. attorney general) are able to collect from the company in question.

Through September 2016, the whistleblower program received more than 18,000 tips, with more than 4,200 tips reported in 2016 alone. The program is not limited to U.S. citizens or residents; foreign persons living abroad may submit tips and are eligible to receive a monetary award. In fact, the SEC gave the largest monetary award to date of $30 million to a foreign national living abroad for original information relating to an ongoing fraud.

Despite criticisms from some financial institutions, the whistleblower-rewards program continues to be a success—reinforcing the point that financial fraud will not go unnoticed by the SEC, employees, and others individuals.

Critical Thinking Questions

1. Despite assurances that companies involved in financial fraud are not allowed to retaliate against their accusers, would you blow the whistle on your employer? Why or why not?
2. What can companies do to make sure their employees are aware of the consequences of financial securities fraud? Provide several examples.

CONCEPT CHECK

1. How do the broker markets differ from dealer markets, and what organizations compose each of these two markets?
2. Why is the globalization of the securities markets important to U.S. investors? What are some of the other exchanges where U.S companies can list their securities?
3. Briefly describe the key provisions of the main federal laws designed to protect securities investors. What is insider trading, and how can it be harmful? How does the securities industry regulate itself?

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15.3.9: Trends in Financial Management and Securities Markets

What are the Current Developments in Financial Management and the Securities Markets?

Many of the key trends shaping the practice of financial management echo those in other disciplines. For example, technology is improving the efficiency with which financial managers run their operations. In the wake of a slowing economy and corporate scandals, the SEC assumed a stronger role and implemented additional regulations to protect investors from fraud and misinformation. A wave of merger mania hit the global securities markets as the securities exchanges themselves have begun to consolidate to capture larger shares of the world's trading volume in multiple types of securities. Online brokerage firms are seeking new ways to capture and keep their customers by broadening the services they offer and keeping the fees they charge highly competitive. Let's now look at two key trends in greater detail. In the era of the Sarbanes-Oxley Act, CFOs find themselves balancing a strategic focus with overseeing corporate compliance with the act. The NYSE and NASDAQ are battling for supremacy as the regional exchanges look for niche markets to exploit.

Finance Looks Outward

No longer does finance operate in its own little world of spreadsheets and banking relationships. Most CFOs want the finance function to be viewed by their company's business units as a strategic partner who can contribute to their success. Finance professionals therefore need a broad view of company operations to communicate effectively with business unit managers, board members, creditors, and investors. The goal is productive cooperation and teamwork between finance and the business units to meet corporate objectives. CFOs are more highly visible and active in company management than ever before. They serve as both business partner to the chief executive and a fiduciary to the board.

In the aftermath of recent accounting scandals and the global recession of 2008–2009, CFOs consider accuracy of financial reporting their top priority, and they also must now provide more detailed explanations of what's behind the numbers to board members and other stakeholders. Rather than showering the board with financial reports and statistics, CFOs are crafting more focused presentations that deal with the company's overall financial health and future prospects. They must also educate board members about the implications of Sarbanes-Oxley and other legislation, such as Dodd-Frank, and what the company is doing to comply with federal regulations.

Vying for the Crown

The NYSE and NASDAQ continue to wage a heated battle for supremacy in the global securities markets. The NYSE fell behind its more nimble rival, which already had an electronic platform. Its answer was to make sweeping changes in its organizational structure by going public and merging with Archipelago, a major ECN, to enter the electronic marketplace. NASDAQ responded immediately by acquiring another ECN, Instinet's INET. The NYSE then made history by signing an agreement to merge with Euronext and create the first exchange to span the Atlantic. Not to be outdone, the NASDAQ increased its ownership of shares in the London Stock Exchange to 25 percent. These transactions reduced the fragmentation in the marketplace and also eliminated many of the differences between the two exchanges.

But the competition between the two companies continued in 2017, as the London Stock Exchange looks for a buyer after the European Commission refused to allow a merger between LSE and Germany's Deutsche Borse. It remains to be seen whether either U.S. exchange is ready to purchase an international exchange; however, their recent strategic moves have made them stronger and more competitive.

CONCEPT CHECK

1. How has the role of CFO changed since the passage of the Sarbanes-Oxley Act?
2. Describe the major changes taking place in the U.S. securities markets. What trends are driving these changes?

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