BMT1570: SMALL BUSINESS MANAGEMENT



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Small Business Management in the 21st Century

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This text was compiled on 05/08/2026

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CHAPTER OVERVIEW

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1.1: Chapter Introduction

The Twenty-First-Century Small-Business Owner



Figure 1.1.1: (*Used with permission from Frank C. Trotta*)

Frank Trotta III is a recent college graduate, class of 2009, and an excellent example of the twenty-first-century small business owner. At 23, he is already running his own business and planning to open a second. This may be second nature because Frank III is a third-generation small business owner. His grandfather, Frank Trotta Sr., opened a supermarket in 1945. His son, Frank C. Trotta Jr., began his career by working in the supermarket. Soon he had his own hardware department within the store and was beginning to understand what it takes to be a successful grocer. He observed his dad interacting with his customers and providing value through customer service.

Frank Jr. now owns and operates one of Long Island's most successful travel companies: the Prime Time Travel Club. The experience Frank Jr. garnered from his father in customer service became the tenet of his business philosophy: give customers value through personal attention and service. At an early age, Frank III worked in his dad's office when he was not busy with school activities. He had a strong entrepreneurial leaning and became very interested in the travel industry. In high school, Frank III worked for his dad and learned different facets of the travel business. While attending a Connecticut university, Frank III reached out to other students on campus and started his own side business: booking spring break trips. The same people are now repeat customers who call him to book their vacations, honeymoons, and family trips.

In his junior year, Frank III created a travel site of his own: Cruisetoanywhere.com. He is involved with every aspect of the site: he takes all calls from the customer service number, produces all the marketing campaigns, and works on contracts with both major and smaller cruise lines. Although the site is still young, it has been very successful. Frank III is learning how larger competitors do business and from their successes and mistakes. Customer service and attention are his first priority. Frank III believes his competitive business edge comes from what he learned from his father's company and business skills such as planning and managing cash flow from his professors. In addition to his cruise website, Frank III plans to launch another site, Tourstoanywhere.com. He exemplifies the skill set that will characterize the twenty-first-century small business owner: a clear focus on creating value for his customers, a willingness to exploit the benefits of digital technology and e-commerce, and the ability to apply basic business skills to the effective operation of the firm.

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1.2: Small Business in the US Economy

Learning Objectives

1. Explain the significance of small business in American history and the US economy.
2. Define small business.
3. Explain how small business contributes to the overall economy.
4. Explain how small business impacts US employment

It's an exciting time to be in small business. This is certainly not anything new, but you might not know it. Scan any issue of the popular business press, and in all probability, you will find a cover story on one of America's or the world's major corporations or a spotlight on their CEOs. Newspapers, talk radio, and television seem to have an unlimited supply of pundits and politicians eager to pontificate on firms that have been labeled as "too big to fail." Listen to any broadcast of a weekday's evening news program, and there will be a segment that highlights the ups and downs of the Dow Jones Industrial Average and the Standard and Poor's (S&P) 500. These market measures provide an insight into what is going on in Wall Street. However, they are clearly biased to not only large firms but also huge firms. This creates the false notion that "real" business is only about big business. It fails to recognize that small businesses are the overwhelming majority of all businesses in America; not only are the majority of jobs in small businesses, but small businesses have also been the major driving force in new job creation and innovation. Small business is *the* dynamo of innovation in our economy. In 2006, Thomas M. Sullivan, the chief counsel for advocacy of the Small Business Administration (SBA), said, "Small business is a major part of our economy,…small businesses innovate and create new jobs at a faster rate than their larger competitors. They are nimble, creative, and a vital part of every community across the country."“Small Business by the Numbers," *National Small Business Administration*, accessed October 7, 2011, www.nsba.biz/docs/bythenumbers.pdf.

This text is devoted to small business, not entrepreneurship. There has always been a challenge to distinguish—correctly—between the small business owner and the entrepreneur. Some argue that there is no difference between the two terms. The word *entrepreneur* is derived from a French word for "to undertake," which might indicate that entrepreneurs should be identified as those who start businesses.“A Definition of Entrepreneurship," *QuickMBA.com*, accessed October 7, 2011, www.quickmba.com/entre/definition. However, this interpretation is too broad and is pointless as a means of distinguishing between the two. Some have tried to find differences based on background, education, or age. Nick Leiber, "The Anatomy of an Entrepreneur," *Bloomberg BusinessWeek*, July 8, 2009, accessed October 7, 2011, www.BusinessWeek.com/smallbiz/running_small__business/archives/2009/07/anatomy_of_an_e.html. Often one finds the argument that entrepreneurs have a different orientation toward risk than small business owners. The standard line is that entrepreneurs are willing to take great risks in starting an enterprise and/or willing to start again after a business failure.“Entrepreneur vs. Small Business Owner: What's the Difference?," *Mills Communication Group*, July 22, 2009, accessed October 7, 2011, www.millscommgroup.com/blog/2009/06/entrepreneur-vs-small-business-owner-whats-the-difference. Others try to make the distinction based on the issue of innovation or the degree of innovation. Given this focus, entrepreneurs need not even work for small business because they can come up with innovative products, services, production, or marketing processes in large organizations.Dale Beermann, "Entrepreneur or Small Business Owner? Does It Matter?," *Brazen Careerist*, January 30, 2009, accessed October 7, 2011, www.brazencareerist.com/2009/01/29/entrepreneur-or-small-business-owner-does-it-matter.Perhaps the most common interpretation of the entrepreneur is an individual involved in a high-tech start-up who becomes a billionaire. That is not the focus of this text. It centers on the true driving force of America's economy—the small business.

This chapter gives a brief history of small business in the United States, the critical importance of small business to the American economy, the challenges facing small business owners as they struggle to survive and prosper, the requisite skills to be an effective small business owner, the critical importance of ethical behavior, and how these businesses may evolve over time. In addition, three critical success factors for the twenty-first-century small business are threaded through the text: (1) *identifying and providing customer value*, (2) *being able to exploit digital technologies with an emphasis on e-business and e-commerce*, and (3) *properly managing your cash flow*. These three threads are essential to the successful decision making of any contemporary small business and should be considered of paramount importance. They are everyday considerations.

A Brief History of Small Business

Throughout American history, from colonial times until today, most businesses were small businesses, and they have played a vital role in America's economic success and are a forge to our national identity. It would not be an exaggeration to say that the small businessperson has always held an important—even exalted—position in American life. Americans in the early republic were as suspicious of large economic enterprises as threats to their liberty as they were of large government. The historian James L. Houston discussed American suspicion of large economic enterprises: "Americans believed that if property was concentrated in the hands of a few in the republic, those few would use their wealth to control other citizens, seize political power, and warp the republic into an oligopoly."Jack Beatty, *The Age of Betrayal: The Triumph of Money in America 1865–1900* (New York: Alfred A. Knopf, 2007), 11.In fact, much of the impetus behind the Boston Tea Party was the fear on the part of local merchants and tradesmen that the East India Company, at that time the world's largest corporation, was dumping low-priced tea in the colonies, which would have driven local business to ruin.Ted Nace, *The Gangs of America: The Rise of Corporate Power and the Disabling of Democracy* (San Francisco: Berrett-Koehler Publishers, 2003), 44. Jefferson's promotion of the yeoman farmer, which included small merchants, as the bulwark of democracy stemmed from his fear of large moneyed interests: "The end of democracy and the defeat of the American Revolution will occur when government falls into the hands of lending institutions and moneyed incorporations."Bob Higgins, "Like Lincoln, Jefferson, Madison—Americans Fear Corporate Control of Public Policy," *TPMCafe*, February 17, 2011, accessed October 23, 2011, tpmcafe.talkingpointsmemo.com/talk/blogs/r/l/rlh974/2010/02/like-lincoln-jefferson-madison.php. So great was the fear of the large aggregation of wealth that the colonies and the early republic placed severe restrictions on the creation of corporate forms. In the first decades of the nineteenth century, state governments restricted the corporate form by limiting its duration, geographic scope, size, and even profits.Ted Nace, *The Gangs of America: The Rise of Corporate Power and the Disabling of Democracy* (San Francisco, Berrett-Koehler Publishers, 2003), 44. This was done because of the concern that corporations had the potential of becoming monopolies that would drive entrepreneurs out of business.

Eventually, however, some businesses grew in size and power. Their growth and size necessitated the development of a professional management class that was distinct from entrepreneurs who started and ran their own businesses. However, not until the post–Civil War period did America see the true explosion in big businesses. This was brought about by several factors: the development of the mass market (facilitated by the railroads); increased capital requirement for mass production; and the 1886 Supreme Court case of *Santa Clara County v. Southern Pacific Railroad*, which granted corporations "personhood" by giving them protection under the Fourteenth Amendment.

The growth of corporations evoked several responses that were designed to protect small businesses from their larger competitors. The Interstate Commerce Act (1887) was a federal law designed to regulate the rates charged by railroads to protect small farmers and businesses. Other federal laws—the Sherman Act (1890) and the Clayton Act (1914)—were passed with the initial intent of restricting the unfair trading practices of trusts. In the early years, however, the Sherman Act was used more frequently against small business alliances and unions than against large businesses. Congress continued to support small businesses through the passage of legislation. The Robinson-Patman Act of 1936 and the Miller-Tydings Act of 1937 were designed to protect small retailers from large chain retailers.Mansel Blackford, *The History of Small Business in America*, 2nd ed. (Chapel Hill, NC: University of North Carolina Press, 2003), 4.

The Depression and the post–World War II environments posed special challenges to small business operations. The Hoover and Roosevelt administrations created organizations (the Reconstruction Finance Corporation in 1932 and the Small War Plants Corporation in 1942) to assist small firms. The functions of several government agencies were subsumed into the **Small Business Administration** in 1953. The designated purpose of the SBA was to "aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns.""What We Do," *Small Business Administration*, accessed October 7, 2011, www.sba.gov/about-sba-services/what-we-do. The SBA functions to ensure that small businesses have a fair chance at securing government contracts. It also has the responsibility of defining what constitutes a small business.

If anything is to be learned from the passage of all this legislation, it is that, as Conte (2006) eloquently put it, "Americans continued to revere small businesspeople for their self-reliance and independence."Christopher Conte, "Small Business in U.S. History," *America.gov*, January 3, 2006, accessed October 7, 2011, www.america.gov/st/business-english/2008/July/20080814215602XJyrreP0.6187664.html.

Definition of Small Business

The SBA definition of a small business has evolved over time and is dependent on the particular industry. In the 1950s, the SBA defined a **small business** firm as "independently owned and operated…and not dominant in its field of operation."Mansel Blackford, *The History of Small Business in America*, 2nd ed. (Chapel Hill, NC: University of North Carolina Press, 2003), 4. This is still part of their definition. At that time, the SBA classified a small firm as being limited to 250 employees for industrial organizations. Currently, this definition depends on the North American Industry Classification System (NAICS) for a business. The SBA recognizes that there are significant differences, across industries, with respect to competitiveness, entry and exit costs, distribution by size, growth rates, and technological change. Although the SBA defines 500 employees as the limit for the majority of industrial firms and receipts of $7 million for the majority of service, retail, and construction firms, there are different values for some industries. Table 1.1 presents a selection of different industries and their size limits.

Table 1.2.1: Examples of Size Limits for Small Businesses by the SBA

NAICS Code	NAICS US Industry Title	Size Standards (Millions of $)	Size Standards (Number of Employees)
111333	Strawberry farming	0.75	
113310	Timber tract operations	7.00	
114112	Shellfish fishing	4.00	
212210	Iron ore mining		500
236115	New single family housing construction	33.50	
311230	Breakfast cereal manufacturer		1,000
315991	Hat, cap, and millenary manufacturing		500
443111	Household appliance store	9.00	
454311	Heating oil dealers		50
483111	Deep sea freight transportation		500
484110	General freight trucking, local	25.50	
511130	Book publishers		500
512230	Music publishers		500
541214	Payroll services	8.50	
541362	Geophysical surveying and mapping services	4.50	
541712	Research and development in physical, engineering, and life sciences		500
	Except aircraft		1,500
722110	Full-service restaurants	7.00	
722310	Food service contractors	20.50	
811111	General automotive repair	7.00	
812320	Dry cleaning and laundry services	4.50	
813910	Business associations	7.00	

Source: "Table of Small Business Size Standards Matched to North American Industry Classification System Codes," *US Small Business Administration*, August 22, 2008, accessed June 1, 2012, http://www.sba.gov/content/small-business-size-standards

The SBA definition of what constitutes a small business has practical significance. Small businesses have access to an extensive support network provided by the SBA. It runs the SCORE program, which has more than 12,000 volunteers who assist small firms with counseling and training. The SBA also operates Small Business Development Centers, Export Assistance Centers, and Women's Business Centers. These centers provide comprehensive assistance to small firms. There can be significant economic support for small firms from the SBA. It offers a variety of guaranteed loan programs to start-ups and small firms. It assists small

firms in acquiring access to nearly half a trillion dollars in federal contracts. In fact, legislation attempts to target 23 percent of this value for small firms. The SBA can also assist with financial aid following a disaster.

Small Business in the American Economy

In 1958, small business contributed 57 percent of the nation's gross domestic product (GDP). This value dropped to 50 percent by 1980. What is remarkable is that this 50 percent figure has essentially held steady for the last thirty years.Katherine Kobe, "The Small Business Share of GDP, 1998–2004," *Small Business Research Summary*, April 2007, accessed October 7, 2011, archive.sba.gov/advo/research/rs299tot.pdf. It is interesting to note that the contribution of small businesses to the GDP can vary considerably based on particular industries. Table 1.2 presents data for selected industries for the period 1998–2004. It can be seen that in some industries—construction and real estate—80 percent or more of that industry's contribution to the GDP comes from small businesses, while in the information industry that number is 20 percent or less.

Few people realize that the overwhelming majority of businesses in the United States are small businesses with fewer than five hundred employees. The SBA puts the number of small businesses at 99.7 percent of the total number of businesses in the United States. However, most of the businesses are nonemployee businesses (i.e., no paid employees) and are home based.

Table 1.2.2: Small Businesses' Component of Industry Contribution to GDP

Year	Construction (%)	Real Estate and Leasing (%)	Wholesale Trade (%)	Transportation and Warehousing (%)	Information (%)
1998	88.0	80.4	59.1	39.1	26.4
1999	87.2	80.0	57.5	39.4	25.4
2000	85.4	79.8	56.8	39.0	22.7
2001	85.1	80.3	55.3	41.1	19.7
2002	84.6	79.4	56.3	41.0	20.3
2003	85.4	79.5	54.6	39.1	20.3
2004	85.6	79.6	55.4	38.6	18.0

Source: Katherine Kobe, "Small Business Share of GDP (Contract No. SBAHQ-05-M-0413)," *SBA Office of Advocacy*, April 2007, accessed October 7, 2011, archive.sba.gov/advo/research/rs299tot.pdf.

One area where the public has a better understanding of the strength of small business is in the area of innovation. Evidence dating back to the 1970s indicates that small businesses disproportionately produce innovations.Zoltan J. Acs and David B. Audretsch. "Innovation in Large and Small Firms: An Empirical Analysis," *American Economic Review* 78, no. 4 (1988): 678–90. It has been estimated that 40 percent of America's scientific and engineering talent is employed by small businesses. The same study found that small businesses that pursue patents produce thirteen to fourteen times as many patents per employee as their larger counterparts. Further, it has been found that these patents are twice as likely to be in the top 1 percent of highest impact patents."Small Business by the Numbers," *National Small Business Administration*, accessed October 7, 2011, www.nsba.biz/docs/bythenumbers.pdf.

It is possible that small size might pose an advantage with respect to being more innovative. The reasons for this have been attributed to several factors:

- **Passion.** Small-business owners are interested in making businesses successful and are more open to new concepts and ideas to achieve that end.
- **Customer connection.** Being small, these firms better know their customers' needs and therefore are better positioned to meet them.
- **Agility.** Being small, these firms can adapt more readily to changing environment.
- **Willingness to experiment.** Small-business owners are willing to risk failure on some experiments.
- **Resource limitation.** Having fewer resources, small businesses become adept at doing more with less.

- **Information sharing.** Smaller size may mean that there is a tighter social network for sharing ideas.Jeff Cornwall, “Innovation in Small Business,” *The Entrepreneurial Mind*, March 16, 2009, accessed June 1, 2012, http://www.drjeffcornwall.com/2009/03/16/innovation_in_small_business/.

Regardless of the reasons, small businesses, particularly in high-tech industries, play a critical role in preserving American global competitiveness.

Small Business and National Employment

The majority—approximately 50.2 percent in 2006—of private sector employees work for small businesses. A breakdown of the percentage of private sector employees by firm size for the period 1988 to 2006 is provided in Table 1.3. For 2006, slightly more than 18 percent of the entire private sector workforce was employed by firms with fewer than twenty employees. It is interesting to note that there can be significant difference in the percentage of employment by small business across states. Although the national average was 50.2 percent in 2006, the state with the lowest percentage working for small businesses was Florida with 44.0 percent, while the state with the highest percentage was Montana with a remarkable 69.8 percent.“Small Business by the Numbers,” *National Small Business Administration*, accessed October 7, 2011, www.nsba.biz/docs/bythenumbers.pdf.

Table 1.2.3: Percentage of Private Sector Employees by Firm Size

Year	0–4 Employees	5–9 Employees	10–19 Employees	20–99 Employees	100–499 Employees	500+ Employees
1988	5.70%	6.90%%	8.26%	19.16%	14.53%	45.45%
1991	5.58%	6.69%	8.00%	18.58%	14.24%	46.91%
1994	5.50%	6.55%	7.80%	18.29%	14.60%	47.26%
1997	5.20%	4.95%	6.36%	16.23%	13.73%	53.54%
2000	4.90%	5.88%	7.26%	17.78%	14.26%	49.92%
2003	5.09%	5.94%	7.35%	17.80%	14.49%	49.34%
2006	4.97%	5.82%	7.24%	17.58%	14.62%	49.78%

Source: US Census Bureau, “Statistics of U.S. Business,” accessed October 7, 2011, www.census.gov/econ/susb.

Small business is the great generator of jobs. Recent data indicate that small businesses produced 64 percent of the net new jobs from 1993 to the third quarter of 2008.“Statistics of U.S. Businesses,” *US Census Bureau*, April 13, 2010, accessed October 7, 2011, www.census.gov/econ/susb. This is not a recent phenomenon. Thirty years of research studies have consistently indicated that the driving force in fostering new job creation is the birth of new companies and the net additions coming from small businesses. In the 1990s, firms with fewer than twenty employees produced far more net jobs proportionally to their size, and two to three times as many jobs were created through new business formation than through job expansion in small businesses.William J Dennis Jr., Bruce D. Phillips, and Edward Starr, “Small Business Job Creation: The Findings and Their Critics”, *Business Economics* 29, no. 3 (1994): 23–30. The US Census Bureau’s Business Dynamics Statistics data confirm that the greatest number of new jobs comes from the creation of new businesses. One can get a sense of the extent of net job change by business size in Table 1.4.

An additional point needs to be made about job creation and loss by small businesses in the context of overall economic conditions. Government data show that of the “net 1.5 million jobs lost in 2008, 64 percent were from small firms.”Brian Headd, “An Analysis of Small Business and Jobs,” *Small Business Administration*, March 2010, accessed October 7, 2011, www.sba.gov/advo/research/rs359tot.pdf (p. 10). However, the same study had some interesting results from the past two recessions. In the 2001 recession, small businesses with fewer than 20 employees experienced 7 percent of the total reduction in jobs, firms with between 20 and 500 employees were responsible for 43 percent of the job losses, and the rest of the job losses came from large firms. As the economy recovered in the following year, firms with fewer than 20 employees created jobs, while the other two groups continued to shed jobs. Following the 1991 recession, it was firms with 20 to 500 employees that were responsible for more than 56 percent of the jobs that were added.

Table 1.2.4: Job Creation by Firm Size

Years	1–4	5–9	10–19	20–99	100–499	500+
2002–2003	1,106,977	307,690	158,795	304,162	112,702	(994,667)
2003–2004	1,087,128	336,236	201,247	199,298	66,209	(214,233)
2004–2005	897,296	141,057	(11,959)	(131,095)	83,803	262,326
2005–2006	1,001,960	295,521	292,065	590,139	345,925	1,072,710

Source: “Small Business Profile,” *SBA Office of Advocacy*, 2009, archive.sba.gov/advo/research/data.html.

One last area concerning the small business contribution to American employment is its role with respect to minority ownership and employment. During the last decade, there has been a remarkable increase in the number of self-employed individuals. From 2000 to 2007, the number of women who were self-employed increased by 9.7 percent. The number of African Americans who were self-employed increased by 36.6 percent for the same time range. However, the most remarkable number was an increase of nearly 110 percent for Hispanics. It is clear that small business has become an increasingly attractive option for minority groups.“Statistics of U.S. Businesses,” *US Census Bureau*, April 13, 2010, accessed October 7, 2011, www.census.gov/econ/susb. Women and Hispanics are also employed by small businesses at a higher rate than the national average.

Learning Objectives

- Small businesses have always played a key role in the US economy.
- Small businesses are responsible for more than half the employment in the United States.
- Small businesses have a prominent role in innovation and minority employment.

Exercises

1. Throughout this text, you will be given several assignments. It would be useful if these assignments had some degree of consistency. Select a type of business that interests you and plan on using it throughout some of the chapter assignments. After selecting your business, go to www.sba.gov/content/table-small-business-size-standards and determine the size of the business.
2. In the United States, 50 percent of those employed are working for small businesses. There are considerable differences across states. Go to www.census.gov/econ/susb/ and compute the percentage for your state. What factors might account for the differences across states?

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1.3: Success and Failure in Small Businesses

Learning Objectives

1. Be able to explain what is meant by business success.
2. Be able to describe the different components of business failure.
3. Understand that statistics on business failure can be confusing and contradictory.
4. Understand that small business failure can be traced to managerial inadequacy, financial issues, and the external environment.
5. Understand that small business owners need to be able to formally plan and understand the accounting and finance needs of their firms.

There are no easy answers to questions about success and failure in a small business. The different points of view are all over the map.

What Is a Successful Small Business?

Ask the average person what the purpose of a business is or how he or she would define a successful business, and the most likely response would be "one that makes a profit." A more sophisticated reply might extend that to "one that makes an acceptable profit now and in the future." Ask anyone in the finance department of a publicly held firm, and his or her answer would be "one that maximizes shareholder wealth." The management guru Peter Drucker said that for businesses to succeed, they needed to create customers, while W. E. Deming, the quality guru, advocated that business success required "delighting" customers. No one can argue, specifically, with any of these definitions of **small business success**, but they miss an important element of the definition of success for the small business owner: *to be free and independent*.

Many people have studied whether there is any significant difference between the small business owner and the entrepreneur. Some entrepreneurs place more emphasis on growth in their definition of success.William Dunkelberg and A. C. Cooper. "Entrepreneurial Typologies: An Empirical Study," *Frontiers of Entrepreneurial Research*, ed. K. H. Vesper (Wellesley, MA: Babson College, Centre for Entrepreneurial Studies, 1982), 1–15. However, it is clear that entrepreneurs and small business owners define much of their personal and their firm's success in the context of providing them with independence. For many small business owners, being in charge of their own life is the prime motivator: a "fervently guarded sense of independence," and money is seen as a beneficial by-product."Report on the Commission or Enquiry on Small Firms," *Bolton Report*, vol. 339 (London: HMSO, February 1973), 156–73.Paul Burns and Christopher Dewhurst, *Small Business and Entrepreneurship*, 2nd ed. (Basingstoke, UK: Macmillan, 1996), 17.Graham Beaver, *Business, Entrepreneurship and Enterprise Development* (Englewood Cliffs, NJ: Prentice Hall, 2002), 33.Oftentimes, financial performance is seen as an important measure of success. However, small businesses are reluctant to report their financial information, so this will always be an imperfect and incomplete measure of success.Terry L. Besser, "Community Involvement and the Perception of Success Among Small Business Operators in Small Towns," *Journal of Small Business Management 37*, no 4 (1999): 16.

Three types of small business operators can be identified based on what they see as constituting success:

1. An artisan whose intrinsic satisfaction comes from performing the business activity
2. The entrepreneur who seeks growth
3. The owner who seeks independence M. K. J. Stanworth and J. Curran, "Growth and the Small Firm: An Alternative View," *Journal of Management Studies* 13, no. 2 (1976): 95–111.

Video Clip 1.3.1:



The story of Popchips, a small business success.

Failure Rates for Small Business

When discussing failure rates in small business, there is only one appropriate word: *confusion*. There are wildly different values, from 90 percent to 1 percent, with a wide range of values in between.Roger Dickinson, "Business Failure Rate," *American Journal of Small Business* 6, no. 2 (1981): 17–25.Obviously, there is a problem with these results, or some factor is missing. One factor that would explain this discrepancy is the different definitions of the term *failure*. A second factor is that of timeline. When will a firm fail after it starts operation?

The term *failure* can have several meanings.A. B. Cochran, "Small Business Failure Rates: A Review of the Literature," *Journal of Small Business Management* 19, no. 4, (1981): 50–59. **Small-business failure** is often measured by the cessation of a firm's operation, but this can be brought about by several things:

- An owner can die or simply choose to discontinue operations.
- The owner may recognize that the business is not generating sufficient return to warrant the effort that is being put into it. This is sometimes referred to as the failure of opportunity cost.
- A firm that is losing money may be terminated to avoid losses to its creditors.
- There can be losses to creditors that bring about cessations of the firm's operations.
- The firm can experience bankruptcy. Bankruptcy is probably what most people think of when they hear the term *business failure*. However, the evidence indicates that bankruptcies constitute only a minor reason for failure.

Failure can therefore be thought of in terms of a cascading series of outcomes (see Figure 1.1). There are even times when small business owners involved in a closure consider the firm successful at its closing.Don Bradley and Chris Cowdery, "Small Business: Causes of Bankruptcy," July 26, 2004, accessed October 7, 2011, www.sbaer.uca.edu/research/asbe/2004_fall/16.pdf. Then there is the complication of considering the industry of the small business when examining failure and bankruptcy. The rates of failure can vary considerably across different industries; in the fourth quarter of 2009, the failure rates for service firms were half that of transportation firms."Equifax Study Shows the Ups and Downs of Commercial Credit Trends," *Equifax*, 2010, accessed October 7, 2011, www.equifax.com/PR/pdfs/CommercialFactSheetFN3810.pdf.

Figure 1.1 *Types of Business Failures*



Figure 1.3.1:*Types of Business Failures*. (Copyright; author via source)

The second issue associated with small business failure is a consideration of the time horizon. Again, there are wildly different viewpoints. The Dan River Small Business Development Center presented data that indicated that 95 percent of small businesses fail within five years.Don Bradley and Chris Cowdery, "Small Business: Causes of Bankruptcy," July 26, 2004, accessed October 7, 2011, www.sbaer.uca.edu/research/asbe/2004_fall/16.pdf. Dun and Bradstreet reported that companies with fewer than twenty employees have only a 37 percent chance of surviving four years, but only 10 percent will go bankrupt.Don Bradley and Chris Cowdery, "Small Business: Causes of Bankruptcy," July 26, 2004, accessed October 7, 2011, www.sbaer.uca.edu/research/asbe/2004_fall/16.pdf. The US Bureau of Labor Statistics indicated that 66 percent of new establishments survive for two years, and that number drops to 44 percent two years later.Anita Campbell, "Business Failure Rates Is Highest in First Two Years," *Small Business Trends*, July 7, 2005, accessed October 7, 2011, smallbiztrends.com/2005/07/business-failure-rates-highest-in.html. It appears that the longer you survive, the higher the probability of your continued existence. This makes sense, but it is no guarantee. Any business can fail after many years of success.

Why Do Small Businesses Fail?

There is no more puzzling or better studied issue in the field of small business than what causes them to fail. Given the critical role of small businesses in the US economy, the economic consequences of failure can be significant. Yet there is no definitive answer to the question.

Three broad categories of causes of failure have been identified: managerial inadequacy, financial inadequacy, and external factors. The first cause, **managerial inadequacy**, is the most frequently mentioned reason for firm failure.T. C. Carbone, "The Challenges of Small Business Management," *Management World* 9, no. 10 (1980): 36. Unfortunately, it is an all-inclusive explanation, much like explaining that all plane crashes are due to pilot failure. Over thirty years ago, it was observed that "while everyone agrees that bad management is the prime cause of failure, no one agrees what 'bad management' means nor how it can be recognized except that the company has collapsed—then everyone agrees that how badly managed it was."John Argenti, *Corporate Collapse: The Causes and Symptoms* (New York: McGraw-Hill, 1976), 45. This observation remains true today.

The second most common explanation cites **financial inadequacy**, or a lack of financial strength in a firm. A third set of explanations center on environmental or **external factors**, such as a significant decline in the economy.

Because it is important that small firms succeed, not fail, each factor will be discussed in detail. However, these factors are not independent elements distinct from each other. A declining economy will depress a firm's sales, which negatively affects a firm's cash flow. An owner who lacks the knowledge and experience to manage this cash flow problem will see his or her firm fail.

Managerial inadequacy is generally perceived as the major cause of small business failure. Unfortunately, this term encompasses a very broad set of issues. It has been estimated that two thirds of small business failures are due to the incompetence of the owner-manager.Graham Beaver, "Small Business: Success and Failure," *Strategic Change* 12, no. 3 (2003): 115–22. The identified problems cover behavioral issues, a lack of business skills, a lack of specific technical skills, and marketing myopia. Specifying every limitation of these owners would be prohibitive. However, some limitations are mentioned with remarkable consistency.

Having poor communication skills, with employees and/or customers, appears to be a marker for failure.Sharon Nelton, “Ten Key Threats to Success,” *Nation’s Business* 80, no. 6 (1992): 18–24. The inability to listen to criticism or divergent views is a marker for failure, as is the inability to be flexible in one’s thinking.Robert N. Steck, “Why New Businesses Fail,” *Dun and Bradstreet Reports* 33, no. 6 (1985): 34–38.

Ask many small business owners where their strategic plans exist, and they may point to their foreheads. The failure to conduct formal planning may be the most frequently mentioned item with respect to small business failure. Given the relative lack of resources, it is not surprising that small firms tend to opt for intuitive approaches to planning.G. E. Tibbits, “Small Business Management: A Normative Approach,” in *Small Business Perspectives*, ed. Peter Gorb, Phillip Dowell, and Peter Wilson (London: Armstrong Publishing, 1981), 105.’Jim Brown, *Business Growth Action Kit* (London: Kogan Page, 1995), 26. Formal approaches to planning are seen as a waste of time,Christopher Orpen, “Strategic Planning, Scanning Activities and the Financial Performance of Small Firms,” *Journal of Strategic Change* 3, no. 1 (1994): 45–55. or they are seen as too theoretical.Sandra Hogarth-Scott, Kathryn Watson, and Nicholas Wilson, “Do Small Business Have to Practice Marketing to Survive and Grow?,” *Marketing Intelligence and Planning* 14, no. 1 (1995): 6–18. The end result is that many small business owners fail to conduct formal strategic planning in a meaningful way.Isaiah A. Litvak and Christopher J. Maule, “Entrepreneurial Success or Failure—Ten Years Later,” *Business Quarterly* 45, no. 4 (1980): 65.’Hans J. Pleitner, “Strategic Behavior in Small and Medium-Sized Firms: Preliminary Considerations,” *Journal of Small Business Management* 27, no. 4 (1989): 70–75. In fact, many fail to conduct any planning;Richard Monk, “Why Small Businesses Fail,” *CMA Management* 74, no. 6 (2000): 12.’Anonymous, “Top-10 Deadly Mistakes for Small Business,” *Green Industry Pro* 19, no. 7 (2007): 58. others may fail to conduct operational planning, such as marketing strategies.Rubik Atamian and Neal R. VanZante, “Continuing Education: A Vital Ingredient of the ‘Success Plan’ for Business,” *Journal of Business and Economic Research* 8, no. 3 (2010): 37–42. The evidence appears to clearly indicate that a small firm that wishes to be successful needs to not only develop an initial strategic plan but also conduct an ongoing process of strategic renewal through planning.

Many managers do not have the ability to correctly select staff or manage them.T. Carbone, “Four Common Management Failures —And How to Avoid Them,” *Management World* 10, no. 8 (1981): 38–39. Other managerial failings appear to be in limitations in the functional area of marketing. Failing firms tend to ignore the changing demands of their customers, something that can have devastating effects.Anonymous, “Top-10 Deadly Mistakes for Small Business,” *Green Industry Pro* 19, no. 7 (2007): 58. The failure to understand what customers value and being able to adapt to changing customer needs often leads to business failure.Rubik Atamian and Neal R. VanZante, “Continuing Education: A Vital Ingredient of the ‘Success Plan’ for Business,” *Journal of Business and Economic Research* 8, no. 3 (2010): 37–42.

The second major cause of small business failure is finance. Financial problems fall into three categories: start-up, cash flow, and financial management. When a firm begins operation (start-up), it will require capital. Unfortunately, many small business owners initially underestimate the amount of capital that should be available for operations.Howard Upton, “Management Mistakes in a New Business,” *National Petroleum News* 84, no. 10 (1992): 50. This may explain why most small firms that fail do so within the first few years of their creation. The failure to start with sufficient capital can be attributed to the inability of the owner to acquire the needed capital. It can also be due to the owner’s failure to sufficiently plan for his or her capital needs. Here we see the possible interactions among the major causes of firm failure. Cash-flow management has been identified as a prime cause for failure.Rubik Atamian and Neal R. VanZante, “Continuing Education: A Vital Ingredient of the ‘Success Plan’ for Business,” *Journal of Business and Economic Research* 8, no. 3 (2010): 37–42.’Arthur R. DeThomas and William B. Fredenberger, “Accounting Needs of Very Small Business,” *The CPA Journal*55, no. 10 (1985): 14–20. Good cash-flow management is essential for the survival of any firm, but small firms in particular must pay close attention to this process. Small businesses must develop and maintain effective financial controls, such as credit controls.Roger Brown, “Keeping Control of Your Credit,” *Motor Transportation*, April 2009, 8. For very small businesses, this translates into having an owner who has at least a fundamental familiarity with accounting and finance.Arthur R. DeThomas and William B. Fredenberger, “Accounting Needs of Very Small Business,” *The CPA Journal* 55, no. 10 (1985): 14–20. In addition, the small firm will need either an in-house or an outsourced accountant.Hugh M. O’Neill and Jacob Duker, “Survival and Failure in Small Business,” *Journal of Small Business Management* 24, no. 1 (1986): 30–37. Unfortunately, many owners fail to fully use their accountants’ advice to manage their businesses.Arthur R. DeThomas and William B. Fredenberger, “Accounting Needs of Very Small Business,” *The CPA Journal* 55, no. 10 (1985): 14–20.

The last major factor identified with the failure of small businesses is the external environment. There is a potentially infinite list of causes, but the economic environment tends to be most prominent. Here again, however, *confusing* appears to describe the list. Some argue that economic conditions contribute to between 30 percent and 50 percent of small business failures, in direct contradiction to the belief that managerial incompetence is the major cause.Jim Everett and John Watson, "Small Business Failures and External Risk Factors," *Small Business Economics* 11, no. 4 (1998): 371–90. Two economic measures appear to affect failure rates: interest rates, which appear to be tied to bankruptcies, and the unemployment rate, which appears to be tied to discontinuance.Jim Everett and John Watson, "Small Business Failures and External Risk Factors," *Small Business Economics* 11, no. 4 (1998): 371–90. The potential impact of these external economic variables might be that small business owners need to be either planners to cover potential contingencies or lucky.

Even given the confusing and sometimes conflicting results with respect to failure in small businesses, some common themes can be identified. The reasons for failure fall into three broad categories: managerial inadequacy, finance, and environmental. They, in turn, have some consistently mentioned factors (see Table 1.5). These factors should be viewed as warning signs—danger areas that need to be avoided if you wish to survive. Although small business owners cannot directly affect environmental conditions, they can recognize the potential problems that they might bring. This text will provide guidance on how the small business owner can minimize these threats through proactive leadership.

Table 1.3.1: Reasons for Small Business Failure

Managerial Inadequacy	Financial Inadequacy	External Factors
• Failure in planning (initial start-up plan and subsequent plans) • Inexperience with managing business operation • Ineffective staffing • Poor communication skills • Failure to seek or respond to criticism • Failure to learn from past failures • Ignoring customers' needs • Ignoring competition • Failure to diversify customer base • Failure to innovate • Ineffective marketing strategies	• Cash-flow problems • Insufficient initial capitalization • Inadequate financial records • Not using accountants' insights • Inadequate capital acquisition strategies • Failure to deal with financial issues brought about by growth	• Downturn in economy • Rising unemployment • Rising interest rates • Product or service no longer desired by customers • Unmatchable foreign competition • Fraud • Disaster

Ultimately, business failure will be a company-specific combination of factors. Monitor101, a company that developed an Internet information monitoring product for institutional investors in 2005, failed badly. One of the cofounders identified the following seven mistakes that were made, most of which can be linked to managerial inadequacy:Roger Ehrenberg, "Monitor 110: A Post Mortem—Turning Failure into Learning," *Making It!*, August 27, 2009, accessed June 1, 2012, http://www.makingittv.com/Small-Business-Entrepreneur-Story-Failure.htm.

1. The lack of a single "the buck stops here" leader until too late in the game
2. No separation between the technology organization and the product organization
3. Too much public relations, too early
4. Too much money
5. Not close enough to the customer
6. Slowness to adapt to market reality
7. Disagreement on strategy within the company and with the board

Learning Objectives

- There is no universal definition for small business success. However, many small business owners see success as their own independence.
- The failure rates for small businesses are wide ranging. There is no consensus.

- Three broad categories of factors are thought to contribute to small business failure: managerial inadequacy, financial inadequacy, and external forces, most notably the economic environment.

Exercises

1. Starting a business can be a daunting task. It can be made even more daunting if the type of business you choose is particularly risky. Go to www.forbes.com/2007/01/18/fairisaac-nordstrom-verizon-ent-fin-cx_mf_0118risky_slide.html?thisSpeed=undefined, where the ten riskiest businesses are identified. Select any two of these businesses and address why you think they are risky.
2. Amy Knaup is the author of a 2005 study "Survival and Longevity in the Business Employment Dynamics Data" (see www.bls.gov/opub/mlr/2005/05/ressum.pdf). The article points to different survival rates for ten different industries. Discuss why there are significant differences in the survival rates among these industries.

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1.4: Evolution

Learning Objectives

1. Define the five stages of small business growth.
2. Identify the stages of the organizational life cycle.
3. Characterize the industry life cycle and its impact on small business

Small businesses come in all shapes and sizes. One thing that they all share, however, is experience with common problems that arise at similar stages in their growth and organizational evolution. Predictable patterns can be seen. These patterns "tend to be sequential, occur as a hierarchical progression that is not easily reversed, and involve a broad range of organizational activities and structures.""Organizational Life Cycle," *Inc.*, 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html. The industry life cycle adds further complications. The success of any small business will depend on its ability to adapt to evolutionary changes, each of which will be characterized by different requirements, opportunities, challenges, risks, and internal and external threats. The decisions that need to be made and the priorities that are established will differ through this evolution.

Stages of Growth

Understanding the **small business growth stages** can be invaluable as a framework for anticipating resource needs and problems, assessing risk, and formulating business strategies (e.g., evaluating and responding to the impact of a new tax). However, the growth stages will not be applicable to all small businesses because not all small businesses will be looking to grow. Business success is commonly associated with growth and financial performance, but these are not necessarily synonymous—especially for small businesses. People become business owners for different reasons, so judgments about the success of their businesses may be related to any of those reasons.B. Kotey and G. G. Meredith, "Relationships among Owner/Manager Personal Values, Business Strategies, and Enterprise Performance," *Journal of Small Business Management* 35, no. 2 (1997): 37–65. A classic study by Churchill and Lewis identified five stages of small business growth: existence, survival, success, take-off, and resource maturity.Neil C. Churchill and Virginia L. Lewis, "The Five Stages of Small Business Growth," *Harvard Business Review* 61, no. 3 (1983): 30–44, 48–50. Each stage has its own challenges.

- **Stage I: Existence**.Neil C. Churchill and Virginia L. Lewis, "The Five Stages of Small Business Growth," *Harvard Business Review* 61, no. 3 (1983): 30–44, 48–50. This is the beginning. The business is up and running. The primary problems will be obtaining customers and establishing a customer base, producing products or services, and tracking and conserving cash flow.Darrell Zahorsky, "Find Your Business Life Cycle," accessed October 7, 2011, sbinformation.about.com/cs/marketing/a/a040603.htm. The organization is simple, with the owner doing everything, including directly supervising a small number of subordinates. Systems and formal planning do not exist. The company strategy? *Staying alive*. The companies that stay in business move to Stage II.
- **Stage II: Survival**.Neil C. Churchill and Virginia L. Lewis, "The Five Stages of Small Business Growth," *Harvard Business Review* 61, no. 3 (1983): 30–44, 48–50. The business is now a viable operation. There are enough customers, and they are being satisfied well enough for them to stay with the business. The company's focal point shifts to the relationship between revenues and expenses. Owners will be concerned with (1) whether they can generate enough cash in the short run to break even and cover the repair/replacement of basic assets and (2) whether they can get enough cash flow to stay in business and finance growth to earn an economic return on assets and labor. The organizational structure remains simple. Little systems development is evident, cash forecasting is the focus of formal planning, and the owner still runs everything.
- **Stage III: Success**.Neil C. Churchill and Virginia L. Lewis, "The Five Stages of Small Business Growth," *Harvard Business Review* 61, no. 3 (1983): 30–44, 48–50. The business is now economically healthy, and the owners are considering whether to leverage the company for growth or consider the company as a means of support for them as they disengage from the company.Shivonne Byrne, "Empowering Small Business," *Innuity*, June 25, 2007, accessed October 7, 2011, innuity.typepad.com/innuity_empowers_small_bu/2007/06/five -stages-of-.html. There are two tracks within the success stage. The first track is the **success-growth substage**, where the small business owner pulls all the company resources together and risks them all in financing growth. Systems are installed with forthcoming needs in mind. Operational planning focuses on

budgets. Strategic planning is extensive, and the owner is deeply involved. The management style is functional, but the owner is active in all phases of the company's business. The second track is the **success-disengagement substage**, where managers take over the owner's operational duties, and the strategy focuses on maintaining the status quo. Cash is plentiful, so the company should be able to maintain itself indefinitely, barring external environmental changes. The owners benefit indefinitely from the positive cash flow or prepare for a sale or a merger. The first professional managers are hired, and basic financial, marketing, and production systems are in place.

- **Stage IV: Take-off**.Neil C. Churchill and Virginia L. Lewis, "The Five Stages of Small Business Growth," *Harvard Business Review* 61, no. 3 (1983): 30–44, 48–50. This is a critical time in a company's life. The business is becoming increasingly complex. The owners must decide how to grow rapidly and how to finance that growth. There are two key questions: (1) Can the owner delegate responsibility to others to improve managerial effectiveness? (2) Will there be enough cash to satisfy the demands of growth? The organization is decentralized and may have some divisions in place. Both operational planning and strategic planning are being conducted and involve specific managers. If the owner rises to the challenges of growth, it can become a very successful big business. If not, it can usually be sold at a profit.
- **Stage V: Resource Maturity**.Neil C. Churchill and Virginia L. Lewis, "The Five Stages of Small Business Growth," *Harvard Business Review* 61, no. 3 (1983): 30–44, 48–50. The company has arrived. It has the staff and financial resources to engage in detailed operational and strategic planning. The management structure is decentralized, with experienced senior staff, and all necessary systems are in place. The owner and the business have separated both financially and operationally. The concerns at this stage are to (1) consolidate and control the financial gains that have been brought on by the rapid growth and (2) retain the advantage of a small size (e.g., response flexibility and the entrepreneurial spirit). If the entrepreneurial spirit can be maintained, there is a strong probability of continued growth and success. If not, the company may find itself in a state of **ossification**. This occurs when there is a lack of innovation and risk aversion that, in turn, will contribute to stalled or halted growth. These are common traits in large corporations.

Organizational Life Cycle

Superimposed on the stages of small business growth is the **organizational life cycle (OLC)**, a concept that specifically acknowledges that organizations go through different life cycles, just like people do.Carter McNamara, "Basic Overview of Organizational Life Cycles," accessed October 7, 2011, http://managementhelp.org/organizations/life-cycles.htm. "They are born (established or formed), they grow and develop, they reach maturity, they begin to decline and age, and finally, in many cases, they die.""Organizational Life Cycle," *Inc.*, 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html. The changes that occur in organizations have a predictable pattern,Robert E. Quinn and Kim Cameron, "Organizational Life Cycles and Shifting Criteria of Effectiveness: Some Preliminary Evidence," *Management Science* 29, no. 1 (1983): 33–51.and this predictability will be very helpful in formulating the objectives and strategies of a small business, altering managerial processes, identifying the sources of risk, and managing organizational change."Organizational Life Cycle," *Inc.*, 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html.·Yash P. Gupta and David C. W. Chin, "Organizational Life Cycle: A Review and Proposed Directions for Research," *The Mid-Atlantic Journal of Business* 30, no. 3 (December 1994): 269–94. Because not all small businesses are looking to grow, however, it is likely that many small companies will retain simple organizational structures.

For those small businesses that are looking to grow, the move from one OLC stage to another occurs because the fit between the organization and its environment is so inadequate that either the organization's efficiency and/or effectiveness is seriously impaired or the organization's very survival is threatened. Pressure will come from changes in the nature and number of requirements, opportunities, and threats."Organizational Life Cycle," *Inc.*, 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html.

Four OLC stages can be observed: birth, youth, midlife, and maturity.Carter McNamara, "Basic Overview of Organizational Life Cycles," accessed October 7, 2011, http://managementhelp.org/organizations/life-cycles.htm. In the **birth** stage, a small business will have a very simple organizational structure, one in which the owner does everything. There are few, if any, subordinates. As the business moves through **youth** and **midlife**, more sophisticated structures will be adopted, and authority will be decentralized to middle- and lower-level managers. At maturity, firms will demonstrate significantly more concern for internal efficiency, install more control mechanisms and processes, and become very bureaucratic. There are other features as well that characterize the movement of an organization from birth to maturity, which are summarized in Table 1.6.

Table 1.4.1: Organizational Life Cycle Features

Feature	Birth Cycle	Youth Cycle	Midlife Cycle	Maturity Cycle
Size	Small	Medium	Large	Very large
Bureaucratic	Nonbureaucratic	Prebureaucratic	Bureaucratic	Very bureaucratic
Division of labor	Overlapping tasks	Some departments	Many departments	Extensive, with small jobs and many descriptions
Centralization	One-person rule	Two leaders rule	Two department heads	Top-management heavy
Formalization	No written rules	Few rules	Policy and procedure manuals	Extensive
Administrative intensity	Secretary, no professional staff	Increasing clerical and maintenance	Increasing professional and staff support	Large-multiple departments
Internal systems	Nonexistent	Crude budget and information	Control systems in place: budget, performance, reports, etc.	Extensive planning, financial, and personnel added
Lateral teams, task forces for coordination	None	Top leaders only	Some use of integrators and task	Frequent at lower levels to break down bureaucracy

Source: Richard L. Daft, *Organizational Theory and Design* (St. Paul, MN: West Publishing, 1992), as cited in Carter McNamara, "Basic Overview of Organizational Life Cycles," accessed October 7, 2011, http://managementhelp.org/organizations/life-cycles.htm.

A small business will always be somewhere on the OLC continuum. Business success will often be based on recognizing where the business is situated along that continuum and adopting strategies best suited to that place in the cycle.

Industry Life Cycle

The industry life cycle (ILC) is another dimension of small business evolution, which needs to be understood and assessed in concert with the stages of small business growth and the OLC. All small businesses compete in an industry, and that industry will experience a life cycle just as products and organizations do. Although there may be overlap in the names of the ILC stages, the meaning and implications of each stage are different.

The **industry life cycle** refers to the continuum along which an industry is born, grows, matures, and eventually experiences decline and then dies. Although the pattern is predictable, the duration of each stage in the cycle is not. The stages are the same for all industries, but every industry will experience the stages differently. The stages will last longer for some and pass quickly for others; even within the same industry various small businesses may find themselves at different life cycle stages."Industry Life Cycle," *Inc.*, 2010, accessed June 1, 2012, www.inc.com/encyclopedia/industry-life-cycle.html.However, no matter where a small business finds itself along the ILC continuum, the strategic planning of that business will be influenced in important ways.

According to one study, the ILC, charted on the basis of the growth of an industry's sales over time, can be observed as having four stages: introduction, growth, maturity, and decline."Industry Life Cycle," *Inc.*, 2010, accessed June 1, 2012, www.inc.com/encyclopedia/industry-life-cycle.html. The **introduction** stage"Organizational Life Cycle," *Inc.*, 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html. finds the industry in its infancy. Although it is possible for a small business to be alone in the industry as a result of having developed and introduced something new to the marketplace, this is not the usual situation. The business strategy will focus on stressing the uniqueness of the product or the service to a small group of customers, commonly referred to as innovators or early adopters. A significant amount of capital is required. Profits are usually negative for both the firm and the industry.

The **growth** stage"Organizational Life Cycle," *Inc.*, 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html. is the second ILC stage. This stage also requires a significant amount of capital, but increasing product standardization may lead to economies of scale that will, in turn, increase profitability. The strategic focus is product differentiation, with an increased focus on responding to customer needs and interests. Intense competition will result as more new competitors join the industry, but many firms will be profitable. The duration of the growth stage will be industry dependent.

The **maturity** stage"Organizational Life Cycle," *Inc.*, 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html. will see some competition from late entrants that will try to take market share away from existing companies. This means that the marketing effort must continue to focus on product or service differentiation. There will be fewer firms in mature industries, so those that survive will be larger and more dominant. Many small businesses may move into the ranks of midsize or big businesses.

The **decline** stage"Organizational Life Cycle," *Inc.*, 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html. occurs in most industries. It is typically triggered by a product or service innovation that renders the industry obsolete. Sales will suffer, and the business goes into decline. Some companies will leave the industry, but others will remain to compete in the smaller market. The smaller businesses may be more agile for competing in a declining industry, but they will need to carefully formulate their business strategies to remain viable.

Learning Objectives

- Small-business management should consider the growth stages, the OLC, and the ILC in its planning.
- There are five stages of small business growth: existence, survival, success, take-off, and resource maturity. The success stage includes two substages, growth and disengagement. Ossification may result if a mature small business loses its entrepreneurial spirit and becomes more risk averse.
- Some small businesses may not be looking to grow, so they may remain in the survival stage.
- The OLC refers to the four stages of development that organizations go through: birth, youth, midlife, and maturity.
- Some small businesses may stick with the very simple organizational structures because they are not interested in growing to the point where more complicated structures are required.
- The ILC is the time continuum along which an industry is born, grows, matures, declines, and dies.
- There are four stages in the ILC: introduction, growth, maturity, and decline.

Exercises

1. Interview the owners of three small businesses in your community, each a different type and size. Where would you put each business with respect to the five stages of small business growth? Justify your answer.

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1.5: Ethics

Learning Objectives

1. Define ethics.
2. Explain business ethics.
3. Describe small business ethics.
4. 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.Manuel Velasquez et al., "What Is Ethics?," *Santa Clara University: Markula Center for Applied Ethics*, 2010, accessed October 7, 2011, www.scu.edu/ethics/practicing/decision/whatisethics.html. They serve as guidelines for making decisions about how to behave in specific situations; they also guide us in evaluating the actions of others.Daniel J. Brown and Jonathan B. King, "Small Business Ethics: Influences and Perceptions," *Journal of Small Business Management* 11, no. 8 (1982): 11–18. 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*."A Framework for Thinking Ethically," *Santa Clara University: Markula Center for Applied Ethics*, 2009, accessed October 7, 2011, www.scu.edu/ethics/practicing/decision/framework.html.

- **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.Milton Rokeach, *The Nature of Human Values* (New York: Free Press, 1973), 5, as cited in Wayne D. Hoyer and Deborah J. MacInnis, *Consumer Behavior* (Boston: Houghton Mifflin, 2001), 416. They create internal judgments that will determine how a person actually behaves. Ethics determine which values should be pursued and which should not.Jeff Landauer and Joseph Rowlands, "Values," *Importance of Philosophy*, 2001, accessed October 7, 2011, www.importanceofphilosophy.com/Ethics_Values.html.

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."Jeff Landauer and Joseph Rowlands, "Values," *Importance of Philosophy*, 2001, accessed October 7, 2011, www.importanceofphilosophy.com/Ethics_Values.html. 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.“Business Ethics,” *Small Business Notes*, accessed October 7, 2011, www.smallbusinessnotes.com/operating/leadership/ethics.html. 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

Do Business Ethics Pay?

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 “outbehave” the competition ethically will also tend to outperform them financially.Richard McGill Murphy, “Why Doing Good Is Good for Business,” *CNNMoney.com*, February 2, 2010, accessed October 7, 2011, money.cnn.com/2010/02/01/news/companies/dov_seidman_lrn.fortune. 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.Simon Webley and Elise More, “Does Business Ethics Pay?,” *Institute of Business Ethics*, 2003, accessed October 7, 2011, www.ibe.org.uk/userfiles/doesbusethicpaysumm.pdf.

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.”Simon Webley and Elise More, “Does Business Ethics Pay?,” *Institute of Business Ethics*, 2003, accessed October 7, 2011, www.ibe.org.uk/userfiles/doesbusethicpaysumm.pdf.

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,“The Hidden Costs of Unethical Behavior,” *Josephson Institute*, 2004, accessed October 7, 2011, josephsoninstitute.org/pdf/Report_HiddenCostsUnethicalBehavior.pdf. unethical business behavior has an adverse impact on sales, stock prices, productivity, the performance of the 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.Terrence Shulman, “Employee Theft Statistics,” *Employee Theft Solutions*, 2007, accessed October 7, 2011, www.employeetheftsolutions.com. Office supplies, money, and merchandise are the most frequently stolen items.Leslie Taylor, “Four in 10 Managers Have Fired Employees for Theft,” *Inc.*, September 1, 2006, accessed October 7, 2011, www.inc.com/news/articles/200609/theft.html?partner=rss. 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.Mary Paulsell, “The Problem of Employee Theft,” *MissouriBusiness.net*, October 10, 2007, accessed October 7, 2011, www.missouribusiness.net/sbtdc/docs/problem_employee_theft.asp.

Learning Objectives

- 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 “outbehave” 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.J. Brooke Hamilton III, “Case Example 1: ‘Less Sugar’ Marketing,” *Operationalizing Ethics in Business Settings*, 2009, accessed June 1, 2012, ethicsops.com/LessSugarMarketingCase.php. 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 do 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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1.6: The Three Threads

Learning Objectives

1. Define customer value and explain why it is important to small business competitiveness.
2. Define digital technology and explain its role in small business competitiveness.
3. Define e-business and explain why e-business is important to small businesses.
4. Define e-commerce and explain why e-commerce should be integrated into small businesses.

There are three threads that flow throughout this text: customer value, cash flow, and digital resources and e-environments. These threads can be likened to the human body. Cash flow is the circulatory system, without which there can be no life. Digital technology and e-business are the internal organs that carry out daily processes. E-commerce is the sensory system that enables business to observe and interact with the external environment. Customer value is overall health. These threads must figure prominently in all small business decision making. Although they are necessary but not sufficient conditions for small business survival, the chances for survival will be reduced significantly if they are not used.

Customer Value

In 1916, Nathan Hanwerker was an employee at one of the largest restaurants on Coney Island—but he had a vision. Using his wife's recipe, he and his wife opened a hot dog stand. He believed that the combination of a better tasting hot dog and the nickel price, half that of his competitors, was his recipe for success. He was wrong. Unfortunately for Nathan, Upton Sinclair's book *The Jungle* a decade before had made the public suspicious of low-cost meat products. Nathan discovered that his initial business model was not working. Customers valued taste and cost, but they also valued the quality of a safe product. To convince customers that his hot dogs were safe, he secured several doctors' smocks and had people wear them. The sight of "doctors" consuming Nathan's hot dogs gave customers the extra value that they needed. It was all about the perception of quality. If doctors were eating the hot dogs, they must be OK. Today there are over 20,000 outlets serving Nathan's hot dogs.John A. Jakle and Keith A. Sculle, *Fast Food* (Baltimore: Johns Hopkins University Press, 1999), 163–64.

In principle, **customer value** is a very simple concept. It is the difference between the benefits that a customer receives from a product or a service and the costs associated with obtaining that product or service. **Total customer benefit** refers to the perceived monetary value of the bundle of economic, functional, and psychological benefits customers expect from a product or a service because of the products, services, personnel, and images involved. **Total customer cost**, the perceived bundle of costs that customers expect to occur when they evaluate, obtain, use, and dispose of the product or use the service, include monetary, time, energy, and psychological costs.Philip Kotler and Kevin Lane, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice-Hall, 2009), 121. In short, it is all about what customers get and what they have to give up.

In reality, the creation of customer value will always be a challenge—particularly because it almost always needs to be defined on the customer's terms.H. Whitelock, "How to Create Customer Value," *eZine Articles*, March 16, 2007, accessed October 7, 2011, ezinearticles.com/?How-to-Create-Customer-Value_&id=491697. Nonetheless, "the number one goal of business should be to 'maximize customer value and strive to increase value continuously.' If a firm maximizes customer value, relative to competitors, success will follow. If a firm's products are viewed as conveying little customer value, the firm will eventually atrophy and fail."Earl Nauman, *Creating Customer Value: The Path to Sustainable Competitive Advantage* (New York: Free Press, 1995), 16. This will certainly be true for the small business that is much closer to its customers than the large business.

The small business owner needs to be thinking about customer value every day: what is offered now, how it can be made better, and what the competition is doing that is offering more value. It is not easy, but it is essential. All business decisions will add to or detract from the value that can be offered to the customer. If your product or service is perceived to offer more value than that of the competition, you will get the sale. Otherwise, you will not get the sale.

Cash Flow

Revenue is vanity…margin is sanity…cash is king.

- Unknown.

Most people would define success with respect to profits or sales. This misses a critical point. The survival of a firm hinges not so much on sales or profits, although these are vitally important, as it does on the firm's ability to meet its financial obligations. A firm must learn to properly manage its **cash flow**, defined as the money coming into and flowing from a business because cash is more than king. *It is a firm's lifeblood*. As the North Dakota Small Business Development Center put it, "Failure to properly plan cash flow is one of the leading causes for small business failure.""Why Is Cash Flow So Important*?," North Dakota Small Business Development Center*, 2005, accessed October 7, 2011, www.ndsbdc.org/faq/default.asp?ID=323.

An understanding of cash flow requires some understanding of accounting systems. There are two types: cash based and accrual. In a **cash-based accounting** system, sales are recorded when you receive the money. This type of system is really meant for small firms with sales totaling less than $1 million. **Accrual accounting** systems, by contrast, are systems that focus on measuring profits. They assume that when you make a sale, you are paid at that point. However, almost all firms make sales on credit, and they also make purchases on credit. Add in that sales are seldom constant, and you begin to see how easily and often cash inflows and outflows can fall out of sync. This can reduce a firm's **liquidity**, which is its ability to pay its bills. Envision the following scenario: A firm generates tremendous sales by using easy credit terms: 10 percent down and one year to pay the remaining 90 percent. However, the firm purchases its materials under tight credit terms. In an accrual accounting system, this might appear to produce significant profits. However, the firm may be unable to pay its bills and salaries. In this type of situation, the firm, particularly the small firm, can easily fail.

There are other reasons why cash flow is critically important. Firms need to have the money to buy new materials or expand. In addition, firms should have cash available to meet unexpected contingencies or investment opportunities.

Cash-flow management requires a future-focused orientation. You have to anticipate your future cash inflows and outflows and what actions you may need to take to preserve your liquidity. Today, even the nonemployee firm can begin this process with simple spreadsheet software. Slightly larger firms could opt for the user-dedicated software. In either case, cash-flow analysis requires the owner to focus on the future and to develop effective planning skills.

Cash-flow management also involves activities such as expense control, receivables management, inventory control, and developing a close relationship with commercial lenders. The small business owner needs to think about these things every day. Their requirements may tax many small business operators, but they are essential skills.

- **Expense control** requires owners or operators to think in terms of constantly seeking out efficiencies and cost-reduction strategies.
- **Receivables management** forces owners to think about how to walk the delicate balance of offering customers the benefits of credit while trying to receive the payments as quickly as possible. They can use technology and e-business to expedite the cash inflow.
- Effective **inventory control** translates into an understanding of the **ABC classification system**(sorting inventory by volume and value), and determining order quantities and reorder points. Inevitably, any serious consideration of inventory management leads one to the study of "lean" philosophies. **Lean inventory management** refers to approaches that focus on minimizing inventory by eliminating all sources of waste. Lean inventory management inevitably leads its practitioners to adopt a new process-driven view of the firm and its operations.
- Lastly, attention to cash-flow management recognizes that there may well be periods when cash outflows will exceed cash inflows. You may have to use commercial loans, **equity loans** (pledging physical assets for cash), and/or lines of credit. These may not be offered by a lender at the drop of a hat. Small-business owners need to anticipate these cash shortfalls and should already have an established working relationship with a commercial lender.

A small business needs to be profitable over the long term if it is going to survive. However, this becomes problematic if the business is not generating enough cash to pay its way on a daily basis.Barry Minnery, "Don't Question the Importance of Cash Flow: Making a Profit Is the Goal but Day-to-Day Costs Must Be Met in Order to Keep a Business Afloat," *The Independent.com*, May 28, 2010, accessed October 7, 2011, www.articlesezinedaily.com/dont-question-the-importance-of-cash-flow/. Cash flow can be a sign of the health—or pending death—of a small business. The need to ensure that cash is properly managed must therefore be a top priority for the business.Barry Minnery, "Don't Question the Importance of Cash Flow: Making a Profit Is the Goal but Day-to-Day Costs Must Be Met in Order to Keep a Business Afloat," *The Independent.com*, May 28, 2010, accessed October 7, 2011, www.articlesezinedaily.com/dont-question-the-importance-of-cash-flow/. This is why cash-flow implications must be considered when making all business decisions. Everything will be a cash flow factor one way or the other. Fred Adler, a venture capitalist,

could not have said it better when he said, “Happiness is a positive cash flow.”Fred Adler, *QuotationsBook.com*, accessed October 7, 2011, quotationsbook.com/quote/18235.

Digital Technology and the E-Environment

Digital technology and the e-environment continue to change the way small and large businesses operate. **Digital technology** refers to a broad spectrum of computer hardware, software, and information retrieval and manipulation systems. The **e-environment** is a catchall term that includes e-business and e-commerce. The Internet in particular has had a powerful impact on the demands of customers, suppliers, and vendors, each of whom is ready—perhaps even expects—to do business 24/7.

Why Digital Technology?

With the advent of the personal computer and the Internet, small firms may be able to compete on a more equal footing with larger firms through their intelligent use of digital technologies. It would be impossible to list all the types of software that can enhance small business operations, so the focus will be on the major types of aids.

Today, even the smallest of firms can acquire a complete accounting system at a reasonable price. These packages can be tailored for specific industries and are designed to grow with the company. They not only generate standard accounting and financial reports but also assist with management decision making. Information about accounting software for small businesses is easily available on the Internet.

Small-business operations have also benefited greatly from affordable software that can handle forecasting, inventory control and purchasing, customer relations, and shipping and receiving. In fact, the software has advanced to the point where a small firm can cost-effectively possess its own **enterprise resource planning (ERP)** system. Only a few years ago, ERP systems were out of reach for all but the largest firms. ERP systems integrate multiple business functions, from purchasing to sales, billings, accounting records, and payroll (see Figure 1.6.1. These advances now give small firms the capability and opportunity to participate in global supply chains, thus broadening their customer base.



Figure 1.6.1: Broad Schematic of an ERP System

Touch screen computers, smartphones, or iPads can bring a new level of sophistication to data entry and manipulation and communications. Smartphones can boost productivity, especially when out of the office.Christopher Elliott, “5 Ways Smartphones & Servers Boost Productivity,” *Microsoft Small Business Center*, 2010, accessed October 7, 2011, www.microsoft.com/business/en-us/resources/technology/communications/smartphones-and-business-productivity.aspx?fbid=WTbndqFrlli. It is predicted that the iPad will change how we build business relationships, particularly with respect to connecting with prospects in a more meaningful way.Brent Leary, “The iPad: Changing How We Build Business Relationships,” *Inc.*, accessed October 7, 2011, www.inc.com/hardware/articles/201005/leary.html. Inventory control may soon be revolutionized by a technology known as **radio-frequency identity devices (RFIDs)**. These small devices enable the tracking of inventory items. These same devices may change retailing by curtailing time at checkout and eliminating pilferage.Kevin Bonsor, Candace Keener,

and Wesley Fenlon, "How RFID Works," *HowStuffWorks.com*, accessed October 23, 2011, electronics.howstuffworks.com/gadgets/high-tech-gadgets/rfid.htm.

Learning Objectives

- The creation of customer value must be a top priority for small business. The small business owner should be thinking about it every day.
- Cash flow is a firm's lifeblood. Without a positive cash flow, a small business cannot survive. All business decisions will have an impact on cash flow—which is why small business owners must think about it every day.
- A cash-based accounting system is for small firms with sales totaling less than $1 million. Accrual accounting systems measure profits instead of cash.
- Digital technologies are very important to small businesses. They can improve efficiencies, help create greater customer value, and make the business more competitive. Digital technology integration should be something that small business owners think about regularly.
- It is not correct to use the terms *e-business* and *e-commerce* interchangeably. E-commerce is a subset of e-business.
- E-business can work for any small business.
- E-commerce generates revenue. E-business does not.
- Moving existing small business practices to e-commerce is increasingly becoming a requirement for survival.

Exercises

1. A customer calls L.L. Bean about a favorite jacket he purchased more than 10 years ago and has recently lost. In a matter of minutes, the sales agent identifies the old jacket, locates a replacement model in the current catalog, suggests a matching size and color, and orders the jacket. The replacement jacket arrives three days later."Peter Kolesar, Garrett van Rysin, and Wayne Cutler, "Creating Customer Value through Industrialized Intimacy," *Strategy + Business*, July 1, 1998, accessed October 7, 2011, www.strategy-business.com/article/19127?gko=81aa7. How has L.L. Bean added to the customer's perception of value?
2. When thinking about customer value, you should plan to address three questions: (a) What do my customers truly value? (b) What do I provide? and (c) How does what I provide differ from my competitors? Select a small business and interview the owner to see how he or she answered these questions. Pay particular attention to the first question.
3. Intuit QuickBooks, Peachtree, and AccountEdge are three popular accounting packages. Gather information from their websites and conduct a comparative analysis as though you were a new small business looking to buy one of them.

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CHAPTER OVERVIEW

2: Your Business Idea- The Quest for Value

2.1: Chapter Introduction

2.2: Defining the Customer’s Concept of Value

2.3: Knowing your customers

2.4: Sources of Business Ideas

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2.1: Chapter Introduction

Cheshire Package Store



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Robert Brown has been the owner and operator of the Cheshire Package Store for 25 years. It is one of several liquor stores in this town of 25,000 people. Some of his competitors are smaller or approximately the same size, and one is significantly larger. Robert is very clear in his understanding of what gives his store a competitive edge. He believes his establishment provides the setting that makes a customer feel at home. “My feeling has always been that small businesses must have a feeling of comfort. If your customers do not feel that they can ask you questions about the product or if they feel that they are imposing on you, then they are not likely to return.”

Robert took every opportunity available to better understand his customers and provide them with value. One way his business does this is by developing a personal relationship with its customers. This may mean carefully looking at checks or credit cards, not for security reasons, but to identify customers by name. Robert points out that he always pays careful attention to what customers like and dislike; by doing so, they develop confidence in his suggestions. To foster this confidence, he and his family actively engage their customers in conversations. Customers, Robert, and the employees share stories, which is a key way to build better customer relationships. By listening to his customers, Robert can identify what they are looking for and assist him in knowing what new products he might offer.

In addition to this personalized level of service, the Cheshire Package Store also recognizes the importance of other factors. Robert talks about the importance of maintaining a well-lit store with spacious aisles, making it an inviting place in which to shop. He is careful about even minor details, such as assuring that there are open parking spaces near the entrance to his store. He recognizes that even walking short distances to or from the store might be a burden or deterrent for his customers. Robert’s store possesses a cutting-edge inventory software package designed specifically for liquor stores. It enables him to track inventory levels, which can provide estimates for future inventory levels of different products; however, he sees this as a guide only. As he puts it, “Your knowledge of your customers will be the key determinant for your success.”

Robert also strongly believes that the success of a small business depends on the owner being there. Stores have their own personality, in his view, and that personality is created by the owner. This personality imparted by the owner impacts all operational aspects of the business—“Your employees will pick up on what you expect, and they will know what your customers deserve.”

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2.2: Defining the Customer's Concept of Value

Learning Objectives

1. Define customer value.
2. Understand the five sources of perceived customer benefits.
3. Understand the three sources of perceived costs.

Look beneath the surface; let not the several qualities of neither the thing, nor its worth escape thee.

Marcus Aurelius Antoninus

In the previous chapter, Peter Drucker and W. Edward Deming placed the customer at the center of their definitions of the purpose of a business. They used the customer as being at the core of that purpose rather than focusing on financial measures such as profit, return on investment (ROI), or shareholders' wealth. Drucker's logic was that if a business did not create a sufficient number of customers, there never would be a profit with the business. Deming argued that delighting customers would become the basis for them to consistently return, and loyalty would ensure that the business would have a higher probability of surviving in the long term. The clearest way of doing that is by focusing on providing your customers with a clear sense of value. This emphasis on value will produce economic benefits. Gale Consulting explains the notion of value this way, "If customers don't get good value from you, they will shop around to find a better deal.""Why Customer Satisfaction Fails," *Gale Consulting*, accessed December 2, 2011, www.galeconsulting.com/index.php?option=com_content&view=article&id=18&Itemid=23. A recent study put it this way, "These firms have been successful…by consistently creating superior **customer value**—and profiting handsomely from that customer value."George Day and Christine Moorman, *Strategy from the Outside In* (New York: McGraw Hill, Kindle Edition, 2010), 104–10.

Strong evidence indicates that this focus on making the customer central to defining the business translates into economic success. It has been estimated that the cost of gaining a new customer over retaining a current customer is a multiple of five. The costs of regaining a dissatisfied customer over the cost of retaining a customer are ten times as much.Forler Massnick, *The Customer Is CEO: How to Measure What Your Customers Want—and Make Sure They Get It* (New York: Amacom, 1997), 76. So a key question for any business then becomes, "How does one then go about making the customer the center of one's business?"

What Is Value?

It is essential to recognize that value is not just price. Value is a much richer concept. Fundamentally, the notion of customer value is fairly basic and relatively simple to understand; however, implementing this concept can prove to be tremendously challenging. It is a challenge because customer value is highly dynamic and can change for a variety of reasons, including the following: the business may change elements that are important to the customer value calculation, customers' preferences and perceptions may change over time, and competitors may change what they offer to customers. One author states that the challenge is to "understand the ever changing customer needs and innovate to gratify those needs."Sudhakar Balachandran, "The Customer Centricity Culture: Drivers for Sustainable Profit," *Course Management* 21, no. 6 (2007): 12.

The simple version of the concept of customer value is that individuals evaluate the perceived benefits of some product or service and then compare that with their perceived cost of acquiring that product or service. If the benefits outweigh the cost, the product or the service is then seen as attractive (see Figure 2.1). This concept is often expressed as a straightforward equation that measures the difference between these two values:

customer value = perceived benefits − perceived cost.

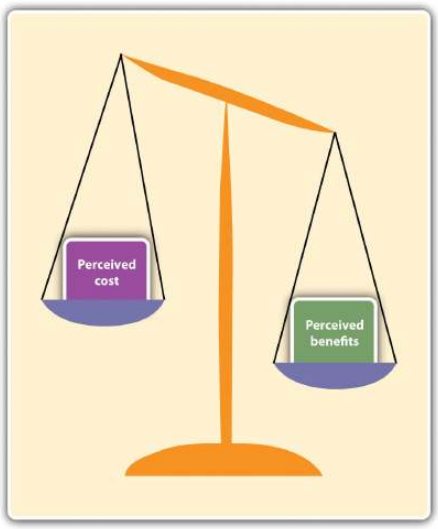


Figure 2.2.1: Perceived Cost versus Perceived Benefits

Some researchers express this idea of customer value not as a difference but as a ratio of these two factors.M. Christopher, "From Brand Value to Customer Value," *Journal of Marketing Practice: Applied Marketing Science* 2, no. 1 (1996): 55. Either way, it needs to be understood that customers do not evaluate these factors in isolation. They evaluate them with respect to their expectations and the competition.

Firms that provide greater customer value relative to their competitors should expect to see higher revenues and superior returns. Robert Buzzell and Bradley Gale, reporting on one finding in the Profit Impact through Marketing Strategy study, a massive research project involving 2,800 businesses, showed that firms with superior customer value outperform their competitors on ROI and market share gains.Robert D. Buzzell and Bradley T. Gale, *The PIMS Principles—Linking Strategy to Performance*(New York: Free Press, 1987), 106.

Given this importance, it is critical to understand what makes up the perceived benefits and the perceived costs in the eyes of the consumer. These critical issues have produced a considerable body of research. Some of the major themes in customer value are evolving, and there is no universal consensus or agreement on all aspects of defining these two components. First, there are approaches that provide richly detailed and academically flavored definitions; others provide simpler and more practical definitions. These latter definitions tend to be ones that are closer to the aforementioned equation approach, where customers evaluate the benefits they gain from the purchase versus what it costs them to purchase. However, one is still left with the issue of identifying the specific components of these benefits and costs. In looking at the benefits portion of the value equation, most researchers find that customer needs define the benefits component of value. But there still is no consensus as to what specific needs should be considered. Park, Jaworski, and McGinnis (1986) specified three broad types of needs of consumers that determine or impact value.C. Whan Park, Bernard J. Jaworski, and Deborah J. MacInnis, "Strategic Brand Concept Image Management," *Journal of Marketing* 50 (1986): 135.Seth, Newman, and Gross (1991)Jagdish N. Seth, Bruce I. Newman, and Barbara L. Gross, *Consumption Values and Market Choice: Theory and Applications* (Cincinnati, OH: Southwest Publishing, 1991), 77. provided five types of value, as did Woodall (2003), although he did not identify the same five values.Tony Woodall, "Conceptualising 'Value for the Customer': An Attributional, Structural and Dispositional Analysis," *Academy of Marketing Science Review* 2003, no. 12 (2003), accessed October 7, 2011, www.amsreview.org/articles/woodall12-2003.pdf. To add to the confusion, Heard (1993–94)Ed Heard, "Walking the Talk of Customers Value," *National Productivity Review* 11 (1993–94): 21. identified three factors, while Ulaga (2003)Wolfgang Ulaga, "Capturing Value Creation in Business Relationships: A Customer Perspective," *Industrial Marketing Management* 32, no. 8 (2003): 677. specified eight categories of value; and Gentile, Spiller, and Noci (2007) mentioned six components of value.Chiara Gentile, Nicola Spiller, and Giuliana Noci, "How to Sustain the Customer Experience: An Overview of Experience Components That Co-Create Value with the Customer," *European Management Journal* 25, no. 5 (2007): 395. Smith and Colgate (2007) attempted to place the discussion of customer value in a pragmatic context that might aid practitioners. They identified four types of values and five sources of value. Their purpose was to provide "a foundation for measuring or assessing value creation strategies."J. Brock Smith and Mark Colgate, "Customer Value Creation: A Practical

Framework," *Journal of Marketing Theory and Practice* 15, no. 1 (2007): 7. In some of these works, the components or dimensions of value singularly consider the benefits side of the equation, while others incorporate cost dimensions as part of value.

From the standpoint of small businesses, what sense can be made of all this confusion? First, the components of the benefits portion of customer value need to be identified in a way that has significance for small businesses. Second, cost components also need to be identified. Seth, Newman, and Gross's five types of value provide a solid basis for considering perceived benefits (see Figure 2.2). Before specifying the five types of value, it is critical to emphasize that a business should not intend to compete on only one type of value. It must consider the mix of values that it will offer its customers. (In discussing these five values, it is important to provide the reader with examples. Most of our examples will relate to small business, but in some cases, good examples will have to be drawn from larger firms because they are better known.)

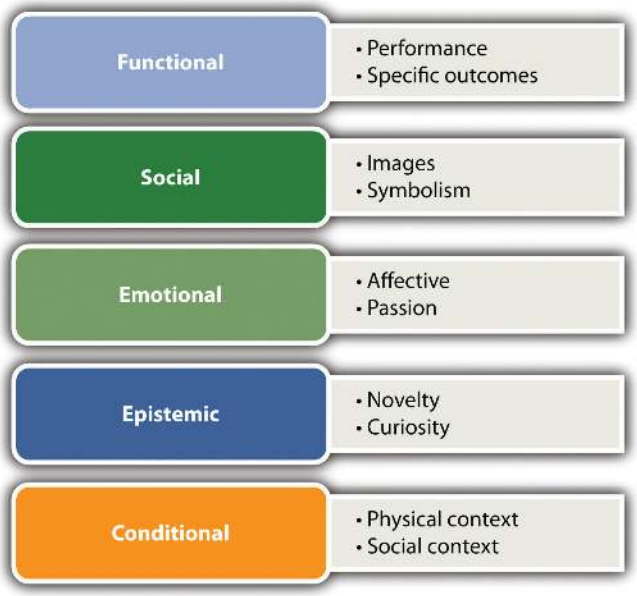


Figure 2.2.2: Five Types of Value

The five types of value are as follows:

1. **Functional value** relates to the product's or the service's ability to perform its utilitarian purpose. Woodruff (1997) identified that functional value can have several dimensions.Robert B. Woodruff, "Customer Value: The Next Source of Competitive Advantage, *Journal of the Academy of Marketing Science* 25, no. 2 (1997): 139. One dimension would be performance related. This relates to characteristics that would have some degree of measurability, such as appropriate performance, speed of service, quality, or reliability. A car may be judged on its miles per gallon or the time to go from zero to sixty miles per hour. These concepts can also be seen when evaluating a garage that is performing auto repairs. Customers have an expectation that the repairs will be done correctly, that the car will not have to be brought back for additional work on the same problem, and that the repairs will be done in a reasonable amount of time. Another dimension of functional value might consider the extent to which the product or the service has the correct features or characteristics. In considering the purchase of a laptop computer, customers may compare different models on the basis of weight, battery lifetime, or speed. The notion of features or characteristics can be, at times, quite broad. Features might include aesthetics or an innovation component. Some restaurants will be judged on their ambiance; others may be judged on the creativity of their cuisine. Another dimension of functional value may be related to the final outcomes produced by a business. A hospital might be evaluated by its number of successes in carrying out a particular surgical procedure.
2. **Social value** involves a sense of relationship with other groups by using images or symbols. This may appear to be a rather abstract concept, but it is used by many businesses in many ways. Boutique clothing stores often try to convey a chic or trendy environment so that customers feel that they are on the cutting edge of fashion. Rolex watches try to convey the sense that their owners are members of an economic elite. Restaurants may alter their menus and decorations to reflect a particular ethnic cuisine. Some businesses may wish to be identified with particular causes. Local businesses may support local Little League

teams. They may promote fundraising for a particular charity that they support. A business, such as Ben & Jerry's Ice Cream, may emphasize a commitment to the environment or sustainability.

3. **Emotional value** is derived from the ability to evoke an emotional or an affective response. This can cover a wide range of emotional responses. Insurance companies and security alarm businesses are able to tap into both fear and the need for security to provide value. Some theme parks emphasize the excitement that customers will experience with a range of rides. A restaurant may seek to create a romantic environment for diners. This might entail the presence of music or candlelight. Some businesses try to remind customers of a particular emotional state. Food companies and restaurants may wish to stimulate childhood memories or the comfort associated with a home-cooked meal. Häagen-Dazs is currently producing a line of all-natural ice cream with a limited number of natural flavors. It is designed to appeal to consumers' sense of nostalgia."Maturalism," *Trendwatching.com*, accessed June 1, 2012, http://trendwatching.com/trends/maturialism/.
4. **Epistemic value** is generated by a sense of novelty or simple fun, which can be derived by inducing curiosity or a desire to learn more about a product or a service. Stew Leonard's began in the 1920s as a small dairy in Norwalk, Connecticut. Today, it is a $300 million per year enterprise of consisting of four grocery stores. It has been discussed in major management textbooks. These accomplishments are due to the desire to turn grocery shopping into a "fun" experience. Stew Leonard's uses a petting zoo, animatronic figures, and costumed characters to create a unique shopping environment. They use a different form of layout from other grocery stores. Customers are required to follow a fixed path that takes them through the entire store. Thus customers are exposed to all items in the store. In 1992, they were awarded a Guinness Book world record for generating more sales per square foot than any food store in the United States."Company Story," *Stew Leonards*, accessed October 7, 2011, www.stewleonards.com/html/about.cfm. Another example of a business that employs epistemic value is Rosetta Stone, a company that sells language-learning software. Rosetta Stone emphasizes the ease of learning and the importance of acquiring fluency in another language through its innovative approach.
5. **Conditional value** is derived from a particular context or a sociocultural setting. Many businesses learn to draw on shared traditions, such as holidays. For the vast majority of Americans, Thanksgiving means eating turkey with the family. Supermarkets and grocery stores recognize this and increase their inventory of turkeys and other foods associated with this period of the year. Holidays become a basis for many retail businesses to tap into conditional value.

   Another way businesses may think about conditional value is to introduce a focus on emphasizing or creating a sociocultural context. Business may want to introduce a "tribal" element into their customer base, by using efforts that cause customers to view themselves as a member of a special group. Apple Computer does this quite well. Many owners of Apple computers view themselves as a special breed set apart from other computer users. This sense of special identity helps Apple in the sale of its other electronic consumer products. They reinforce this notion in the design and setup of Apple stores. Harley-Davidson does not just sell motorcycles; it sells a lifestyle. Harley-Davidson also has a lucrative side business selling accessories and apparel. The company supports owner groups around the world. All of this reinforces, among its customers, a sense of shared identity.

   It should be readily seen that these five sources of value benefits are not rigorously distinct from each other. A notion of aesthetics might be applied, in different ways, across several of these value benefits. It also should be obvious that no business should plan to compete on the basis of only one source of value benefits. Likewise, it may be impossible for many businesses, particularly start-ups, to attempt to use all five dimensions. Each business, after identifying its customer base, must determine its own mix of these value benefits.

   As previously pointed out, the notion of perceived customer value has two components—perceived value benefits and perceived value costs. When examining the cost component, customers need to recognize that it is more than just the cost of purchasing a product or a service. Perceived cost should also be seen having multiple dimensions (see Figure 2.3).



Figure 2.2.3: Components of Customer Value

Perceived costs can be seen as being monetary, time, and psychic. The **monetary component** of perceived costs should, in turn, be broken down into its constituent elements. Obviously, the first component is the purchase price of the product or the service. Many would mistakenly think that this is the only element to be considered as part of the cost component. They fail to consider several other cost components that are quite often of equal—if not greater—importance to customers. Many customers will consider the operating cost of a product or a service. A television cable company may promote an introductory offer with a very low price for the cable box and its installation. Most customers will consider the monthly fees for cable service rather than just looking at the installation cost. They often use service costs when evaluating the value proposition. Customers have discovered that there are high costs associated with servicing a product. If there are service costs, particularly if they are hidden costs, then customers will find significantly less value from that product or service. Two other costs also need to be considered. Switching cost is associated with moving from one provider to another. In some parts of the country, the cost of heating one's home with propane gas might be significantly less than using home heating oil on an annualized basis. However, this switch from heating oil to propane would require the homeowner to install a new type of furnace. That cost might deter the homeowner from moving to the cheaper form of energy. Opportunity cost involves selecting among alternative purchases. A customer may be looking at an expensive piece of jewelry that he wishes to buy for his wife. If he buys the jewelry, he may have to forgo the purchase of a new television. The jewelry would then be the opportunity cost for the television; likewise, the television would be the opportunity cost for the piece of jewelry. When considering the cost component of the value equation, businesspeople should view each cost as part of an integrated package to be set forth before customers. More and more car dealerships are trying to win customers by not only lowering the sticker price but also offering low-cost or free maintenance during a significant portion of the lifetime of the vehicle.

These monetary components are what we most often think of when we discuss the term *cost*, and, of course, they will influence the decision of customers; however, the **time component** is also vital to the decision-making process. Customers may have to expend time acquiring information about the nature of the product or the service or make comparisons between competing products and services. Time must be expended to acquire the product or the service. This notion of time would be associated with learning where the product or the service could be purchased. It would include time spent traveling to the location where the item would be purchased or the time it takes to have the item delivered to the customer. One also must consider the time that might be required to learn how to use the product or the service. Any product or service with a steep learning curve might deter customers from purchasing it. Firms can provide additional value by reducing the time component. They could simplify access to the product or the service. They may offer a wide number of locations. Easy-to-understand instructions or simplicity in operations may reduce the amount of time that is required to learn how to properly use the product or the service.

The **psychic component** of cost can be associated with those factors that might induce stress on the customer. There can be stress associated with finding or evaluating products and services. In addition, products or services that are difficult to use or require a long time to learn how to use properly can cause stress on customers. Campbell's soup introduced a meal product called Souper Combos, which consisted of a sandwich and a cup of soup. At face value, one would think that this would be a successful product. Unfortunately, there were problems with the demands that this product placed on the customer in terms of preparing the meal. The frozen soup took twice as long to microwave as anticipated, and the consumer had to repeatedly insert and remove both the soup and the sandwich from the microwave.Calvin L. Hodock, *Why Smart Companies Do Dumb Things* (Amherst, NY: Prometheus Books, 2007), 65.

In summary, business owners need to constantly consider how they can enhance the benefits component while reducing the cost components of the value equation. Table 2.1 summarizes the subcomponents of perceived value, the types of firms that emphasize

those components, and the activities that might be necessary to either enhance benefits or reduce costs.

Table 2.2.1: Components of Perceived Benefit and Perceived Cost

Component	Aspects	Activities to Deliver
Components of Perceived Benefit		
Functional	• Measurable quality • Performance • Reliability • Support network	• Quality assurance in product and services • Superior product and process design • Selection of correct attributes • Ability to improve product and operations • Management of value chain
Social	• Builds identification with social, ethnic, or class group • Emphasize lifestyle • Development of interaction among people • Build bonds within groups	• Market research correctly identifies customer base(s) • Ability to build social community among customers
Emotional	• Assist in making one feel good about themselves • Attachment to product or service • Produces a change in how others see the user • Trustworthiness • Profound customer experience • Aesthetics	• Market research understands psychological dimensions of customer base(s) • Marketing content emphasizes desired psychological dimensions • Reliability between marketing message and delivery
Epistemic	• Novelty • Fun • Evoke interest in product or service • Interest in learning • Produces a willing suspension of disbelief	• Creative personnel • Creative product or process development • Commitment to innovation • Willingness to experiment
Conditional	• Produces meaning in a specific context • Tied to particular events • Tied to holidays • Demonstrates social responsibility	• Flexibility (can alter physical facilities or marketing message depending on context) • Management commitment to responsible action
Components of Perceived Cost		
Monetary	• Reduce purchase price • Reduce operating costs • Reduce maintenance costs • Reduce opportunity costs	• Superior design • Operational efficiency • Cost containment • Quality control and assurance • Easy acquisition
Time	• Reduce time to search for product or service • Reduce time to purchase • Reduced learning curve	• Broad distribution channels • Web-based purchasing option • Web-based information • Superior design
Psychic	• Simplified use • “Comfortable” feeling with regard to product or service use	• Superior design • Ability to write clear instructions

Video Clip 2.2.1:

Customer Value



What creates a customer experience of value?

Video Clip 2.2.2:

Creating Customer Value



Creating value is the essence of a start-up. This video reviews the product and value created by a watch with no hands.

Video Clip 2.2.3:

Simple Rules: Three Logics of Value Creation



o)

Three core logics of the value proposition.

Video Clip 2.2.4:

Articulating Your Value Proposition



A video on how to better articulate your value proposition. This is informative but very long (about one hour).

Different Customers—Different Definitions

It is a cliché to say that people are different; nonetheless, it is true to a certain extent. If all people were totally distinct individuals, the notion of customer value might be an interesting intellectual exercise, but it would be absolutely useless from the standpoint of business because it would be impossible to identify a very unique definition of value for every individual. Fortunately, although people are individuals, they often operate as members of groups that share similar traits, insights, and interests. This notion of customers being members of some type of group becomes the basis of the concept known as **market segmentation**. This involves dividing the market into several portions that are different from each other.“Market Segmentation,” *NetMBA Business Knowledge*

Center, accessed October 7, 2011, www.netmba.com/marketing/market/segmentation. It simply involves recognizing that the market at large is not homogeneous. There can be several dimensions along which a market may be segmented: geography, demographics, psychographics, or purchasing behavior. Geographic segmentation can be done by global or national region, population size or density, or even climate. Demographic segmentation divides a market on factors such as gender, age, income, ethnicity, or occupation. Psychographic segmentation is carried out on dimensions that reflect differences in personality, opinions, values, or lifestyle. Purchasing behavior can be another basis for segmentation. Differences among customers are determined based on a customer's usage of the product or the service, the frequency of purchases, the average value of purchases, and the status as a customer—major purchaser, first-time user, or infrequent customer. In the business-to-business (B2B) environment, one might want to segment customers on the basis of the type of company.

Market segmentation recognizes that not all people of the same segment are identical; it facilitates a better understanding of the needs and wants of particular customer groups. This comprehension should enable a business to provide greater customer value. There are several reasons why a small business should be concerned with market segmentation. The main reason centers on providing better customer value. This may be the main source of competitive advantage for a small business over its larger rivals. Segmentation may also indicate that a small business should focus on particular subsets of customers. Not all customers are equally attractive. Some customers may be the source of most of the profits of a business, while others may represent a net loss to a business. The requirements for providing value to a first-time buyer may differ significantly from the value notions for long time, valued customer. A failure to recognize differences among customers may lead to significant waste of resources and might even be a threat to the very existence of a firm.

Video Clip 2.2.5:

Tom Peters: The Biggest Underserved Markets



Tom Peters, a self-described "professional loudmouth" who has been compared to Ralph Waldo Emerson, Walt Whitman, Henry David Thoreau, and H. L. (Henry Louis) Mencken, declares war on the worthless rules and absurd organizational barriers that stand in the way of creativity and success. In a totally outrageous, in-your-face presentation, Peters reveals the following: a reimagining of American business; two big markets—underserved and worth trillions; the top qualities of leadership excellence; and why passion, talent, and action must rule business today.

Learning Objectives

- Essential to the success of any business is the need to correctly identify customer value.
- Customer value can be seen as the difference between a customer's perceived benefits and the perceived costs.
- Perceived benefits can be derived from five value sources: functional, social, emotional, epistemic, and conditional.
- Perceived costs can be seen as having three elements: monetary, time, and psychic.

- To better provide value to customers, it may be necessary to segment the market.
- Market segmentation can be done on the basis of demographics, psychographics, or purchasing behavior.

Exercises

1. Discuss how Robert should explicitly consider the customer value currently offered by Frank's All-American BarBeQue. In your discussion, comment on the five value benefits and the perceived costs.
2. Robert has several possible options for expanding his father's business—find a larger location in Fairfield, add a takeout option, open more restaurants in surrounding communities, incorporate web marketing concepts, and expand the sales of sauces. Review each in terms of value benefits.
3. What would be the costs associated with those options?

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2.3: Knowing your customers

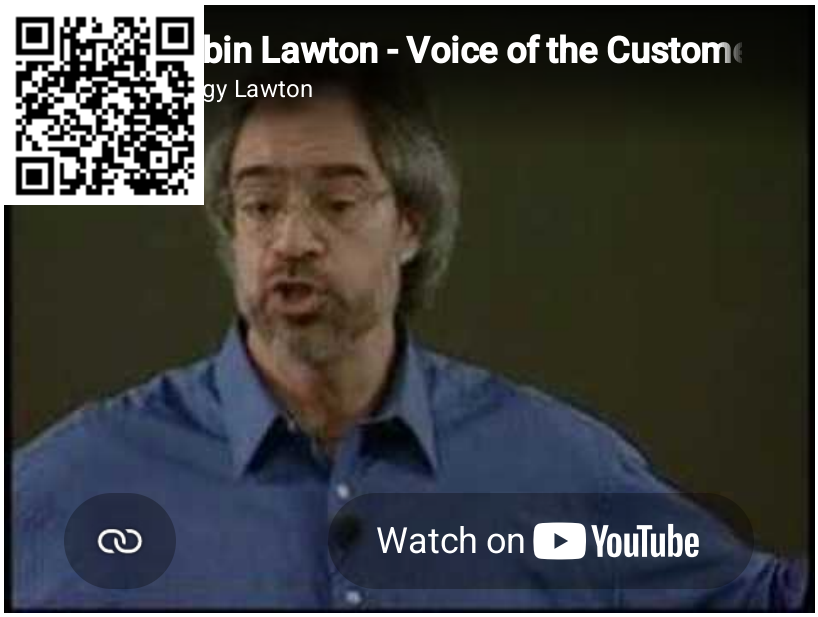
Learning Objectives

1. Understand that in order to provide customer value, firms must be able to listen to the voice of the customer.
2. Comprehend that businesses must attempt to identify those customers' needs that are not being met by competitors.
3. Understand that businesses should segment their customers to better meet their needs.
4. Understand that businesses should consider the lifetime value of their various customer segments.
5. Understand that although some businesses can create products and services based on their intuitive insights, others need to conduct careful analyses.
6. Comprehend that new product or service development requires that organizations support creativity and innovation.

The perceived value proposition offers a significant challenge to any business. It requires that a business have a fairly complete understanding of the customer's perception of benefits and costs. Although market segmentation may help a business better understand some segments of the market, the challenge is still getting to understand the customer. In many cases, customers themselves may have difficulty in clearly understanding what they perceive as the benefits and costs of any offer. How then is a business, particularly a small business, to identify this vital requirement? The simple answer is that a business must be open to every opportunity to listen to the **voice of the customer (VOC)**. This may involve actively talking to your customers on a one-to-one basis, as illustrated by Robert Brown, the small business owner highlighted at the beginning of this chapter. It may involve other methods of soliciting feedback from your customers, such as satisfaction surveys or using the company's website. Businesses may engage in market research projects to better understand their customers or evaluate proposed new products and services. Regardless of what mechanism is used, it should serve one purpose—to better understand the needs and wants of your customers.

Video Clip 2.3.1:

Robin Lawton—Voice of the Customer—What Do Customers Value?



International Management Technologies introduces Robin Lawton on the topic of "What Do Customers Value?"

Video Clip 2.3.2:

Robin Lawton—Voice of the Customer—Basis for Satisfaction Keynote



The customer-centered organization begins the transformation process by understanding how to uncover and understand the VOC.

Research

The chapter on"Marketing Basics" of this text will focus on the topic of marketing for small business. Naturally, it will include significant materials on the subject of market research. In this section, the focus will be on how a business may gain better insight into what constitutes the benefits and the costs for particular customers. It will take a broad view and leave the details of market research for "Marketing Basics".

Good research in the area of customer value simply means that one must stop talking to the customer—talking through displays, advertising, and/or a website. It means that one is always open to listening carefully to the VOC. Active listening in the service of better identifying customer value means that one is always open to the question of how your business can better solve the problems of particular customers.

If businesses are to become better listeners, what should they be listening for? What types of questions should they be asking their customers? Businesses should address the following questions when they attempt to make customer value the focus of their existence:

- What needs of our customers are we currently meeting?
- What needs of our customers are we currently failing to meet?
- Do our customers understand their own needs and are they aware of them?
- How are we going to identify those unmet customer needs?
- How are we going to listen to the VOC?
- How are we going to let the customer talk to us?
- What is the current value proposition that is desired by customers?
- How is the value proposition different for different customers?
- How—exactly—is our value proposition different from our competitors?
- Do I know why customers have left our business for our competitors?

Who Your Customer Is—and Is Not

At the beginning of this chapter, it was argued that your central focus must be the customer. One critical way that this might be achieved is by providing a customer with superior value. However, creating this value must be done in a way that assures that the business makes money. One way of doing this is by identifying and selecting those customers who will be profitable. Some have put forth the concept of **customer lifetime value**, a measure of the revenue generated by a customer, the cost generated for that particular customer, and the projected retention rate of that customer over his or her lifetime.Jack Schmid, “How Much Are Your Customers Worth?,” *Catalog Age* 18, no. 3 (2001): 63.ˈJonathon Lee and Lawrence Feick, “Cooperating Word-of-Mouth Affection Estimating Customer Lifetime Value,” *Journal of Database Marketing and Customer Strategy Management* 14 (2006): 29.

This concept is popular enough that there are lifetime value calculator templates available on the web. The Harvard Business School created the calculator used in Exercise 2.1. It looks at the cost of acquiring a customer and then computes the **net present**

value of the customer during his or her lifetime. Net present value discounts the value of future cash flows. It recognizes the time value of money. You can use one of two models: a simple model that examines a single product or a more complex model with additional variables. One of the great benefits in conducting customer lifetime value analysis is combining it with the notion of market segmentation. The use of market segmentation allows for recognizing that certain classes of customers may produce significantly different profits during their lifetimes. Not all customers are the same.

Let us look at a simple case of segmentation based on behavioral factors. Some customers make more frequent purchases; these loyal customers may generate a disproportionate contribution of a firm's overall profit. It has been estimated that only 15 percent of American customers have loyalty to a single retailer, yet these customers generate between 55 percent and 70 percent of retail sales."Loyalty Promotions," *Little & King Integrated Marketing Group*, accessed December 5, 2011, www.littleandking.com/white_papers/loyalty_promotions.pdf. Likewise, a lifetime-based economic analysis of different customer segments may show that certain groups of customers actually cost more than the revenues that they generate.

Having segmented your customers, you will probably find that some require more handholding during and after the sale. Some customer groups may need you to "tailor" your product or service to their needs."Determining Your Customer Perspective—Can You Satisfy These Customer Segments?," *Business901.com*, accessed October 8, 2011, business901.com/blog1/determining-your-customer-perspective-can-you-satisfy-these-customer-segments. As previously mentioned, market segmentation can be done along several dimensions. Today, some firms use data mining to determine the basis of segmentation, but that often requires extensive databases, software, and statisticians. One simple way to segment your customers is the customer value matrix that is well suited for small retail and service businesses. It uses just three variables: recency, frequency, and monetary value. Its data requirements are basic. It needs customer identification, the date of purchase, and the total amount of purchase. This enables one to easily calculate the average purchase amount of each customer. From this, you can create programs that reach out to particular segments.Claudio Marcus, "A Practical yet Meaningful Approach to Customer Segmentation," *Journal of Consumer Marketing* 15, no. 5 (1998): 494.

Video Clip 2.3.3:

Customer Lifetime Value



Jack Daly presents the "client for life" concept, featuring Continuity Programs BCL programs of customer loyalty outsourced service.

Video Clip 2.3.4:

Lifetime Customer Value



Patrick McTigue explains how critical the lifetime value of a customer is to your business. He covers some tips to integrate superb customer service into your business model.

What Your Gut Tells You

The role of market research was already discussed in this chapter. For many small businesses, particularly very small businesses, formal market research may pose a problem. In many small businesses, there may be a conflict between decision making made on a professional basis and decision making made on an instinctual basis.Malcolm Goodman, "The Pursuit of Value through Qualitative Market Research," *Qualitative Market Research: An International Journal* 2, no. 2 (1999): 111. Some small business owners will always decide based on a gut instinct. We can point to many instances in which gut instinct concerning the possible success in product paid off, whereas a formal market research evaluation might consider the product to be a nonstarter.

In 1975, California salesman Gary Dahl came up with the idea of the ideal pet—a pet that would require minimal care and cost to maintain. He developed the idea of the pet rock. This unlikely concept became a fad and a great success for Dahl. Ken Hakuta, also known as Dr. Fad, developed a toy known as the Wallwalker in 1983. It sold over 240 million units."What Are Wacky WallWalkers?," *DrFad.com*, accessed December 2, 2011, www.drfad.com/fad_facts/wallwalker.htm. These and other fad products, such as the Cabbage Patch dolls and Rubik's Cube, are so peculiar that one would be hard pressed to think of any marketing research that would have indicated that they would be viable, let alone major successes.

Sometimes it is an issue of having a product idea and knowing where the correct market for the product will be. Jill Litwin created *Peas a Pie Pizza*, which is a natural food pizza pie with vegetables baked in the crust. She knew that the best place to market her unique product would be in the San Francisco area with its appreciation of organic foods.Susan Smith Hendrickson, "Mining Her Peas and Carrots Wins Investors," *Mississippi Business Journal* 32, no. 21 (2010): S4.

This notion of going with one's gut instinct is not limited to fad products. Think of the birth of Apple Computer. The objective situation was dealing with a company whose two major executives were college dropouts. The business was operating out of the garage of the mother of one of these two executives. They were producing a product that up to that point had only a limited number of hobbyists as a market. None of this would add up to very attractive prospect for investment. You could easily envision a venture capitalist considering a possible investment asking for a market research study that would identify the target market(s) for its computers. None existed at the company's birth. Even today, there is a strong indication that Apple does not rely heavily on formal marketing research. As Steve Jobs put it,

It's not about pop culture, it's not about fooling people, and it's not about convincing people that they want something they don't. We figure out what we want. And I think we're pretty good at having the right discipline to think through whether a lot of other people are going to want it, too. That's what we get paid to do. So you can't go out and ask people, you know, what's the next big [thing.] There is a great quote by Henry Ford, right? He said, "If I had asked my customers what they wanted, they would've told

me ‘A faster horse.’”Alain Breillatt, “You Can’t Innovate Like Apple,” *Pragmatic Marketing* 6, no. 4, accessed October 8, 2011, www.pragmaticmarketing.com/publications/magazine/6/4/you_cant_innovate_like_apple.

The Voice of the Customer—QFD

Quality function deployment (QFD) is an approach that is meant to take the VOC concept seriously and uses it to help design new products and services or improve existing ones. It is an approach that was initially developed in Japan for manufacturing applications. It seeks “to transform user demands into design quality, to deploy the functions forming quality, and to deploy methods for achieving the design quality into subsystems and component parts, and ultimately to specific elements.”Yoji Akao, *Quality Function Deployment: Integrating Customer Requirements into Product Design* (New York: Productivity Press, 1990), 17. To put it more clearly, QFD takes the desires of consumers and explores how well the individual activities of the business are meeting those desires. It also considers how company activities interact with each other and how well the company is meeting those customer desires with respect to the competition. It achieves all these ends through the means of a schematic; see Figure 2.3.1: , which is known as the house of quality. The schematic provides the backbone for the entire QFD process. A comprehensive design process may use several houses of quality, moving from the first house, which concentrates on the initial specification of customer desires, all the way down to developing a house that focuses on the specification for parts or processes. Any house is composed of several components:

- **Customer requirements (the *whats*).** Here you identify the elements desired by customers; this section also contains the relative importance of these needs as identified by customers.
- **Engineering characteristics (the *hows*).** This is the means by which an organization seeks to meet customer needs.
- **Relationship matrix.** This illustrates the correlations among customer requirements and engineering characteristics. The degree of the correlation may be represented by different symbols.
- **“Roof” of the house.** This section illustrates the correlations among the engineering characteristics and reveals synergies that might exist among the engineering characteristics.
- **Competitive assessment matrix.** This is used to evaluate the position of a business with respect to its competition.
- **“Basement.”** This section is used for assessing the engineering characteristics or setting target values. The “basement” enables participants to instantly see the relative benefits of the activities undertaken by a company in meeting consumer desires by multiplying the values in each cell by the weight of the “why” and then adding the values together.

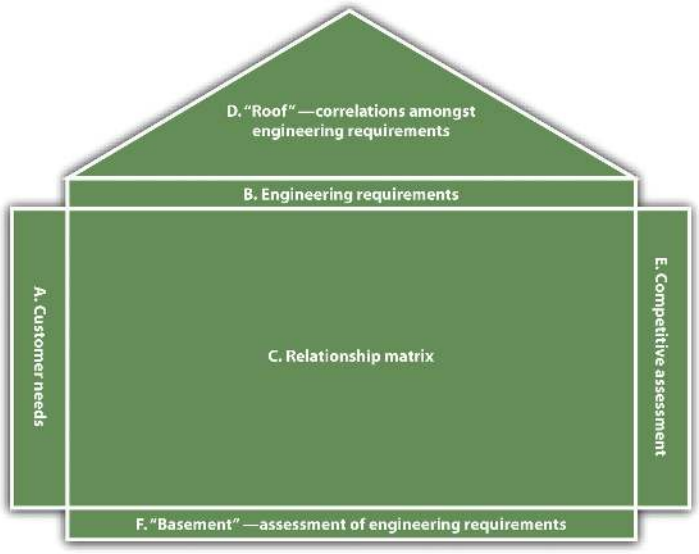
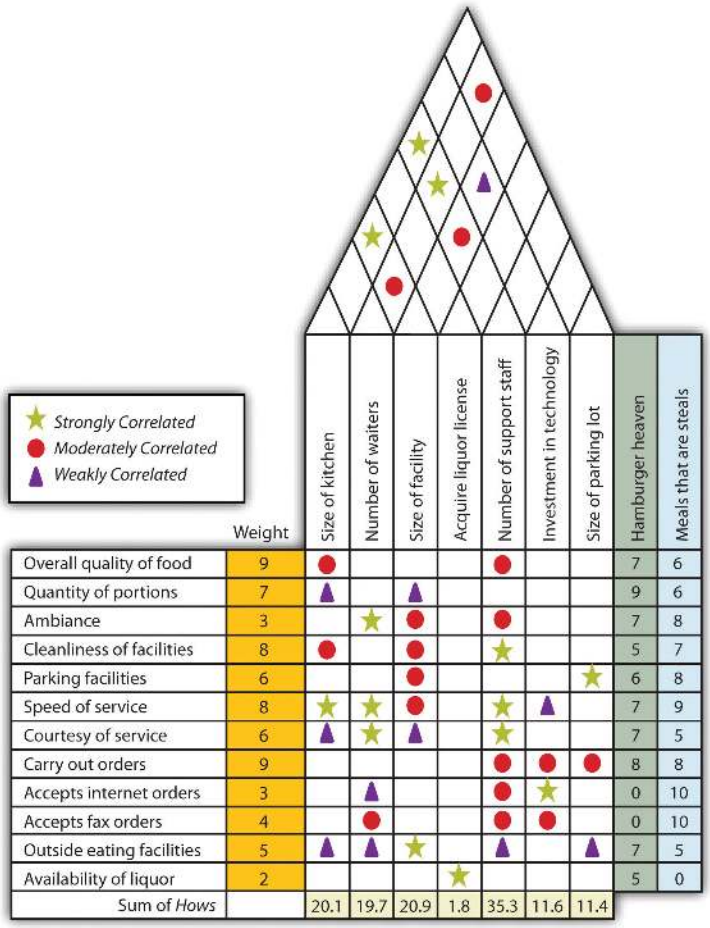


Figure 2.3.1: House of Quality

Although it might initially appear to be complex, QFD provides many benefits, including the following: (1) reduces time and effort during the design phase, (2) reduces alterations in design, (3) reduces the entire development time, (4) reduces the probability of inept design, (5) assists in team development, and (6) helps achieve common consensus.Gerson Tontini, “Deployment of Customer Needs in the QFD Using a Modified Kano Model,” *Journal of the Academy of Business and Economics* 2, no. 1 (2003).

Unfortunately, QFD is most often associated with manufacturing. Few realize that it has found wide acceptance in many other areas—software development, services, education, amusement parks, restaurants, and food services. (For examples of these applications of QFD, go to http://www.mazur.net/publishe.htm.) Further, company size should not be seen as a limitation to its possible application. The QFD approach, in a simplified form, can be easily and successfully used by any business regardless of its size.Glen Mazur, "QFD for Small Business: A Shortcut through the Maze of Matrices" (paper presented at the Sixth Symposium on Quality Function Deployment, Novi, MI, June 1994). Its visual nature makes it extremely easy to comprehend, and it can convey to all members of the business the relative importance of the elements and what they do to help meet customers' expectations. Figure 2.3.2: illustrates this by providing a simplified house of quality chart for a restaurant.

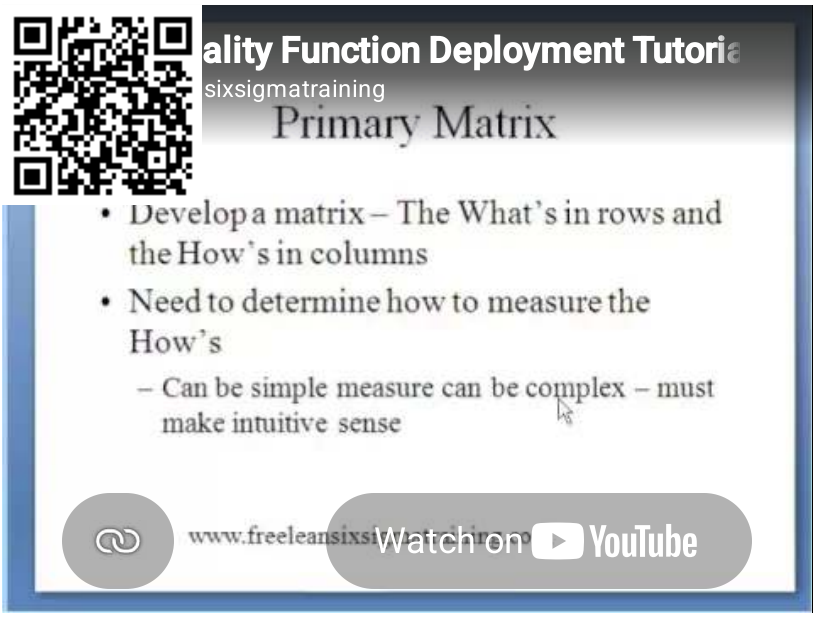


	Weight	Size of kitchen	Number of waiters	Size of facility	Acquire liquor license	Number of support staff	Investment in technology	Size of parking lot	Hamburger heaven	Meals that are steals
Overall quality of food	9	●				●			7	6
Quantity of portions	7	▲		▲					9	6
Ambiance	3		★	●		●			7	8
Cleanliness of facilities	8	●		●		★			5	7
Parking facilities	6			●				★	6	8
Speed of service	8	★	★	●		★	▲		7	9
Courtesy of service	6	▲	★	▲		★			7	5
Carry out orders	9					●	●	●	8	8
Accepts internet orders	3		▲			●	★		0	10
Accepts fax orders	4		●			●	●		0	10
Outside eating facilities	5	▲	▲	★		▲		▲	7	5
Availability of liquor	2				★				5	0
Sum of *Hows*		20.1	19.7	20.9	1.8	35.3	11.6	11.4		

Figure 2.3.2: Simplified House of Quality for a Restaurant

Video Clip 2.3.5:

Quality Function Deployment Tutorial



This gives a brief overview of QFD.

QFD Analysis and Excel

Some companies provide Excel-based software that can assist in conducting a QFD analysis. This shows a template in the QI Macros software to help structure your thinking, making sure nothing is left out. For more information and to download a 30-day trial of the QI Macros, including the QFD template, see www.qimacros.com/six-sigma-articles.html.

How to Become a Better Listener

Although some succeed by listening to their instincts—their inner voices—it is highly advisable to all businesses to be proactive in trying to listen to the VOC. Listening to the customer is the domain of market research. However, it should not be surprising that many small businesses have severe resource constraints that make it difficult for them to use complex and sophisticated marketing and market research approaches.David Carson, Stanley Cromie, Pauric McGowan, Jimmy Hill, *Marketing and Entrepreneurship in Small and Midsize Enterprises* (Hemel Hempstead, UK: Prentice-Hall, 1995), 108. To some extent, this is changing with the introduction of powerful, yet relatively low cost, web-based tools and social media. These will be discussed in greater detail in Section 2.4.2 "Digital Technology and E-Environment Implications" of this chapter. Another restriction that a small business may face in the area of marketing is that the owner's marketing skills and knowledge may not be very extensive. The owners of such firms may opt for several types of solutions. They may try to mimic the marketing techniques employed by larger organizations, drawing on what was just mentioned. They may opt for sophisticated but easy to use analytical tools, or they may just simply take marketing tools and techniques and apply them to the small business environment.Malcolm Goodman, "The Pursuit of Value through Qualitative Market Research," *Qualitative Market Research: An International Journal* 2, no. 2 (1999): 111.

The most basic and obvious way to listen to customers is by talking to them. All businesses should support programs in which employees talk to customers and then record what they have to say about the product or the service. It is important to centralize these observations.

Other ways of listening to customers are through comment cards and paper and online surveys. These approaches have their strengths and limitations (see Note 2.31 "Video Clip 2.11"). Regardless of these limitations, they do provide an insight into your customers. Another way one can gather information about customers is through loyalty programs. Loyalty programs are used by 81 percent of US households.Shallee Fitzgerald, "It's in the Cards," *Canadian Grocer* 118, no. 10 (2004/2005): 30. Social media options—see Section 2.4.2 "Digital Technology and E-Environment Implications"—offer a tremendous opportunity to not only listen to your customer but also engage in an active dialog that can build a sustainable relationship with customers.

Video Clip 2.3.6:

Listen to Your Customers and Express How Much You Care



This video details how easy and simple it is to show that you listen to your customers and care about them.

Video Clip 2.3.7:

Ask, Listen, and Retain Video #4: Listening and Analyzing What Your Customers Say?



This is the fourth in a series of videos on listening to customers. This video covers how to analyze any disengaged or disgruntled customers. Once a customer is identified, our process ensures that action is taken to reengage the customer by dealing with the concerns at hand. But most importantly, the process encourages the development of a relationship between the customer and branch level management.

Website

Cisco Website for Innovation

A web forum for small businesses to share information: communities.cisco.com/community/technology/collaboration/business/blog/tags/innovation.

Exercises

1. The Harvard Business School provides an online customer lifetime value calculator at hbsp.harvard.edu/multimedia/flashtools/cltv/index.html. You provide some key values, and it computes the net present value of customer purchases. Go to the site and use the following data. What impact does changing the customer retention have on the value of the customer?

Average spent per purchase	$250.00
Average number of purchases per period	4
Direct marketing cost per period per year	$30
Average gross margin	20%
Average retention rate	**25%, 35%, 50%, 70%, 80%, and 90%**
Annual discount rate	10%

2. Imagine you are planning to open a boutique clothing store in the downtown section of a major city in the United States. You are interested in using a QFD chart to help you design the store. Identify the customer requirements (*whats*) in the engineering characteristics (*hows*). You need not to conduct a full-blown QFD analysis but at least show the degree of relationship between customer requirements and engineering characteristics.
3. You are the owner of a children's clothing store in a prosperous suburban community. What methods and techniques might you use to become more adept at listening to the VOC? Outline specific programs that go beyond just talking to your customer that might enable you to better understand their notion of value.

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2.4: Sources of Business Ideas

Learning Objectives

- Small businesses must be open to innovation with respect to products, services, marketing methods, and packaging.
- Creativity in any organization can be easily stifled by a variety of factors. These should be avoided at all cost.
- Small businesses should be sensitive to the emergence of new social and consumer trends.
- Online databases can provide even the smallest of businesses with valuable insights into the existence and emergence of social and consumer trends.

Exercises

1. Generate a new product or service idea. You should be able to describe it in two or three sentences. Work with your fellow students in groups of three to four and then ask them to review their ideas and select one for presentation in class. At the end of the presentation, everyone should write what he or she saw as occurring during the process of group decision making. Did it make the process more creative? Did it allow for the better evaluation of ideas? Do they see problems with this type of group innovation thinking?
2. In Exercise 1, students were asked to develop a new product or service. Repeat this exercise but now ask students to think up an innovation for an existing product in the area of either packaging or marketing. Again, ask them the following questions after the group decision-making process: (a) Did it make the process more creative? (b) Did it allow for the better evaluation of ideas? (c) Do they see problems with this type of group innovation thinking?
3. Consider that you are at the gym mentioned earlier in this section. This gym is considering adding a weight-loss program. Use some of the online tracking programs with respect to the term *weight loss program*. What useful information could be extracted from these searches?

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CHAPTER OVERVIEW

3: The Business Plan

3.1: The Business Plan
3.2: Developing Your Strategy
3.3: The Necessity for a Business Plan
3.4: Building a Plan
3.5: The Three Threads

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3.1: 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 3.1.1: 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 codesign 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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3.2: Developing Your Strategy

Learning Objectives

1. Understand the term *strategy* and why it is important for small business.
2. Define the four generic strategies identified by Porter.
3. Evaluate the ramifications of each generic strategy for the operations of a small business.

> *Without a strategy, the organization is like a ship without a rudder, going around in circles. -Joel Ross and Michael Kami*

As mentioned in"Your Business Idea: The Quest for Value", 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 than 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 Concept of Corporate Strategy (Homewood, IL: Irwin, 1971), 28. -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, Strategy and Structure (Cambridge, MA: MIT Press, 1962), 13. -Alfred Chandler*

> *What business strategy is all about, in a word, is competitive advantage.Kenichi Ohmae, The Mind of the Strategist (Harmondsworth, UK: Penguin Books, 1983), 6. -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.Henry Mintzberg, Joseph Lampel, and Bruce Ahlstrand, *Strategic Safari: A Guided Tour through the Wilds of Strategic Management* (New York: Free Press, 1998). 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 (Figure 3.2.1) of the entire process. This concept is often forgotten in large bureaucratic organizations.

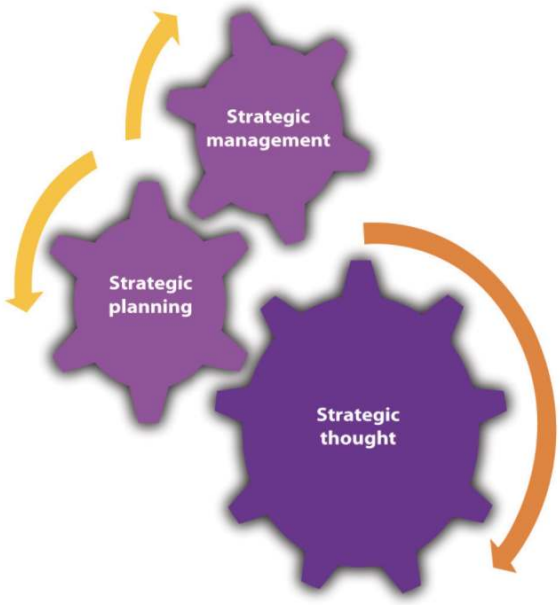


Figure 3.2.1: Strategy Troika (CC BY-SA-NC; anonymous)

The three gears of strategy, thought, planning and managment

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.Paul Solman and Thomas Friedman, *Life and Death on the Corporate Battlefield: How Companies Win, Lose, Survive* (New York: Simon and Schuster, 1982), 24–27. 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 3.2.1

What Is Strategy?



Michael Porter of Harvard Business School provides a brief discussion of what strategy is.

Video Clip 3.2.2

Strategic Thinking and the Definition of Strategy



A Center for Management Organization and Effectiveness (CMOE) discussion of strategy; it leads to other similar videos.

Video Clip 3.2.3

Strategic Thinking—Develop Strategic Thinking Skills to Give Yourself a Competitive Edge



Follow-up CMOE video on strategic thinking.

Video Clip 3.2.4

Strategic Thinking and Management for Competitive Advantage

(



Two Wharton professors discuss how strategic thinking is critical to the acquisition of competitive advantage.

Video Clip 3.2.5

Mastering Strategic Thinking Workshop



A professor discusses the importance of strategic thinking for leadership.

Video Clip 3.2.6

From Strategic Thinking to Planning



A speaker illustrates that successful plans are tied to strategic thinking.

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."Stephen C. Perry, "A Comparison of Failed and Non-Failed Small Businesses in the United States: Do Men and Women Use Different Planning and Decision Making Strategies?," *Journal of Developmental Entrepreneurship* 7, no. 4 (2002): 415.

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. Stephen C. Perry, "An Exploratory Study of U.S. Business Failures and the Influence of Relevant Experience and Planning," (PhD diss., George Washington University, 1998; dissertation available through UMI Dissertation Services, Ann Arbor, MI), 42. 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."David A. Curtis, *Strategic Planning for Smaller Businesses: Improving Corporate Performance and Personal Reward* (Cambridge, MA: Lexington Books, 1983), 29. These ad hoc (realized) strategies may be at odds with the planned (intended) strategies to guide a firm.Henry Mintzberg, *The Rise and Fall of Strategic Planning* (New York: Free Press, 1994), 46. 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 the can do it without any strategy, or without any guiding road-map."Harry Tucci, comment posted to the following blog: Rieva Lesonsky, "A Small Business Plan Doubles Your Chances

for Success, Says a New Survey, *Small Business Trends*, June 20, 2010, accessed October 10, 2011, smallbiztrends.com/2010/06/business-plan-success-twice-as-likely.html.

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*.Michael Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980), 21. 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 (see Figure 5.2): 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.

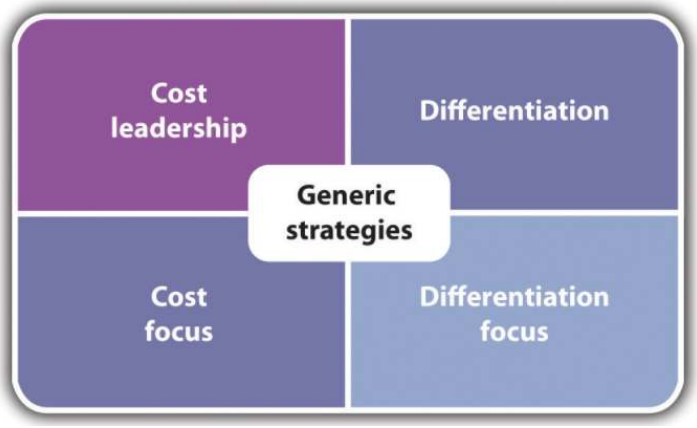


Figure 3.2.2: Generic Strategies

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 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. "Kogi Truck Schedule," *Kogi BBQ*, accessed October 10, 2011, kogibbq.com. 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 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. *Max and Mina's Ice Cream*, accessed October 10, 2011, www.maxandminasicecream.com.

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.”Michael Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980), 21. 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 (see Table 3.2.1").

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 3.2.1: 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 3.2.7

Porter's Strategies—Generic Strategies



Examples of generic strategies.

Video Clip 3.2.8

The Five Competitive Forces That Shape Strategy



A long interview with Michael Porter discussing the five forces model.

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. (Look at Exercise 1 in Section 5.2 for some additional questions that you might want to ask these owners.)

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3.3: The Necessity for a Business Plan

Learning Objectives

1. Understand that the probability of running a successful business is significantly increased with a formal business plan.
2. Understand that although many small business owners express reasons for not planning, they do themselves a great disservice by not having a formal plan.
3. Understand that businesses that seek to secure external funding must produce a formal plan.

An intelligent plan is the first step to success. The man who plans knows where he is going, knows what progress he is making and has a pretty good idea of when he will arrive. Planning is the open road to your destination. If you don't know where you're going, how can you expect to get there?

Basil Walsh

In "Foundations for Small Business", 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.Jason Cohen, "Don't Write a Business Plan," *Building43*, January 27, 2010, accessed October 10, 2011, www.building43.com/blogs/2010/01/27/dont-write-a -business-plan. The overwhelming consensus is that a well-developed plan is essential for the survival of any small (or large) business.T. C. Carbone, "Four Common Management Failures and How to Avoid Them," *Management World* 10, no. 8 (1981): 38.Patricia Schaeffer, "The Seven Pitfalls of Business Failure and How to Avoid Them," *Business Know-How*, 2011, accessed October 10, 2011, www.businessknowhow.com/startup/business-failure.htm.Isabel M. Isodoro, "10 Rules for Small Business Success," *PowerHomeBiz.com*, 2011, www.powerhomebiz.com/vol19/rules.htm.Rubik Atamian and Neal R. VanZante, "Continuing Education: A Vital Ingredient of the 'Success Plan' for Small Business," *Journal of Business and Economic Research* 8, no. 3 (2010): 37. Perry found that firms with more than five people benefit from having a well-developed business plan.Stephen C. Perry, "A Comparison of Failed and Non-Failed Small Businesses in the United States: Do Men and Women Use Different Planning and Decision Making Strategies?," *Journal of Developmental Entrepreneurship* 7, no. 4 (2002): 415.

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."Rieva Lesonsky, "A Small Business Plan Doubles Your Chances for Success, Says a New Survey," *Small Business Trends*, June 20, 2010, accessed October 10, 2011, smallbiztrends.com/2010/06/business-plan-success-twice-as-likely.html.

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

By failing to prepare, you will prepare them to fail.

Benjamin Franklin

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.H. Hodges and T. Kent, "Impact of Planning and Control Sophistication in Small Business," *Journal of Small Business Strategy* 17, no. 2 (2006–7): 75. Fortunately, this situation has changed rather significantly in the last decade. As we will illustrate in Section 5.3, 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.Tim Berry, "What Bankers Look for in a Business Plan…and What You Should Expect When Taking Your Business Plan to a Bank," *AllBusiness.com*, November 7, 2006, accessed October 10, 2011, www.allbusiness.com/business-planning-structures/business-plans/3878953-1.html. 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.Marc Mays, "Small Business Venture Capital Strategies," *eZine Articles*, 2010, accessed October 10, 2011, ezinearticles.com/?Small-Business-Venture-Capital-Strategies &id=4714691.

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 is 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 capitalist. 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."The Importance of Angel Investing in Financing the Growth of Entrepreneurial Ventures," *Small Business Notes*, September 2008, accessed October 10, 2011, www.smallbusinessnotes.com/aboutsb/rs331.html.

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

1. In Exercise 2 in Section 5.1, 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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3.4: Building a Plan

Learning Objectives

1. 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.
2. Understand that any solidly written plan will require information about the competitive environment. There are many publicly available sources of such information.
3. 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.
4. Understand that formal business plans should contain specific sections.
5. Know that scenario planning should help businesses prepare for low-probability events that might have a significant impact on the firm.
6. 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? Melinda Emerson, "Life Plan before Business Plan," *Small Business Trends*, March 22, 2010, accessed October 10, 2011, smallbiztrends.com/2010/03/life-plan -before-business-plan.html.

Having addressed these questions, one will be in a much better position to craft a formal business plan.

Video Clip 3.4.1:

How to Write a Business Plan



Cartoon introduction to building a business plan.

Video Clip 3.4.2:

How to Write a Business Plan in 6 Minutes—Template



Voiceover PowerPoint video.

Video Clip 3.4.3:

How to Start a Business: How to Write a Business Plan



A video from Startupdaddy.com that emphasizes the need for a business plan.

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

Prediction is very difficult, especially about the future.

Nils Bohr, Nobel Prize winner

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 3.4.1: provides examples of both qualitative forecasting methods and quantitative forecasting methods for sales forecasting. Each method is described, and their strengths and weaknesses are given.

Table 3.4.1: 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 3.4.4:

Ask Tim Berry—How Do I Start a Sales Forecast?



Provides useful insights on how to start forecasting in the small business environment.

Video Clip 3.4.5:

Sales Forecast, Part 1: Structure



Tim Berry starts a discussion about using spreadsheets for forecasting.

Video Clip 3.4.6:

Sales Forecast, Part 2: Logic



This module discusses how to explain the logic behind a forecast.

Video Clip 3.4.7:

Sales Forecast, Part 3: Back to the Spreadsheet



This module continues by explaining how to use spreadsheets in forecasting.

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.Jeffry Timmons, Andrew Zachary, and Stephen Spinelli, *Business Plans That Work—A Guide for Small Business* (New York: McGraw-Hill, 2004), 113. 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.”Carolyn Brown, “The Dos and Don’ts of Writing a Winning Business Plan,” *Black Enterprise*, April 1996, 114–122. 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 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 achieved 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." "Inc. 500 Mission Statements," *MissionStatements.com*, accessed October 10, 2011, www.missionstatements.com/inc_500_mission_statements.html. 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.""Mission Statement," *Ben & Jerry's*, accessed October 10, 2011, www.benjerry.com/activism/mission-statement.

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.""Invest in People, Not Ideas," *Michael Karnjanaprakorn*, January 15, 2009, accessed October 10, 2011, www.mikekarnj.com/blog/2009/01/15/invest-in-people-not-ideas.

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.Amir M Hormozi, Gail S. Sutton, Robert D. McMinn, Wendy Lucio, "Business Plans for New or Small Businesses: Paving the Path to Success," *Management Decision* 40, no. 8 (2002): 755.

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. We will have a much more in-depth discussion of these statements in Accounting and Cash Flow".

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 (they will be reviewed in much greater detail in "Financial Management" 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. Given the critical importance of cash flow to the survival of the small business, it will be covered in much more detail in "Financial Management".

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

Change is constant.

Benjamin Disraeli

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."Workshops and Events," *SCORE*, accessed October 10, 2011, www.score.org/events/workshops.

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.P. McNamee, *Tools and Techniques for Strategic Management* (New York: Pergamon Press, 1985), 187.

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. As mentioned in "Your Business Idea: The Quest for 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 stereo lithography, 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.Ashlee Vance, "A Technology Sets Inventors Free to Dream," *New York Times*, September 14, 2010.

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."2012 Business Plan Software Product Comparisons," *TopTenReviews.com*, accessed October 10, 2011, business-plan-software-review.toptenreviews.com. 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 Exercise 2 of "Developing our Strategy", 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 ("Appendix: A Sample Business Plan"), 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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3.5: The Three Threads

Learning Objectives

1. Learn that the planning process can add significantly to the delivery of customer value.
2. Understand that the proper management of the cash flow of a business can occur only in an environment of comprehensive planning.
3. 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**,Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 759. 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 Question 2 of Exercise 5.1, 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

The man who is prepared has his battle half won.

Miguel de Cervantes

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 are 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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CHAPTER OVERVIEW

4: Marketing Basics

4.1: Chapter Introduction
4.2: What Marketing Is All About
4.3: The Customer
4.4: Marketing Research
4.5: The Three Threads

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4.1: Chapter Introduction

Max and Mina's Homemade Ice Cream and Ices

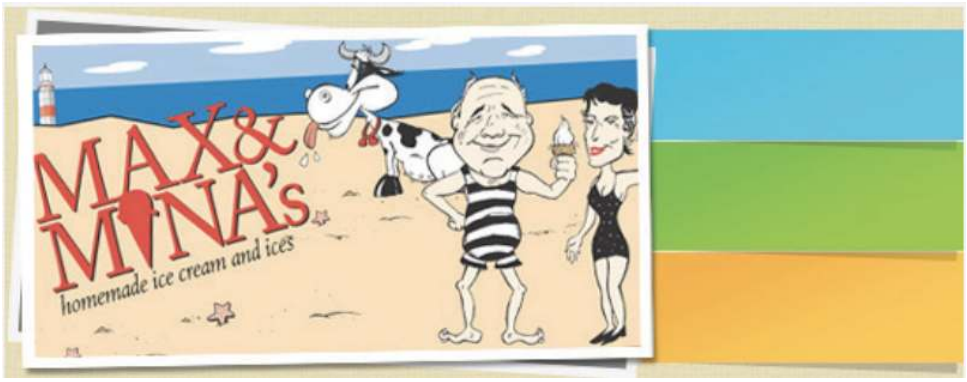


Figure 4.1.1: Source: Used with permission from Max and Mina's Ice Cream.

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.

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 compliment events. Turkey ice cream, anyone? Have an idea? Stop by and give Max and Mina's a try."About Us," *Max and Mina's Ice Cream*, accessed December 2, 2011, www.maxandminasicecream.com/about.html; Miriam Hill, "1000 Flavors and a Little Romance," *Philadelphia Inquirer*, accessed December 2, 2011, www.maxandminasicecream.com/images/articles/4.jpg; John Hyland, "Lox in a Cone: Sliced Thin It's Not," *New York Times*, August 16, 2000, accessed December 2, 2011, www.maxandminasicecream.com/images/articles/1.jpg.

Video Clip 4.1.1

Max and Mina's Ice Cream



An ice cream revolution.

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4.2: What Marketing Is All About

Learning Objectives

1. Define marketing.
2. Explain why marketing is so important to small business.
3. Explain the marketing concept, the societal marketing concept, and the holistic marketing concept.
4. Define customer value and discuss the role of marketing and delivering it.
5. 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.Jack Trout, "Peter Drucker on Marketing," *Forbes*, July 3, 2006, accessed January 19, 2012, www.forbes.com/2006/06/30/jack-trout-on-marketing-cx_jt_0703drucker .html.

Peter Drucker

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.""AMA Definition of Marketing," *American Marketing Association*, December 17, 2007, accessed December 1, 2011, www.marketingpower.com/Community/ARC/Pages/Additional/Definition/default.aspx. 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.Adapted from Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 6–7.

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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 19. 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.Rohit Deshpande and John U. Farley, "Measuring Market Orientation: Generalization and Synthesis," *Journal of Market-Focused Management* 2 (1998): 213–32; Ajay K. Kohli and Bernard J. Jaworski, "Market Orientation: The Construct, Research Propositions, and Managerial Implications," *Journal of Marketing* 54 (1990): 1–18; and John C. Narver and Stanley F. Slater, "The Effect of a Market Orientation on Business Profitability," *Journal of Marketing* 54 (1990): 20–35—all as cited in Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 19. "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."Charles W. Lamb, Joseph F. Hair, and Carl McDaniel, *Essentials of Marketing* (Mason, OH: South-Western, 2004), 8.

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.""You Don't Say?," *Sales and Marketing*

Management, October 1994, 111–12. 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"Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 12. 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 Link 4.2.1:

Do Well While Doing Good

Small business sustainability practices.



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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 19. 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."Charles S. Mack, "Holistic Marketing," *Association Management*, February 1, 1999, accessed January 19, 2012, www.asaecenter.org/Resources/AMMagArticleDetail.cfm?ItemNumber=880. 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** is discussed at length in Chapter 2, but we can define it 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. (See Chapter 2 for a detailed discussion of the 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.Center for Business Planning, "Market Segmentation," *Business Resource Software, Inc.*, accessed December 1, 2011, www.businessplans.org/segment.html. **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 4.2.1:

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 4.2.1: 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. The marketing research process is discussed in Section 6.3.

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.Rick Suttle, "Define Market Segmentation & Targeting," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/define-market-segmentation-targeting-3253 .html.

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. The marketing mix is discussed in more detail in "Marketing Strategy". A brief overview is presented here.



Figure 4.2.1: 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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 401.

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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 294–95.
- **Ethics.** For example, appropriate corporate and employee behavior.



Figure 4.2.2: 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.

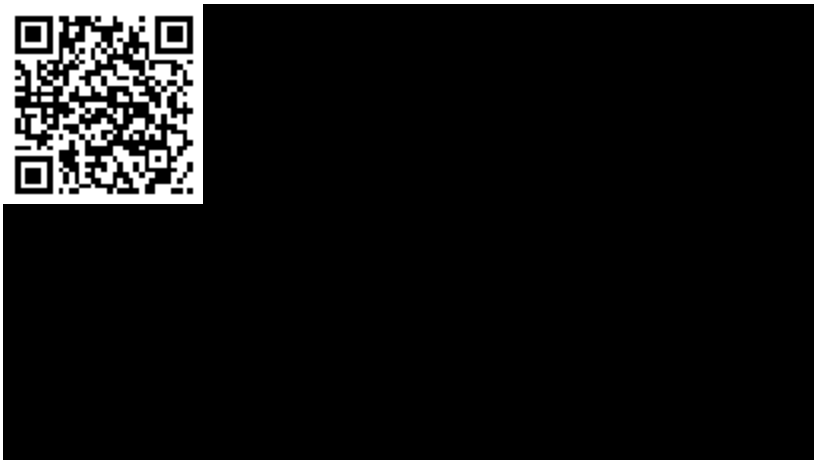
Marketing Strategy versus Marketing Management

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."Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 170. Segmentation, target market, differentiation, and positioning are discussed in greater detail in Chapter 7.

Video Link 4.2.2:

Small business makeover successes



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, which is discussed in Chapter 8.

Video Clip 4.2.3:

Marketing Concepts in Two Minutes



A humorous definition of key marketing concepts.

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

1. 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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4.3: The Customer

Learning Objectives

1. Explain the difference between a customer and a consumer.
2. Understand the relationship between the customer/consumer and the marketing mix.
3. Define the two types of customer markets.
4. Understand the factors that contribute to consumer behavior.
5. Describe the B2C and B2B buying processes.
6. Understand the differences between B2C and B2B buying behavior.
7. Define customer experience and explain its role in small business marketing.
8. 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.

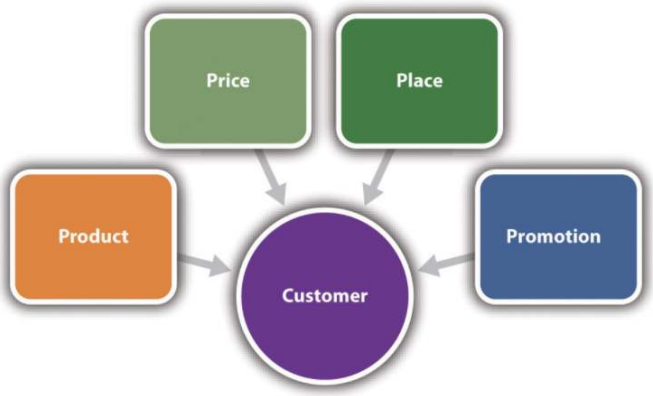


Figure 4.3.1: The Customer and the Marketing Mix

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.“History of Ivory Soap,” *Essortment.com*, accessed December 1, 2011, www.essortment.com/history-ivory-soap-21051.html. 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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 182. 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 4.3.1:

Consumer Behavior Matters



Understanding a customer's behavior will increase sales.

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"Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 182.—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).Adapted from Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 155. 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 4.3.1), 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. Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 112. Knowing and understanding the consumer decision process provides a small business with better tools for designing and implementing its marketing mix.

Table 4.3.1: Five Stages of the Consumer Buying Process

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.

Source: Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 168; Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 112–17.

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, Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 137. 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."Bill Furlong, "How the Internet Is Transforming B2B Marketing," *BrandNewBusinesses.com*, accessed December 1, 2011, www.brandnewbusinesses.com/NewsletterAugust2008A1.aspx.

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."Frederick E. Webster Jr. and Yoram Wind, *Organizational Buying Behavior* (Upper Saddle River, NJ: Prentice-Hall, 1972), 2, as cited in Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 188. 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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 188; Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 139. 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 ofSolutions, Identification of Vendors, Evaluation of Vendors, Vendor selection, Negotiation of Terms

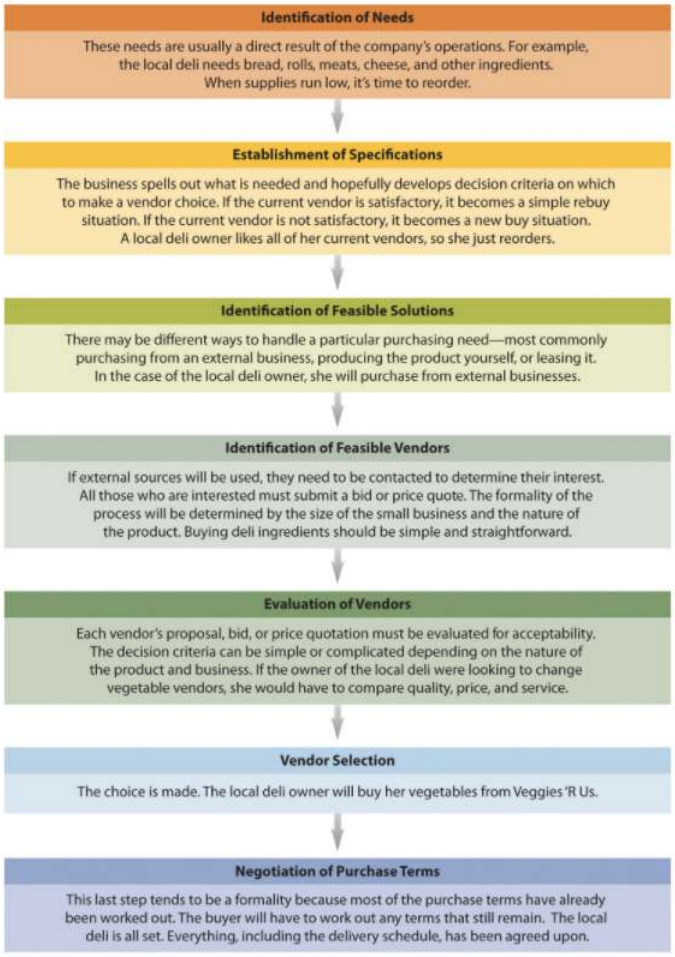


Figure 4.3.2: The *B2B Buying Process Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 148–55.*

The B2B purchasing process for any small business will be some variation of the process described in 4.3.2. 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 is one of the great frontiers for innovation.Jeneanne Rae, "The Importance of Great Customer Experiences…And the Best Ways to Deliver Them," Bloomberg BusinessWeek, November 27, 2006, accessed December 1, 2011, www.BusinessWeek.com/magazine/content/06_48/b4011429.htm?chan =search.*
>
> *Jeneanne Rae*

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.Fran ONeal, "'Customer Experience' for Small Business: When Does It Start?," *Small Business Growing*, August 23, 2010, accessed December 1, 2011, smallbusinessgrowing.com/2010/08/23/what-is-the-customer-experience-for-small -business.

Customer Experience in the B2C Market

Customers will experience multiple **touch points** (i.e., all the communication, human, and physical interactions that customers experience during their relationship life cycle with a small business)Eric Brown, "Engage Emotion and Shape the Customer Experience," *Small Business Answers*, December 14, 2010, accessed December 1, 2011, www.smallbusinessanswers.com/eric-brown/engage-emotion-and-shape-the -customer-ex.php. 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

   www.retailcustomerexperience.com/slideshow.php?ssn=273

2. The Diamond Cellar, Dublin, Ohio

   www.retailcustomerexperience.com/slideshow.php?ssn=145

3. Roche Bros. Supermarkets

   www.retailcustomerexperience.com/slideshow.php?ssn=261

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)."Harley Manning, "Customer Experience Defined," *Forrester's Blogs*, November 23, 2010, accessed December 1, 2011, blogs.forrester.com/harley_manning ?page=1&10-11-23-customer_experience_defined=. A customer experience can be a one-time occurrence with a particular company, but experiences are more likely to happen across many time frames.Harley Manning, "Customer Experience Defined," *Forrester's Blogs*, November 23, 2010, accessed December 1, 2011, blogs.forrester.com/harley_manning ?page=1&10-11-23-customer_experience_defined=. The experience begins at the point of need awareness and ends at need extinction. Lynn Hunsaker, *Innovating Superior Customer Experience* (Sunnyvale, CA: ClearAction, 2009), e-book, accessed December 1, 2011, www.clearaction.biz/innovation.

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.

> *What does all this mean in the real world? At the very least, it suggests that your local bookstore—where you can reach out and ruffle a paperback's pages—may have more staying power than e-commerce experts might think.*

https://web.archive.org/web/20100912...releases/13380

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."Grow Customers and Referrals!" *Small Business Growing*, accessed December 1, 2011, smallbusinessgrowing.com/grow-customers-and-referrals.

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.Colin Shaw, "Engage Your Customers Emotionally to Create Advocates," *CustomerThink*, September 17, 2007, accessed December 1, 2011, www.customerthink.com/article/engage_your_customers_emotionally. "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.”Jeneanne Rae, “The Importance of Great Customer Experiences…And the Best Ways to Deliver Them,” *Bloomberg BusinessWeek*, November 27, 2006, accessed December 1, 2011, www.BusinessWeek.com/magazine/content/06_48/b4011429.htm?chan =search.

Small businesses should learn and think about how to market a great B2C customer experience, not just a product or a service.Shaun Smith, “When Is a Store Not a Store—The Next Stage of the Retail Customer Experience,” *shaunsmith+co Ltd*, March 29, 2010, accessed December 1, 2011, www.smithcoconsultancy.com/2010/03/when-is-a-store-not-a-store-%E2%80%93 -the-next-stage-of-the-retail-customer-experience. Design an experience that is emotionally engaging by mapping the customer’s journeyColin Shaw, “Engage Your Customers Emotionally to Create Advocates,” *CustomerThink*, September 17, 2007, accessed December 1, 2011, www.customerthink.com/article/engage_your_customers_emotionally.—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.Jeneanne Rae, “The Importance of Great Customer Experiences…And the Best Ways to Deliver Them,” *Bloomberg BusinessWeek*, November 27, 2006, accessed December 1, 2011, www.BusinessWeek.com/magazine/content/06_48/b4011429.htm?chan =search.

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.Sydney Barrows, “6 Ways to Create a Memorable Customer Experience,” *Entrepreneur*, May 19, 2010, accessed December 1, 2011, www.entrepreneur.com/article/206760.

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 4.3.2:

How to Hire the Right Customer Service Person For Your Small Business



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.Lior Arussy, "Creating Customer Experience in B2B Relationships: Managing 'Multiple Customers' Is the Key," *G-CEM*, accessed December 28, 2011, www.g-cem.org/eng/content_details.jsp?contentid=2203&subjectid=107.

Lior Arussy

Creating customer relationships in the B2B environment is radically different from the B2C environment because customers face different challenges, resources, and suppliers.Lior Arussy, "Creating Customer Experience in B2B Relationships: Managing 'Multiple Customers' Is the Key," *G-CEM*, accessed December 28, 2011, www.g-cem.org/eng/content_details.jsp?contentid=2203&subjectid=107. 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."Richard Tait, "What's Different about the B2B Customer Experience," *Winning Customer Experiences*, August 16, 2010, accessed December 1, 2011, winningcustomerexperiences.wordpress.com/2010/08/16/whats-different-about_-the-b2b-customer-experience. 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.Richard Tait, "What's Different about the B2B Customer Experience," *Winning Customer Experiences*, August 16, 2010, accessed December 1, 2011, winningcustomerexperiences.wordpress.com/2010/08/16/whats-different-about -the-b2b-customer-experience.

Video Clip 4.3.3:

How Customer Experience Applies in the B2B Sector



Customer experience concerns are relevant in the B2B environment.

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."Richard Tait, "What's Different about the B2B Customer Experience," *Winning Customer Experiences*, August 16, 2010, accessed December 1, 2011, winningcustomerexperiences.wordpress.com/2010/08/16/whats-different-about_-the-b2b-customer-experience. 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 touch points in B2B processesAdapted from Pawan Singh, "The 9 Drivers of B2B Customer Centricity," *Destination CRM.com*, December 11, 2010, accessed December 1, 2011, www.destinationcrm.com/Articles/Web-Exclusives/Viewpoints/The-9-

Drivers-of -B2B-Customer-Centricity-72672.aspx. 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 postsale interactions. Experiences at every stage of the customer life cycle should be customized to each individual customer.Lior Arussy, "Creating Customer Experience in B2B Relationships: Managing 'Multiple Customers' Is the Key," *G-CEM*, accessed December 28, 2011, www.g-cem.org/eng/content_details.jsp?contentid=2203&subjectid=107.

Video Link4.3.4:

Customer Experience Differentiation

Customer experience in the B2C and B2B environments.



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.""What Is Customer Loyalty?," *Customer Loyalty Institute*, accessed December 1, 2011, www.customerloyalty.org/what-is-customer-loyalty. 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.Adapted from "Why Measure—What Is Loyalty?," *Mindshare Technologies*, accessed December 1, 2011, www.mshare.net/why/what-is-loyalty.html. 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 in customer loyalty.

The benefits of loyal customers are numerous: Adapted from Rama Ramaswami, "Eight Reasons to Keep Your Customers Loyal," *Multichannel Merchant*, January 12, 2005, accessed December 1, 2011, multichannelmerchant.com/opsandfulfillment/advisor/Brandi-custloyal/.

- 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.Jeffrey Gangemi, "Customer Loyalty: Dos and Don'ts," *BusinessWeek*, June 29, 2010, accessed December 1, 2011, www.BusinessWeek.com/smallbiz/tipsheet/06/29.htm. 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.Bruce Temkin, "The Four Customer Experience Core Competencies," *Temkin Group*, June 2010, accessed December 1, 2011, experiencematters.files.wordpress.com/2010/06/1006_thefourcustomerexperiencecorecompetencies_v2.pdf. 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 (Chapter 2). 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. Paul Gauvreau, "Making Customers Feel Special Brings Loyalty," *Pharmacy Post* 11, no. 10 (2003): 40.

Video Link Video Link4.3.5:

Listening to Customers Leads to Loyalty

All customers really want is for the companies they do business with to listen to them.



Video Link 4.3.6:

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.



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."Michael Lowenstein, "Customer Loyalty Behavior in B2B vs. B2C Scenarios," *SearchCRM*, January 31, 2007, accessed December 1, 2011, searchcrm.techtarget.com/answer/Customer-loyalty-behavior-in-B2B-vs-B2C -scenarios. 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 touch points) 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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4.4: Marketing Research

Learning Objectives

1. Understand and be able to explain what marketing research is all about.
2. Explain why a small business should conduct marketing research and why many small businesses do not do it.
3. Define and give examples of the two types of marketing research.
4. Understand the marketing research process.
5. 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."Shaun Smith, "Why Steve Jobs Doesn't Listen to Customers," *Customer Think*, February 8, 2010, accessed December 1, 2011, www.customerthink.com/blog/why_steve_jobs_doesnt_listen_to_customers. 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."Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, Ohio: Atomic Dog Publishing, 2007), 191. 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."Market Research Basics," *SmallBusiness.com*, October 26, 2009, accessed December 1, 2011, smallbusiness.com/wiki/Market_research_basics. 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:Susan Ward, "Do-It-Yourself Market Research—Part 1: You Need Market Research," *About.com*, accessed December 1, 2011, sbinfocanada.about.com/cs/marketing/a/marketresearch.htm. 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:Jesse Hopps, "Market Research Best Practices," *EvanCarmichael.com*, accessed December 1, 2011, www.evancarmichael.com/Marketing/5604/Market-Research -Best-Practices.html; adapted from Joy Levin, "How Marketing Research Can Benefit a Small Business," *Small Business Trends*, January 26, 2006, accessed December 1, 2011, smallbiztrends.com/2006/01/how-marketing-research-can-benefit-a-small -business.html.

- 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.""Market Research Basics," *SmallBusiness.com*, October 26, 2009, accessed December 1, 2011, smallbusiness.com/wiki/Market_research_basics.

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.""Market Research Basics," *SmallBusiness.com*, October 26, 2009, accessed December 1, 2011, smallbusiness.com/wiki/Market_research_basics. 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. Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 91. 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. Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson, Prentice Hall, 2009), 93. 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,Patricia Faulhaber, "Today's Headlines Provide Market Research," *Marketing and PR @ Suite101*, May 14, 2009, accessed December 1, 2011, patricia-faulhaber.suite101.com/todays-healines-provide-market-research-a117653.

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.Joy Levin, "How Marketing Research Can Benefit a Small Business," *Small Business Trends*, January 26, 2006, accessed December 1, 2011, smallbiztrends.com/2006/01/how-marketing-research-can-benefit-a-small-business.html. Secondary research would also be appropriate when looking for things such as economic trends, online consumer purchasing habits, and competitor identification.

Table 4.4.1: 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."Market Research Basics," *SmallBusiness.com*, October 26, 2009, accessed December 1, 2011, smallbusiness.com/wiki/Market_research_basics. Effective marketing research follows the following six steps: Adapted from Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 91–103.

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.“Market Research Basics,” *SmallBusiness.com*, October 26, 2009, accessed December 1, 2011, smallbusiness.com/wiki/Market_research_basics.

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.John Tozzi, “Market Research on the Cheap,” *Bloomberg BusinessWeek*, January 9, 2008, accessed December 1, 2011, www.BusinessWeek.com/smallbiz/content/jan2008/sb2008019_352779.htm. 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.”Joy Levin, “How Marketing Research Can Benefit a Small Business,” *Small Business Trends*, January 26, 2006, accessed December 1, 2011, smallbiztrends.com/2006/01/how-marketing-research-can-benefit-a-small-business.html.

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:Darrell Zahorsky, “6 Common Market Research Mistakes of Small Business,” *About.com*, accessed December 1, 2011, sbinformation.about.com/od/marketresearch/a/marketresearch.htm; Lesley Spencer Pyle, “How to Do Market Research—The Basics,” *Entrepreneur*, September 23, 2010, accessed December 1, 2011, www.entrepreneur.com/article/217345.

- **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

1. 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 by 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? (You may want to consult Chapter 16 and review Robert's business plan for a new restaurant.) Answer the question from a marketing perspective.

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4.5: The Three Threads

Learning Objectives

1. Understand how marketing contributes to customer value.
2. Explain how marketing can positively and negatively impact cash flow.
3. 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."Robert R. Harmon and Greg Laird, "Linking Marketing Strategy to Customer Value: Implications for Technology Marketers," *IEEEXplore Digital Library*, July 31, 1997, accessed December 1, 2011, ieeexplore.ieee.org/xpl/freeabs_all.jsp?arnumber=653700. 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. Robert R. Harmon and Greg Laird, "Linking Marketing Strategy to Customer Value: Implications for Technology Marketers," *IEEEXplore Digital Library*, July 31, 1997, accessed December 1, 2011, ieeexplore.ieee.org/xpl/freeabs_all.jsp?arnumber=653700.

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 4.5.1:

Cash Flow and the Marketing Budget



Why cash flow is relevant to marketing.

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."Nathan Pettyjohn, "Evolving the Customer Experience with Mobile Technology," *MarketingProfs*, December 28, 2010, accessed December 1, 2011, www.marketingprofs.com/articles/2010/4134/evolving-the-customer-experience -with-mobile-technology. 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.""Mobile Retail Shopping Solution Featuring Near Field Communication Technology," *PRWeb*, January 6, 2011, accessed December 1, 2011, www.prweb.com/releases/2011/ARSMOBILE/prweb4946004.htm.

Video Clip 4.5.2:

Mobile Marketing Solutions for Retail



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 companyBradley T. Gale, "Webinar on Customer Value Mapping," *Customer Value, Inc.*, accessed December 1, 2011, www.cval.com.

- 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."Robbin Block, *Social Persuasion: Making Sense of Social Media for Small Business* (Breinigsville, PA: Block Media, 2010), 2. 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

1. 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.The Customer's Shoes, "How to Turn a Disaster into a Great Customer Experience," *The Customer's Shoes Ltd.*, December 6, 2010, accessed December 1, 2011, www.thecustomersshoes.com/2010/12/how-to-turn-a-disaster-into-a-great -customer-experience. 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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CHAPTER OVERVIEW

5: Marketing Strategy

5.1: Chapter Introduction
5.2: The Importance of a Marketing Strategy
5.3: The Marketing Strategy Process
5.4: The Three Threads
5.5: Segmentation and the Target Market
5.6: Differentiation and Positioning
5.7: Marketing Strategy and Product
5.8: Marketing Strategy and Price
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5.1: Chapter Introduction

Elegant Touch



Figure 5.1.1: Used with permission from Anita Bruscino.

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 sectionsLeslie Hutchison, "Elegant Touch Fine Gifts," *CheshirePatch*, accessed March 24, 2012, cheshire.patch.com/listings/elegant-touch-fine-gifts.—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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5.2: The Importance of a Marketing Strategy

Learning Objectives

1. Understand how marketing for small businesses differs from marketing for big businesses.
2. Understand the most significant risk factor facing small businesses.
3. 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. Lynne Saarte, "Small Business Marketing Is Different from Big Business Marketing," *Articlecity*, accessed December 1, 2011, www.articlecity.com/articles/marketing/article_4959.shtml; Lyndon David, "Small Business Marketing Strategy: How Different Is It from Larger Businesses?," *Slideshare*, accessed December 1, 2011, www.slideshare.net/lyndondavid/small-business-marketing-strategy-how-different_-is-it-from-larger-businesses. (See Chapter 6 for a discussion of marketing principles.) 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."Lyndon David, "Small Business Marketing Strategy: How Different Is It from Larger Businesses?," *Slideshare*, accessed December 1, 2011, www.slideshare.net/lyndondavid/small-business-marketing-strategy-how-different-is-it-from-larger -businesses.

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. Lyndon David, "Small Business Marketing Strategy: How Different Is It from Larger Businesses?," *Slideshare*, accessed December 1, 2011, www.slideshare.net/lyndondavid/small-business-marketing-strategy-how-different-is-it-from-larger_-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.Ann Handley, "Act Your Shoe Size, Not Your Age: 3 Ways to Market Smaller in 2011," *MarketingProfs*, January 3, 2011, accessed December 1, 2011, www.mpdailyfix.com/3-ways-to-market-smaller-in-2011.

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."John Jantsch, "Marketing without Strategy Is the Noise before Failure," *Duct Tape Marketing*, November 29, 2010, accessed December 1, 2011, www.ducttapemarketing.com/blog/2010/11/29/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

1. 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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5.3: The Marketing Strategy Process

Learning Objectives

1. Describe the marketing strategy process.
2. Explain why segmentation, target market, differentiation, positioning, and website decisions are so important for the small business.
3. 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 (Figure 7.1). Each component should be considered and designed carefully: company vision, company mission, marketing objectives, and the marketing strategy itself.



Figure 5.3.1: 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.Jay Ebben, "Developing Effective Vision and Mission Statements," *Inc.*, February 1, 2005, accessed December 1, 2011, www.inc.com/resources/startup/articles/20050201/missionstatement.html.

Gertrude Stein

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.Jay Ebben, "Developing Effective Vision and Mission Statements," *Inc.*, February 1, 2005, accessed December 1, 2011, www.inc.com/resources/startup/articles/20050201/missionstatement.html. 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."Jay Ebben, "Developing Effective Vision and Mission Statements," *Inc.*, February 1, 2005, accessed December 1, 2011, www.inc.com/resources/startup/articles/20050201/missionstatement.html. 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."Susan Ward, "Sample Vision Statements," *About.com*, accessed December 1, 2011, sbinfocanada.about.com/od/businessplanning/a/samplevisions.htm.
- **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.""Organic Restaurant Business Plan: Studio67," *Bplans*, accessed December 1, 2011, www.bplans.com/organic_restaurant_business_plan/executive_summary_fc.cfm.

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."How to Choose Marketing Plan Objectives," accessed January 24, 2012, www.hellomarketing.biz/planning-strategy/marketing-plan-objectives.php. 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. Adapted from "Marketing Plan: Marketing Objectives and Strategies," *Small Business Notes*, accessed December 1, 2011, www.smallbusinessnotes.com/starting -a-business/marketing-plan-marketing-objectives-and-strategies.html.

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."Judy Strauss and Raymond Frost, *E-Marketing* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 6. 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; Bobette Kyle, "Marketing Objectives for Your Website," *WebSiteMarketingPlan.com*, December 10, 2010, accessed December 1, 2011, www.websitemarketingplan.com/marketing_management/marketingobjectivesarticle.htm. 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."Judy Strauss and Raymond Frost, *E-Marketing* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 5.

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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 179. These steps are discussed in Section 7.3 through Section 7.8. 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."John Jantsch, "The Cycle of Strategy," *Duct Tape Marketing*, March 29, 2010, accessed December 1, 2011, www.ducttapemarketing.com/blog/2010/03/29/the-cycle-of -strategy.

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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5.4: The Three Threads

Learning Objectives

1. derstand the role of marketing strategy in delivering customer value.
2. Explain how marketing strategy can positively and negatively impact cash flow.
3. Explain how digital technology and the e-environment are impacting marketing strategy.

Customer Value Implications

As stated in Chapter 6, 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.Robert R. Harmon and Greg Laird, "Linking Marketing Strategy to Customer Value: Implications for Technology Marketers," *PDFCast.org*, accessed December 1, 2011, pdfcast.org/pdf/linking-marketing-strategy-to-customer-value-implications-for -technology-marketers. 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 onground 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.Angela Hausman, "Marketing Strategy: Using Social Media to Create Customer Value," *Hausman Marketing Letter*, October 25, 2010, accessed June 1, 2012, www.hausmanmarketingletter.co...ocial-media-to -create-customer-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.Mark Hunter, "Discounting to Create Cash Flow? Be Careful," *PowerHomeBiz.com*, May 19, 2011, accessed December 1, 2011, www.powerhomebiz.com/blog/2011/05/discounting-to-create-cash-flow-be-careful.

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. Lauren Simonds, "Mobile Commerce Experts Talk Small Business," *Small Business Computing.com*, May 3, 2011, accessed December 1, 2011, www.smallbusinesscomputing.com/emarketing/article.php/3932506/Mobile_-Commerce-Experts-Talk-Small-Business.htm. 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,Emily Glazer, "Target: Customers on the Go," *Wall Street Journal*, May 16, 2011, accessed December 1, 2011, online.wsj.com/article/SB10001424052748704132204576285631212564952.html. 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. See "Trends in Selling."

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.Javier Espinoza, "Need to Bank? Phone It In," *Wall Street Journal*, November 14, 2011, accessed December 1, 2011, online.wsj.com/article/SB10001424052970204485304576644853956740860.html. 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.Sarah E. Needleman, "Raise Cash on Crowdfunding Sites," *Wall Street Journal*, November 27, 2011, accessed December 1, 2011, online.wsj.com/article/SB10001424052970204443404577052013654406558.html?mod=googlenews_ws.

Video Clip 5.4.1:



How wireless technology can provide communication and distribution support.

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?Michael Raymond, "Costly Small Business Marketing Mistakes Every Entrepreneur Must Avoid," *Helium*, accessed December 1, 2011, www.helium.com/items/1644285-current-domain-registration-expired-domain-names.

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5.5: Segmentation and the Target Market

Learning Objectives

1. Explain segmentation and the target market.
2. Explain why segmentation, the target market, differentiation, positioning, and website decisions are so important for a small business.
3. 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 onground 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. 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**.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 175–76. 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. Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 176.
- **Differential response.** The extent to which market segments are easily distinguishable from each other and respond differently to company marketing strategies.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 176. 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. (In "Marketing Basics", 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:Susan MaGee, "How to Identify a Target Market and Prepare a Customer Profile," accessed January 24, 2012, http://edwardlowe.org/erc/?ercID=6378; Adapted from "3 Reasons to Choose a Target Market," *Morningstar Marketing Coach*, December 16, 2008, accessed December 1, 2011, www.morningstarmultimedia.com/3-reasons-to-choose-a-target-market.

- **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."Susan Ward, "Niche Market," *About.com*, accessed December 1, 2011, sbinfocanada.about.com/cs/marketing/g/nichemarket.htm. 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 onground 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. Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 185.

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5.6: Differentiation and Positioning

Learning Objectives

1. Explain differentiation and positioning.
2. Explain why differentiation and positioning are so important for an online marketing strategy and an onground marketing strategy.
3. Understand that a successful differentiation strategy cannot be copied by competitors.
4. Understand that there are many ways to differentiate a product or a service.
5. 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 onground 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."Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 276.

Differentiation

Differentiation, setting yourself apart from the competition, is one of the most important and effective marketing tools available to small business owners.Bonny Albo, "Making a Business Stand Out from Its Competitors," *Entrepreneurs @ Suite 101*, August 9, 2009, accessed December 1, 2011, bonny-albo.suite101.com/marketing-strategy-differentiation-a136498. 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.Kim T. Gordon, "Dare to Be Different," April 1, 2005, accessed December 1, 2011, www.entrepreneur.com/article/76736. A successful differentiation strategy cannot be imitated by competitors—but it can bring you great success with consumers.Dan Herman, "The Surprising Secret of Successful Differentiation," *Fast Company*, June 7, 2008, accessed December 1, 2011, www.fastcompany.com/blog/dan -herman/outsmart-mba-clones/surprising-secret-successful-differentiation?.

Video Clip 5.6.1:



Differentiation is everyone's goal, but few are able to achieve it.

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,

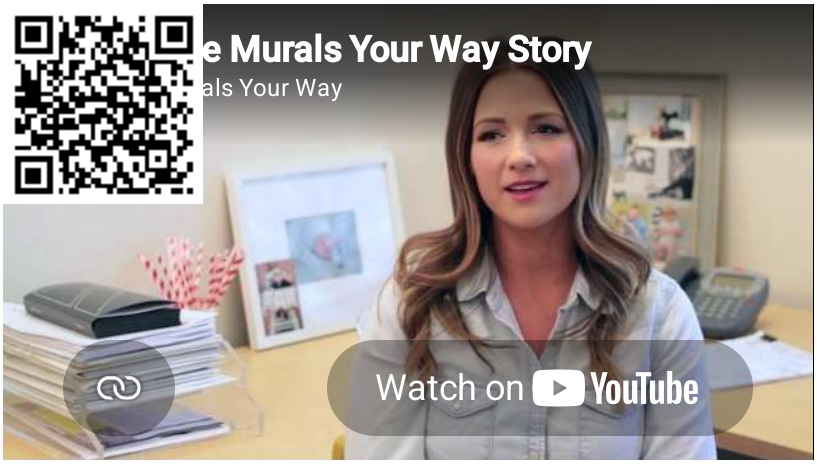
range of products/services offered, accessibility, production method(s), reliability, familiarity, product ingredients, and company image are all differentiation possibilities.Bonny Albo, “Making a Business Stand Out from Its Competitors,” *Entrepreneurs @ Suite 101*, August 9, 2009, accessed December 1, 2011, bonny-albo.suite101.com/marketing-strategy-differentiation-a136498. 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:Ian C. MacMillan and Rita Gunther McGrath, “Discovering New Points of Differentiation,” *Harvard Business Review*, July–August 1997, 133–145, as cited in Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 277.

- 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 5.6.2:

The “Murals Your Way” Advantage

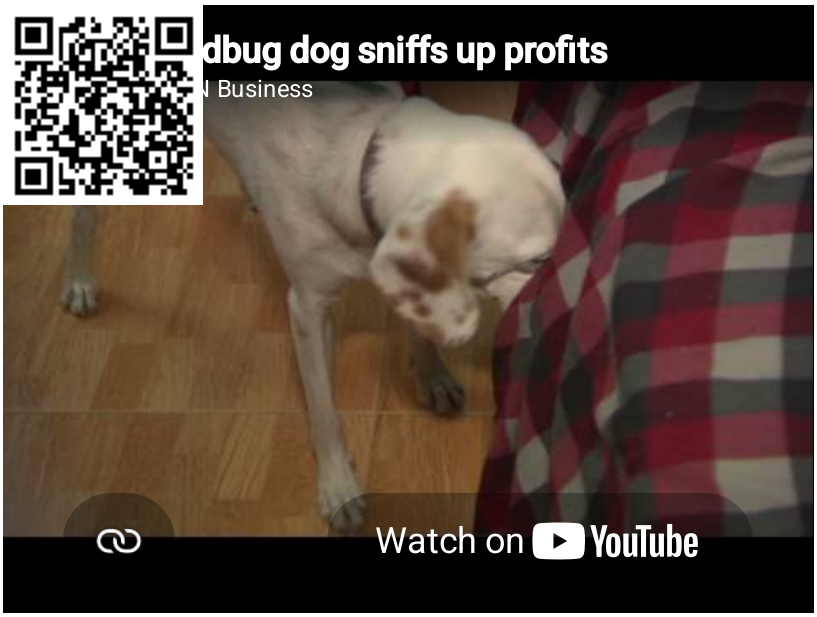


How Murals Your Way sets itself apart from other wall mural companies.

Video Link 5.6.3:

Bedbug Dog Sniffs Up Profits

An unusual means of differentiation.



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.Al Ries and Jack Trout, *Positioning: The Battle for Your Mind* (New York: McGraw-Hill, 2001), 3.

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.David A. Aaker and Gary Shansby, "Positioning Your Product," *Business Horizons*, May–June 1982, 56–62.

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."“Product Positioning,” *Inc.*, accessed December 1, 2011, www.inc.com/encyclopedia/product-positioning.html. This notwithstanding, an understanding of positioning should be in every small business owner's tool kit.

Video Clip 5.6.4:

Small-Business Market Position



Small-business owners must figure out how the company should be positioned.

Video Clip 5.6.5:

What Is Market Positioning?



A discussion of positioning.

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:David A. Aaker and Gary Shansby, “Positioning Your Product,” *Business Horizons*, May–June 1982, 56–62.

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 Link 5.6.6:

Welcome to CakeLove

An introduction to CakeLove bakery.

We couldn't verify the security of your connection.

Access to this content has been restricted. Contact your internet service provider for help.

Welcome to CakeLove (3 min) from Warren Brown on Vimeo.

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 the very high quality that justifies a high price.Jim T. Ryan, "Sweet Strategy: Artisan Chocolatier Eyes Internet, Corporate Giving for Growth," *Central Penn Business Journal*, November 26, 2010, 3–6.
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.""Our Story," *KIND Healthy Snacks*, accessed December 8, 2011, www.kindsnacks.com/our-story. 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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 181. 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.Lisa Nielsen, "Product Positioning and Differentiation Strategy," *Chron.com*, accessed June 1, 2012, smallbusiness.chron.com/product-positioning -strategy-3350.html.

Joe's Redhots' Business Positioning Strategy

Joe's Redhots will sell premium-quality hot dogs and other ready-to-eat luncheon products to upscale business people 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."Positioning Strategy Statement," *Business Owner's Toolkit*, accessed December 1, 2011, www.toolkit.com/small_business_guide/sbg.aspx?nid=P03_7003.

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."David A. Aaker and Gary Shansby, "Positioning Your Product," *Business Horizons*, May–June 1982, 56–62. 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.Andy LaPointe, "Is Your Positioning Statement Confusing Your Customers?," *Small Business Branding*, May 13, 2007, accessed December 1, 2011, www.smallbusinessbranding.com/714/is-your-positioning-statement-confusing -your-customers. 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"Andy LaPointe, "Is Your Positioning Statement Confusing Your Customers?," *Small Business Branding*, May 13, 2007, accessed December 1, 2011, www.smallbusinessbranding.com/714/is-your-positioning-statement-confusing -your-customers.

KEY TAKEAWAYS

- Differentiation and positioning considerations are relevant to each element of the marketing mix as well as the onground 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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5.7: Marketing Strategy and Product

Learning Objectives

1. Understand why product is the key element in the marketing mix.
2. Identify the multiple decisions and considerations that factor into product or service development.
3. Describe the three product layers and explain why small businesses should pay attention to them.
4. Explain the importance of product design to marketing strategy.
5. Understand the role of packaging to product success.
6. Explain what a brand is and why it is probably a company's most important asset.
7. Explain the implications of the product life cycle for the marketing mix.
8. Understand that a company's website is part of its product or service, whether or not the company sells anything online.
9. 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).

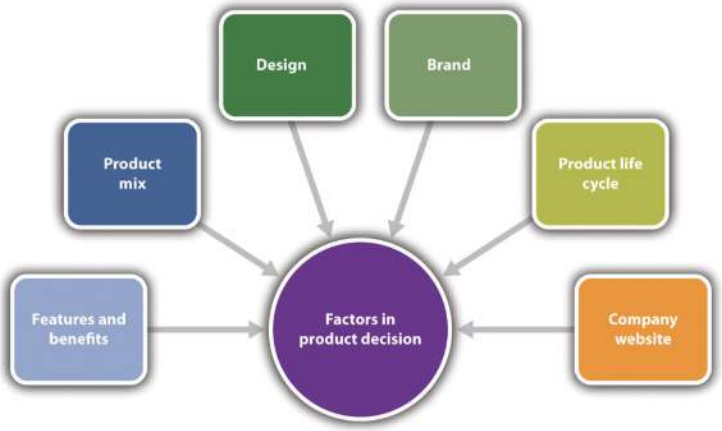


Figure 5.7.1: Factors in Product or Service Decisions

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.

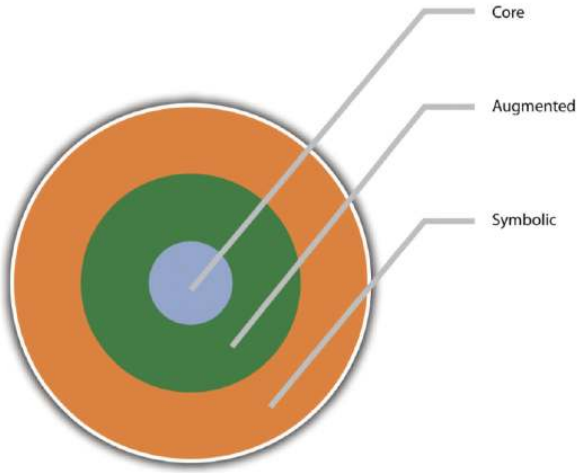


Figure 5.7.2: The Product Layers

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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 226. 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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 117. 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.Rick Suttle, "What Is a Product Mix?," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/product-mix-639.html. 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.Jan Zimmerman, *Web Marketing for*

Dummies, 2nd ed. (Hoboken, NJ: Wiley, 2009), 101. 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.Jan Zimmerman, *Web Marketing for Dummies*, 2nd ed. (Hoboken, NJ: Wiley, 2009), 101. 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.Jan Zimmerman, *Web Marketing for Dummies*, 2nd ed. (Hoboken, NJ: Wiley, 2009), 101–2.

Product Design

In his book, *Re-imagine! Business Excellence in a Disruptive Age*,Tom Peters, *Re-imagine! Business Excellence in a Disruptive Age* (London: Dorling Kindersley Limited, 2003), 132–46. 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."Tom Peters, *Re-imagine! Business Excellence in a Disruptive Age* (London: Dorling Kindersley Limited, 2003), 132–146, as cited in Bob Lamons, "Strong Image Design Creates Passion for Firm, Its Products," *Marketing News*, April 15, 2005, 7. 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 usabilityDana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 242; Dominic Donaldson, "The Importance of Good Product Design," *Artipot*, December 8, 2008, accessed December 1, 2011, www.artipot.com/articles/246078/the -importance-of-good-product-design.htm. 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."Ted Mininni, "Design: The New Corporate Marketing Strategy," *MarketingProfs*, November 5, 2005, accessed December 1, 2011, www.marketingprofs.com/articles/2005/1670/design-the-new-corporate-marketing-strategy.

Design offers a powerful way to differentiate and position a company's products and services, often giving company a competitive edge.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 325. 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.Dominic Donaldson, "The Importance of Good Product Design," *Artipot*, December 8, 2008, accessed December 1, 2011, www.artipot.com/articles/246078/the -importance-of-good-product-design.htm.

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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 325.

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,"Cliff Kuang, "Product-Design Startup Quirky Gets $6 Million in VC Funding," *Fast Company*, April 7, 2010, accessed December 1, 2011, www.fastcompany.com/1609737/product-design-startup-quirky-gets-6-million-in-vc-funding. Quirky recently secured $6 million in venture financing. Check out how they operate in Note 7.42 "Video Clip 7.5". A company like this could be very helpful to a small business that is looking to introduce a new product.

Video Clip 5.7.1:

Quirky's Ben Kaufman on Innovation



An innovative approach to product design: collaboration.

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 5.7.3 present design challenges that are different from those faced by physical products.

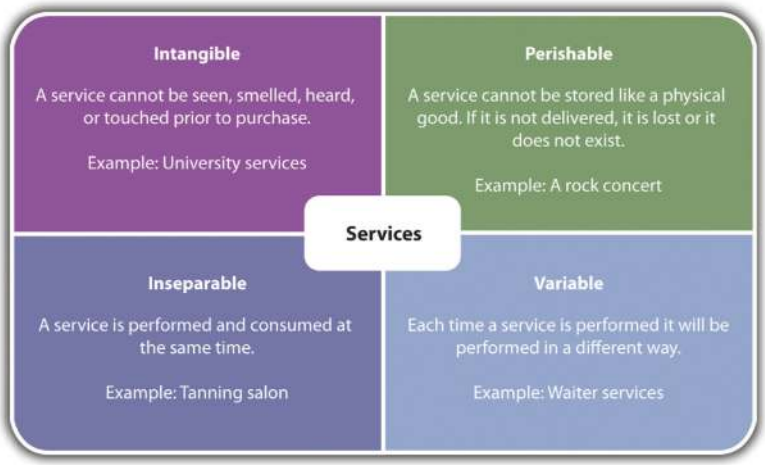


Figure 5.7.3: The Characteristics of Services *Source: Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 264–68.*

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."Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 239. 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."Randall Frost, "Packaging Your Brand's Personality," *Brandchannel*, October 3, 2005, accessed December 1, 2011, www.brandchannel.com/features_effect.asp?pf_id =283. 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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 339. 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 (see Note 7.48 "Video Clip 7.6"). 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 5.7.2:

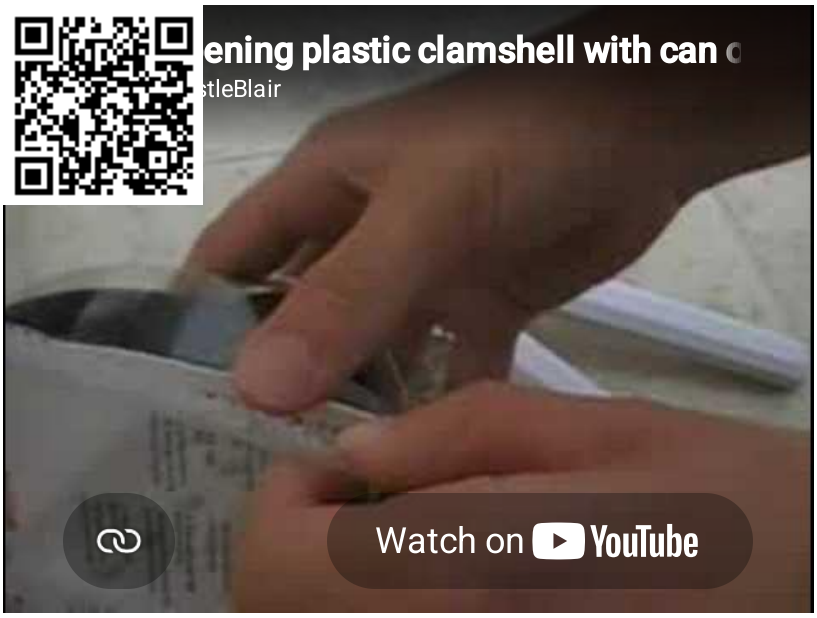
Wrap Rage



Wrap rage: what it is about, with examples.

Video Clip 5.7.3:

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.

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.”“Brand,” *American Marketing Association*, accessed December 1, 2011, www.marketingpower.com/_layouts/Dictionary.aspx?dLetter=B. 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 5.7.4:

A Brand Is More Than a Logo



What a brand is all about.

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.Miranda Brookins, “How to Brand a Business,” *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/brand-business-211.html. The brand needs to reach people on an emotional levelMarc Gobe, *Emotional Branding: The New Paradigm for Connecting Brands to People* (New York: Allworth Press, 2001), xv. 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.”Martin Lindstrom, *Brand Sense: Build Powerful Brands through Touch, Taste, Smell, Sight, and Sound* (New York: Free Press, 2005), 10. 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:Adapted from Patrick Barwise and Sean Meehan, “The One Thing You Must Get Right When Building a Brand,” *Harvard Business Review*, December 2010, 80–84.

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.Laura Lake, “What Is Branding and How Important Is It to Your Marketing Strategy?,” *About.com*, accessed December 1, 2011,

marketing.about.com/cs/brandmktg/a/whatisbranding.htm; Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 230.

Video Clip 5.7.5:

Good Branding Will Build a Company



A strong branding and marketing strategy is an investment that will pay dividends for years to come.

Video Clip 7. 5.7.6:

Small Business Branding Tips



A small business owner talks about the importance and mechanisms of creating a strong and memorable company brand.

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).“Top 25 Biggest Product Flops of All Time,” *Daily Finance*, accessed December 1, 2011, www.dailyfinance.com/photos/top-25-biggest-product-flops-of-all-time.

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."Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 244. The traditional PLC is shown in Figure 7.5.

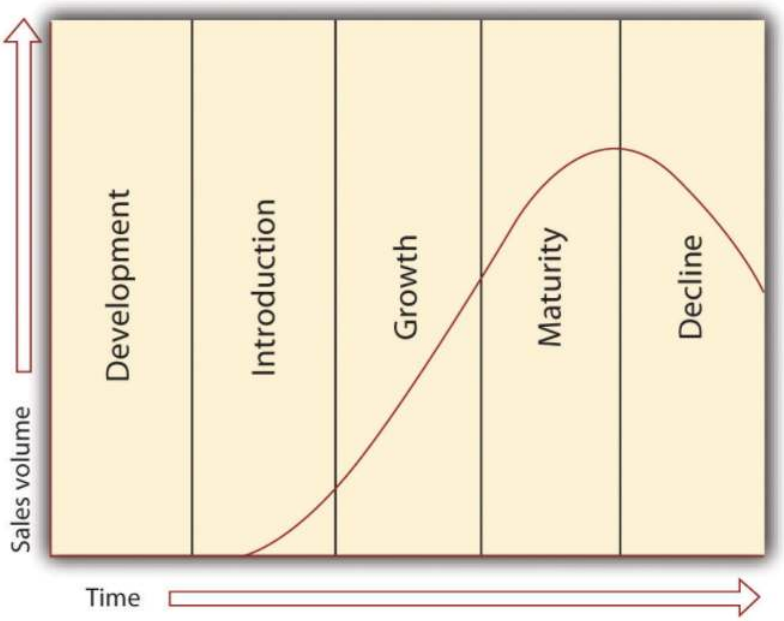


Figure 5.7.4: The Traditional Product Life Cycle *Source: "The Product Life Cycle," NetMBA, accessed December 2, 2011, http://www.netmba.com/marketing/product/lifecycle*.

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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 339; Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 244; Kristie Lorette, "How Would the Marketing Mix Change at Different Stages of the Product Life Cycle?," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/would-marketing-mix-change-different-stages-product-life-cycle-3283.html. 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. Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 339; Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 244; Kristie Lorette, "How Would the Marketing Mix Change at Different Stages of the Product Life Cycle?," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/would-marketing-mix-change-different-stages-product-life-cycle-3283.html. 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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 339; Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 244; Kristie Lorette, "How Would the Marketing Mix Change at Different Stages of the Product Life Cycle?," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/would-marketing-mix-change-different-stages-product-life-cycle-3283.html. 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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 239–43.

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 Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 751.—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. Jan Zimmerman, *Web Marketing for Dummies*, 2nd ed. (Hoboken, NJ: Wiley, 2009), 67. 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. Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 22–23. "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). Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 23.

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 5.7.7:

Web Design Mistakes Small Businesses Make



Mistakes that small businesses should watch for when designing their websites.

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."Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 751. **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."What Are the Objectives of Your Web Site?," *3w designs*, accessed December 1, 2011, www.3w-designs.co.uk/textonly/new-web-site-aims.html. Whichever objective or combination of objectives is chosen, each objective should meet the criteria discussed in Section 7.2. Clear-cut objectives will increase the chances that a company's website design and content will work to achieve those objectives.Ottavio Storace, "How to Build a Web Site That Achieves Objectives," *Webmaster Resources @ Suite 101*, July 13, 2009, accessed December 1, 2011.

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),"Glossary of Web Terminology: Website Layout," April 5, 2010, accessed January 24, 2012, www.azurewebdesign.com/glossary-of-web-terminology; Sue A. Conger and Richard O. Mason, *Planning and Designing Effective Web Sites* (Cambridge, MA: Course Technology, 1998), 96. 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."Jakob Nielsen, "Horizontal Attention Leans Left," *Useit.com*, April 6, 2010, accessed December 1, 2011, www.useit.com/alertbox/horizontal-attention.html.

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.""Welcome to Color Voodoo Publications," *Color Voodoo*, accessed December 1, 2011, www.colorvoodoo.com. 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.”Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 751.

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.Jacci Howard Bear, “The Meaning of Color,” *About.com*, accessed December 1, 2011, desktoppub.about.com/od/choosingcolors/p/color_meanings.htm?p=1. The wrong choice could adversely affect a visitor’s experience at the site,Joanne Glasspoole, “Choosing a Color Scheme,” *Metamorphosis Design*, accessed December 1, 2011, www.metamorphozis.com/content_articles/web_design/Choosing_A_Color_Scheme.php. which could adversely affect a company’s sales and image.

Video Clip 7. 5.7.8:

Color Psychology in Web Design



Insights into color and its importance in website design.

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."Lena Claxton and Alison Woo, *How to Say It: Marketing with New Media* (New York: Prentice Hall, 2008), 34.

Typography

"**Typography** is the art of designing a communication by using the printed word."Colin Wheildon, *Type & Layout: How Typography and Design Can Get Your Message Across—or Get in the Way* (Berkeley, CA: Strathmoor Press, 1996), 19. 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.Shannon Noack, "Basic Look at Typography in Web Design," *Six Revisions*, April 7, 2010, accessed December 1, 2011, sixrevisions.com/web_design/a-basic -look-at-typography-in-web-design. 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).Oliver Reichenstein, "Web Design Is 95% Typography," *Information Architects, Inc.*, October 19, 2006, accessed December 1, 2011, www.informationarchitects.jp/en/the-web-is-all-about-typography-period. It is possible to blow away more than 50 percent of website visitors and readers by choosing the wrong typeface.Colin Wheildon, *Type & Layout: How Typography and Design Can Get Your Message Across—or Get in the Way* (Berkeley, CA: Strathmoor Press, 1996), 19.

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."Lena Claxton and Alison Woo, *How to Say It: Marketing with New Media* (New York: Prentice Hall, 2008), 35. Graphics should also help create a mood, or a sense of place. The use of the graphics has to be thoroughly considered because they slow the loading of a website."When to Use Graphics on Your Website," *Improve the Web*, May 9, 2007, accessed December 1, 2011, www.improvetheweb.com/when-use-graphics-your-site.

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."Dave Young, "Quality Images Boost Sales," *Practical eCommerce*, March 14, 2007, accessed December 1, 2011, www.practicalecommerce.com/articles/436-Quality -Images-Boost-Sales. 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.Jennifer Kyrnin, "Basics of Web Layout," *About.com*, accessed December 1, 2011, webdesign.about.com/od/layout/a/aa062104.htm.

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.Steve Krug, *Don't Make Me Think: A Common Sense Approach to Web Usability* (Berkeley, CA: New Riders Publishing, 2000), 51. "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?"Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 754.

Site navigation must be easy, predictable, consistent, and intuitive enough so that visitors do not have to think about it.Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 754. "Designing effective navigation can also entice your visitors to try out the other things you offer on your site.""Website Navigation Tips," *Entheos*, accessed December 1, 2011, www.entheosweb.com/website_design/website_navigation_tips.asp. 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."Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 38. Website usability measures the quality of a user's experience when interacting with a website,"Usability Basics," *Usability.gov*, accessed December 1, 2011, www.usability.gov/basics/index.html. and it works hand in hand with site navigation. According to usability.gov, usability is a combination of five factors:"Usability Basics," *Usability.gov*, accessed December 1, 2011, www.usability.gov/basics/index.html.

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."Definition of User Interface," accessed December 1, 2011, www.pcmag.com/encyclopedia_term/0,2542,t=user+interface&i=53558,00.asp.
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,Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 756. 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."Web Development Glossary for Small Businesses," *Lightwave Communications*, accessed December 1, 2011, www.lightwavewebdesign.com/web-development -glossary/website-glossary-g-i.html. 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. Folusho Orokunie, "Do Not Make Your Website Visitors Yawn! Make Your Site Interactive," accessed December 1, 2011, folusho.com/do-not-make-your-website-visitors -yawn-make-your-site-interactive.

There are many ways in which a small business can provide interactivity on its site. The following are some examples:"Examples of Possible Interactive Features on Your Website," *Zamba*, accessed December 1, 2011, www.zambagrafix.com/interact.htm; "Importance of Web Interactivity: Tips and Examples, *Hongkiat.com*, accessed December 1, 2011, www.hongkiat.com/blog/importance-of-web-interactivity-tips-and-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."Importance of Interactive Websites," *Thunder Data Systems*, accessed December 1, 2011, www.thunderdata.com/thunder_bits/importance_of_interactive_websites.html.

Content

Content refers to all the words, images, products, sound, video, interactive features, and any other material that a business puts on its website.Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 744; Jan Zimmerman, *Web Marketing for Dummies*, 2nd ed. (Hoboken, NJ: Wiley, 2009), 67. 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."JPDC, "The Importance of Visitor-Oriented Online Content on Your Website," *Mycustomer.com*, June 12, 2009, accessed December 1, 2011, www.mycustomer.com/blogs/marketingadvisor/marketing-advisor/importance-visitor-oriented-online -content-your-website.

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.Jan Zimmerman, *Web Marketing for Dummies*, 2nd ed. (Hoboken, NJ: Wiley, 2009), 73. If a company's content does not fit its target audience(s), the website will not generate good results.JPDC, "The Importance of Visitor-Oriented Online Content on Your Website," *Mycustomer.com*, June 12, 2009, accessed December 1, 2011, www.mycustomer.com/blogs/marketingadvisor/marketing-advisor/importance-visitor-oriented-online -content-your-website.

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. Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 55. User-generated content includes the following: Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 55.

- 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."Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 56.

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."Content Is King—Good Content Holy Grail of Successful Web Publishing," *The Media Pro*, August 14, 2010, accessed December 1, 2011, www.themediapro.com/earn-sleeping/content-is-king-holy-grail-of-successful-web-publishing.

Video Link 5.7.9:

The Value of the About Page

Why the “About” page is so important to a business website.



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).Jan Zimmerman, *Web Marketing for Dummies*, 2nd ed. (Hoboken, NJ: Wiley, 2009), 103.

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.“Google Finally Sets the Record Straight: Website Speed Is a Legit Search Ranking Factor,” *Linkbuilding.net*, June 13, 2010, accessed December 1, 2011, linkbuilding.net/2010/06/13/google-finally-sets-the-record-straight-website-speed-is-a-legit -search-ranking-factor.

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.Imad Mouline, “Is Your Website Fast Enough for Your Customers?,” *CNN Money*, August 27, 2010, accessed June 1, 2012, tech.fortune.cnn.com/2010/04/...rs/#more-24083. Google claims that the amount of site traffic drops by 20 percent for every 0.5 seconds of load time.“Improving Site Speed and Load Times,” *Optimum7.com*, April 6, 2010, accessed December 1, 2011, www.optimum7.com/internet-marketing/website-speed/improving-site-speed-and-load-time.html.

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. Efraim Turban et al., *Electronic Commerce: A Managerial Perspective* (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 755. 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. Imad Mouline, “Is Your Website Fast Enough for Your Customers?,” *CNN Money*, August 27, 2010, accessed June 1, 2012, tech.fortune.cnn.com/2010/04/...r-website-fast -enough-for-your-customers/#more-24083. 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.“Google Finally Sets the Record Straight: Website Speed Is a Legit Search Ranking Factor,” *Linkbuilding.net*, June 13, 2010, accessed December 1, 2011, linkbuilding.net/2010/06/13/google-

finally-sets-the-record-straight-website-speed-is-a-legit -search-ranking-factor; "Improving Site Speed and Load Times," *Optimum7.com*, April 6, 2010, December 7, 2011, www.optimum7.com/internet-marketing/website -speed/improving-site-speed-and-load-time.html. 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. Go to "How to Rate a Web Site" at www.newentrepreneur.com/Resources/Articles/Rate_a_Web_Site/rate_a_web_site.html and download the Web Site Scorecard. Select two small business websites or use the websites specified by your professor. Working with the "How to Rate a Web Site" article and the Web Site Scorecard, evaluate the two sites. Be sure to note your impressions about the site's performance in each area.
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.Philip Kotler and Kevin Lane Kotler, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 343.

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5.8: Marketing Strategy and Price

Learning Objectives

1. Understand the role of price in the marketing mix and to a company.
2. Understand the different pricing strategies that a small business can follow.
3. Understand price-quality signaling and its importance to the pricing decision.
4. Understand that the price of a product or a service lets customers know what to expect from a business.

Marketing, whether online or onground, 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."Judy Strauss and Raymond Frost, *E-Marketing* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 233. Ultimately, the meaning of price will depend on the viewpoints of the buyer and the seller.Judy Strauss and Raymond Frost, *E-Marketing* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 233.

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."Pricing a Product or Service," *Small Business Notes*, accessed June 1, 2012, http://www.smallbusinessnotes.com/ma...r-service.html.

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.Judy Strauss and Raymond Frost, *E-Marketing* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 233.

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. Darrell Zahorsky, "Pricing Strategies for Small Business," *About.com*, accessed December 1, 2011, sbinformation.about.com/cs/bestpractices/a/aa112402a.htm. 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. Dana Griffin, "Pricing Strategy Theory," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/pricing-strategy-theory-1106.html. 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. Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 383. 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. Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 358–59.

- **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.Judy Strauss and Raymond Frost, *E-Marketing* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 247. 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** strategyDiane Watkins, "What Is Discount Pricing Strategy?," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/discount-pricing-strategy-794.html. 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.Rick Suttle, "Industry Pricing Strategy," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/industry-pricing-strategy-4684.html. 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.Diane Watkins, "What Is Discount Pricing Strategy?," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/discount-pricing-strategy-794.html. 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.Diane Watkins, "What Is Discount Pricing Strategy?," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/discount-pricing-strategy-794.html.

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.[citation redacted per publisher request]. 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," *Small Business Notes*, accessed December 1, 2011, www.smallbusinessnotes.com/marketing-your-business/cost-based-pricing.html.

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."The Highs And Lows of Cost-Based Pricing," *Fiona Mackenzie*, August 26, 2009, December 1, 2011, fionamackenzie.com.au/pricing-strategy/the-highs-and-lows-of -cost-based-pricing.html.

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."Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing), 358–59. 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.Lisa Magloff, "What Is Premium Pricing Strategy?," *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/premium-pricing-strategy-1107.html.

Even-Odd Pricing

Also known as the "nine and zero effect,"Ivana Taylor, "8 Pricing Strategies You Can Implement Right Now," August 19, 2008, accessed December 1, 2011, *Small Business Trends*, smallbiztrends.com/2008/08/8-pricing-strategies-you-can-implement-right-now.html. **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. Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing), 369. 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 onground 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? Adapted from David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 488. *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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5.9: Marketing Strategy and Place

Learning Objectives

1. Understand the role of place in the marketing mix and the importance of place to a company.
2. Understand the different distribution strategies that a small business can follow.
3. 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 onground 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.

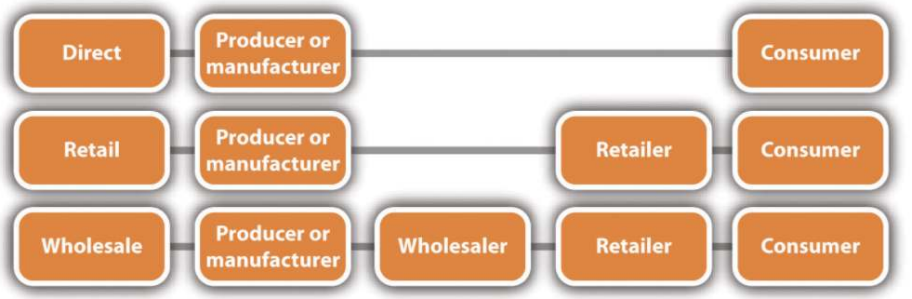


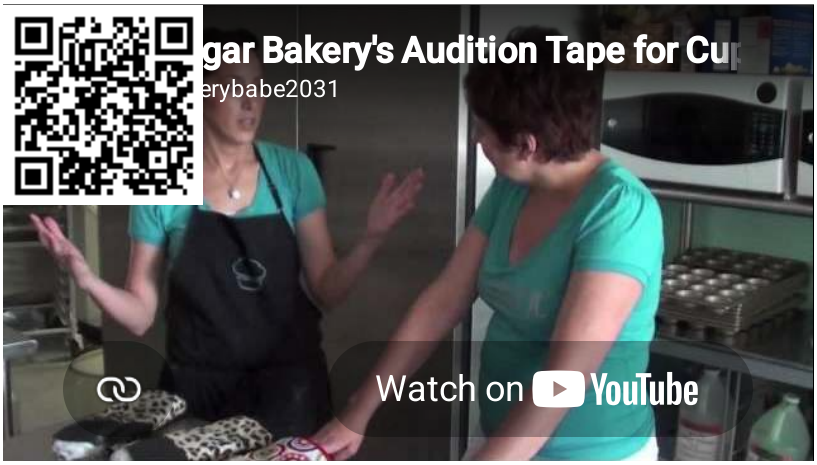
Figure 5.9.1: Channels of Distribution, Direct, Retail and Wholesale

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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 300. 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. [citation redacted per publisher request]. 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. (See Chapter 5 for more information on Consolidated Industries, Inc.)

Video Clip 5.9.1:

Sugar Bakery & Sweet Shop



The story of the winner of the Food Network's 2010 "Cupcake Wars."

Video Link 5.9.2:

iPhone App Beefs Up Sausage Sales

How an iPhone app has made business easier and better for a mobile sausage vendor.

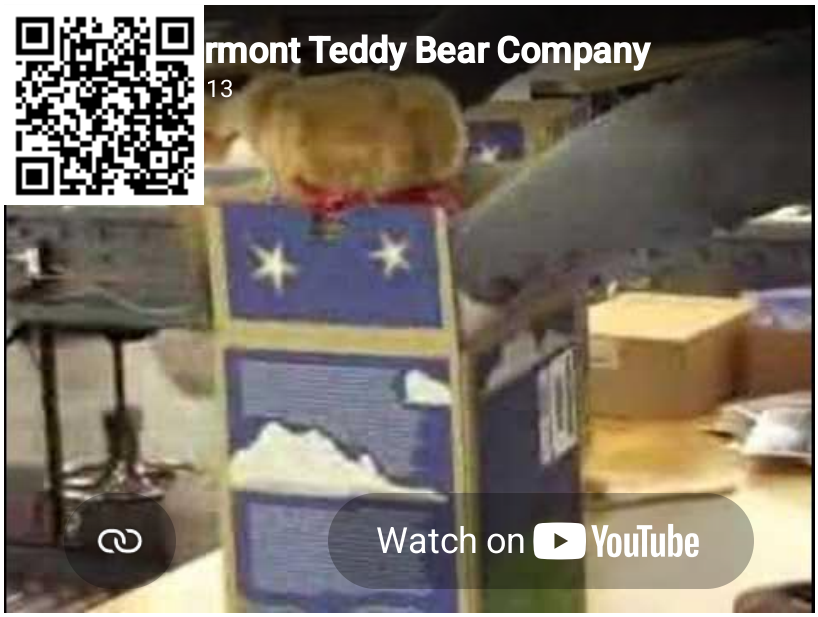


Service businesses use the direct channel because there is no way to do otherwise. Services are performed and consumed at the same time, so there is no role for intermediaries. Tanning salons, home repair services, legal services, real estate services, and medical services all deliver directly to the 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 onground factory tours that are offered year-round.

Video Clip 5.9.3:

Vermont Teddy Bear Company



How the company started and how it has grown. It now makes 5,000 bears a day.

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 5.9.4:

Future Vision of Retailing



Microsoft's vision of future retailing.

Video Clip 5.9.5:

YOUReality Retail Visualization Product



A new software product that enables customers to interact with products in their own space—really, really cool.

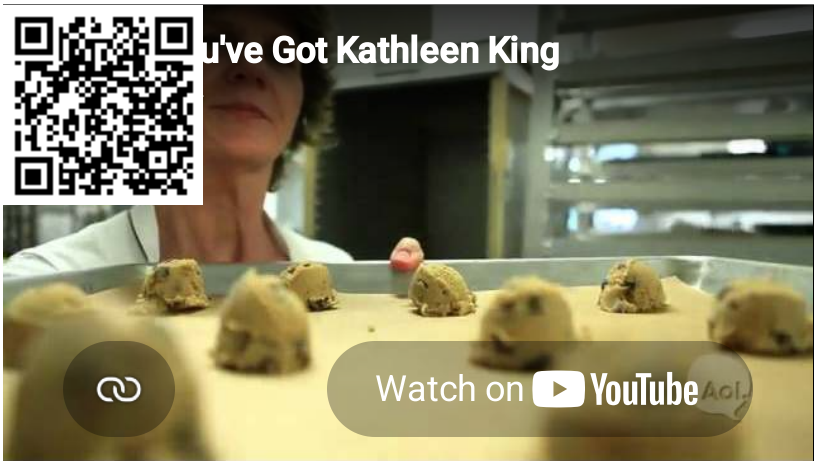
Although selling through retailers may expand the distribution coverage to a small business's target market, the business must give up some control over pricing and promotion. In addition, the business should expect to get a wholesale price from the retailer that is significantly lower than what it would 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)."“Monthly & Annual Wholesale Trade Definitions,” *US Census Bureau*, October 22, 2010, accessed December 1, 2011, www.census.gov/wholesale/definitions.html. 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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 300. 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 Note 7.107 "Video Clip 7.17".

Video Clip 5.9.6:

Tate's Bake Shop



The story of Kathleen King's gourmet baked goods business—and some important business lessons learned.

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.Philip Kotler and Kevin Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 458–59. 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.Jeff Madura, *Introduction to Business* (St. Paul, MN: Paradigm Publishing, 2010), 445.

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.Philip Kotler and Kevin Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 429; Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 303. The multichannel approach offers three important advantages:Philip Kotler and Kevin Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 429.

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."Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 306. 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. Jennifer Nichols, "Guide to Transportation and Logistics Companies for Small Business," *Business.com*, accessed December 1, 2011, www.business.com/guides/logistics-management-for-small-business-175. Logistics are relevant to both online and onground 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. Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 307.

Video Clip 5.9.7:

Logistics



UPS Commercial: We Love Logistics. A fun insight into what logistics are all about.

Logistics involve the following four primary functions: transportation, warehousing, inventory control, and order processing.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 307.

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 5.9.1: 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 5.9.1: 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.**Philip Kotler and Kevin Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 464. 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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 312. 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."How to Run a Small Business: Inventory Management," *StartupNation LLC*, accessed December 1, 2011, www.startupnation.com/business-articles/899/1/AT_InventoryMgt.asp.
4. **Order processing.**Philip Kotler and Kevin Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 464. 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.Jennifer Nichols, "Guide to Transportation and Logistics Companies for Small Business," *Business.com*, accessed December 1, 2011, www.business.com/guides/logistics-management-for-small-business-175. 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. This is the focus of "Supply Chain Management: You Better Get It Right".

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 experienceAdapted from Sharad Singh, “Five Retail IT Trends to Watch in 2011,” *RetailCustomerExperience.com*, December 10, 2010, accessed December 1, 2011, www.retailcustomerexperience.com/article/178220/Five-retail-IT-trends-to-watch-in -2011; Jan Zimmerman, *Web Marketing for Dummies*, 2nd ed. (Hoboken, NJ: Wiley, 2009), 111–19. 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. (See Chapter 4 for a discussion of payment options.)
- **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.“Digital Window Shopping: The Long Journey to ‘Buy’” *McAfee, Inc.*, accessed December 1, 2011, www.mcafeesecure.com/us/resources/whitepapers/digital_window_shopping.jsp. An understanding of why shoppers are abandoning their carts should lead to some serious thinking during website design and operation. Table 5.9.1 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.Jan Zimmerman, *Web Marketing for Dummies*, 2nd ed. (Hoboken, NJ: Wiley, 2009), 118.

Table 5.9.2: 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 onground 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 (Chapter 16), 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 onground 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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5.10: Marketing Strategy and Promotion

Learning Objectives

1. Understand the role of promotion in the marketing mix and its importance to a company.
2. Understand the different ways that a small business can promote its products or services.
3. Explain the differences and similarities in the marketing communications mix of online and onground 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.”Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 470. 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.”Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 380. 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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 393. 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),Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 393–96. and brand recognition. As with all objectives, IMC objectives must meet the SMART (specific, measurable, achievable, realistic, and time-based) criteria that are described in Section 7.2.

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. Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 470. Each mode of communication has its own advantages and disadvantages, which should all be considered carefully before any final selections should be made.



Figure 5.10.1: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."Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472. 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).Susan Ward, "17 Advertising Ideas for Small Businesses," *About.com*, accessed December 1, 2011, sbinfocanada.about.com/od/advertising/a/17adideas.htm. Lanee Blunt, "Small Business Advertising: Low Cost Flyers," *Advertising @ Suite 101*, February 11, 2011, accessed December 1, 2011, lanee-blunt.suite101.com/small-business -advertising-low-cost-flyers-a346278. 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.The Street, "Small Shops Aim for Super Bowl Edge," *MSN Money*, February 1, 2011, accessed December 1, 2011, money.msn.com/how-to-invest/small-shops-aim-for-a -super-edge-thestreet.aspx.

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*,Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 157. 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.)Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 159–61. 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.“Google AdWords: Advertise Your Business on Google,” accessed January 24, 2012, accounts.google.com/ServiceLogin?service=adwords&hl=en&ltmpl=regionalc &passive=true&ifr=false&alwf=true&continue=https://adwords.google.com/um/gaiaau...&sourceid=awo& subid=us-en-et-bizsol.

Video Link 5.10.1:

Attracting Consumer Attention through Advertising

Relating ads to the target market, making ads appealing, and including the element of surprise.



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.Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 487. 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.Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472; “Sales Promotion Strategy,” *Small Business Bible*, accessed December 1, 2011, www.smallbusinessbible.org/salespromotionstrategy.html. These promotions can be used by and offer several advantages to small businesses:Chris Joseph, “Sales Promotion Advantages,” *Chron.com*, accessed December 1, 2011, smallbusiness.chron.com/sales-promotion-advantages-1059.html.

- **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 onground 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 (see Note 7.132 "Video Clip 7.19"), 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 5.10.2:

Learn How Groupon Works!



A hot new source of coupons for local businesses.

Events and Experiences

Events and experiences are “company-sponsored activities and programs designed to create daily or special brand interactions.”Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472. A small business could choose to sponsor a Halloween costume event for petsJerry Robertson, “Secrets to Low Cost PR for Small Businesses,” *Yahoo! Voices*, February 14, 2007, accessed December 1, 2011, voices.yahoo.com/secrets-low-cost -pr-small-businesses-193968.html. 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:Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 489. (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, discussed in Chapter 6. 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."Bernd H. Schmitt, *Experiential Marketing* (New York: The Free Press, 1999), 22, 24. By having special events, a small business will stand out from the rest,Jerry Robertson, "Secrets to Low Cost PR for Small Businesses," *Yahoo! Voices*, February 14, 2007, accessed December 1, 2011, voices.yahoo.com/secrets-low-cost-pr -small-businesses-193968.html. 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.Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472. 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.")Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 382. 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."Developing a Press Kit for Your Small Business," *AllBusiness*, accessed December 1, 2011, www.allbusiness.com/print/445-1-22eeq.html. (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.Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472. 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."Erica DeWolf, "Social Media Tools Should Be Used for PR," *eMarketing & New Media*, May 4, 2009, accessed December 1, 2011, ericadewolf.wordpress.com/2009/05/04/social-media-tools-should-be-used-for-pr. 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."Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 444.

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.Jerry Robertson, "Secrets to Low Cost PR for Small Businesses," *Yahoo! Voices*, February 14, 2007, accessed December 1, 2011, voices.yahoo.com/secrets-low-cost-pr -small-businesses-193968.html.

Video Link 5.10.3:

Obtaining Publicity for a Business

Information and tips for small businesses.



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:Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 488–489.

- **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."Erica DeWolf, "Social Media Tools Should Be Used for PR," *eMarketing & New Media*, May 4, 2009, accessed December 1, 2011, ericadewolf.wordpress.com/2009/05/04/social-media-tools-should-be-used-for-pr. Common direct marketing platforms include catalogs; direct mailing; telemarketing; television shopping; electronic shopping; fax mail; voice mail; blogs; websites;Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 473. e-mail; direct response radio, television, and Internet;Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 505. 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.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 504.

Video Link 5.10.4:

What Is Direct Marketing?

A brief explanation of direct marketing.



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,Lisa Barone, "Webcast: Direct Marketing for Small Businesses," *Outspoken Media*, April 16, 2009, accessed December 1, 2011, outspokenmedia.com/online-marketing/webcast-direct-marketing-for-small-businesses. 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."Lisa Barone, "Webcast: Direct Marketing for Small Businesses," *Outspoken Media*, April 16, 2009, accessed December 1, 2011, outspokenmedia.com/online-marketing/webcast-direct-marketing-for-small-businesses.

Direct marketing offers several advantages to both the business-to-consumer (B2C) and B2B small businesses:Kris Carrie, "Advantages of Direct Marketing," Article Dashboard, accessed December 1, 2011, www.articledashboard.com/Article/Advantages-of-Direct-Marketing/587894.

- **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."Philip Kotler and David Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472. Everything is personalized and individualized—from the website content to the products being promoted.Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 558. The audience is engaged with the brand, with customers getting the chance to reshape and market it in their own unique way.Mike Yapp, "10 Best Interactive Marketing Practices," *iMedia Connection*, January 9, 2006, accessed December 1, 2011, www.imediaconnection.com/content/7764.asp. 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.Joe Mandese, "Forrester Revises Interactive Outlook, Will Account for 21% of Marketing by 2014," *MediaPost News*, July 8, 2009, accessed December 1, 2011, www.mediapost.com/publications/?fa=Articles.showArticle&art_aid=109381.

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.Karen Scharf, "Small Business Marketing with Video," *Business Know-How*, accessed December 1, 2011, www.businessknowhow.com/internet/videomarketing.htm. 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.Sean Rasmussen, "Using Online Videos to Increase Popularity," *Aussie Internet Marketing Blog*, July 30, 2009, accessed December 1, 2011, seanseo.com/internet-marketing/using-online-videos. 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.Mike Sachoff, "Small Businesses Plan to Focus on Mobile Marketing and Online Video in 2011," *SmallBusinessNewz*, January 18, 2011, accessed December 1, 2011, www.smallbusinessnewz.com/topnews/2011/01/18/small-businesses-plan-to -focus-on-mobile-marketing-and-online-video-in-

2011. 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.Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 73–74. 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 onground 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."Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 72. 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."Robbin Block, *Social Persuasion: Making Sense of Social Media for Small Business* (Breinigsville, PA: Block Media, December 2010), 2. 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."Lorrie Thomas, *Online Marketing* (New York: McGraw-Hill, 2011), 99.

The top four social media networks are Twitter, Facebook, LinkedIn, and YouTube. This is true in general and for small businesses in particular.Lisa Barone, "Which Social Media Sites Are Most Beneficial?," *Small Business Trends*, January 26, 2011, accessed December 1, 2011, smallbiztrends.com/2011/01/which-social-media-site-most-beneficial%E2%80%99.html. 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.Lisa Barone, "Which Social Media Sites Are Most Beneficial?," *Small Business Trends*, January 26, 2011, accessed December 1, 2011, smallbiztrends.com/2011/01/which-social-media-site-most-beneficial%E2%80%99.html. 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.Lisa Barone, "Study: How Are B2Bs Using Social Media," *Small Business Trends*, November 25, 2009, accessed December 1, 2011, smallbiztrends.com/2009/11/b2bs-social-media-study.html.

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, cofounder 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."Lisa Barone, "Which Social Media Sites Are Most Beneficial?," *Small Business Trends*, January 26, 2011, accessed December 1, 2011, smallbiztrends.com/2011/01/which-social-media-site-most-beneficial%E2%80%99.html. This will undoubtedly continue to be the case.

Video Clip 5.10.5:

Social Media



The top five things you should know about social media.

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,""Personal Selling," *eNotes*, accessed December 1, 2011, www.enotes.com/personal-selling-reference/personal-selling-178681. 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."Personal Selling," *eNotes*, accessed December 1, 2011, enotes.com/personal -selling-reference/personal-selling-178681. 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.John M. Ivancevich and Thomas N. Duening, *Business Principles, Guidelines, and Practices* (Mason, OH: Thomson Learning, 2007), 431. Regardless of the type of customer or consumer, however, the objectives of personal selling are the same:"Objectives of Personal Selling," *KnowThis.com*, accessed December 1, 2011, www.knowthis.com/principles-of-marketing-tutorials/personal-selling/objectives-of -personal-selling.

- **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."Advantages of Personal Selling," *KnowThis.com*, accessed December 1, 2011, www.knowthis.com/principles-of-marketing-tutorials/personal-selling/advantages -of-personal-selling. 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.“Disadvantages of Personal Selling,” *KnowThis.com*, accessed December 1, 2011, www.knowthis.com/principles-of-marketing-tutorials/personal-selling/disadvantages-of-personal-selling. Then there are the costs of training the sales staff on product knowledge, industry information, and perhaps selling skills.“Disadvantages of Personal Selling,” *KnowThis.com*, accessed December 1, 2011, www.knowthis.com/principles-of-marketing-tutorials/personal-selling/disadvantages-of-personal-selling. 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:John M. Ivancevich and Thomas N. Duening, *Business Principles, Guidelines, and Practices* (Mason, OH: Thomson Learning, 2007), 435; Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 560–561; Dana-Nicoleta Lascu and Kenneth E. Clow, *Essentials of Marketing* (Mason, OH: Atomic Dog Publishing, 2007), 489–98.

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.Thomas Young, “A Selling Revolution: How the Internet Changed Personal Selling (Part 1),” *Executive Street*, accessed December 1, 2011, blog.vistage.com/marketing/a-selling-revolution-how-the-internet-changed-personal-selling. 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.Thomas Young, “A Selling Revolution: How the Internet Changed Personal Selling (Part 1),” *Executive Street*, accessed December 1, 2011, blog.vistage.com/marketing/a-selling-revolution-how-the-internet-changed-personal-selling.

Video Link 5.10.6:

Small Business Selling

An overview of personal selling.



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 onground 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?Adapted from David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 488. *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

6: The Marketing Plan

6.1: Chapter Introduction
6.2: The Need for a Marketing Plan
6.3: The Marketing Plan
6.4: The Three Threads

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6.1: Chapter Introduction

The New Britain Rock Cats

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Source: Reprinted with permission from the New Britain Rock Cats official website: http://web.minorleaguebaseball.com/index.jsp?sid=t538.

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.

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.William Dowling (Rock Cats president and CEO), personal interview, March 15, 2011; "Rock Cats History," *Minor League Baseball*, accessed December 2, 2011, web.minorleaguebaseball.com/team5/page.jsp?ymd=20100316&content_id=8806396&vkey=team5_t538&fext=.jsp&sid=t538; "New Britain Rock Cats," *Wikipedia*, accessed December 2, 2011, en.Wikipedia.org/wiki/New_Britain_Rock_Cats. 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 affililiated with the Colorado Rockies

Video Clip 8.1

Rock Cats Baseball



A fun look at what the Rock Cats offer to fans.

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6.2: The Need for a Marketing Plan

Learning Objectives

1. Understand why a small business should have a marketing plan.
2. Understand the implications of not having a marketing plan.

Let's face it, as a small business owner, you are really in the business of marketing.John Jantsch, *Duct Tape Marketing: The World's Most Practical Small Business Marketing Guide* (Nashville, TN: Thomas Nelson, Inc., 2006), back cover copy.

John Jantsch

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.Becky McCray, "Simplify Your Small Business Marketing Plan," *Small Biz Survival*, February 12, 2010, accessed December 2, 2011, www.smallbizsurvival.com/2010/02/simplify-your-small-business-marketing.html.

There are many reasons why so many small businesses do not have marketing plans. Among the reasons are the following:Adapted from Danielle MacInnis, "74% of Small Business [sic] Have No Marketing Plan!" *Marketing Blog for Small Businesses*, February 7, 2011, accessed December 2, 2011, www.daniellemacinnis.com/small-business-marketing/74-of-small-business -have-no-marketing-plan.

- 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."Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 56. 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."How to Write Small Business Marketing Plans," *SmallBusiness-Marketing-Plans.com*, accessed December 2, 2011, www.smallbusiness-marketing-plans.com.

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,"How to Write Small Business Marketing Plans," *SmallBusiness-Marketing-Plans.com*, accessed December 2, 2011, www.smallbusiness-marketing-plans.com. 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.Tim Berry, "How Long Should a Business Plan Be?," *BPlans*, accessed December 2, 2011, articles.bplans.com/writing-a-business-plan/how-long-should-a-business -plan-be/49. 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.“How to Write Small Business Marketing Plans,” *SmallBusiness-Marketing-Plans.com*, accessed December 2, 2011, www.smallbusiness-marketing-plans.com.

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.“How to Create a Marketing Plan,” *Entrepreneur*, August 7, 2001, accessed June 1, 2012, http://www.entrepreneur.com/article/186830.

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, which is now included as part of Sales and Marketing 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.“About SCORE,” *Score.org*, accessed December 1, 2011, www.score.org/about-score.

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.Joanna L. Krotz, “5 Easy Steps to Create a Marketing Plan,” *Microsoft*, accessed December 2, 2011, www.microsoft.com/business/en-us/resources/marketing/market-research/5-easy-steps-to-create-a-marketing-plan.aspx?fbid=WTbndqFrlli. There are many good reasons for developing a marketing plan, including the following:“Marketing,” *University of Missouri*, January 2010, accessed December 2, 2011, www.missouribusiness.net/sbtdc/docs/marketing.pdf; Entrepreneur, “How to Create a Marketing Plan,” *Entrepreneur*, August 7, 2001, accessed December 2, 2011, www.entrepreneur.com/article/43018; Joanna L. Krotz, “5 Easy Steps to Create a Marketing Plan,” *Microsoft*, accessed December 2, 2011, www.microsoft.com/business/en-us/resources/marketing/market-research/5-easy-steps-to-create-a-marketing-plan.aspx?fbid=WTbndqFrlli; Emily Suess, “Marketing Plan Basics for Small Business,” *Small Business Bonfire*, April 13, 2011, accessed December 2, 2011, smallbusinessbonfire.com/marketing-plan-basics-for-small-business-owners; “How to Write Small Business Marketing Plans,” *SmallBusiness-Marketing-Plans.com*, accessed December 2, 2011, www.smallbusiness-marketing-plans.com.

- 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*. David Campbell, *If You Don’t Know Where You’re Going, You’ll Probably End Up Somewhere Else* (Allen, TX:

Thomas Moore Publishing, 1974). 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

1. 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: The Marketing Plan

Learning Objectives

1. 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 8.1. 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,Cash Miller, "Why Does Your Business Need a Good Marketing Plan?," *Yesformn*, October 27, 2010, accessed December 2, 2011, www.yesformn.org/why-does-your -business-need-a-good-marketing-plan.php. and the marketing strategy should have onground 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."An Online Marketing Plan for the Small Business Owner," *WebMarketingNow*, accessed December 1, 2011, www.webmarketingnow.com/who/who_business_owner.html.



Figure 6.3.1: 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."How to Write a Marketing Plan," *Arizona Office of Tourism*, accessed December 1, 2011, www.azot.gov/documents/Marketing_Tool_Kit.pdf. 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."Marketing Plan: The Executive Summary," *Small Business Notes*, accessed December 1, 2011, www.smallbusinessnotes.com/starting-a-business/marketing-plan-the -executive-summary.html.

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.Adapted from "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/executive_summary_fc.php.

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.Jay Ebben, "Developing Effective Vision and Mission Statements," *Inc.*, February 1, 2005, accessed December 2, 2011, www.inc.com/resources/startup/articles/20050201/missionstatement.html.

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.""Sample Marketing Plan," MoreBusiness.com, accessed December 1, 2011, www.morebusiness.com/templates_worksheets/bplans/printpre.brc.*

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.""Restaurant Marketing Plan: Neon Memories Diner," *MPlans.com*, accessed December 2, 2011, www.mplans.com/restaurant_marketing_plan/marketing_vision_fc.php.

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.Corte Swearingen, "Writing a Mission Statement," *SmallBiz Marketing Tips*, accessed December 2, 2011, www.small-biz-marketing-tips.com/writing-a-mission- statement.html. 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."Corte Swearingen, "Writing a Mission Statement," SmallBiz Marketing Tips, accessed December 2, 2011, www.small-biz-marketing-tips.com/writing-a-mission -statement.html.*

Coca-Cola

> *"To Refresh the World…in body, mind, and spirit."Corte Swearingen, "Writing a Mission Statement," SmallBiz Marketing Tips, accessed December 2, 2011, www.small-biz-marketing-tips.com/writing-a-mission -statement.html.*

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."Kristie Lorette, "Examples of How to Write a Marketing Plan," Chron.com, accessed December 2, 2011, smallbusiness.chron.com/examples-write-marketing-plan -1689.html.*

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.""Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," Mplans.com, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.*

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 (see Figure 8.2). 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 8.2

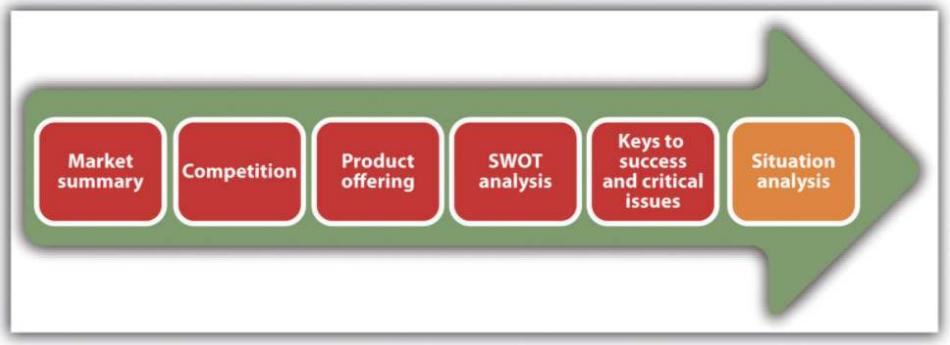


Figure 6.3.2: Situation Analysis

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. See Figure 8.3.



Figure 6.3.3: 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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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 onground 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:Adapted from "Marketing," *University of Missouri*, January 2010, accessed December 2, 2011, www.missouribusiness.net/sbtdc/docs/marketing.pdf.

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: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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"Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

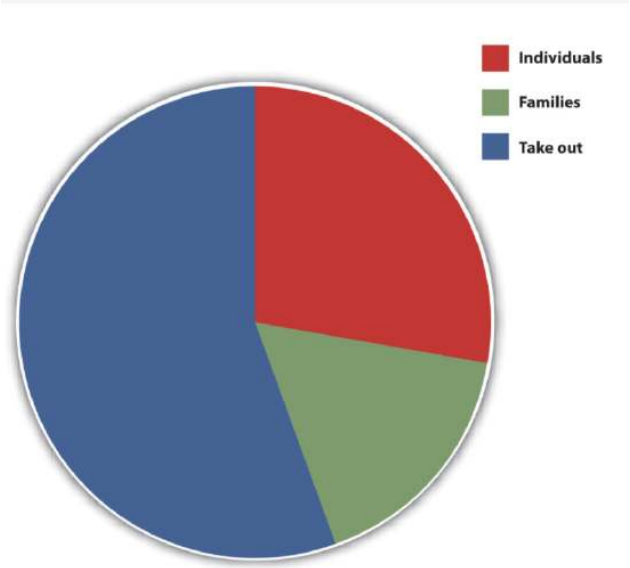


Figure 6.3.4: Target Markets—Sigmund's Gourmet Pasta *Source: "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 2, 2011, http://www.mplans.com/pasta_restaura...nalysis_fc.php. Reprinted by permission of Palo Alto Software.*

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.Adapted from "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

Table 6.3.1: 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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php. 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.Adapted from "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php. 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.“Market Share,” *BusinessDictionary.com*, accessed December 1, 2011, www.businessdictionary.com/definition/market-share.html. 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,“Market Share,” *QuickMBA*, accessed December 1, 2011, www.quickmba.com/marketing/market-share. 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.“Pasta Restaurant Marketing Plan: Sigmund’s Gourmet Pasta,” *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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.The authors of this textbook added this product characteristic.

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.“Pasta Restaurant Marketing Plan: Sigmund’s Gourmet Pasta,” *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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.The authors of this textbook added this dimension of Sigmund’s Prototype Store, drawing from the following two articles: Brodie Beta, “How Restaurants Are Using the iPad,” *The Next Web*, May 1, 2011, accessed December 2, 2011, thenextweb.com/apple/2011/01/05/how-restaurants-are-using-the-ipad/; “Apple iPad Restaurant Menus: The New Way to Order Food,” *QuickOnlineTips.com*, June 6, 2010, accessed December 2, 2011, www.quickonlinetips.com/archives/2010/06/apple-ipad -restaurant-menus.
- Employees: six to seven full time
- Seating: 35–45
- Types of transactions: 80 percent dine in, 20 percent takeout

Sigmund’s websiteThis information about the Sigmund’s website is a combination of the ideas of the authors of this textbook and the following two sample marketing plans: “Locally Produced Clothing Retailer Marketing Plan: Local Threads,” *MPlans.com*, accessed December 2, 2011, www.mplans.com/locally_produced_clothing_retailer__marketing_plan/marketing_vision_fc.php; “Restaurant Marketing Plan: Neon Memories Diner,” *MPlans.com*, accessed December 2, 2011,

www.mplans.com/restaurant_marketing_plan/marketing_vision_fc.php. 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.Tim Berry, "How to Perform a SWOT Analysis," *MPlans.com*, accessed December 2, 2011, articles.mplans.com/how-to-perform-a-swot-analysis. 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."How to Write a Marketing Plan," *Arizona Office of Tourism*, accessed December 1, 2011, www.azot.gov/documents/Marketing_Tool_Kit.pdf; Tim Berry, "How to Perform a SWOT Analysis," *MPlans.com*, accessed December 2, 2011, articles.mplans.com/how-to-perform-a-swot-analysis. 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"Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

Video Link 6.3.1:

Rebirth of the American-Made Baseball Mitt

The strengths of the Insignia company.



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 Language of Branding: Brand Equity," *Branding Strategy Insider*, January 20, 2008, accessed December 2, 2011, www.brandingstrategyinsider.com/brand_equity. 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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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.Tim Berry, "How to Perform a SWOT Analysis," *MPlans.com*, accessed December 2, 2011, articles.mplans.com/how-to-perform-a-swot-analysis. 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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

Video Link 6.3.2:

Vinyl Makes a Comeback

A small company in Brooklyn, New York, takes advantage of the opportunity presented by the surging interest in vinyl records.



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 "leap frog" technology that may make a company's products, equipment, or services obsolete.Tim Berry, "How to Perform a SWOT Analysis," *MPlans.com*, accessed December 2, 2011, articles.mplans.com/how-to-perform-a-swot-analysis. 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"Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

Video Link 6.3.3:

Historic Paper Company Thrives

Surviving threats and taking advantage of opportunities.



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.Corte Swearingen, "Marketing SWOT Analysis," *SmallBiz Marketing Tips*, accessed December 2, 2011, www.small-biz-marketing-tips.com/marketing-swot-analysis .html.

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.Kris Bovay, "Build a Successful Marketing Plan—15 Key Business Success Factors," *eZine @rticles*, accessed December 2, 2011, ezinearticles.com/?Build-a -Successful-Marketing-Plan—15-Key-Business-Success-Factors&id=2156709. 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,Kris Bovay, "Build a Successful Marketing Plan—15 Key Business Success Factors," *eZine @rticles*, accessed December 2, 2011, ezinearticles.com/?Build-a -Successful-Marketing-Plan—15-Key-Business-Success-Factors&id=2156709. 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"Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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“Pasta Restaurant Marketing Plan: Sigmund’s Gourmet Pasta,” *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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 onground 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.Bobette Kyle, “Internet Marketing Strategy: Developing a Website Marketing Plan,” *WebSiteMarketingPlan.com*, accessed December 1, 2011, www.websitemarketingplan.com/marketing_management/MarketingPlanningArticle.htm.

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.Adapted from “Pasta Restaurant Marketing Plan: Sigmund’s Gourmet Pasta,” *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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 onground 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.Adapted from “Pasta Restaurant Marketing Plan: Sigmund’s Gourmet Pasta,” *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.
5. Achieve one thousand Facebook fans in six months.This is an addition to “Pasta Restaurant Marketing Plan: Sigmund’s Gourmet Pasta,” *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.
6. Achieve a Twitter follower base of five hundred people in six months.This is an addition to “Pasta Restaurant Marketing Plan: Sigmund’s Gourmet Pasta,” *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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"Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

Video Clip 6.3.4:

Small Business Market Position



Market position refers to how the general public views the business or the product.

Video Clip 6.3.5:

Small Business Market Position Tips



Choose a unique position for a business or a product.

Video Clip 6.3.6:

Choosing a Small Business Market Position



Look ten to fifteen years into the future when thinking about positioning.

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.Tim Berry, "What Is the Marketing Strategy Pyramid, Where Did It Come From?," *BPlans*, accessed June 1, 2012, http://www.bplans.com/ask-bplans/640/what-is-the -marketing-strategy-pyramid-where-did-it-come-from.



Figure 6.3.5: 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 6.3.5 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.Tim Berry, "What Is the Marketing Strategy Pyramid, Where Did It Come From?," *BPlans*, accessed June 1, 2012, http://www.bplans.com/ask-bplans/640/what-is-the -marketing-strategy-pyramid-where-did-it-come-from. 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 website and social media are additions to "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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*."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 57.

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 onlineThe authors of this textbook added the capability to place an order 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.The addition of coupons is a combination of ideas from the authors of this textbook and the following sample marketing plan: "Restaurant Marketing Plan: Neon Memories Diner," *MPlans.com*, accessed June 1, 2012, http://www.mplans.com/restaurant_mar..._vision_fc.php. 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.The Facebook plan was drawn from the following two sample marketing plans: "Locally Produced Clothing Retailer Marketing Plan: Local Threads," *MPlans.com*, accessed December 2, 2011, www.mplans.com/locally_produced_clothing_retailer_marketing_plan/marketing_vision_fc.php; "Restaurant Marketing Plan: Neon Memories Diner," *MPlans.com*, accessed December 2, 2011, http://www.mplans.com/restaurant_mar..._vision_fc.php. Sigmund's will also establish a Twitter presence."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php. The authors of this textbook added Twitter to the social media plan.

Video Clip 6.3.7:

How To Use Twitter For Business



A tutorial about using Twitter for business.

Video Clip 6.3.8:

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.

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 authors of this textbook added the online suggestion system.

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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

Breakeven Analysis

A **breakeven analysis** is used to determine the amount of sales volume a company needs to start making a profit.Susan Ward, "Breakeven Analysis," *About.com*, accessed December 1, 2011, sbinfocanada.about.com/cs/startup/g/breakevenanal.htm. 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.Daniel Richards, "How to Do a Breakeven Analysis," *About.com*, accessed December 1, 2011, entrepreneurs.about.com/od/businessplan/a/breakeven.htm.

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.Daniel Richards, "How to Do a Breakeven Analysis," *About.com*, accessed December 1, 2011, entrepreneurs.about.com/od/businessplan/a/breakeven.htm; Susan Ward, "Breakeven Analysis," *About.com*, accessed December 1, 2011, sbinfocanada.about.com/cs/startup/g/breakevenanal.htm.

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.Daniel Richards, "How to Do a Breakeven Analysis," *About.com*, accessed December 1, 2011, entrepreneurs.about.com/od/businessplan/a/breakeven.htm; Susan Ward, "Breakeven Analysis," *About.com*, accessed December 1, 2011, sbinfocanada.about.com/cs/startup/g/breakevenanal.htm. Labor costs and the cost of materials are examples of variable costs.

Breakeven Analysis for Sigmund's Gourmet Pasta

Figure 8.6 Sigmund's Breakeven Analysis



Figure 6.3.6: Sigmund's Breakeven Analysis *"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.*

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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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. Philip Kotler and Kevin Lane Keller, *Marketing Management*

(Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 112. 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. "Expense and Sales Forecasting," *Chic-CEO.com*, accessed December 2, 2011, www.chic-ceo.com/expense-and-sales-forecasting.

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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

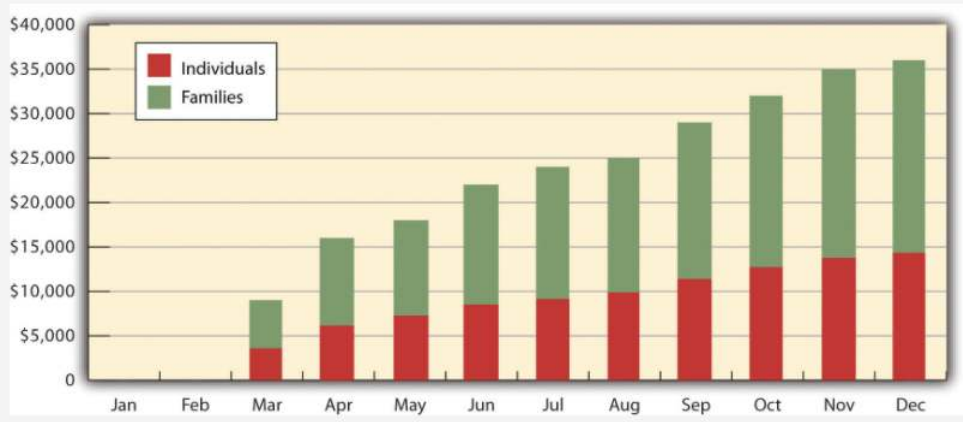


Figure 6.3.7: Sigmund's Sales Forecast "*Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 2, 2011, http://www.mplans.com/pasta_restaura...nalysis_fc.php. Reprinted by permission of Palo Alto Software.*

Table 6.3.2: 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."Expense and Sales Forecasting," *Chic-CEO.com*, accessed December 2, 2011, www.chic-

ceo.com/expense-and-sales-forecasting. 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."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

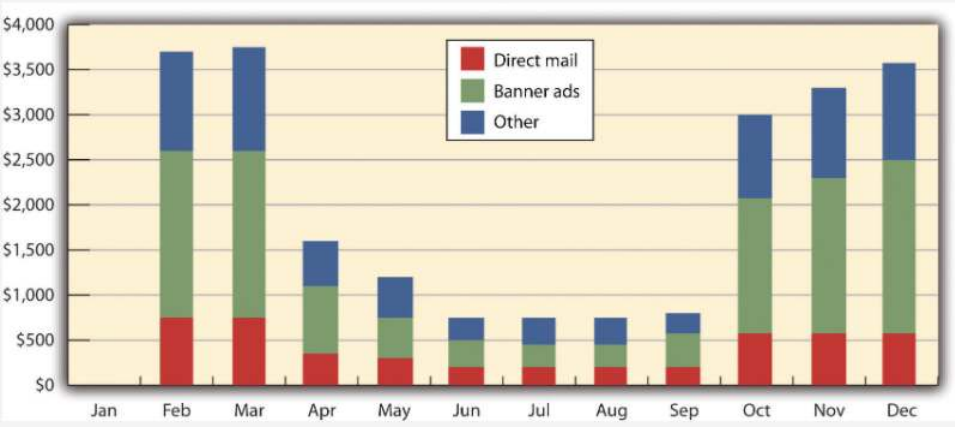


Figure 6.3.8: Sigmund's Expense Forecast *"Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 2, 2011, http://www.mplans.com/pasta_restaura...nalysis_fc.php. Reprinted by permission of Palo Alto Softwar*

Table 6.3.3: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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 57; Emily Suess, "Marketing Plan Basics for Small Business," *Small Business Bonfire*, April 13, 2011, accessed December 2, 2011, smallbusinessbonfire.com/marketing-plan-basics-for-small-business-owners.

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?Steve Arun, “How to Successfully Implement Your Marketing Plan,” *VA4Business*, March 14, 2010, accessed December 2, 2011, www.va4business.com/business/428/how-to-successfully-implement-your-marketing-plan. 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.“Implementing Your Marketing Plan,” *Marketing Plan Success*, accessed December 2, 2011, www.marketing-plan-success.com/articles/controls-implementation.php. 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.Steve Arun, “How to Successfully Implement Your Marketing Plan,” *VA4Business*, March 14, 2010, accessed December 2, 2011, www.va4business.com/business/428/how-to-successfully-implement-your-marketing-plan.

Several steps are recommended for the proper implementation of a marketing plan. Examples include the following:“Implementing Your Marketing Plan,” *Marketing Plan Success*, accessed December 2, 2011, www.marketing-plan-success.com/articles/controls-implementation.php; Steve Arun, “How to Successfully Implement Your Marketing Plan,” *VA4Business*, March 14, 2010, accessed December 2, 2011, www.va4business.com/business/428/how-to-successfully-implement-your-marketing-plan.

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.“Pasta Restaurant Marketing Plan: Sigmund’s Gourmet Pasta,” *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

Table 6.3.4: 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 authors of this textbook added the web development milestone 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

You can't manage what you don't measure."Measuring Brand Performance," *Branding Strategy Insider*, February 22, 2011, accessed December 2, 2011, www.brandingstrategyinsider.com/brand_equity.

Peter Drucker

The evaluation section of the marketing plan is about assessing the strengths and weaknesses of a marketing plan to improve its effectiveness."About Us," *American Evaluation Association*, accessed December 2, 2011, www.eval.org/aboutus/organization/aboutus.asp. 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."Marketing Plan: Evaluation," *Will It Fly*, accessed December 1, 2011, www.willitfly.com/wif/educelbrief.jsp?briefId=93&sponsorId=61&modId=241& modNm=Marketing%2BPlan&sectionNm=Evaluation.

There are many ways to evaluate how well a company is doing. The following are some of the ways:Adapted from Stuart Ayling, "7 Ways to Evaluate Your Marketing Plan," *WebSiteMarketingPlan.com*, accessed December 2, 2011, www.websitemarketingplan.com/mplan/evaluateplan.htm.

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 onground, 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 onground 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 onground 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.John Vencil, "The Marketing Plan VII—Evaluation," *VPI Strategies*, 2003, accessed December 2, 2011, www.vpistrategies.com/articles_pdf/Mktg7_Eval.pdf.
- **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.John Vencil, "The Marketing Plan VII—Evaluation," *VPI Strategies*, 2003, accessed December 2, 2011, www.vpistrategies.com/articles_pdf/Mktg7_Eval.pdf.
- **Sales closure rate.** The number of sales closed compared to sales leads. Collect data for both online and onground 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.Justin Whitney, "What Is Web Analytics," *AllBusiness.com*, accessed December 2, 2011, www.allbusiness.com/marketing-advertising/marketing-advertising/11382028 -1.html.

Video Link 6.3.9:

Using Web Analytics Tools

How analytics tools can help you make informed decisions about online endeavors.



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 6.3.10:

Three Important Questions to Ask Google Analytics



How Google Analytics helps to answer the three most important questions about a website

- **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. Community eBook, *Practical Social Media Measurement & Analysis* (Fredericton, New Brunswick, Canada: Radian6, 2010), 9, accessed December 2, 2011, www.radian6.com/wp-content/uploads/2010/03/Radian6_eBook_March2010.pdf. 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. Anoop George Joseph, "Twitter Metrics," *Web Technology and Softwares—A Technical Blog*, December 16, 2011, accessed June 1, 2012, webtechsoftwares.wordpress.co...itter-metrics/; "The Klout Score," accessed June 1, 2012, klout.com/understand/score. It is also important to tap into the analytics provided by LinkedIn and Facebook.Viveka Von Rosen, "ROI and Measuring your LinkedIn Presence," *#LinkedInChat*, February 21, 2012, accessed May 30, 2012, http://linkedintobusiness.com/roi-an...edin-presence/; Jenn Deering Davis, Ph.D., "5 Most Essential Facebook Marketing Metrics," *AllFacebook*, April 17, 2012, accessed May 30, 2012, http://allfacebook.com/facebook-metr...entials_b86156. 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. The website and social media activities added by the authors of this textbook would have to be measured and evaluated for their effectiveness as well."Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

Controls

There is no planning without control, the process of monitoring a proposed plan as it proceeds and adjusting it when necessary."Marketing Controls," *MarketingTeacher.com*, accessed December 2, 2011, www.marketingteacher.com/lesson-store/lesson-control.html. 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?"How to Write a Marketing Plan," *Arizona Office of Tourism*, accessed December 1, 2011, www.azot.gov/documents/Marketing_Tool_Kit.pdf.

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.Larry A. Bauman, "Contingency Planning Occurs before the Crisis Begins," *Small Business Success*, accessed December 1, 2011, www.smallbusinesssuccess.biz/articles_week/business_contingency_planning.htm. 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"Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," *Mplans.com*, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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

1. 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 (Chapter 16).

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6.4: The Three Threads

Learning Objectives

1. Understand how having a marketing plan contributes to customer value.
2. Understand how having a marketing plan can impact cash flow.
3. 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.Philip Kotler and Kevin Lane Keller, *Marketing Management* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 123.

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."Expense and Sales Forecasting," *Chic-CEO.com*, accessed December 2, 2011, www.chic-ceo.com/expense-and-sales-forecasting. 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.Adapted from "Use of Technology in Marketing," *Microsoft Business*, accessed December 2, 2011, www.microsoft.com/business/en-us/resources/ArticleReader/website/default.aspx?Print=1&ArticleId=techstrategiestopoweryourmarketingmuscleanddollars&fbid=knBWf5av0wR.
- Technology can help a company quickly customize offers for top-tier customers or personalize discounts for those who buy a specific product.Adapted from "Use of Technology in Marketing," *Microsoft Business*, accessed December 2, 2011, www.microsoft.com/business/en-us/resources/ArticleReader/website/default.aspx?Print=1&ArticleId=techstrategiestopoweryourmarketingmuscleanddollars &fbid=knBWf5av0wR.
- 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.Adapted from "Use of Technology in Marketing," *Microsoft Business*, accessed December 2, 2011,

www.microsoft.com/business/en-us/resources/ArticleReader/website/default.aspx?Print=1&ArticleId=techstrategiestopoweryourmarketingmuscleanddollars &fbid=knBWf5av0wR.

- 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."How Has Online Technology Changed Small Business Marketing and Advertising?," *Torian Group.com*, accessed December 1, 2011, www.toriangroup.com/Portals/0/Documents/How%20Has%20Online%20Technology%20Changed%20Small%20Business%20Marketing%20and%20Advertising.pdf.
- 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)."How Has Online Technology Changed Small Business Marketing and Advertising?," *Torian Group.com*, accessed December 1, 2011, www.toriangroup.com/Portals/0/Documents/How%20Has%20Online%20Technology%20Changed%20Small%20Business%20Marketing%20and%20Advertising.pdf.
- SurveyMonkey, a do-it-yourself survey program, can be used to find out customer likes, dislikes, and demographic profiles."How Has Online Technology Changed Small Business Marketing and Advertising?," *Torian Group.com*, accessed December 1, 2011, www.toriangroup.com/Portals/0/Documents/How%20Has%20Online%20Technology%20Changed%20Small%20Business%20Marketing%20and%20Advertising.pdf.
- A multitude of online tools are available to measure online and onground 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

1. 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.David Frey, "6 Deadly Small Business Marketing Mistakes," accessed June 21, 2012, www.onyxwebsolutions.com.au/r...g_Mistakes.pdf. 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.David Frey, "6 Deadly Small Business Marketing Mistakes," accessed June 21, 2012, www.onyxwebsolutions.com.au/r...g_Mistakes.pdf. 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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CHAPTER OVERVIEW

7: Accounting and Cash Flow

7.1: Chapter Introduction
7.2: Understanding the Need for Accounting Systems
7.3: Financial Accouting Statements
7.4: Financial Ratio Analysis
7.5: The Three Threads

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7.1: Chapter Introduction

Simione Consultants LLC



Figure 7.1.1: Used with permission from 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 health-care industry covers an extraordinary 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 a granular level so that clients can improve their operational efficiencies. The compliance division consulting services include working with health-care 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 health-care 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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https://biz.libretexts.org/@go/page/66815

7.2: Understanding the Need for Accounting Systems

Learning Objectives

1. Understand why a basic knowledge of accounting is important for a small business.
2. Understand the importance of selecting an accountant to enhance the overall operation of a business.
3. Define the two major approaches to accounting systems: cash versus accruals.

The older I get, the more interesting I find lawyers and accountants.*Independent* (London), April 21, 2010, quoted in "Accounting Quotes," *Qfinance*, accessed February 14, 2012, www.qfinance.com/finance-and-business-quotes/accounting.

Alex James

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 in Section 9.4, 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."Ramnik Singh Wahla, *Accounting Terminology Bulletin No. 1: Review and Résumé*, 1953, accessed February 14, 2012, c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1950/1953_0101_AccountingReview.pdf. 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.Denise Schmandt-Besseart, "An Ancient Token System: The Precursor to Numerals and Writing," *Archaeology* 39 (1986): 32–39; Richard Mattessich, "Prehistoric Accounting and the Problem of Representation: On Recent Archeological Evidence of Middle East from 8000 B.C. to 3000 B.C.," *Accounting Historians Journal* 14, no. 2 (1987): 71–91. 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. Salvador Carmona and Mahmoud Ezzamel, "Accounting and Forms of Accountability in Major Civilizations: Mesopotamia and Ancient Egypt" (working paper, Instituto de Empresa Business School, Madrid, Spain, and Cardiff University, Cardiff, UK, 2005), accessed December 2, 2011, latienda.ie.edu/working_papers_economia/WP05-21.pdf.

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. John R. Alexander, *History of*

Accounting (Princeville, HI: Association of Chartered Accountants in the United States, 2002), 4. 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. John R. Alexander, *History of Accounting* (Princeville, HI: Association of Chartered Accountants in the United States, 2002), 9. 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. Obvious, 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 (see Section 9.1). 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 in Section 9.3, 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.Jean Murray, "Finding Help with Bookkeeping and Accounting Tasks," *About.com*, accessed December 2, 2011, biztaxlaw.about.com/od/businessaccountingrecords/a/findacpa.htm.

Video Clip 7.2.1:

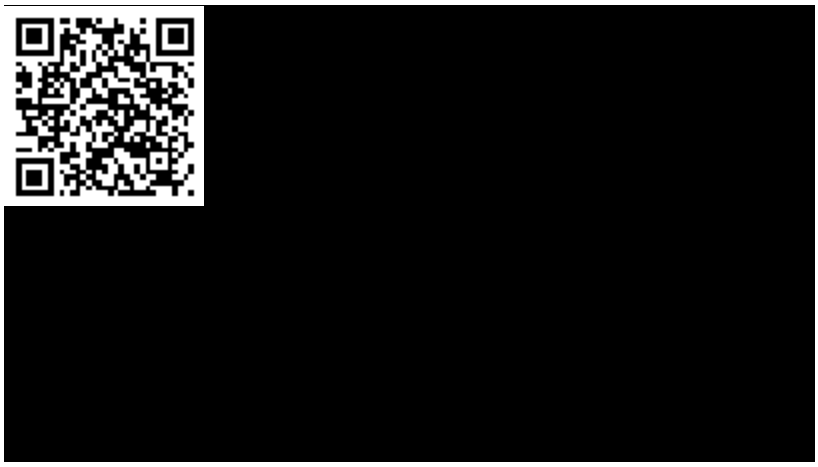
Why Warren Buffett Said Accounting Is the Language of Business



This video introduces the importance of accounting.

Video Clip 7.2.2:

Why You Need an Accountant



This video explains why a small business needs the services of a professional accountant.

Video Clip 7.2.3:

What CPAs Wish Every Small Business Knew



This video approaches small business's need for accounting from the accountant's perspective.

Alternative Approaches to Accounting Systems

> *The system of double-entry bookkeeping is, perhaps, the most beautiful one in the wide domain of literature or science. If it were less known, it would be the admiration of the learned world."Edwin T. Freedley," Cyber Nation, accessed February 14, 2012, www.cybernation.com/victory/quotations/authors/quotes_freedley_edwint.html.*
>
> *Edwin T. Freedley*

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 some 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.“Comparison of Cash and Accrual Methods of Accounting,” *Wikipedia*, accessed December 2, 2011, en.Wikipedia.org/wiki/comparison_of_cash_method_and_accrual_method_of_accounting. 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.Melissa Bushman, “Cash Basis versus Accrual Accounting,” *Yahoo! Voices*, accessed December 2, 2011, voices.yahoo.com/cash-basis-versus-accrual-basis_-accounting-147864.html?cat=3. 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.“Cash vs. Accrual Accounting,” *Nolo.com*, accessed December 2, 2011, www.nolo.com/legal-encyclopedia/cash-vs-accrual-accounting-29513.html. A summary of the pros and cons of the two systems is provided in Figure 7.2.1.

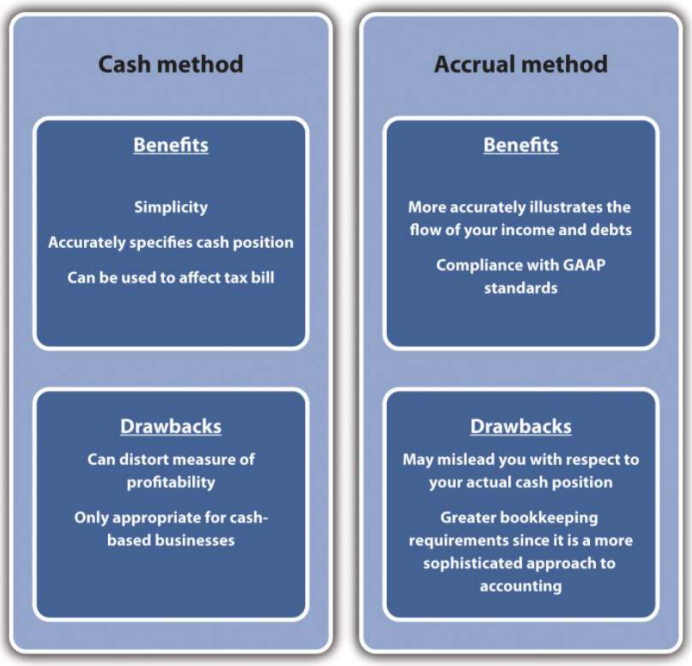
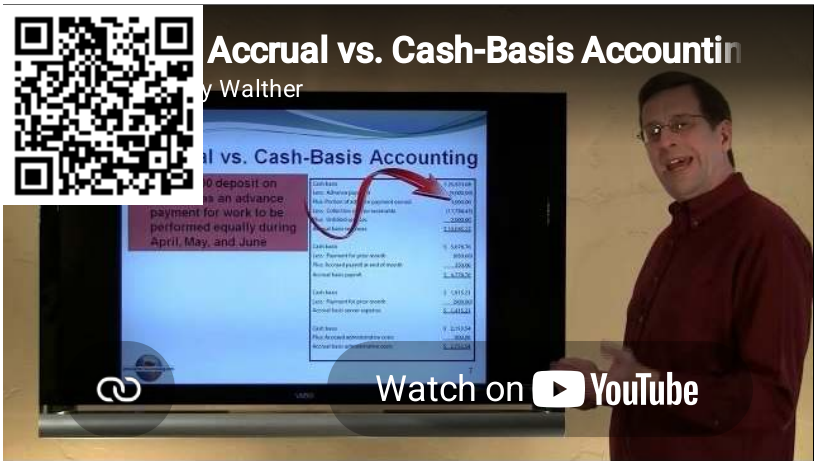


Figure 7.2.1: Comparative Accounting Systems

(Copyright; author via source)

Video Clip 7.2.4:

Accrual versus Cash-Basis Accounting Video Presentation



A lecture on the two accounting systems.

Video Clip 7.2.5:

Accrual Basis versus Cash Basis Accounting Power



A video with voice-over of a PowerPoint presentation.

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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7.3: Financial Accouting Statements

Learning Objectives

1. Understand what is measured on a balance sheet.
2. Understand the term *depreciation*.
3. Understand what goes on an income statement.
4. Understand what is measured in a cash-flow statement.
5. Appreciate the importance of forecasting when developing a cash-flow projection statement.

It sounds extraordinary, but it's a fact that balance sheets can make fascinating reading."Accounting Quotes," *Qfinance*, accessed February 14, 2012, www.qfinance.com/finance-and-business-quotes/accounting.

Mary, Lady Archer of Weston

As discussed in "The Business Plan", 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. This 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:

assets = liabilities + owner's equity.

Assets are "economic resources that are expected to produce a benefit in the future."Walter Harrison, Charles Lungren, and Bill Thomas, *Financial Accounting*, 8th ed. (Boston, MA: Prentice Hall, 2010), 63. **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."“Work in Process,” *BusinessDictionary.com*, accessed December 2, 2011, www.businessdictionary.com/definition/work-in-process.html. 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 7.3.1.

Table 7.3.1: 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."Paid in Capital," *Investopedia*, accessed December 2, 2011, www.investopedia.com/terms/p/paidincapital.asp. **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."Retained Earnings," *The Free Dictionary*, accessed December 2, 2011, financial-dictionary.thefreedictionary.com/Retained+Earnings.

The entire balance sheet and its calculations are summarized in Figure 7.3.1.

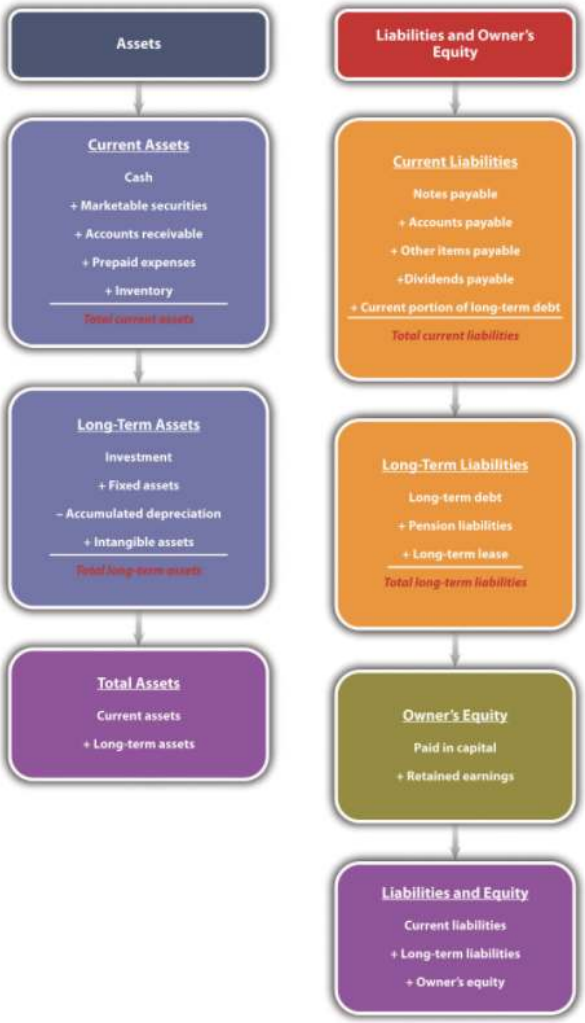


Figure 7.3.1: The Balance Sheet

In Table 7.3.2, 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 in Section 9.3 to show how those questions can be addressed with ratio analysis.

Table 7.3.2 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 7.3.1:

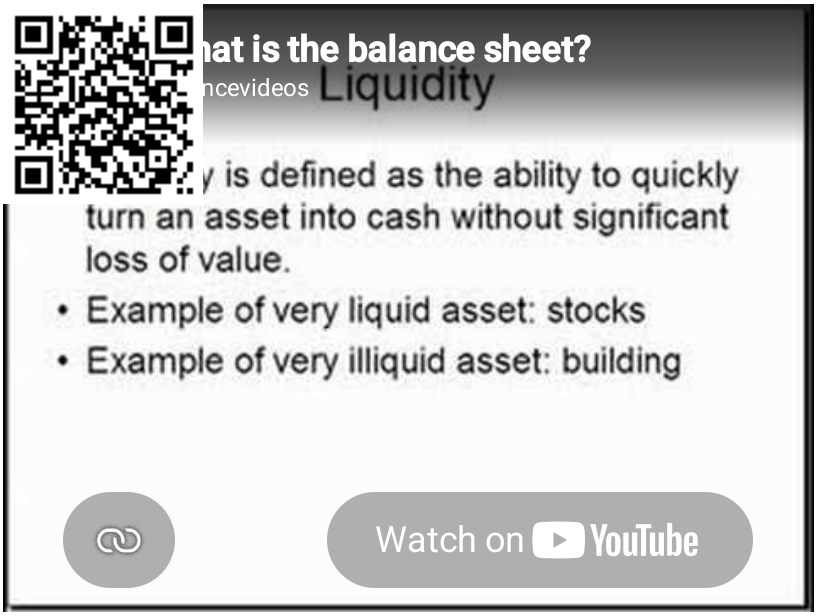
Beginner's Guide to Financial Statements: Balance Sheets



An introduction to the balance sheet.

Video Clip 7.3.1:

What Is the Balance Sheet?



A voice-over PowerPoint presentation describing the balance sheet. Be aware that this is seven minutes long.

Video Clip 7.3.1:

Balance Sheet: How to Explain How a Balance Sheet Works



Another description of the balance sheet.

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:

gross profit = income − 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 9.1, 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 7.3.3:.The income statement is the item that most individuals look at to determine the success of business operations. In Table 7.3.3. Table 9.3, the income statements for Acme Enterprises are given for the period 2005 to 2010.

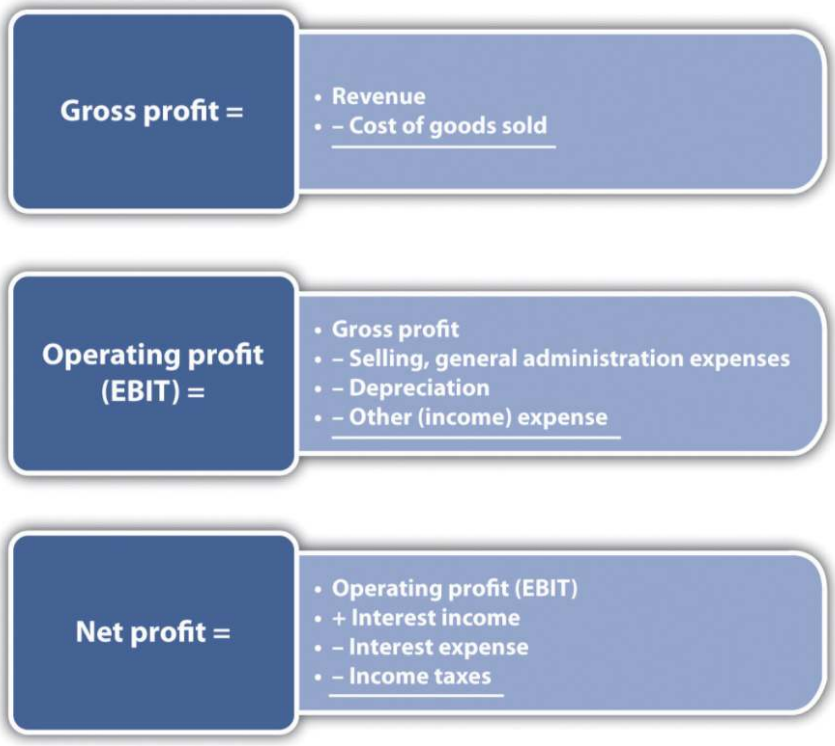


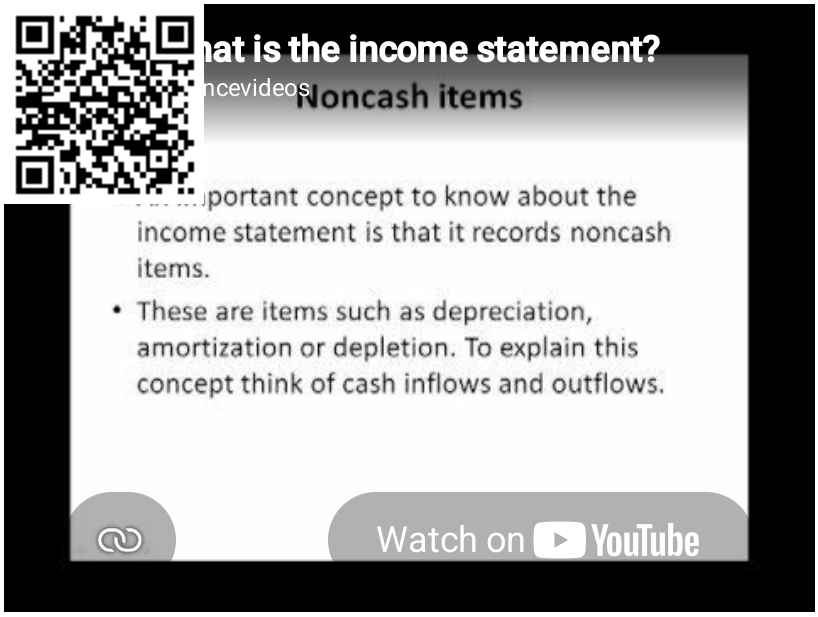
Figure 7.3.3: The Income Statement

Table 7.3.3: 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 7.3.1:

What Is the Income Statement?



A basic introduction to income statements.

Video Clip 7.3.1:

Income Statement

https://youtu.be/Bpcn7QYOTx0



A further description of an income statement.

The Cash-Flow Statement

Customer satisfaction, employee satisfaction and cash flow the three most important indicators for business.Jack Welch, "A Healthy Company?," *Business Week*, May 3, 2006.

Jack Welch

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 7.3.4.

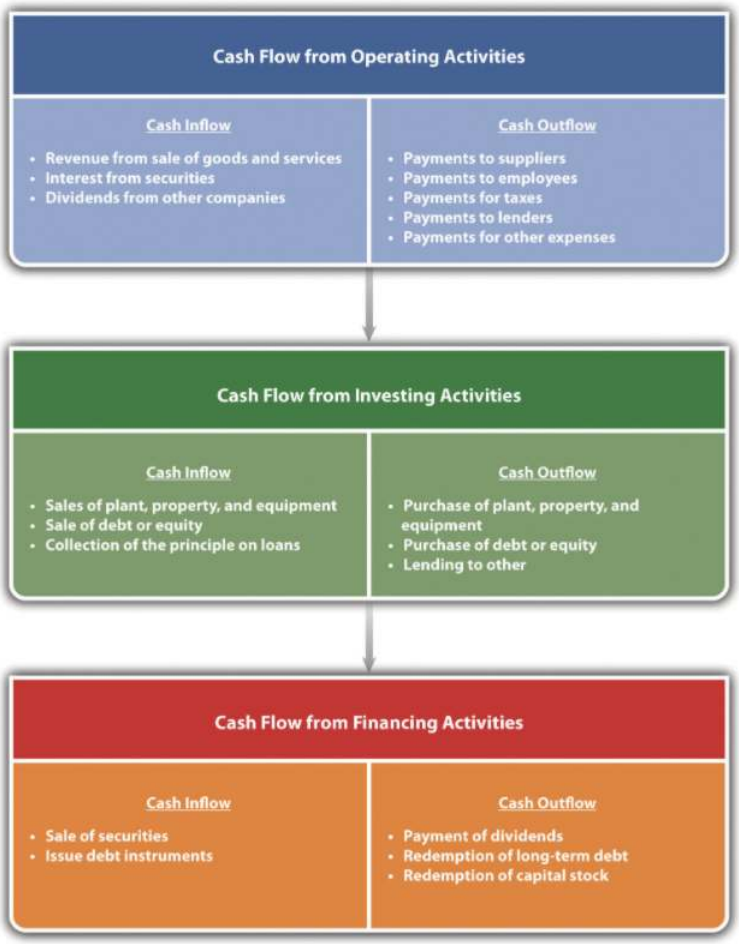


Figure 7.3.4: Cash Flow Breakdown

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 importance of forecasts for planning is discussed in Chapter 5.

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.Richard Bort, "Medium-Term Funds Flow Forecasting," in *Corporate Cash Management Handbook*, ed. Richard Bort (New York: Warren Gorham & Lamont, 1990), 125.

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 7.3.4.

Table 7.3.4: 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, as illustrated in Figure 9.5. 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 7.3.5, as are the averages for each month.

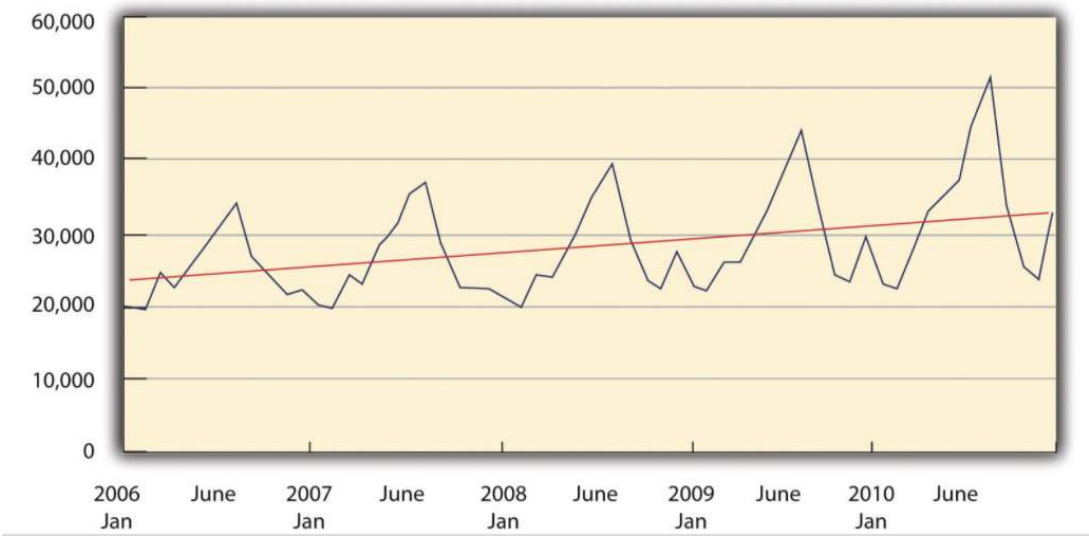


Figure 7.3.1: Seasonality in Sales

Figure 9.5 Seasonality in Sales

Table 7.3.5: 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:These calculations have been rounded to the nearest dollar. This is also true for the values in Table 9.6.

November 2010 sales = $23,466December 2010 sales = $33,583January 2011 sales = $26,737cash inflow from November 2010 sales = ($23,466) × 15 percent = $3,520cash inflow from December 2010 sales = ($33,583) × 35 percent = $11,754cash inflow from January 2011 sales = ($26,737) × 50 percent = $13,368total 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 = $25,637parts 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 = $13,369parts and materials cash outlay in January 2011 = 60 percent of purchases January 2011 + 40 percent of purchases December 2010parts 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 9.6. 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 7.3.6. 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 7.3.6: 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 7.3.1:

Cash-Flow Analysis



A discussion of cash flow.

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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7.4: Financial Ratio Analysis

Learning Objectives

1. 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.
2. Understand the concept of financial ratios and the different categories of financial ratios.
3. Acquire the ability to calculate financial ratios and interpret their meaning.

One can say that figures lie. But figures, when used in financial arguments, seem to have the bad habit of expressing a small part of the truth forcibly, and neglecting the other, as do some people we know."Accounting Quotes," *Qfinance*, accessed February 14, 2012, www.qfinance.com/finance-and-business-quotes/accounting.

Fred Schwed

Section 9.1 discusses the differences between managerial accounting and financial accounting. 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

current assets / 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:

current assets − inventory / current liabilities.

Using the data provided in the balance sheet for Acme Enterprises ("Acme Enterprises' Balance Sheet, 2005–2010 ($ Thousands)") we can compute the current ratio and the quick ratio. The results for Acme Enterprises and its industry's means are provided in Table 7.4.1.

Table 7.4.1: 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."Debt/Equity Ratio," *Investopedia*, accessed December 2, 2011, www.investopedia.com/terms/D/debtequityratio.asp. 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 7.4.2. 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 7.4.2: 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:

gross profit margin = gross profit / revenue.

The next examines operating profit per dollar of sales and is calculated in the following manner:

operating profit margin = operating profit / 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:

net profit margin = net profit / revenue.

The profitability ratios for Acme and its industry are provided in Table 7.4.3. 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 7.4.3: 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 7.4.4.

Table 7.4.4: Efficiency Ratios Results

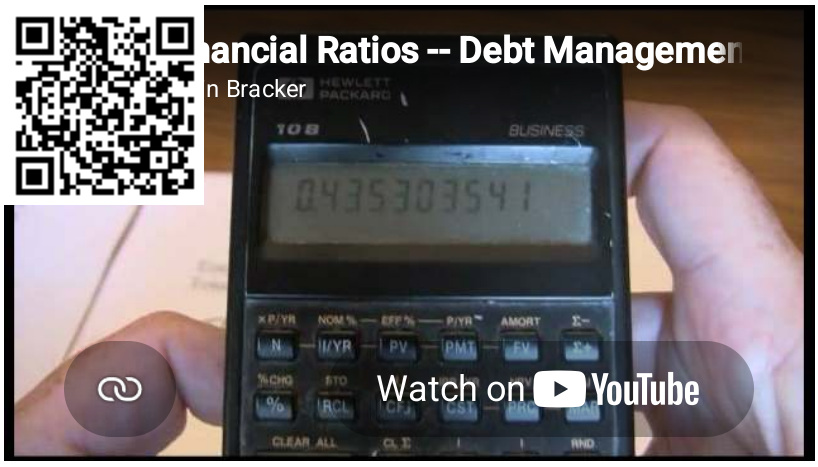
	2005 (%)	2006 (%)	2007 (%)	2008 (%)	2009 (%)	2010 (%)
Acme's sales to inventory	14.3	14.3	14.3	14.3	14.3	14.3
Industry's sales to inventory	16.2	15.7	15.3	14.9	14.3	13.7
Acme's sales to fixed assets	8.57	7.02	6.01	5.28	4.75	4.33
Industry's sales to fixed assets	7.64	7.12	6.78	6.55	6.71	6.34
Acme's days 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 7.4.1:

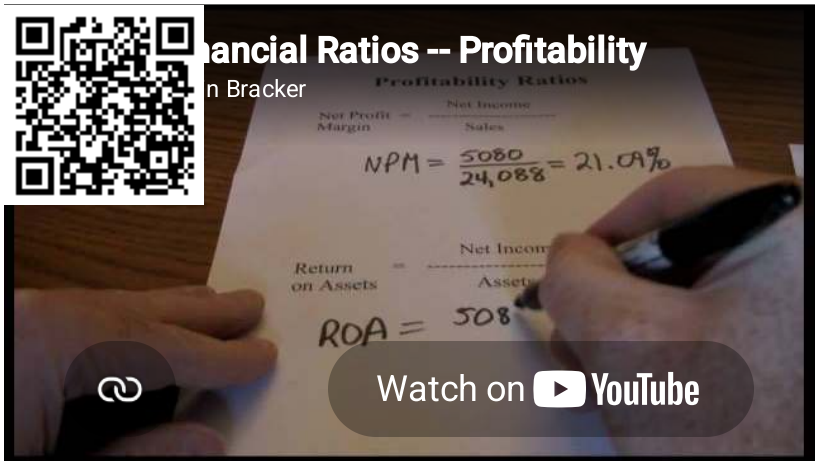
Financial Ratios: Debt Management



Basic coverage for calculating debt ratios.

Video Clip 7.4.1:

Financial Ratios: Profitability



Basic coverage for calculating profitability ratios.

Video Clip 7.4.1:

Financial Ratios: Asset Management



Basic coverage for calculating asset management ratios.

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 (Chapter 16), 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 (Chapter 16) 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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7.5: The Three Threads

Learning Objectives

1. To understand that a functioning accounting system can provide customer value through accurate billings and records.
2. To understand that there are several techniques that can help a small business maintain a positive cash flow.
3. 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."Customer Value Analysis," *Quality Solutions, Inc.*, accessed December 2, 2011, www.qualitysolutions.com/customer_value_analysis.htm.

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."Andrew Hereth, "Accounting for Superior Customer Service," *Andrew M. Hereth Blog*, accessed December 2, 2011, andrewmhereth.com/blog/accounting-for_-superior-customer-service.

Cash-Flow Implications

Like good health, positive cash flow is something you're most aware of when you haven't got it. That's one of the most profound truths in life."The Importance of Cash Flow Management—Entrepreneur University," *Young Entrepreneur Blog*, February 9, 2009, accessed February 14, 2012, www.youngentrepreneur.com/blog/entrepreneur-university/the-importance-of_-cash-flow-management-entrepreneur-university.

Robert Heller

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."The Advantages of Using a Computerized Accounting Package such as MYOB Accounting Software," *ITS Tutorial School*, accessed December 2, 2011, www.tuition.com.hk/computerized-accounting.htm.
- **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.Sheila Shanker, "Differences between Manual and Computerized Accounting Systems, *Chron.com*, accessed January 31, 2012, smallbusiness.chron.com/differences-between-manual-computerized-accounting-systems-3764.html.

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.John Hedtke, "Natural Selection of Low-Cost Accounting," *Accounting Technology* 22, no. 5 (2006): 34–38. 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 "Understanding the Need for Accounting Systems", 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 7.5.1. 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."Accounting Software A to Z," *Business-Software.com*, accessed March 11, 2021. 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.

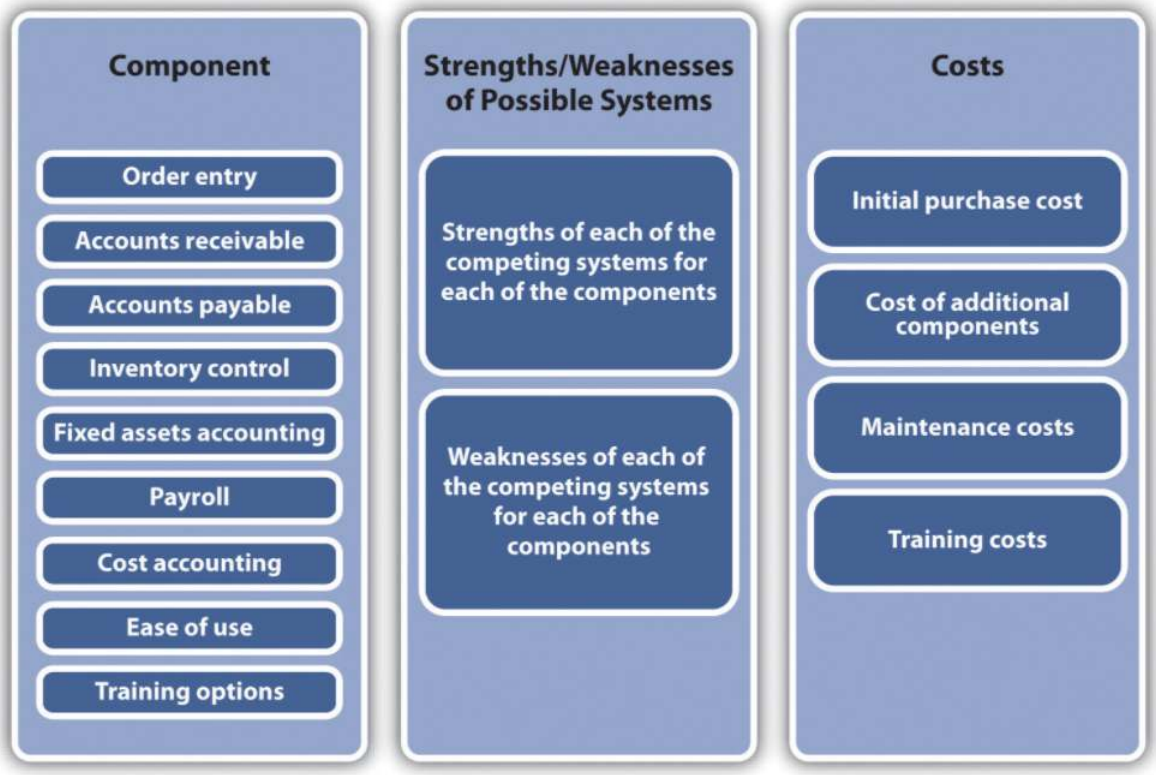


Figure 7.5.1: Evaluation of Computer Accounting Systems

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 Link 9.1

Evaluating Accounting Software

Video that discusses ways to determine what software is best.



www.ehow.com/video_5103398_evaluating-accounting-software.html

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.Josh Morgan, “Yankee Gas Work Upsets Local Businessowners,” *The Cheshire Herald* (Cheshire, Connecticut), October 21, 2010. 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."Josh Morgan, "Yankee Gas Work Upsets Local Businessowners," *The Cheshire Herald* (Cheshire, Connecticut), October 21, 2010. 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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CHAPTER OVERVIEW

8: Financial Management

8.1: Chapter Introduction

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8.3: Financial Control

8.4: Financial Decision Making

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8.1: Chapter Introduction

The Notch Store



Figure 8.1.1: The Notch Store. *Used with permission from Frank Salvatore.*

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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8.2: The Importance of Financial Management in Small Business

Learning Objectives

1. Understand the difference between accounting and finance for small businesses.
2. Understand the major activities of finance.
3. Understand how finance can affect the selection of a business form.
4. Understand the various sources that can be used to finance the start-up operations of a business.
5. Understand what factors might affect the extent to which a firm is financed by either debt or equity.

"Accounting and Cash Flow" discusses 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."Difference between Accounting and Finance," *DifferenceBetween.net*, accessed February 1, 2012. Yet some have argued that accounting should be seen as a subset of finance."Difference between Accounting and Finance," *DifferenceBetween.net*, accessed February 1, 2012. 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, which is presented in "Accounting and Cash Flow". 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."Types of Business Organizations," *BusinessFinance.com*, accessed December 2, 2011. 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."Business Finance—by Category," *About.com*, accessed December 2, 2011. 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 8.2.1).



Figure 8.2.1: Copy and Paste Caption here. (Copyright; author via source)

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."Financing," *Small Business Notes*, accessed December 2, 2011, www.smallbusinessnotes.com/business-finances/financing. 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."Checklist: Issuing Stock," *San Francisco Chronicle*, accessed December 2, 2011, allbusiness.sfgate.com/10809-1.html. 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."How to Form a Corporation," *Yahoo! Small Business Advisor*, April 26, 2011, accessed February 1, 2012, smallbusiness.yahoo.com/advisor/how-to-form-a-corporation -201616320.html.

"The Business Plan" discusses 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."How Will a Credit Crunch Affect Small Business Finance?," *Federal Reserve Bank of San Francisco*, March 6, 2009, accessed December 2, 2011. 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. For a more comprehensive discussion of bank loans, see "Relationships with Bank and Bankers".

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.Anita Campbell, "Trade Credit: What It Is and Why You Should Pay Attention," *Small Business Trends*, May 11, 2009, accessed December 2, 2011, smallbiztrends.com/2009/05/trade-credit-what-it-is-and-why-you-should-pay-attention.html. 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 8.2.1:

How to Raise Capital: The #1 Skill of an Entrepreneur



Describes what an entrepreneur needs to do in order to acquire capital for the firm.

Video Clip 8.2.2:

Pat Gage: Getting Business Financing for a Small Business



Voice-over PowerPoint identifies where a small business owner can acquire funding.

Video Clip 8.2.3:

How to Finance a Business: How to Get Start-Up Business Financing



Examines the use of bank financing for the small business.

Video Clip 8.2.4:

Financing a New Business: 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.

Video Clip 8.2.5:

The Role of Credit Cards in Small Business Financing



Congressional testimony that warns of the use of using credit cards to finance small businesses.

Video Clip 8.2.6:

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.

Web Resources

Credit Loans for Small Businesses

The Chase portal—one provider of loans for small businesses.

https://www.chase.com/business/loans

Five Ways to Finance a Business in Difficult Financial Times

Alternative ways of financing when banks are not lending.

biztaxlaw.about.com/od/financingyourstartup/tp/financingsmallbiz.htm

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.Gavin Cassar, "The Financing of Business Startups," *Journal of Business Venturing* 19 (2004): 261–83. 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.Lola Fabowale, Barbara Orse, and Alan Riding, "Gender, Structural Factors, and Credit Terms between Canadian Small Businesses and Financial Institutions," *Entrepreneurship Theory and Practice* 19 (1995): 41–65. 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, as more clearly shown in "Capital Structure Issues in Practice", 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 8.2.2). 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 8.2.2). 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.

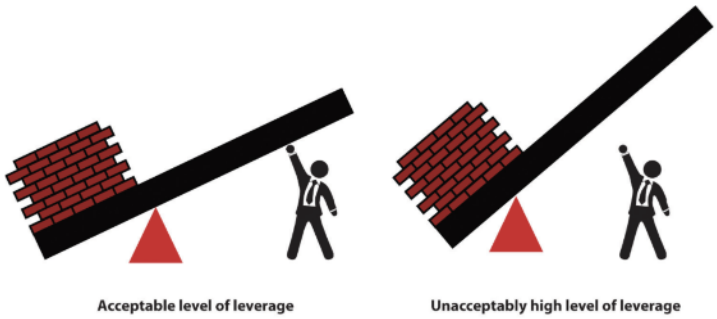


Figure 8.2.2: Acceptable and Unacceptable Levels of Leverage

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.Harry Sapienza, M. Audrey Korsgaard, and Daniel Forbes, “The Self-Determination Mode of an Entrepreneur’s Choice of Financing,” in *Advances in Entrepreneurship, Firm Emergence, and Growth: Cognitive Approaches to Entrepreneurship Research*, ed. Jerome A. Katz and Dean Shepherd (Oxford: Elsevier JAI, 2003) 6:105–38. 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.Allen N. Berger and Gregory F. Udell, “The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle,” *Journal of Banking and Finance* 22, no. 6–8 (1998): 613–73.

A recent research paperRowena Ortiz-Walters and Mark Gius, “Performance of Newly Formed Micro Firms: The Role of Capital Financing Structure and Entrepreneurs’ Personal Characteristics” (unpublished manuscript), 2011. 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.

www.enotes.com/capital-structure-reference/capital-structure-178334

Capital Structure from an Investor’s Perspective

This reviews how an investor would interpret a business’s capital structure.

Links available

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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8.3: Financial Control

Learning Objectives

1. Learn about the importance of cultivating a relationship with a banker.
2. 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*."The Benefits of Making Your Banker Your Friend," *Small Business Administration*, accessed December 2, 2011.

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
    1. a start-up business
    2. a line-of-credit
    3. an equipment purchase
    4. 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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8.4: Financial Decision Making

Learning Objectives

1. Learn the importance of a breakeven analysis.
2. Understand how to conduct a breakeven analysis.
3. Understand the potential power and danger of financial leverage.
4. Learn how changing financial leverage can affect measures of profitability, such as ROA and ROE.
5. 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."Breakeven Analysis: Know When You Can Expect a Profit," *Small Business Administration*, accessed December 2, 2011, www.sba.gov/content/breakeven-analysis -know-when-you-can-expect-profit. 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

total revenue − total costs = $0.

By moving terms, we can see that the break-even point occurs when total revenues equal total costs:

total revenue = 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:

total revenue (TR) = selling price (SP) × sales volume (Q)TR = SP × 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:

total variable costs (TVC) = variable cost per unit (VC) × sales quantity (Q)TVC = VC × Q.

Total costs are simply the summation of fixed costs plus the total variable costs:

total costs (TC) = [fixed costs (FC) + total variable cost (TVC)]TC = FC + TVC.

The original equation for the break-even point can now be rewritten as follows:

[selling price (SP) × sales volume (Q)] − total costs (TC) = $0(SP × Q) − TC = $0.

At the break-even point, revenues equal total costs, so this equation can be rewritten as

SP × Q = TC.

Given that the total costs equal the fixed costs plus the total variable costs, this equation can now be extended as follows:

selling price (SP) × sales volume (Q) = [fixed costs (FC) + total variable costs (TVC)]SP × Q = FC + TVC.

This equation can be expanded by incorporating the definition of total variable costs as a function of sales volume:

SP × Q = FC + (VC × Q).

This equation can now be rewritten to solve for the sales value:

(SP × Q) − (VC × 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 × (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 8.4.1.

Table 8.4.1: break-even 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 8.4.2.

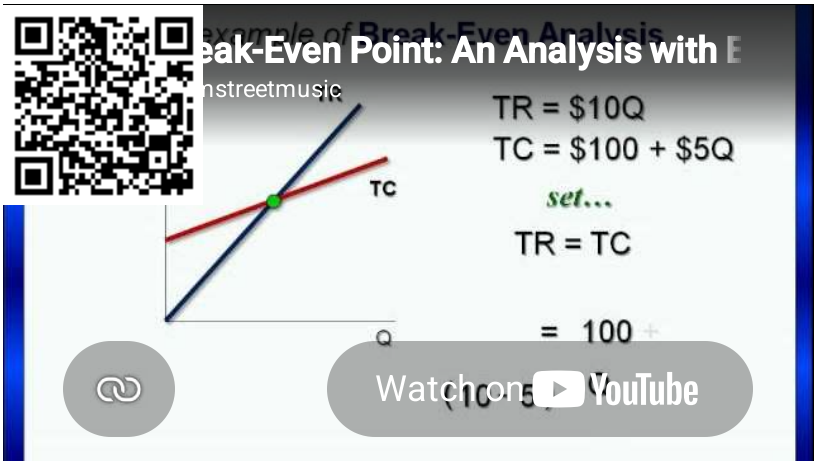
Table 8.4.2: Sales Level versus Profit Breakdown

	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 8.4.1:

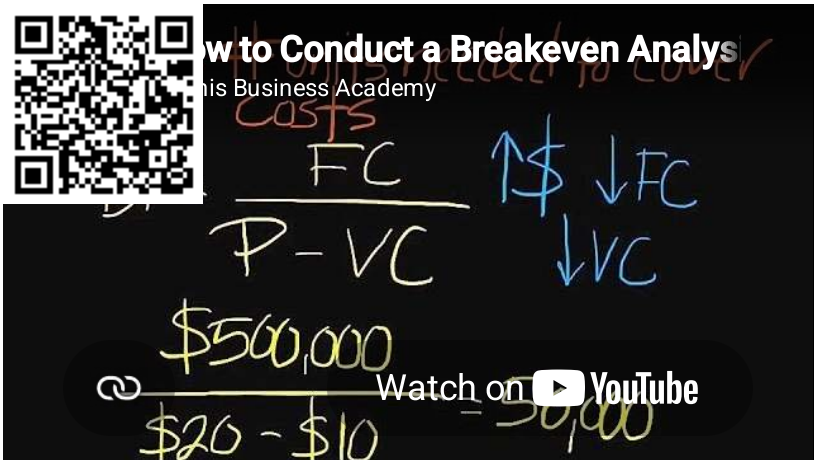
Breakeven Analysis: Economics for Managers



A slide show showing breakeven calculations.

Video Clip 8.4.2:

Breakeven Analysis



A breakeven tutorial with voice-over.

Video Clip 8.4.3:

Perform a Breakeven Analysis with Excel's Goal Seek Tool



Shows how Excel can be used to conduct sophisticated breakeven analyses.

Breakeven Analysis

This site provides a straightforward description of breakeven analysis with an example.

Capital Structure Issues in Practice

In "Financial Control", the need to balance debt and equity, with respect to financing a firm's operations, is 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 a "Foundations for Small Business" 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.David Durand, "Cost of Debt and Equity Funds for Business: Trends and Problems of Measurement," *Conference on Research in Business Finance* (New York: National Bureau of Economic Research, 1952), 220. A major breakthrough occurred with the works of Franco Modigliani and Merton Miller.Franco Modigliani and Merton Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," *American Economic Review* 48, no. 3 (1958): 261–97; Franco Modigliani and Merton Miller, "Taxes and the Cost of Capital: A Correction," *American Economic Review* 53 (1963): 433–43. 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 8.4.3:. 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 8.4.4 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 8.4.5:.

Table 8.4.3: 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 8.4.4: 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 8.4.5: 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 multiyear 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 8.4.6: presents the income statement for these five scenarios. (An abbreviated balance sheet for the five scenarios is given in Table 8.4.7.) 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 8.4.6: 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 8.4.7: 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 8.4.8). 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 (see Figure 10.3). 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 8.4.8: 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%

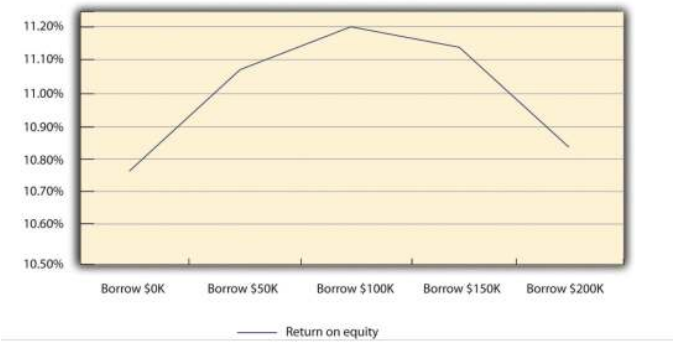


Figure 8.4.1: ROE for the Five Scenarios

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 8.4.9. 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 8.4.10.

Table 8.4.9: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 10.10 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 8.4.4:

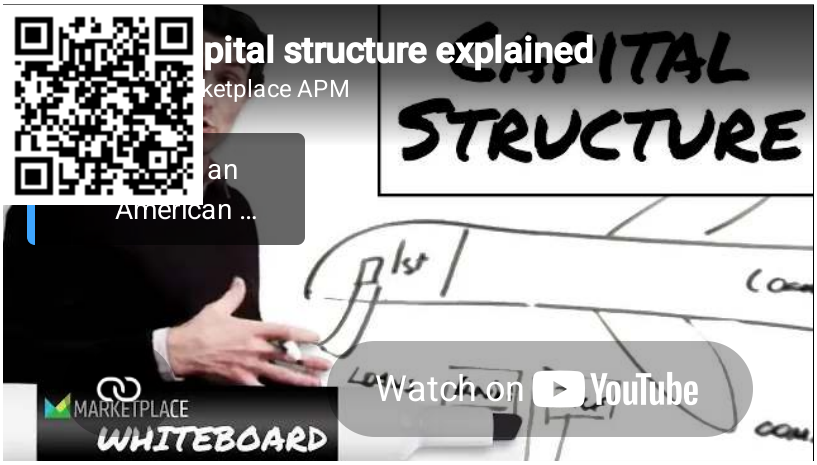
Debt Financing versus Equity Financing: Which Is Best for Us?



Overview of the benefits and dangers associated with debt financing and equity financing.

Video Clip 8.4.5:

Capital Structure



Compares capital structure to a commercial aircraft.

Video Clip 8.4.6:

Lecture in Capital Structure



Explains why capital structure matters.

Video Clip 8.4.7:

The Capital Structure of a Company



Discusses the issue of long-term and short-term debt in capital structure.

KEY TAKEAWAYS

- A relatively simply 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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8.5: The Three Threads

Learning Objectives

1. Understand that effective and efficient financial management can enhance value provided to customers.
2. Appreciate that effective financial management can improve the firm's cash-flow position.
3. Understand that the use of technologies can significantly reduce cost of operations and improve profitability.

Customer Value

In "Your Business Idea: The Quest for Value", "Marketing Basics", and "Marketing Strategy", 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."Tiffany Bradford, "Activity-Based Costing," *Accounting @ Suite 101*, accessed December 2, 2011, tiffany-bradford.suite101.com/activitybased-costing-abc-a52148.

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.Peter Robbins, "E-Procurement—Making Cash Flow King," *Credit Control* 26, no. 2 (2005): 23–26. 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. We discuss supply chain management in "People and Organization".

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. (See "The Importance of Financial Management in Small Business" for a discussion of trade credits.) 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 in "The Importance of Financial Management in Small Business", 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.”Sharif Sakr, “GeeknRolla: Tech Start-Ups Reveal Cost-Cutting Tips,” *BBC Business*, accessed December 2, 2011.

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. "The Three Threads" mentions that 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.”Sharif Sakr, “GeeknRolla: Tech Start-Ups Reveal Cost-Cutting Tips,” *BBC Business*, accessed December 2, 2011.

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 every one’s data are secure and safe. They have 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.Eilene Zimmerman, “A Small Business Made to Seem Bigger,” *New York Times*, March 2, 2011, accessed December 2, 2011, www.nytimes.com/2011/03/03/business/smallbusiness/03sbiz.html?_r=1.

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

At the beginning of "Financial Management", 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."How Will a Credit Crunch Affect Small Business Finance?," *Federal Reserve Bank of San Francisco*, March 6, 2009, accessed December 2, 2011, . 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.Allen N. Berger and Gregory F. Udell, "Did Risk-Based Capital Allocate Bank Credit and Cause a Credit Crunch in the US?," *Journal of Money, Credit and Banking* 26 (1994): 585–628.

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.Gregory F. Udell, *Asset-Based Finance: Proven Disciplines for Prudent Lending* (New York: Commercial Finance Association, 2004), 16. 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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CHAPTER OVERVIEW

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9.2: Principles of Management and Organization
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9.1: Chapter 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.

Source: Interview with Jeff Shelstad, March 31, 2011; "Unnamed Publisher Named to EContent Magazine Top 100 Digital Companies of 2010," *Pressitt*, December 15, 2010, accessed February 2, 2012.

Alexandra Torres, "Company Offers Alternatives to Enter the World of Knowledge," *The Ticker*, October 10, 2010, accessed February 2, 2012.

John Tozzi, "Online Startups Target College Book Costs," *Bloomberg BusinessWeek*, September 23, 2010

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9.2: Principles of Management and Organization

Learning Objectives

1. Understand the functions of management.
2. Explain the three basic leadership styles.
3. Explain the three basic levels of management.
4. Understand the management skills that are important for a successful small business.
5. 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."John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 172. Put more simply, management is all about achieving organizational objectives through people and other resources.David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 254.

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 9.2.1).



Figure 9.2.1: Management Functions

Planning

Planning "is the process of anticipating future events and conditions and determining courses of action for achieving organizational objectives."David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 257. 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."Management Principles," *Small Business Notes*, accessed February 2, 2012. 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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 176; David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 257. Business planning for the small business is discussed in "The Business Plan", and marketing planning is discussed in "The Marketing Plan".

Organizing

> *". . . consists of grouping people and assigning activities so that job tasks and the mission can be properly carried out."John M. Ivancevich and Thomas N. Duening, Business: Principles, Guidelines, and Practices (Mason, OH: Atomic Dog Publishing, 2007), 176. Establishing a management hierarchy is the foundation for carrying out the organizing function.*

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.""Traditional Management Principles," *Small Business Notes*, accessed February 2, 2012, www.smallbusinessnotes.com/managing-your-business/traditional-management -principles.html. 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."Traditional Management Principles," *Small Business Notes*, accessed February 2, 2012, www.smallbusinessnotes.com/managing-your-business/traditional-management -principles.html.

The organizational design and structure of a small business are important parts of organizing, which are discussed in Section 12.2.

Video Link 9.2.1:

Glassblowing Business Thrives

Lesson learned: Everyone should know his or her role in the business.



Staffing

The **staffing** function involves selecting, placing, training, developing, compensating, and evaluating (the performance appraisal) employees.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 176. 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. Many of the issues associated with staffing in a small business are discussed in Section 12.4.

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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 177; David L. Kurtz, *Contemporary Business* (Hoboken, NJ: John Wiley & Sons, 2011), 257. 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."William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 224.

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.Kurt Lewin, Ronald Lippitt, and Ralph K. White, "Patterns of Aggressive Behavior in Experimentally Created 'Social Climates,'" *Journal of Social Psychology* 10, no. 2 (1939): 269–99. 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.Don Clark, "Leadership Styles," *Big Dog and Little Dog's Performance Juxtaposition*, June 13, 2010, accessed February 2, 2012.

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.Kurt Lewin, "Lewin's Leadership Styles," *Changing Minds*, accessed February 2, 2012; Don Clark, "Leadership Styles," *Big Dog and Little Dog's Performance Juxtaposition*, June 13, 2010, accessed February 2, 2012.

Lewin et al. found that this style creates the most discontent.Kurt Lewin, Ronald Lippitt, and Ralph K. White, "Patterns of Aggressive Behavior in Experimentally Created 'Social Climates,'" *Journal of Social Psychology* 10, no. 2 (1939): 269–99. 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.Kurt Lewin, "Lewin's Leadership Styles," *Changing Minds*, accessed February 2, 2012, ; Don Clark, "Leadership Styles," *Big Dog and Little Dog's Performance Juxtaposition*, June 13, 2010, accessed February 2, 2012. 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."Participative Leadership," *Changing Minds*, accessed February 2, 2012. 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.Kurt Lewin, "Lewin's Leadership Styles," *Changing Minds*, accessed February 2, 2012; Don Clark, "Leadership Styles," *Big Dog and Little Dog's Performance Juxtaposition*, June 13, 2010, accessed February 2, 2012. In experiments that Lewin et al. conducted with others, the democratic leadership style was revealed as the most effective.Kurt Lewin, Ronald Lippitt, and Ralph K. White, "Patterns of Aggressive Behavior in Experimentally Created 'Social Climates,'" *Journal of Social Psychology* 10, no. 2 (1939): 269–99.

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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 178. 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.Kurt Lewin, "Lewin's Leadership Styles," *Changing Minds*, accessed February 2, 2012; Don Clark, "Leadership Styles," *Big Dog and Little Dog's Performance Juxtaposition*, June 13, 2010, accessed February 2, 2012. However, this is not the style to use if the leader wants to blame others when things go wrong.Don Clark, "Leadership Styles," *Big Dog and Little Dog's Performance Juxtaposition*, June 13, 2010, accessed February 2, 2012. 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.Kurt Lewin, Ronald Lippitt, and Ralph K. White, "Patterns of Aggressive Behavior in Experimentally Created 'Social Climates,'" *Journal of Social Psychology* 10, no. 2 (1939): 269–99; Kurt Lewin, "Lewin's Leadership Styles," *Changing Minds*, accessed February 2, 2012.

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."Susan Ward, "5 Keys to Leadership for Small Business," *About.com*, accessed February 2, 2012.

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."Post-hoc Management," *Changing Minds*, accessed February 2, 2012.
- **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."Micromanagement," *Changing Minds*, accessed February 2, 2012.
- **Seagull management.** This humorous term is used to describe a management style whereby a person flies in, poops on you, and then flies away."Leadership Styles," *Changing Minds*, accessed February 2, 2012. 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."Seagull Management," *Changing Minds*, accessed February 2, 2012.

- **Mushroom management.** This manager plants you knee-deep (or worse) in the smelly stuff and keeps you in the dark."Leadership Styles," *Changing Minds*, accessed February 2, 2012. 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."Leadership Styles," *Changing Minds*, accessed February 2, 2012. 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."William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 224. Controlling provides feedback for future planning activities and aims to modify behavior and performance when deviations from plans are discovered.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 176. There are four commonly identified steps in the controlling process.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 176; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 224. (Figure 9.2.2.) **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.

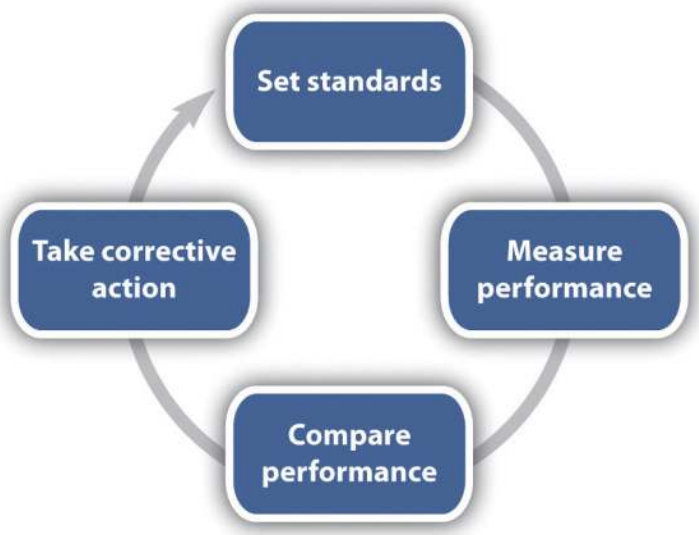


Figure 9.2.2: The Controlling Function

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** (Figure 9.2.3), 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.

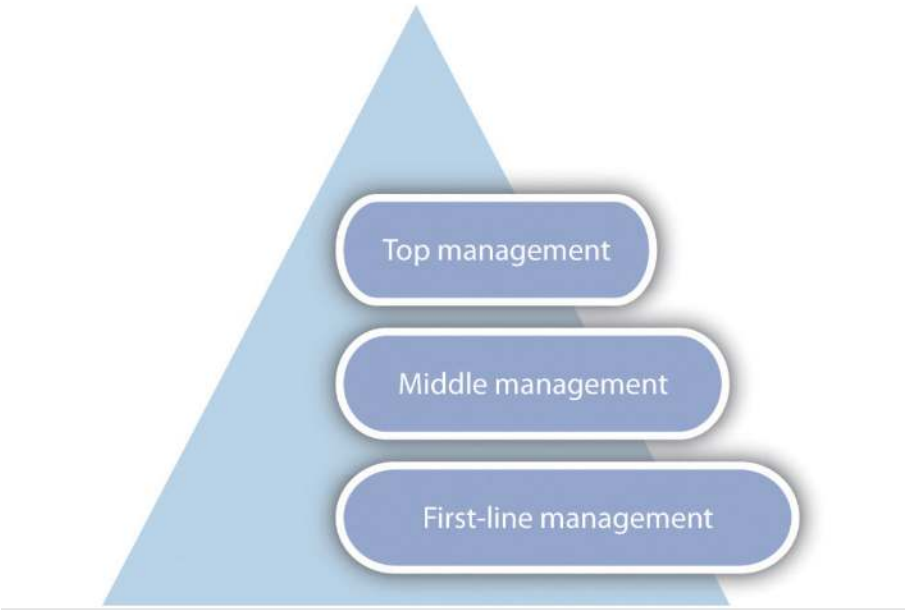


Figure 9.2.3: The Management Hierarchy

Top management, also referred to as the executive level, guides and controls the overall fortunes of a business.William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 226. 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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 183.

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.David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 255.

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.David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 255. 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.William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 227. Examples of first-line positions include supervisor, section chief, office manager, foreman, and team leader.David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 255; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 227.

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.John Seiffer, "3 Levels of Management," *Better CEO*, April 14, 2006, accessed June 1, 2012. 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."Samuel C. Certo and S. Trevis Certo, *Modern Management: Concepts and Skills* (Upper Saddle River, NJ: Prentice Hall, 2012), 11. Possessing management skill is generally considered a requirement for success.Les Worral and Cary Cooper, "Management Skills Development: A Perspective on Current Issues and Setting the Future Agenda," *Leadership & Organization Development Journal* 22, no. 1 (2001): 34–39, as cited in Samuel C. Certo and S. Trevis Certo, *Modern Management: Concepts and Skills* (Upper Saddle River, NJ: Prentice Hall, 2012), 11. An effective manager is the 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."David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 256. These skills are mostly related to working with processes or physical objects. Engineering, accounting, and computer programming are examples of technical skills.Samuel C. Certo and S. Trevis Certo, *Modern Management: Concepts and Skills* (Upper Saddle River, NJ: Prentice Hall, 2012), 11. 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."David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 257. 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,"David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 256. 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** (Figure 9.2.4), 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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 188.

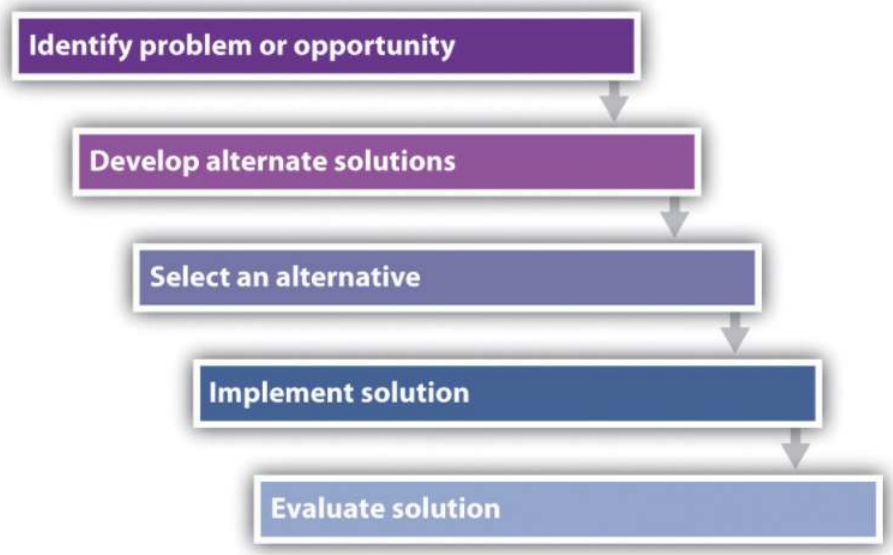


Figure 9.2.4: Management Decision Making

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.”“Decision Making,” *eNotes*, March 17, 2011, accessed June 1, 2012, www.enotes.com/decision-makin...-making-178403.

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.“A Framework for Thinking Ethically,” *Santa Clara University*, accessed June 1, 2012, www.scu.edu/ethics/practicing/decision/framework.html. 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

1. 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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9.3: Organizational Design

Learning Objectives

1. Understand why an organizational structure is necessary.
2. Understand organizational principles.
3. Explain the guidelines for organizing a small business.
4. 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. David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 272. 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.Hal Babson and John Bowen, *Instructor's Manual to Accompany Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2004), 8–9.

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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 199. Each small business must decide what organizational design best fits the business.

Fundamentals of Organization

Ivancevich and DueningJohn M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 200–204. 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."John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 200–204. 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.William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 263. 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:"Reinventing the Strategic Communicator," *Strategic Communication Management*, August/September 2001, 32–35, as cited in John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 201.

1. What is my job?
2. How am I doing?

3. Does anyone care?
4. How are we doing?
5. What are our vision, mission, and values?
6. 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 Organizational Structure—What Is It?,” *The Business Plan*, accessed February 2, 2012, www.the-business-plan.com/formal-organizational-structure.html. 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.“Formal Organizational Structure—What Is It?,” *The Business Plan*, accessed February 2, 2012, www.the-business-plan.com/formal-organizational-structure.html.

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.Marshall Goldsmith and Jon Katzenbach, “Navigating the ‘Informal’ Organization,” *Bloomberg BusinessWeek*, February 14, 2007, accessed February 2, 2012, www.BusinessWeek.com/careers/content/feb2007/ca20070214_709560.htm. 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.”Charles Hall, *Getting Results…for the Hands-On Manager* (Saranac Lake, NY: American Management Association, 1986), 40–42. 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.”William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 264. Small business owners must acknowledge the existence of the grapevine and figure out how to use it constructively.

Video Clip 12.1

Leading Outside the Lines



The formal and informal organizations need to work together to sustain peak performance over time.

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.“Introduction to Organizational Charts,” *OrgChart.net*, July 18, 2011, accessed February 2, 2012, www.orgchart.net/wiki/Main_Page. 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.“Organization Charts,” *Small Business Notes*, accessed February 2, 2012, www.smallbusinessnotes.com/managing-your-business/organization-charts.html. Figure 9.3.1 illustrates a simple organization chart for a one-person retail business.“Organization Charts,” *Small Business Notes*, accessed February 2, 2012, www.smallbusinessnotes.com/managing-your-business/organization-charts.html.

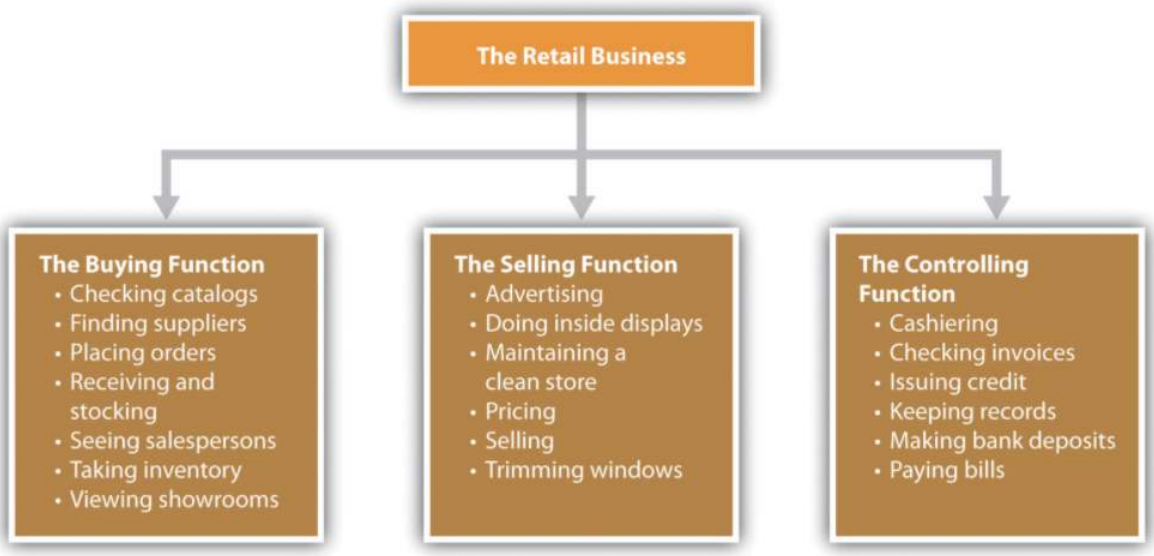


Figure 9.3.1: Copy and Paste Caption here. (Copyright; author via source)

Organization charts offer the following benefits:“Introduction to Organizational Charts,” *OrgChart.net*, March 16, 2011, accessed February 2, 2012, www.orgchart.net/wiki/Main_Page; “Organization Chart,” *12 Manage—The Executive Fast Track*, accessed February 2, 2012. 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

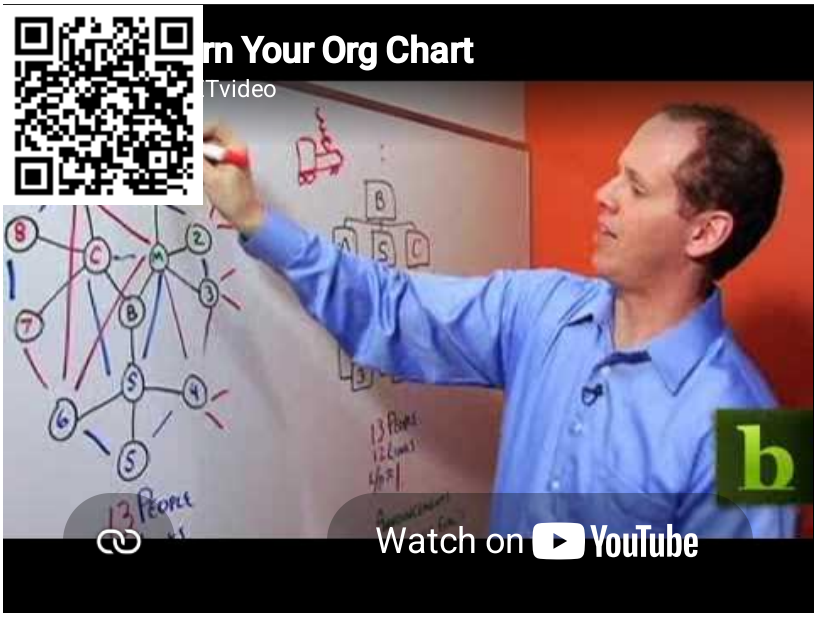
There are, of course, several limitations to organization charts:“Organization Chart,” *12Manage—The Executive Fast Track*, accessed February 2, 2012.

- 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.William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 247. 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 12.2

Burn Your Org Chart



Not all organizational charts reflect the real world.

Formal authority is "the right to give orders and set policy."John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 203. 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.Samuel C. Certo and S. Trevis Certo, *Modern Management: Concepts and Skills* (Upper Saddle River, NJ: Prentice Hall, 2012), 276; John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 203. 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.Samuel C. Certo and S. Trevis Certo, *Modern Management: Concepts and Skills* (Upper Saddle River, NJ: Prentice Hall, 2012), 278. **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."John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 203. The day-to-day tasks of those with line authority involve working directly toward accomplishing an organization's mission, goals, and objectives.K. J. Henderson, "Features of the Line & Staff Organization Structure," *Chron.com*, accessed February 2, 2012, smallbusiness.chron.com/features-line-staff -organization-structure-449.html. 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.Samuel C. Certo and S. Trevis Certo, *Modern Management: Concepts and Skills* (Upper Saddle River, NJ: Prentice Hall, 2012), 278. 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.Samuel C. Certo and S. Trevis Certo, *Modern Management: Concepts and Skills* (Upper Saddle River, NJ: Prentice Hall, 2012), 283; John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 204.

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.Zhiang Lin and Kathleen M. Carley, "Organizational Design and Adaptation in Response to Crises: Theory and Practice," *Academy of Management Proceedings*, 2001, B1–B6. A noncrisis or a normal work situation would favor decentralized decision making and encourages employee empowerment and delegated authority.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 204. 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."Francis Fukuyama, "Why There Is No Science of Public Administration," *Journal of International Affairs*, Fall 2004, 189–201. 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.Samuel C. Certo and S. Trevis Certo, *Modern Management: Concepts and Skills* (Upper Saddle River, NJ: Prentice Hall, 2012), 33; John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 205–206.

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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 207. 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."Principles of Management," *Management Study Guide*, accessed February 2, 2012, www.managementstudyguide.com/management_principles.htm. 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.Samuel C. Certo and S. Trevis Certo, *Modern Management: Concepts and Skills* (Upper Saddle River, NJ: Prentice Hall, 2012), 33; John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 206. 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."Marce Kelly and Jim McGowen, *BUSN* (Mason, OH: South-Western, 2008), 206. 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.Ashim Gupta, "Organization's Size and Span of Control," *Practical Management*, January 10, 2010, accessed February 2, 2012; Marce Kelly and Jim McGowen, *BUSN* (Mason, OH: South-Western, 2008), 206; David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 275. 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."John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 207. 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."Patricia M. Buhler, "Changing Organizational Structures and Their Impact on Managers," *Supervision*, 2011, 24–26. 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."A Strong Business Organization Structure Is Paramount to Business Success," *The Business Plan*, accessed February 2, 2012. 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 9.3.2 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)."Small Business Management Skills," *How to Start a Small Business*, accessed February 2, 2012. As a small business grows, the need for additional departments will grow as well.

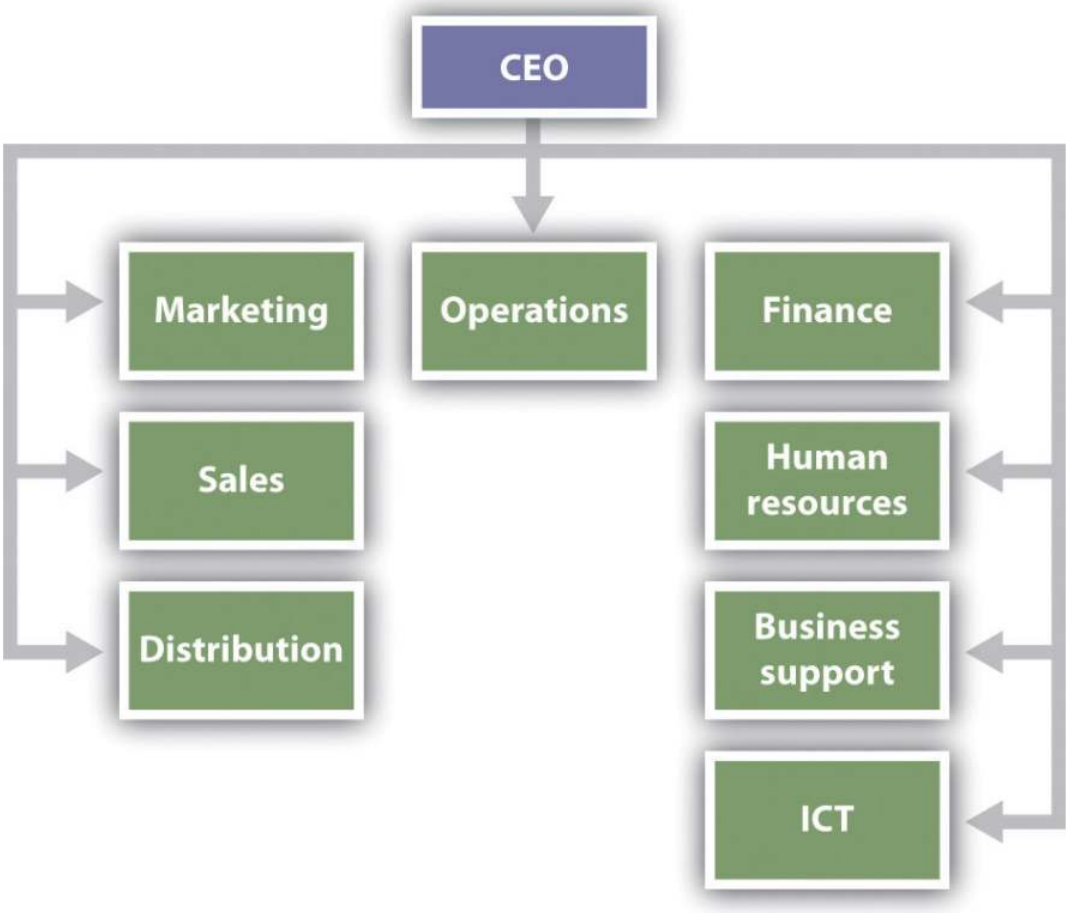


Figure 9.3.2: An Example of a Functional Structure"*Small Business Management Skills,*" *How to Start a Business, accessed February 2, 2012*

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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 210; Kristie Lorette, "Organizational Structure Types in Companies," *Chron.com*, accessed February 2, 2012, smallbusiness.chron.com/organizational-structure-types-companies-2791 .html.

At the same time, the functional structure can create divisions between departments if conflict occurs,Kristie Lorette, "Organizational Structure Types in Companies," *Chron.com*, accessed February 2, 2012, smallbusiness.chron.com/organizational-structure-types -companies-2791.html. and it can become an obstruction if the objectives and the environment of the business require coordination across departments.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 211.

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).Kristie Lorette, "Organizational Structure Types in Companies," *Chron.com*, accessed February 2, 2012, smallbusiness.chron.com/organizational-structure-types -companies-2791.html. (See Figure 9.3.3 for an example of a divisional structure.)

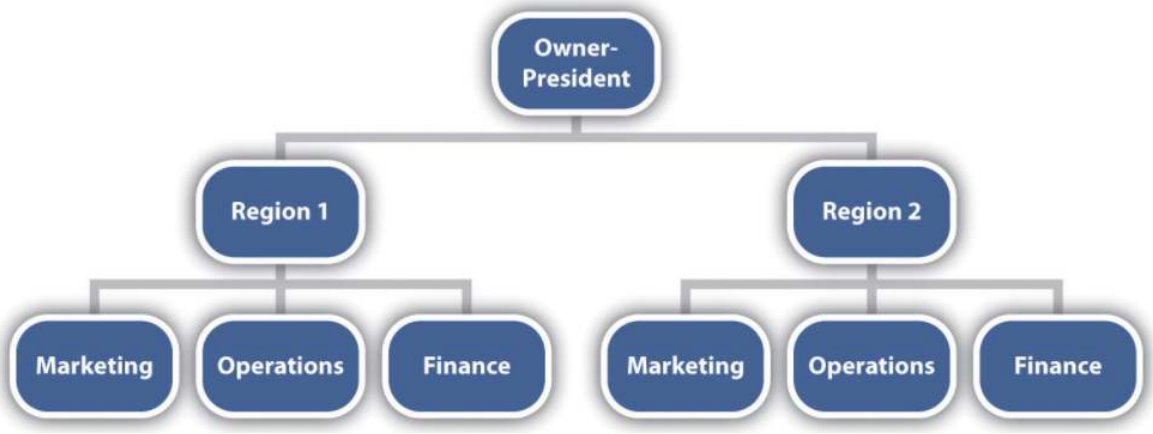


Figure 9.3.3: An Example of a Divisional Structure

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."Jason Gillikin, "Advantages and Disadvantages of Divisional Organizational Structure," *Chron.com*, accessed February 2, 2012, smallbusiness.chron.com/advantages-disadvantages-divisional-organizational-structure-611.html. 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.Jason Gillikin, "Advantages and Disadvantages of Divisional Organizational Structure," *Chron.com*, accessed February 2, 2012, smallbusiness.chron.com/advantages-disadvantages-divisional-organizational-structure-611.html.

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 9.3.4: 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.Marce Kelly and Jim McGowen, *BUSN* (Mason, OH: South-Western 2008), 208; David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 278; Kristie Lorette, "Organizational Structure Types in Companies," *Chron.com*, accessed February 2, 2012, smallbusiness.chron.com/organizational -structure-types-companies-2791.html. 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;Robert C. Ford and W. Alan Randolph, "Cross-Functional Structures: A Review and Integration of Matrix Organization and Project Management," *Journal of Management*, June 1992, 2. 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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 214; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 259. 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.Jay R. Galbraith, "Matrix Is the Ladder to Success," *Bloomberg BusinessWeek*, August 2009, accessed February 2, 2012, www.BusinessWeek.com/debateroom/archives/2009/08/matrix_is_the_l.html.

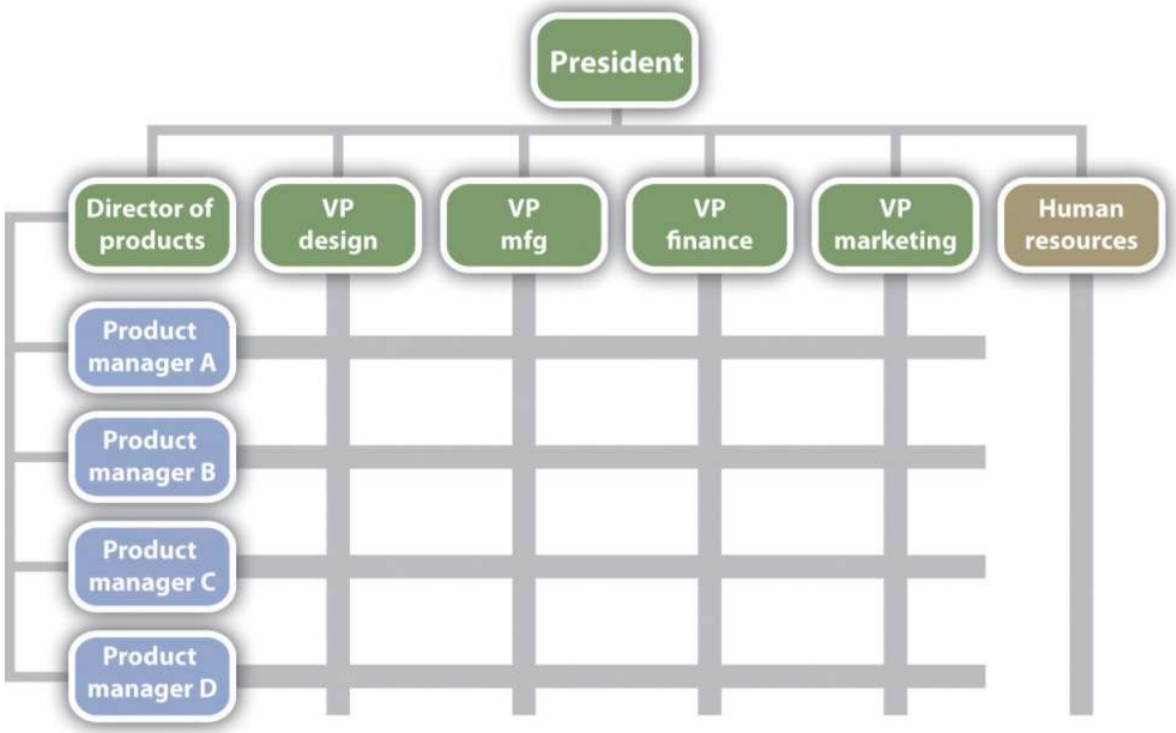


Figure 9.3.4: An Example of a Matrix Structure "*Sample Organization Charts: Matrix Organizational Structure,*" *Vertex41.com*, *accessed February 2, 2012.*

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 9.3.5 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.Manju K. Ahuja and Kathleen M. Carley, "Network Structure in Virtual Organizations," *Organization Science* 10, no. 6 (November 1999): 741–57; Les Phang, "Understanding Virtual Organizations," *ISACA Journal* 6 (2001): 42–47; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 260.

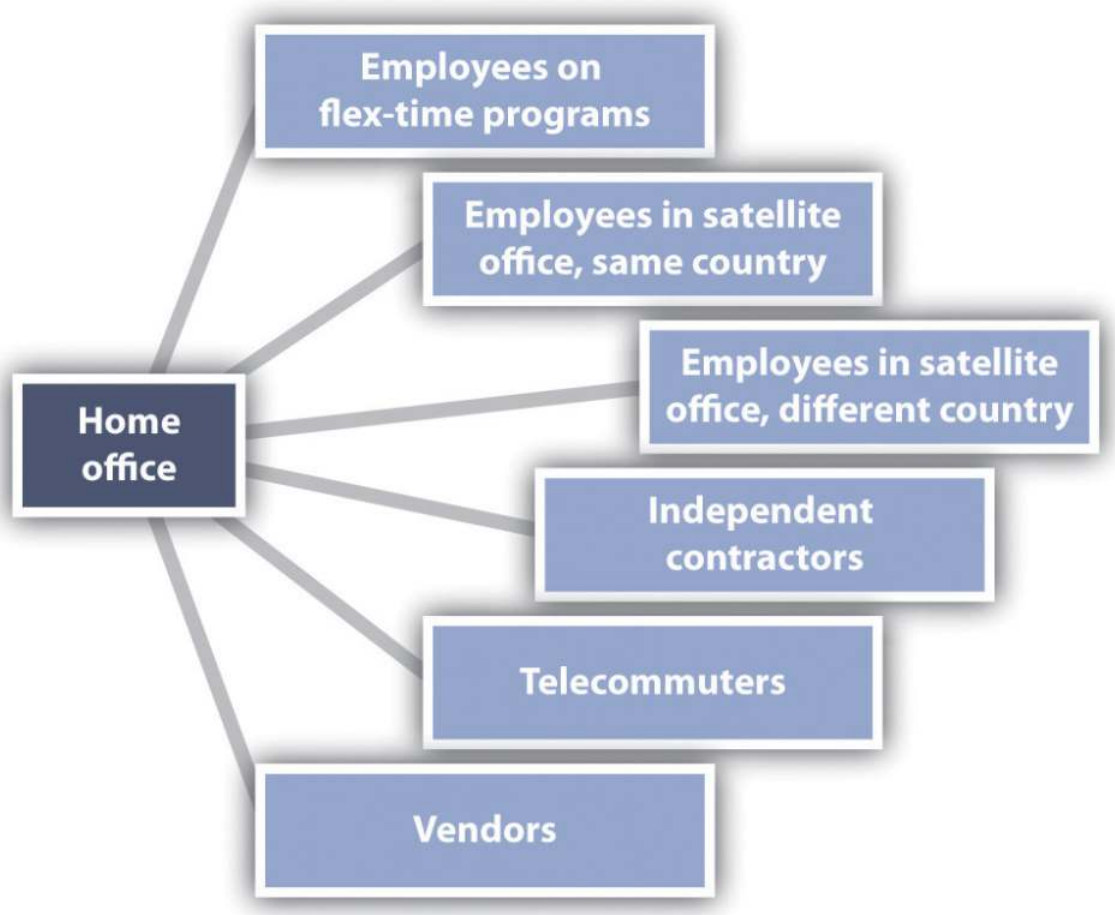


Figure 9.3.5: An Example of a Virtual Organization *"Supporting Skills," Eviton, Inc., accessed February 2, 2012, http://eviton.com/organizations.htm*

Figure 12.9 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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 214; Les Phang, "Understanding Virtual Organizations," *ISACA Journal* 6 (2001): 42–47. 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. John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 214; Les Phang, "Understanding Virtual Organizations," *ISACA Journal* 6 (2001): 42–47.

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.""Return on Investment—ROI," *Investopedia*, accessed February 2, 2012. **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.”“Return on Assets—ROA,” *Investopedia*, accessed February 2, 2012.

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.“A Strong Business Organization Structure Is Paramount to Business Success,” *The Business Plan*, accessed February 2, 2012.

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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9.4: Legal Forms of Organization for the Small Business

Learning Objectives

1. Understand the different legal forms that a small business can take.
2. Explain the factors that should be considered when choosing a legal form.
3. Understand the advantages and disadvantages of each legal form.
4. 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:[citation redacted per publisher request]; "Small Business Planner: Choose a Structure," *US Small Business Association*, accessed February 3, 2012, archive.sba.gov/smallbusinessplanner/start/chooseastructure/index.html.

- **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."Limited Liability Company," *Entrepreneur.com*, July 9, 2007, accessed February 3, 2012, www.entrepreneur.com/article/24484.

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 TTable 9.4.1). Sole proprietorships are very popular, comprising 72 percent of all businesses and nearly $1.3 trillion in total revenue.US Internal Revenue Service, "Selected Returns and Forms Filed or to Be Filed by Type During Specified Calendar Years 1980–2005," SOI Bulletin, Historical Table, Fall 2004, as cited in John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 60. 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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 60; adapted from David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 163. Clearly, the sole proprietorship is the choice for most small businesses.

Table 9.4.1: 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

Source: John M. Ivancevich and Thomas N. Duening, *Business: Principles, Practices, and Guidelines* (Mason, OH: Atomic Dog Publishing, 2007), 60; David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 163; "How to Choose the Right Business Structure for Your Small Business," *National Federation of Independent Business*, accessed February 3, 2012; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 150–51.

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.William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 150. Like the sole proprietorship, the partnership does not distinguish between the business and its owners (see Table 12.2). 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.""Small Business Planner: Choose a Structure," *US Small Business Association*, accessed February 3, 2012, archive.sba.gov/smallbusinessplanner/start/chooseastructure/index.html.

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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 60; David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 163; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 150.

Before creating a partnership, the partners should get to know each other. According to Michael Lee Stallard, cofounder 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."Shelley Banjo, "Before You Tie the Knot…," *Wall Street Journal*, November 26, 2007, accessed February 3, 2012.

Table 9.4.2: 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

Source: John M. Ivancevich and Thomas N. Duening, *Business: Principles, Practices, and Guidelines* (Mason, OH: Atomic Dog Publishing, 2007), 64–65; David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 163; "How to Choose the Right Business Structure for Your Small Business," *National Federation of Independent Business*, accessed February 3, 2012; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 154–55; "Small Business Planner—Choose a Structure," *US Small Business Administration*, accessed February 3, 2012.

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" William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 157. (see Table 12.3). Corporations make up 20 percent of all businesses in the United States, but they account for almost 90 percent of the revenue. Jeff Madura, *Introduction to Business* (St. Paul, MN: Paradigm Publishers International, 2010), 150. 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. Matthew Bandyk, "Turning Your Small Business into a Corporation," *US News & World Report*, March 14, 2008, accessed February 3, 2012.

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.Matthew Bandyk, "Turning Your Small Business into a Corporation," *US News & World Report*, March 14, 2008, accessed February 3, 2012. 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.Matthew Bandyk, "Turning Your Small Business into a Corporation," *US News & World Report*, March 14, 2008, accessed February 3, 2012. 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 9.4.3: 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

Source: "How—and Why—to Incorporate Your Business," *Entrepreneur*, accessed February 3, 2012, ; John M. Ivancevich and Thomas N. Duening, *Business: Principles, Practices, and Guidelines* (Mason, OH: Atomic Dog Publishing, 2007), 64–65; "How to Choose the Right Business Structure for Your Small Business," *National Federation of Independent Business*, accessed February 3, 2012; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 154–55.

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."How to Choose the Right Business Structure for Your Small Business," *National Federation of Independent Business*, accessed February 3, 2012. 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 9.4.4"). "LLCs were created to provide business owners with the liability protection that corporations enjoy without the double taxation.""Limited Liability Company," *Entrepreneur.com*, July 9, 2007, accessed February 3, 2012.

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."Annalyn Censky, "Business Structures 101," *CNN Money*, August 4, 2008, accessed February 3, 2012. 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.Annalyn Censky, "Business Structures 101," *CNN Money*, August 4, 2008, accessed February 3, 2012.

Table 9.4.4: 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

Source: Annalyn Censky, "Business Structures 101," *CNN Money*, August 4, 2008, accessed February 3, 2012; "Limited Liability Company," *Entrepreneur.com*, accessed February 3, 2012; John M. Ivancevich and Thomas N. Duening, *Business: Principles, Practices, and Guidelines* (Mason, OH: Atomic Dog Publishing, 2007), 64–65; "How to Choose the Right Business Structure for Your Small Business," *National Federation of Independent Business*, accessed February 3, 2012; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 159.

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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9.5: People

Learning Objectives

1. Understand the complexities of hiring, retaining, and terminating employees.
2. Be aware of the laws that apply to businesses of all sizes and specifically to small businesses of certain sizes.
3. Understand outsourcing: what it is; when it is a good idea; and when it is a bad idea.
4. 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.“Human Resources,” *Small Business Notes*, accessed June 1, 2012, www.smallbusinessnotes.com/managing-your-business/human-resources. 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. David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 288. 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 9.5.1 illustrates the basics of any hiring process, whether for a sole proprietorship or a large multinational corporation.

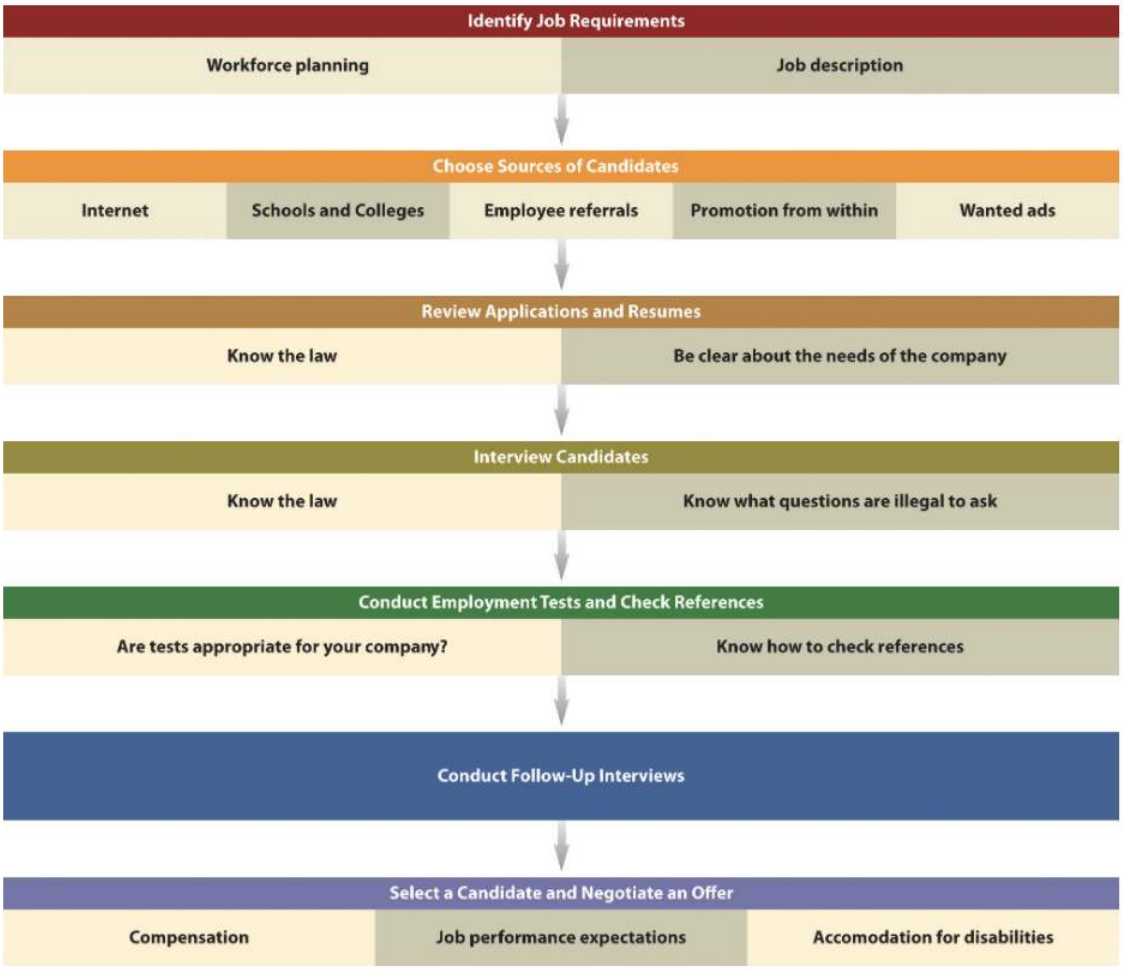


Figure 9.5.1: Steps in the Hiring Process *Adapted from David L. Kurtz, Contemporary Business, 13th Edition Update (Hoboken, NJ: John Wiley & Sons, 2011), 289.*

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,""Workforce Planning," accessed February 3, 2012, . 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.William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 159. 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."Job Descriptions," *Small Business Notes*, accessed February 3, 2012.

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."When Is It Better to Promote from Within Your Company?," *AllBusiness*, accessed February 3, 2012. 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."Hiring Issues," *Small Business Notes*, accessed February 3, 2012.
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.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 299. 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."Labor Laws Governing Employers," *Small Business Notes*, accessed February 3, 2012, . 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?"John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 303. 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."Interviewing Guidelines," *Small Business Notes*, accessed February 3, 2012. 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."Employment Testing and Selection," *Chron.com*, accessed February 3, 2012, smallbusiness.chron.com/employment-testing-selection-4794.html. 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. John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 304–305. 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 preemployment 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."Employment Testing and Selection," *Chron.com*, accessed February 3, 2012, smallbusiness.chron.com/employment-testing-selection-4794.html. Just be sure that all employment tests can be linked to a business necessity."Employment Testing and Selection," *Chron.com*, accessed February 3, 2012, smallbusiness.chron.com/employment-testing-selection-4794.html.

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."How to Request References," University of Texas at Austin Human Resource Services, accessed February 3, 2012.

Unfortunately, many former employers are reluctant to reveal anything other than an employee's date of hire and departure and job title,"Hiring Issues," *Small Business Notes*, accessed February 3, 2012. 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.Alison Doyle, "Reference Check Questions," *About.com*, accessed February 3, 2012.

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.David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 294–95.**Salaries** are typically calculated weekly, biweekly, or monthly. They are usually paid to office personnel, executives, and professional employees.David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 295. 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.David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 296. 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."Employee Benefits," *Small Business Notes*, accessed February 3, 2012, . 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."Employee Benefits," *Small Business Notes*, accessed February 3, 2012. 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."Improve Your Employee Retention Rate," *Small Business Notes*, accessed February 3, 2012.

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."Setting Clearer Performance Expectations," *SmallBusinessLand.com*, accessed February 3, 2012, www.smallbusinessland.com/article/setting-clearer -performance-expectations.html.

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."What Is Reasonable Accommodation?," *Marines*, accessed February 27, 2012. 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.Robert I. Sutton, "Quiz: Are You Hiring and Breeding Greedy and Selfish Employees?," *Fast Company*, September 2, 2010, accessed February 3, 2012.

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."Improve Your Employee Retention Rate," *Small Business Notes*, accessed February 3, 2012.

Because of the costly and time-consuming nature of hiring new employees, many companies today increasingly emphasize retaining productive people.John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 295. 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."John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 309. 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 and Development," *Inc.com*, accessed February 3, 2012. 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. John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 309. 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"Building a Better Benefits Program without Breaking the Budget: Five Practical Steps Every Small Business Should Consider," *MetLife*, 2010, accessed February 3, 2012, www.metlife.com/assets/institutional/services/insights-and-tools/ebts/small-market -whitepaper-v2.pdf. 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 9.5.2:).

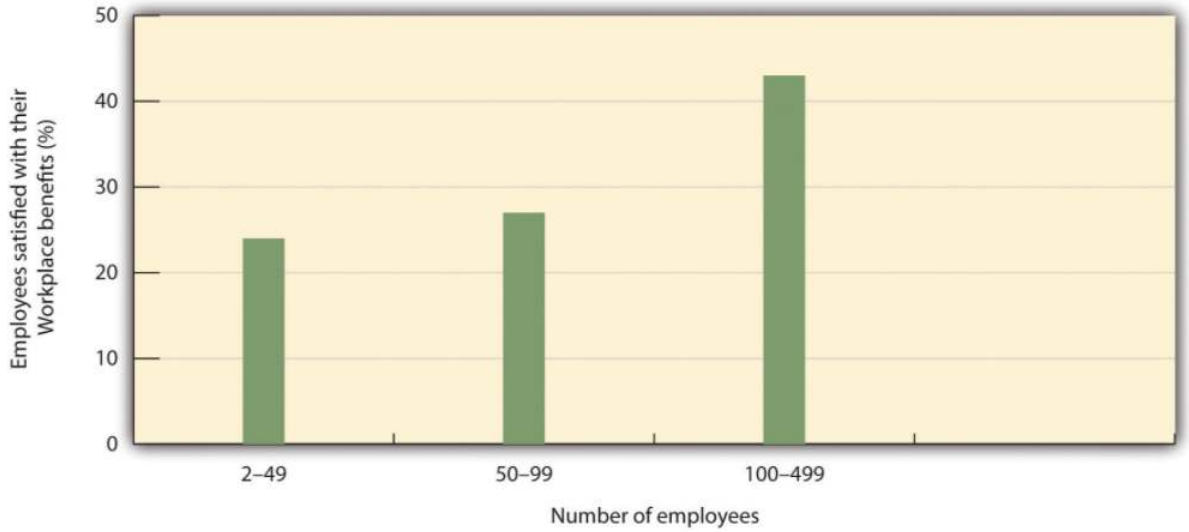


Figure 9.5.2: Benefits Satisfaction in Small Businesses. *"Building a Better Benefits Program without Breaking the Budget:Five Practical Steps Every Small Business Should Consider," MetLife, 2010, accessed February 3, 2012.*

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,"Employee Incentives for Small Business," *Yahoo! Voices*, May 24, 2007, accessed February 3, 2012, voices.yahoo.com/employee-incentives-small-business -359161.html. but to increase employee retention and attract the best and brightest, there will need to be more.Sharon McLoone, "How Do I…Offer Employee Incentives," *Washington Post*, December 4, 2008, voices.washingtonpost.com/small-business/2008/12/how do ioffer employee incenti.html. Creating a sense of community, offering leadership opportunities, creating a culture of recognition, and constantly offering opportunity can be powerful incentives."Employee Incentive Programs on a Small Business Budget," *Small Business Notes*, accessed February 3, 2012. 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.""Report: Cost-Effective Benefits Strategies for Small Businesses," *ESBJournal.com*, October 19, 2010, accessed February 3, 2012.

Video Clip 9.5.1:

Keeping Small Business Employees



Some ideas for keeping small business employees. They begin with a good job description.

Termination

Termination or firing will always be unavoidably painful,"Employee Termination," *Inc.com*, accessed February 3, 2012. 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."Employee Termination," *Inc.com*, accessed February 3, 2012. 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.""Employees: Job Termination Rights FAQs," *Lawyers.com*, accessed February 3, 2012.
- **Termination for cause.** When someone is terminated for cause, that person is being fired for a specific reason,Alison Doyle, "Terminated for Cause," *About.com*, accessed February 3, 2012one 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.Alison Doyle, "Terminated for Cause," *About.com*, accessed February 3, 2012; "Employee Termination," *Inc.com*, accessed February 3, 2012. 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.""Facts about Sexual Harassment," *US Equal Employment Opportunity Commission*, June 27, 2002, accessed February 3, 2012.

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."Employee Termination: Informing Other Employees," *Small Business Notes*, accessed February 3, 2012. 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."Employee Termination: Informing Other Employees," *Small Business Notes*, accessed February 3, 2012.

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."The Benefits of Outsourcing for Small Businesses," *New York Times*, January 1, 2008, accessed February 3, 2012, . Small business owners routinely outsource a range of services, such as landscaping; building, utility, and furniture maintenance; distribution; and cleaning.Joanna L. Krotz, "Tips for Outsourcing Your Small-Business Needs," *Microsoft*, accessed February 3, 2012, www.microsoft.com/business/en-us/resources/management/recruiting-staffing/tips-for-outsourcing-your-small-business-needs .aspx?fbid=WTbndqFrlli#T; David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 303. 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.David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 303.

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."The Benefits of Outsourcing for Small Businesses," *New York Times*, January 1, 2008, accessed February 3, 2012, . 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."David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 303. 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:Joanna L. Krotz, "Tips for Outsourcing Your Small-Business Needs," *Microsoft*, accessed February 3, 2012, www.microsoft.com/business/en-us/resources/management/recruiting-staffing/tips-for-outsourcing-your-small-business-needs .aspx?fbid=WTbndqFrlli#T.

- **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.Peter Emerson, "Accounts Receivable Outsourcing," *Streetdirectory.com*, accessed February 3, 2012. As a small business grows, the process of collecting accounts receivable may become too cumbersome to handle without collection agencies becoming involved."When Does Outsourcing Accounts Receivables Make Sense," *Streetdirectory.com*, accessed February 3, 2012.
- **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.Joanna L. Krotz, "Tips for Outsourcing Your Small-Business Needs," *Microsoft*, accessed February 3, 2012, www.microsoft.com/business/en-us/resources/management/recruiting-staffing/tips-for-outsourcing-your-small-business-needs .aspx?fbid=ZR0tpRAO-q#T.
- **Public relations and marketing services.** These services are costly, require specialized expertise, and are not usually full-time needs."When Does Outsourcing Accounts Receivables Make Sense," *Streetdirectory.com*, accessed February 3, 2012. 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.Adapted from Joanna L. Krotz, "Tips for Outsourcing Your Small-Business Needs," *Microsoft*, accessed February 3, 2012, www.microsoft.com/business/en-us/resources/management/recruiting-staffing/tips-for-outsourcing-your-small-business-needs .aspx?fbid=ZR0tpRAO-q#T.
- **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."Benefits Packages for Emerging Businesses: Creating Long-Term Value for Your Employees," *Monster Hiring Center*, accessed February 3, 2012 Given the vast complexities of health care, including health-care 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"Business Law and Regulations," *US Small Business Association*, accessed February 3, 2012. "Small Business Planner: Protect Your Ideas," *US Small Business Administration*, accessed February 3, 2012; adapted from William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 159.

  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,Rob Johnson, "Legal Advice…

on a Budget," *Wall Street Journal*, November 15, 2010, accessed February 3, 2012. 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."When Does Outsourcing Accounts Receivables Make Sense," *Streetdirectory.com*, accessed February 3, 2012, 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."When Outsourcing Is Not a Good Idea," *Streetdirectory.com*, accessed February 3, 2012. 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."The Benefits of Outsourcing for Small Businesses," *New York Times*, January 1, 2008, accessed February 3, 2012.

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 extracompany 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."Technology: Your Roadmap to Small-Business Success," *Intel*, accessed February 3, 2012. 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.Donna Fuscaldo, "Using Social Networking to Boost Office Productivity," *Fox Business*, November 12, 2010, accessed February 3, 2012, . 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."Donna Fuscaldo, "Using Social Networking to Boost Office Productivity," *Fox Business*, November 12, 2010, accessed February 3, 2012,. 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.Brent Leary, "The iPad: Changing How We Build Business Relationships," *Inc.com*, May 2010, accessed February 3, 2012. 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.Ken Burgin, "20 Ways an iPad can Improve Your Restaurant, Café, Hotel or Bar," *ProfitableHospitality.com*, March 14, 2011, accessed February 3, 2012, profitablehospitality.com/news/index.php/kitchen-management/20-ways-an-ipad -can-improve-your-restaurant-cafe-hotel-or-bar. Just want to take notes? Use Evernote. Michael Hyatt, "How to Use Evernote with an iPad to Take Meeting Notes," accessed February 3, 2012, michaelhyatt.com/how-to-use-evernote-with-an-ipad-to-take-meeting-notes.html. 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.Ken Burgin, "20 Ways an iPad can Improve Your Restaurant, Café, Hotel or Bar," *ProfitableHospitality.com*, March 14, 2011, accessed February 3, 2012, profitablehospitality.com/news/index.php/kitchen-management/20-ways-an -ipad-can-improve-your-restaurant-cafe-hotel-or-bar. 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.Natalie Zmuda, "iPad Poised to Revolutionize Retail Industry," *Business Insider*, April 24, 2010, accessed February 3, 2012, www.businessinsider.com/ipad-poised -to-revolutionize-retail-industry-2010-4. In real estate, the iPad can be used for buyer consultations, listing presentations, tracking properties, and chatting with clients—just to name a few.Patrick Woods, "Tips for Using the iPad for Real Estate," *PatrickWoods.com*, July 5, 2010, www.patrickwwoods.com/tips-for-using-the-ipad-for-real-estate.

Video Clip 9.5.2:

Using the iPad for Real Estate



Some tips on how to use the iPad in real estate.

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.Liane Cassavoy, "What Is a Smartphone?," *About.com*, accessed February 3, 2012, cellphones.about.com/od/glossary/g/smart defined.htm. 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)**.Christopher Elliott, "5 Ways Smartphones & Servers Boost Productivity," *Microsoft*, accessed February 3, 2012, www.microsoft.com/business/en-us/resources/technology/communications/smartphones-and-business-productivity.aspx?fbid=WTbndqFrlli. A server is a computer or a series of computers that link other computers or electronic devices together."Server (Computing)," *Wikipedia*, February 2010, accessed February 3, 2012, en.Wikipedia.org/wiki/Server (computing). 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."Craig Freudenrich and Carmen Carmack, "How PDAs Work," accessed February 2, 2012. 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.Craig Freudenrich and Carmen Carmack, "How PDAs Work," accessed February 2, 2012.

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.""Evaluating Shift to Online Communication Tools," *Pgi.com*,

accessed February 3, 2012, www.pgi.com/us/en/content/download/7845/130408/file/PGi_WhitePaper_Return%2Bon%2BCollaboration_v05.pdf. A recent study reported that among companies that used collaboration tools, 72 percent reported better business performance."Evaluating Shift to Online Communication Tools," *Pgi.com*, accessed February 3, 2012, www.pgi.com/us/en/content/download/7845/130408/file/PGi_WhitePaper_Return%2Bon%2BCollaboration_v05.pdf. 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.""Web Conferencing Review," *Top Ten Reviews*, accessed February 3, 2012, web-conferencing-services.toptenreviews.com.

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.Ruth Mayhew, "What Are the Advantages & Disadvantages of Virtual Offices and Telecommuting?" *Chron.com*, accessed May 30, 2012, smallbusiness.chron.com/advantages-disadvantages-virtual-offices-telecommuting-1167.html. 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."Analysis Shows Telecommuting Can Cut Persian Gulf Oil Use by Almost Half," *Telecommunte Connecticut*, accessed May 30, 2012; Peter Suciu, "Telecommuting Can Save Employers Money, Too," *AllBusiness.com*, March 9, 2011, accessed February 3, 2012, www.allbusiness.com/labor-employment/working-hours-patterns_-telecommuting/15480193-1.html.

The advantages of virtual employees include the following:"Flexible Telecommuting Has Many Benefits for Your Small Business," *AllBusiness.com*, March 9, 2011, accessed February 3, 2012, www.allbusiness.com/labor-employment/working-hours-patterns-telecommuting/11493648-1.html; Peter Suciu, "Telecommuting Can Save Employers Money, Too," *AllBusiness.com*, March 9, 2011, accessed February 3, 2012, www.allbusiness.com/labor-employment/working-hours-patterns-telecommuting/15480193-1.html; James Ware and Charles Grantham, "Flexible Work: Rhetoric and Reality," *Tech Republic*, accessed February 3, 2012, www.techrepublic.com/whitepapers/flexible-work-rhetoric-and-reality/384538.

- 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.Arnold Anderson, "Advantages of Telecommuting Jobs," *Chron.com*, accessed May 30, 2012, http://smallbusiness.chron.com/advan...-jobs-765.html.

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.Stegmeier Consulting Group, "The Business Case for Web Commuting: How to Reduce Workplace Costs and Increase Workforce Performance," *Computer World*, accessed February 3, 2012, www.computerworld.com/pdfs/Citrix_Business_Case_Web_Commuting.pdf. For support with telecommuting challenges, small business owners can tap into The Alternative Board, an organization with three thousand small- and midsized-business owners."Flexible Telecommuting Has Many Benefits for Your Small Business," *AllBusiness.com*, March 9, 2011, accessed February 3, 2012, www.allbusiness.com/labor-employment/working-hours-patterns-telecommuting/11493648-1.html.

Video Link 9.5.3: NOT TO BE FOUND> FIND OTHER VIDEO

Making Telecommuting Work

Looking at telecommuting from the employee and the employer perspectives.

www.cbsnews.com/video/watch/?id=10162239n?tag=bnetdomain

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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9.6: The Three Threads

Learning Objectives

1. Explain how people and organization can add to customer value.
2. Explain how decisions about people and organization can impact cash flow.
3. 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, from "Foundations for Small Business". 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.Jonathan Blum, “Running an Entire Business from Smartphones,” *CNN Money*, March 12, 2008, accessed February 3, 2012.

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.Julie Bos, “Top Trends in Staffing: Is Your Organization Prepared for What Lies Ahead?,” *Workforce*

Management 90, no. 2 (2011): 33–38. 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.""Taleo Business Edition," *Taleo.com*, accessed February 3, 2012. 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

1. 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 word play, 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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CHAPTER OVERVIEW

10: Appendix - A Sample Business Plan

10.1: Executive Summary

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10.1: Executive Summary

The following business plan for Frank's All-American BarBeQue was built using Business Plan Pro software. It is for the purpose of illustration and does not represent the full capabilities of the software.

Frank's All-American BarBeQue has operated for decades in the southern Connecticut shore region. With a tradition of superlative food at fair prices served in a family-friendly atmosphere, the owners now believe it is time to open a second restaurant and expand the production and the distribution of Frank's signature barbecue sauces. This second restaurant will be in Darien, Connecticut, and will be nearly twice as large, in terms of seating capacity, as the current Fairfield restaurant. The company also plans to ramp up production of its sauces and increase their sales fourfold in the next three years.

Objectives

The owners of Frank's All-American BarBeQue and other investors plan to put $160,000 of their own money into the second restaurant and expand the production of the signature sauces. They seek to raise an addition $175,000 from a bank loan that will be repaid in two years.

Mission

Vision Statement

To produce the best barbecue food in New England.

Mission Statement

The mission of Frank's All-American BarBeQue is to provide the southern Connecticut shore region with the finest barbecue food in four major regional styles at affordable prices in a family-friendly setting. As we grow, we will never forget and remain faithful to those factors that have made us a success.

Keys to Success

Frank's All-American BarBeQue has been in business for nearly forty years. It has weathered good times and bad times through all types of economic conditions. We have survived because Frank's has remained committed to several principles.

- The only objective of a restaurant is to serve the finest food it can prepare. Good food—not more gimmicks or advertising—brings in customers and, more importantly, *keeps* customers.
- Preparing the finest foods means a commitment to excellence, which means obtaining the best ingredients and a dedication to cooking barbecue properly, which means cooking carefully and *slowly*.
- In addition to providing the finest food, we remain committed to providing excellent service. To us, this means friendly and knowledgeable staff members who make the customers feel like they are dining with family.
- We provide the right atmosphere. Our goal is to have a setting that says "barbecue." We do not provide a fancy setting; our basic setting complements the food we serve.

Company Summary

Frank's All-American BarBeQue has been a highly successful restaurant in Fairfield, Connecticut, for nearly forty years. It was started and is still managed by Frank Rainsford. Its food and sauces have won awards at both regional and national barbecue cook-offs. In addition, Frank's has been voted the best barbecue establishment in Connecticut numerous times by many local newspapers and magazines.

The management team of Frank's All-American BarBeQue has decided that *now* is the time to expand to an additional location. After careful analysis, a second Frank's All-American BarBeQue can and should be opened in Darien, Connecticut. This restaurant will be larger and geared to better tap into the growing premade, take-home dinner market.

In the last few years, Frank's has been selling its four signature barbecue sauces—Texan, Memphis, Kansas City, and Carolina—in local supermarkets. Although this represents a small portion of overall revenues, sales have been growing at a remarkable pace.

This market must be exploited. Preliminary market research indicates that this segment of the business will grow at 20 percent per year for the next five years.

Company Ownership

Presently, Frank's All-American BarBeQue is a limited liability partnership with Frank Rainsford and his wife Betty as owners. Each has a 50 percent share in the business.

The plans for expansion will bring in capital from three other investors: Robert Rainsford, Susan Rainsford Rogers, and Alice Jacobs. Robert Rainsford and Susan Rainsford Rogers are the son and daughter of Frank and Betty. Both have extensive work experience at Frank's. Alice Jacobs has been the restaurant's accountant for over twenty years.

To assist the financing of the expansion, Robert Rainsford and Susan Rainsford Rogers will each invest $50,000, while Alice Jacobs will invest $60,000.

The new limited liability partnership will result in the investors holding the following equity percentages:

Frank Rainsford	40.00%
Betty Rainsford	40.00%
Robert Rainsford	6.25%
Susan Rainsford Rogers	6.25%
Alice Jacobs	7.50%

Company History

Frank's All-American BarBeQue was founded in 1972 by Frank Rainsford. Although a native New Englander, Frank learned about cooking barbecue while serving in the US Air Force. During his twelve years of service, he traveled across the country and learned about the four major styles of American barbecue—Texas, Memphis, Kansas City, and Carolina. His plan was to introduce people in southern Connecticut to *real* barbecue that entailed high-quality meats properly cooked and smoked over an appropriate length of time.

In the beginning, Frank's All-American BarBeQue was a small facility; it could seat about thirty people. It was located near the Fairfield railroad station and was the first full-service barbecue restaurant in Fairfield. Frank's placed an emphasis on featuring the food; it had a highly simplified decor where the tables were covered with butcher paper, not linen tablecloths. The restaurant was an immediate hit, received considerable local press, and won several food awards. This success enabled Frank's to move to a larger facility in Fairfield on the town's main thoroughfare—Boston Post Road. The new location was a midsize restaurant of about eighty seats. Frank has built this location into a relatively successful and locally well-known enterprise. It has been at the present location since the early 1980s. It shares a parking lot with several other stores in the small mall in which it is located.

Frank's has won many awards at regional and national barbecue cook-offs (for both the food and the sauces), which is unusual for a barbecue business in New England. The restaurant has been written up, repeatedly, in the local and New York papers for the quality of its food and its four signature barbecue sauces. In the last few years, Frank's has sold small lots of these sauces in local supermarkets. They have been distributed because of Frank's personal connections with the store managers. Frank Rainsford has been approached by a major regional supermarket to sell his sauces. The supermarket is willing to find a facility that could produce Frank's sauces in significantly larger volumes, which would represent a substantial increase in the sales of sauces. Table 10.1.1 provides a summary of key financial figures for the last three years—2008 to 2010. Table 10.1.1 illustrates these key numbers for that period of time.

Table 10.1.1: Past Performance of Frank's All-American BarBeQue

Past Performance	2008	2009	2010
Sales	$1,637,610	$1,696,564	$1,793,268
Gross margin	$851,557	$909,358	$943,259
Gross margin %	52.00%	53.60%	52.60%
Operating expenses	$542,080	$577,315	$600,408
Inventory turnover	13.20	12.10	12.90
Balance Sheet			
Current Assets			
Cash	$102,665	$125,172	$102,665
Inventory	$391,238	$331,045	$345,678
Other current assets	$278,372	$230,074	$278,372
Total current assets	$772,275	$686,291	$726,715
Long-Term Assets			
Long-term assets	$504,580	$388,820	$423,675
Accumulated depreciation	$180,856	$135,739	$145,765
Total long-term assets	$323,724	$253,081	$277,910
Total assets	$1,095,999	$939,372	$1,004,625
Current Liabilities			
Accounts payable	$155,534	$132,206	$145,321
Current borrowing	$170,000	$150,000	$135,000
Other current liabilities (interest free)	$81,888	$63,972	$74,329
Total current liabilities	$407,422	$346,178	$354,650
Long-term liabilities	$220,000	$190,000	$175,000
Total liabilities	$627,422	$536,178	$529,650
Paid-in capital	$75,000	$75,000	$75,000
Retained earnings	$281,838	$234,377	$287,114
Earnings	$111,739	$93,817	$112,861
Total capital	$468,577	$403,194	$474,975
Total capital and liabilities	$1,095,999	$939,372	$1,004,625
Other Inputs			
Payment Days	30	30	30

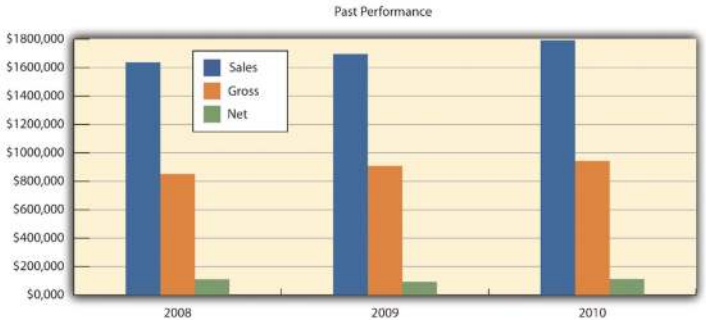


Figure 10.1.1: Past Performance Chart

Company Locations and Facilities

Frank's All-American BarBeQue has been in Fairfield, Connecticut, for decades. It has a reputation throughout the southern Connecticut shore region for excellent food and has received numerous awards. The management team determined that a second location could tap into this local name recognition. Several towns in the region were evaluated for total population, population density, family income, and home value. These factors were considered because of their impact on generating traffic and consumers being able to pay for meals that are priced slightly higher than typical fast-food outlets. In addition, the average family size and the percentage of family households were considered because Frank's is a family restaurant. Lastly, data were gathered on the average travel time to and from work for residents and the real estate tax rate. Because the new location of Frank's will emphasize prepared meals, we felt that individuals with longer commutes would be more likely to order meals and pick them up at Frank's. A summary of these data is provided in Table 110.1.2".

After thorough analysis, it was concluded that Darien, Connecticut, would be the best location for the new branch of Frank's All-American BarBeQue. It has a high-income population and a high population density, and a large percentage of its inhabitants are members of family households. They have longer commuting times, which increase the potential need for prepared meals.

Table 10.1.2: Demographic Data for Selected Connecticut Towns—Part 1

Item	Fairfield	Westport	Easton	Darien	Norwalk
Population	57,578	25.884	7,383	19,375	83,802
Population density	1,917	1,293	269	1,508	3,675
Income	$108,209	$155,322	$162,688	$180,474	$79,693
House value	$589,179	$1,169,081	$868,622	$1,430,589	$504,100
Percentage of family households	72.6%	74.6%	84.3%	81.7%	64.1%
Travel time (minutes)	31.3	39.4	34.8	36.4	25.4
Real estate tax rate	1.3%	0.9%	1.3%	0.8%	1.1%
Family size	3.07	2.70	3.0	3.0	2.50

Table 10.1.3: Demographic Data for Selected Connecticut Towns—Part 2

Item	Stamford	Weston	Wilton	Trumbull	State of Connecticut
Population	121,026	10,199	17,771	34,422	3,574,097
Population density	3,206	515	659	478	739/sq. mile
Income	$81,206	$190,080	$183,252	$103,019	$68,595
House value	$612,900	$1,198,615	$1,044,316	$492,623	$306,000
Percentage of family households	63.8%	84.9%	82.3%	81.5%	67.7%
Travel time (minutes)	24.0	41.6	39.2	27.1	
Real estate tax rate	0.7%	1.1%	1.2%	1.5%	1.8%
Family size	2.50	3.0	3.25	2.80	

A specific location has been identified in Darien for the second Frank's All-American BarBeQue. It is in a small mall and is large enough to have a seating capacity of 150–160 plus takeout facilities. The mall has more than adequate parking for future customers. The mall is located three blocks from the Metro-North Darien railroad station and is four blocks from the I-95 exit. It is therefore well positioned to attract traffic from both car and rail commuters. The lease fee for a three-year contract is very reasonable for a property of this size.

Products and Services

Frank's All-American BarBeQue specializes in the finest barbecue served in a family-friendly format. It uses the finest cuts of meats that are free of any growth hormones. It is known for a variety of slow-smoked and slow-cooked meats, such as ribs, beef, pulled pork, and chicken. These are served with Frank's famous and award-winning sauce varieties, which represent the four major styles of barbecue cooking. Frank's is also noted for its side dishes and desserts.

Our goal is to expand operations to a second location in Darien, Connecticut. This outlet will be significantly larger and will have a section devoted to takeout meals.

Competitive Comparison

There are approximately forty specialty barbecue restaurants in Connecticut. They are spread throughout the state, but only four (including Frank's All-American BarBeQue) are in the southern shore region. The three competitors are smaller operations. None of the barbecue restaurants in Connecticut have the history, reputation, acclaim, or awards that match Frank's All-American BarBeQue. It is not an exaggeration to say that Frank's is the preeminent barbecue restaurant in Connecticut. It has a loyal following that reaches as far as New York City.

Frank's is the only barbecue restaurant in Connecticut where supermarkets are vying for the right to market Frank's signature barbecue sauces. This sideline business promises to be extremely profitable and support the overall marketing efforts for both locations of Frank's All-American BarBeQue.

Fulfillment

Frank's All-American BarBeQue has always been committed to providing the absolute best in barbecue food. This has meant assuring the highest quality ingredients in food preparation. Frank has established a decades-long relationship with suppliers in the New York and Connecticut areas. He selects nothing but the choicest selections of beef, pork, and chicken. He has always made sure that his meats come from suppliers who are committed to quality ingredients and who never use growth hormones. This long-term relationship with a variety of key suppliers enables Frank to secure the best cuts at reasonable prices. Frank is equally careful in using the finest spices for his barbecue sauces. The same is true for all the side dishes that Frank's All-American BarBeQue offers its customers.

This commitment to quality is not limited to the selection of meats and ingredients. Frank and his staff recognize that top-quality barbecue food requires a knowledgeable and deep commitment to cooking the food properly. All meats must be cooked and smoked slowly. This requires time, effort, expense, and commitment, but the results are spectacular. Some cuts of meat at Frank's may require as many as eleven hours of preparation and cooking. Excellence is not achieved without a commitment to effort. This effort has been recognized with numerous awards at national barbecue cook-offs. Frank has clearly recognized that the meal is clearly a function of the quality of the meat, quality ingredients, and careful preparation.

Future Products and Services

Frank's All-American BarBeQue is ready to accept new challenges. Opening a second restaurant will significantly increase sales, but the second location is only the beginning of new directions for Frank's. Although Frank has been selling his regional barbecue sauces in local outlets for years, he is now ready to sign a contract with a major regional supermarket chain to market and sell these sauces throughout New England. Preliminary studies indicate that Frank can anticipate a 20 percent annual growth rate in the sales of sauces for the next five years.

With the growth of two-income families, less and less time is available to prepare meals at home. Recognizing this simple fact, Frank's All-American BarBeQue plans to offer a variety of prepackaged barbecue meals that can be picked up at the restaurant and reheated at home. As part of its new commitment to a web-based presence, customers will be able to order these meals by regular phone, with smartphones, or through the Internet. Customers will be able to select from a list of prepackaged dinner meals or any combination of items. Customers can designate the time to pick up the meals, and the meals will be ready for them. This service promises significant revenue growth.

Market Analysis Summary

Since the 1930s, the American public has spent at least 5 percent of its disposable income on eating out. Even with annual fluctuations, this is a strong indicator of the viability of this industry. This can be best illustrated by reviewing industry results for the last few years.

Both 2009 and 2010 were difficult years for the restaurant industry. In 2008, sales increased by 3.8 percent. However, sales fell by nearly 0.75 percent in 2009. *This was the first year in the history of the industry that sales actually declined.* The restaurant industry's sales in 2009 were $566 billion, down from over $570 billion. Prices rose by 2.2 percent in 2009. The increase in sales for 2010 was 0.5 percent, and price increases stabilized at 0.75 percent.

It is anticipated that there will be significant price competition in every segment of the restaurant industry. Some analysts argued that the poor performances for the restaurant industry in both 2009 and 2010 could be attributed to declines in both business and personal travel. Hotel occupancy rates in 2009 were down by nearly 10 percent. A study conducted by the National Restaurant Association argued that 20 percent of the sales in casual dining restaurants might be due to travelers and visitors. Frank's All-American BarBeQue relies to a far lesser extent on travelers as customers. A rough estimate based on credit card receipts, for the period 2006–2010, indicated that travelers represented less than 2 percent of Frank's sales. The pressure on the restaurant industry has been felt by many chain restaurants, which significantly curtailed their expansion plans.

Even though the recession was in full bloom in 2009, many food prices rose and rose significantly. Beef prices rose between 4 percent and 12 percent, while pork prices rose between 5 percent and 13 percent. Numerous studies have indicated that the increase in commodity prices will not be a transitory phenomenon.

With 925,000 food service locations in operation in the United States, this translates into 1 restaurant for every 330 Americans.

The health-care reform bill passed in 2010 should, in the near future, provide some relief for restaurants by creating a system that will assume greater responsibility by individuals to pay for their own health-care coverage.

Restaurants must also be much more cautious in the future about the possibility of hiring illegal aliens. As a whole, the National Restaurant Association supports immigration reform. However, it is concerned that any legislation should not limit a restaurant's ability to hire workers. It is also concerned about the cost to assure worker eligibility.

The Mintel Group, a market research firm, found that consumers who are interested in quality opt for independent restaurants over chain outlets. An increasing consumer focus on health translates into an emphasis on natural ingredients. In the barbecue industry,

this translates into naturally raised meats (i.e., the avoidance of artificial growth hormones in cattle), which are a hallmark of Frank's All-American BarBeQue.

The National Restaurant Association estimated that sales in full-service restaurants in 2010 would exceed $184 billion—an increase of 1.2 percent from 2009 sales.

Several macroeconomic factors make opening a restaurant in Darien attractive, including the following:

- **Increases in the growth domestic product (GDP).** The GDP is estimated to grow 1.7 percent in 2011 and 1.5 percent in 2012. The estimates for Fairfield County are significantly higher.
- **Disposable personal income.** The national level of personal income should rise nearly 4 percent in 2011, and there is an expectation of 3 percent growth in 2012. These numbers appear to be much stronger in the Fairfield County area.

Although 2010 was not a banner year for the restaurant industry—it was one where more restaurants closed than opened each month—there was one bright spot: Chain barbecue restaurants grew between 2 percent and 3 percent—an auspicious sign even for independent operators.

The home meal replacement market and the existing investment in restaurant equipment provide a nice growth opportunity for restaurants. It is been estimated that takeout sales in limited service chain restaurants might be as large as 60 percent of total sales. The same study found that takeout food has been growing twice as fast as the overall restaurant industry. Natural competitors in this market are supermarkets that offer prepackaged meals. However, we feel that few—if any—supermarkets provide the quality barbecue food that can be found at Frank's.

Market Segmentation

Frank's All-American BarBeQue views its major market segment as suburbanites in the south shore region of Connecticut. One way of further segmenting the market is by the type of meal being provided.Table 10.1.4: Market Analysis provides estimated growth rates for each type of meal (plus sauce sales) and projected number of meals (and jars of sauce) for the period 2011 to 2015. Figure 10.1.2 illustrates the relative contributions.

Table 10.1.4: Market Analysis

Potential Customers	Growth	2011	2012	2013	2014	2015
Lunch	8%	17,000	18,275	19,646	21,119	22,703
Dinner	5%	40,000	42,000	44,100	46,305	48,620
Takeout	20%	10,000	12,000	14,400	17,280	20,736
Sauces	15%	12,000	13,800	15,870	18,251	20,989
Total	9.37%	79,000	86,075	94,016	102,955	113,048

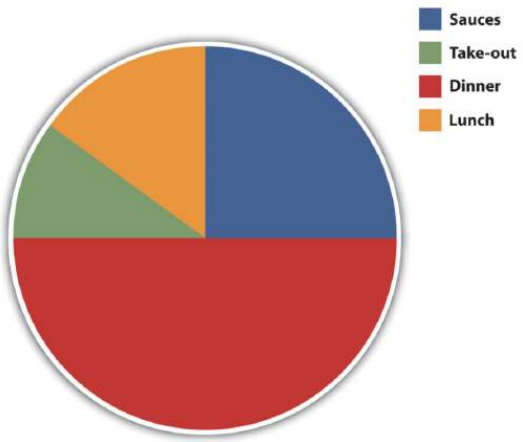


Figure 10.1.2: Market Analysis

Market Needs

We believe that the market centers on excellent barbecue food served at reasonable prices and served in a family-friendly manner. We further believe that a growing segment of the market will want prepared meals that can be conveniently picked up and served at home. Table 16.4 provides a projected breakdown of the potential customers for the next five years. This breakdown is predicated on the type of meals served and includes the sale of sauces. We provide estimated growth rates and forecasted sale of meals (and bottles of sauces) for the period 2011 to 2015. Figure 16.2 shows the breakdown of the number of meals by type in 2015.

Web Plan Summary

Presently, Frank's All-American BarBeQue has a very simple website. The website provides minimal information—listing some of the menu items and the restaurant's telephone number. It was created eight years ago by a college student who was working at Frank's.

Robert Rainsford's professional expertise is in the area of website development. After graduating from college, Robert was hired by a firm that specialized in developing web and social media presences for other companies. He worked for that firm in New York City for seven years. Robert rose rapidly through the company's ranks, eventually becoming one of its vice presidents. His expertise in this area will enable Frank's All-American BarBeQue to significantly enhance its web presence. Rather than just having a website that identifies the restaurant's location and telephone number, along with a brief summary of its menu, the new website will be far richer in content and capability. It will provide a complete menu listing, identifying all items with corresponding images. The new website will enable customers to place orders through the Internet for lunch, dinner, or takeout items. The section devoted to takeout items will enable a customer to purchase prepared meals or choose from all items on the menu to develop a prepackaged meal. Customers will be able to identify the time that they will arrive for the pickup.

The website will have links to the Facebook and Twitter accounts of Frank's All-American BarBeQue. These connections will enhance its social media presence. Customers will be asked to post comments about their dining experience and suggestions on how Frank's can improve its operations and service. It will enable Frank's to expand operations and still maintain the same close customer relationship that currently exists at the Fairfield restaurant.

Website Marketing Strategy

The new web presence for Frank's All-American BarBeQue will be geared to developing a new level of customer relationships. Customers at both restaurants will be asked to fill out forms where they will supply an e-mail address and a birthdate. (This information can also be supplied through Frank's new website.) This information will enable Frank's to keep customers informed of specials and offer coupons and the new rewards card program for special occasions, such as holidays or birthdays.

We view the website of Frank's All-American BarBeQue as a major component of enhancing our relationship with our customers. It should provide convenience to customers through their ability to see what is on the menu, identify new specials, and order meals

and pick them up at their convenience. The use of social media will expand awareness of Frank's and enable it to develop closer relationships with present and future customers.

Development Requirements

Robert Rainsford tapped into his expertise in social media and has already developed a far more sophisticated website for Frank's All-American BarBeQue. He has secured the necessary server capacity to handle additional traffic on the website. In addition, he has set up several social media accounts for Frank's All-American BarBeQue, including Facebook and Twitter. Robert also created a program linked to a database that will monitor customer purchases through the rewards card program. This program will send out birthday notices and discounts to customers and will inform them of their current status in the rewards card program.

Robert contacted several former colleagues at his former place of employment and has identified several candidates for the role of website manager. This individual will be responsible for updating the website and the social media sites on a daily basis. He or she will also be responsible for analyzing the flow of information that comes through these sites and preparing management reports.

Strategy and Implementation Summary

The core strategy of Frank's All-American BarBeQue is to continue what has made it a success at a new location. Simply put, our strategy is to provide our customers with the finest barbecue food in Connecticut, at reasonable prices, in a family-friendly environment. In addition, we hope to improve our ability to meet customer needs by making life more convenient for our customers. We believe that these fundamentals are universally applicable.

SWOT Analysis

A strengths, weaknesses, opportunities, and threats (SWOT) analysis was undertaken for Frank's All-American BarBeQue.

Strengths

The key strength of Frank's All-American BarBeQue is the quality of its food and service. It has been the recipient of numerous local and national awards for its foods and sauces. Other strengths include a highly knowledgeable management team with expertise in operating a barbecue restaurant, a close working relationship with suppliers of premier cuts of meats, and a loyal clientele in the south shore region.

Weaknesses

The weaknesses associated with this business plan center on operating an additional restaurant with a much larger capacity than the Fairfield, Connecticut, restaurant. The second location will require an experienced restaurant manager. This plan calls for a significant increase in prepared (takeout) meals. Orders will be placed either by phone or through the website. Current personnel have little experience in ratcheting up the takeout portion of the business.

Opportunities

This business plan offers significant opportunities for Frank's All-American BarBeQue. A second, larger location will translate into a significant increase in sales. Finalizing a business relationship with the regional supermarket chain will enable Frank's to significantly increase the production and the sales of its signature sauces. The sales of sauces are expected to increase by 20 percent per year for the next five years.

Threats

Any expansion with the opening of a new location always entails some risk. The principals of Frank's All-American BarBeQue will be investing a significant amount of capital and will be borrowing money from a bank to open a second location. It is strongly believed that the second location will capitalize on the success of the Fairfield restaurant and will become a success.

Competitive Edge

The competitive edge of Frank's All-American BarBeQue resides mainly in the quality of its food and its commitment to serve the food in a family-friendly environment. The quality of its food is unmatched in the entire state. No other barbecue restaurant has

received the awards and the accolades that Frank's All-American BarBeQue has received for the past forty years. Its reputation for quality gives it an edge that no other barbecue restaurant or chain can match.

Marketing Strategy

The target market for Frank's All-American BarBeQue is essentially suburban families in the south shore region of Connecticut. These people appreciate the finest barbecue food at reasonable prices. It is expected that an important group within this target market will be families with two incomes whose busy schedules would make prepared meals a very attractive option. We further assume that this market is technically sophisticated and will appreciate the convenience of ordering these meals via the Internet.

A key component of the marketing strategy of Frank's All-American BarBeQue is to use the Internet and technology to enhance the relationship with its customer base. Frank's will use the website, Facebook, Twitter, and e-mails to inform customers of special food items or discounts based on holidays and customers' birthdays. We intend to use the website as a mechanism to gain an improved insight into customer needs and wants.

Frank's All-American BarBeQue will also initiate a rewards card program. Customers will sign up for the rewards card program either at the two locations or online. They can use this program every time they make a purchase either at the restaurants or online. After a set number of visits (seven), customers will be entitled to either discounts or free items. The rewards card program will enable Frank's All-American BarBeQue to track customers' buying patterns and anticipate the ways in which they can better serve their customers.

Sales Forecasts

We provide a five-year forecast of the dollar value of sales broken down by the two restaurants and the sauces in Table 10.1.5 illustrates a forecast for the breakdown of sales on monthly basis in 2011, and Figure 10.1.4 illustrates the breakdown of sales for the next five years.

Table 10.1.5: Sales Forecast

Sales	**2011**	**2012**	**2013**	**2014**	**2015**
Frank's (Fairfield)	$1,907,183	$1,954,863	$2,003,734	$2,053,827	$2,105,173
Frank's (Darien)	$2,222,000	$2,555,300	$2,810,830	$3,091,913	$3,401,104
Sauces	$62,500	$75,000	$90,000	$108,000	$130,000
Total sales	$4,191,683	$4,585,163	$4,904,564	$5,253,740	$5,636,277
Direct Cost of Sales	**2011**	**2012**	**2013**	**2014**	**2015**
Frank's (Fairfield)	$953,594	$977,430	$1,001,867	$1,026,914	$1,052,587
Frank's (Darien)	$1,111,000	$1,277,650	$1,405,415	$1,545,957	$1,700,552
Sauces	$31,250	$37,500	$45,000	$54,000	$64,800
Subtotal direct cost of sales	$2,095,844	$2,292,580	$2,452,282	$2,626,871	$2,817,939

Figure 16.3 Monthly Sales for Two Restaurants and Sauces

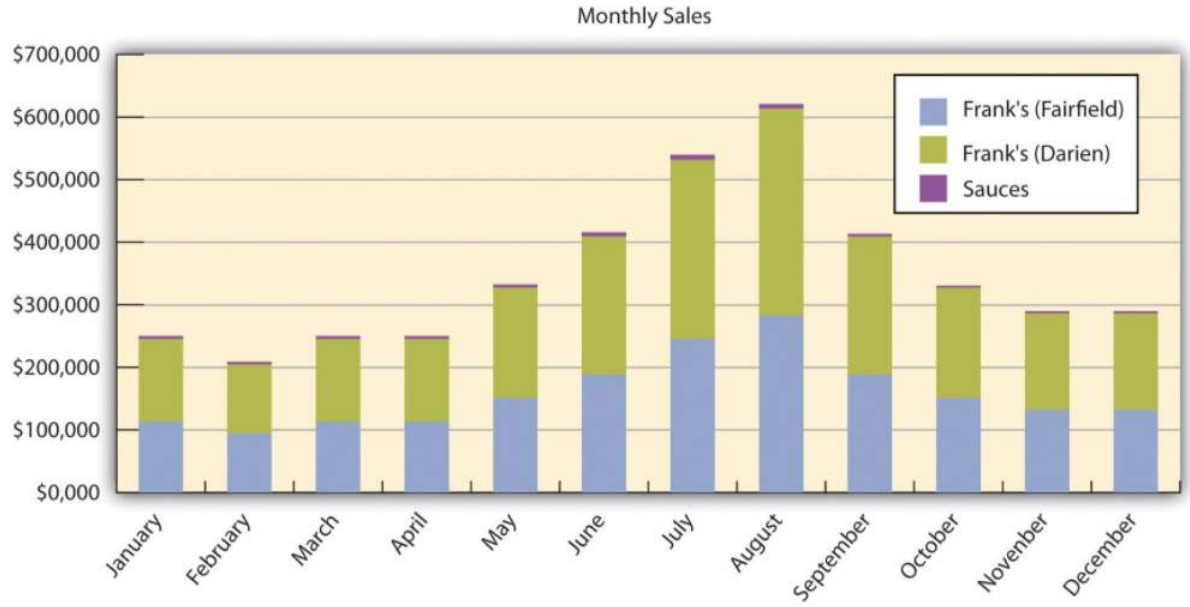


Figure 10.1.3: Monthly Sales for Two Restaurants and Sauces

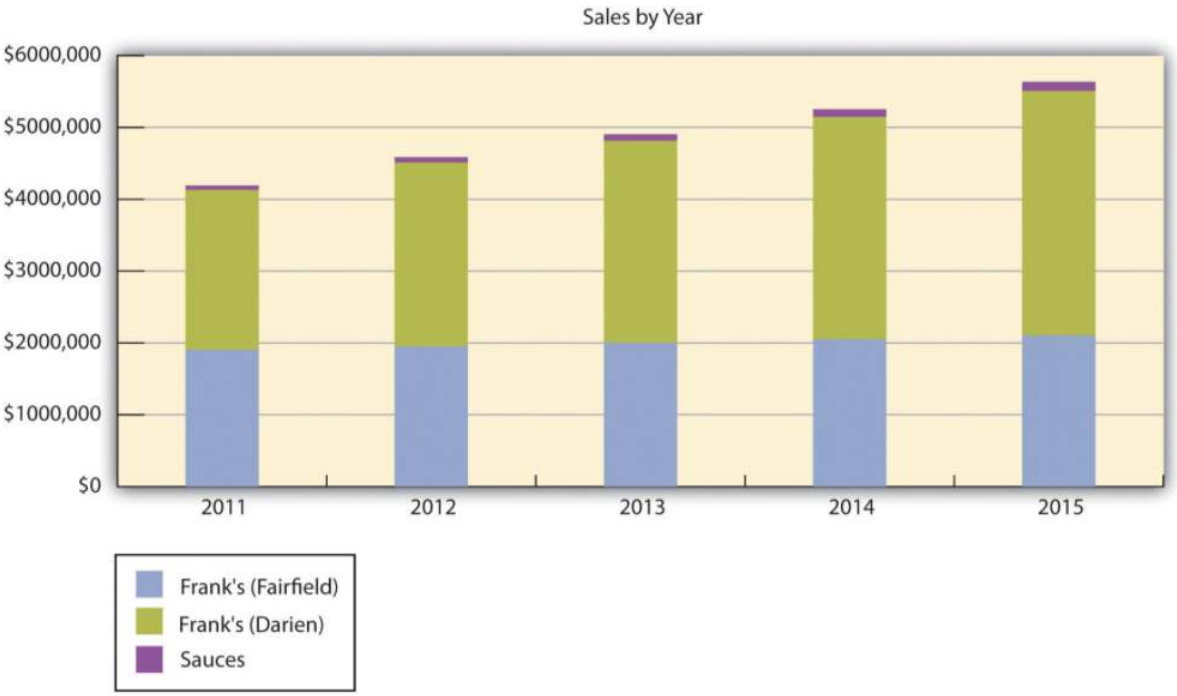


Figure 10.1.4: Five-Year Forecast of Sales for Two Restaurants and Sauces

Management Summary

Currently, Frank Rainsford is the CEO and chief operating officer of Frank's All-American BarBeQue. He is also the restaurant manager at the Fairfield restaurant. During the week, his daughter (Susan Rainsford Rogers) often replaces Frank as the restaurant manager. The Fairfield restaurant has a full-time cook who operates under Frank's supervision, and two other full-time employees function as waiters and waitresses. These full-time employees are supplemented by six part-time employees.

Under the new management structure, Frank Rainsford will hold the position of CEO. His wife, Betty Rainsford, will be designated the president and chief operating officer. Their daughter, Susan Rainsford Rogers, will be given the title vice president for operations. She will be responsible for the day-to-day operations of the Darien, Connecticut, restaurant. Robert Rainsford will have

the title of vice president of marketing. He will be responsible for all marketing activities and the operation of the website. Alice Jacobs will be the vice president of finance and the comptroller of Frank's All-American BarBeQue.

Organizational Structure

The new management structure of Frank's All-American BarBeQue is a basic functional layout appropriate for this type of business and is shown in Figure 10.1.5.

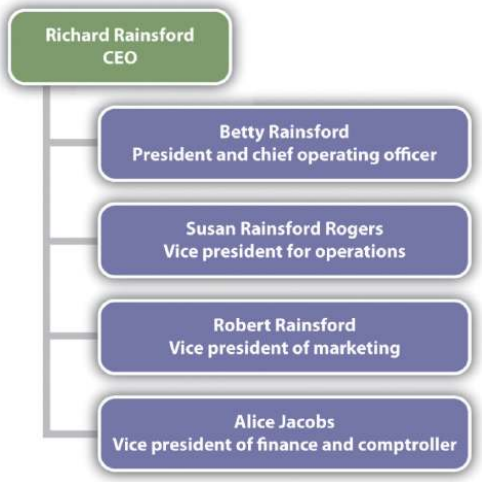


Figure 10.1.1: Organizational Chart

Personnel Plan

Table 10.1.6 is a five-year breakdown of the types and costs of personnel.

Table 10.1.6 Forecasts of Personnel

Personnel Plan	2011	2012	2013	2014	2015
Cooks Personnel					
Cook (Fairfield)	$54,000	$54,600	$55,000	$55,500	$56,000
Cook (Darien)	$66,000	$66,000	$66,500	$67,000	$67,500
Subtotal	$120,000	$120,600	$121,500	$122,500	$123,500
Servers Personnel					
Full-time servers (Fairfield)	$28,800	$28,800	$16,000	$17,500	$18,000
Full-time servers (Darien)	$57,600	$57,600	$24,500	$25,000	$2,600
Part-time servers both locations	$192,000	$192,000	$192,000	$192,000	$192,000
Subtotal	$278,400	$278,400	$232,500	$234,500	$212,600
General and Administrative Personnel					
Restaurant manager (Fairfield)	$42,000	$42,000	$43,000	$43,500	$44,000
Restaurant manager (Darien)	$54,000	$54,600	$56,000	$56,500	$57,000
Subtotal	$96,000	$96,600	$99,000	$100,000	$101,000
Total people	39	39	39	39	39
Total payroll	$494,400	$495,600	$453,000	$457,000	$437,100

Financial Plan

Frank's All-American BarBeQue will be financing the creation of a second restaurant through a combination of private investment and a bank loan. The private investment will raise $160,000, and Frank's will seek another $175,000 as a two-year loan. These funds will be used to pay for equipment and leasing expenses associated with opening a second restaurant.

Important Assumptions

The assumptions associated with the grow rates of sales each year for the next five years are the keys to the financial planning process. We began with very modest assumptions of 8 percent growth in lunch sales and 5 percent growth in dinner sales. We anticipate fairly vigorous growth in takeout meals (20 percent) and sauces (15 percent). Although these are large growth rates, we do not feel that they are unrealistic.

Key Financial Indicators

Figure 10.1.6 provides historical (2008–2010) and forecasted (2011–2015) values for the key financial indicators.

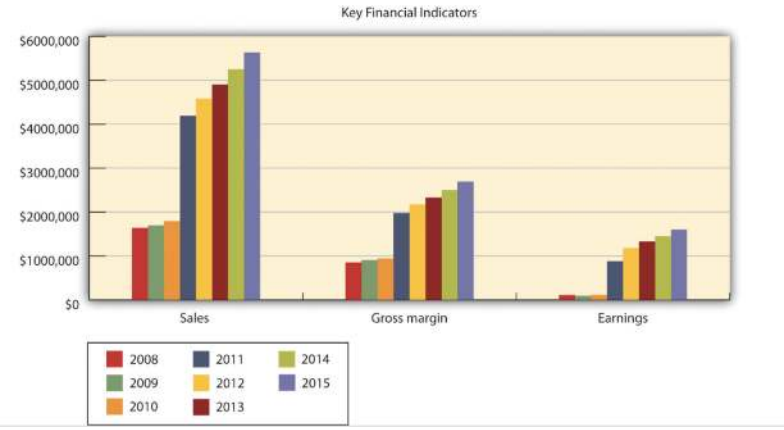


Figure 10.1.6: Key Financial Indicators

Breakeven Analysis

InTable 10.1.7 and Figure 10.1.7, we show the results of our breakeven analysis for Frank's All-American BarBeQue. The results indicate that with sales of approximately $110,000 each month, Frank's All-American BarBeQue will break even.

Table 10.1.7: Breakeven Analysis

Monthly revenue	$112,627
Assumptions	
Average variable cost	50%
Estimated monthly fixed cost	$56,313

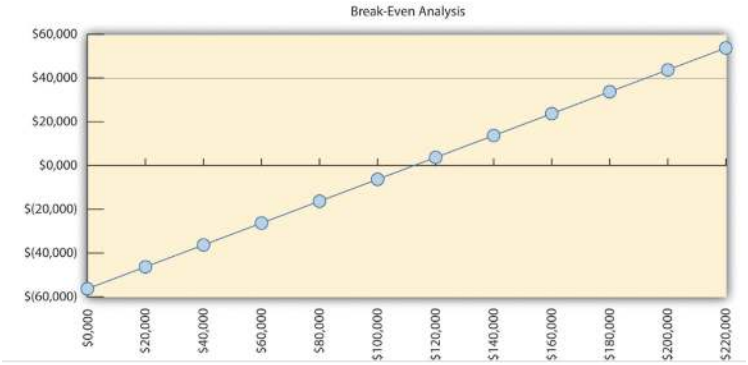


Figure 10.1.7: Breakeven Analysis

Projected Profit and Loss

Our analysis anticipates significant growth in profits in the next five years with the opening of a second Frank's All-American BarBeQue in Darien. The profit margins should increase from in excess of $850,000 in 2011 to nearly $1,600,000 by 2015 and should be in excess of 20 percent for all five years. A complete analysis of the profit and loss statements is in Table 10.1.8. The annual profits are illustrated in Figure 10.1.8".

Table 10.1.8: Profit and Loss

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Pro Forma Profit and Loss	2011	2012	2013	2014	2015
Sales	$4,191,683	$4,585,163	$4,904,564	$5,253,740	$5,636,277
Direct cost of sales	$2,095,844	$2,292,580	$2,452,282	$2,626,871	$2,817,939
Cooks payroll	$120,000	$120,600	$121,500	$122,500	$123,500
Other costs of sales	$0	$0	$0	$0	$0
Total cost of sales	$2,215,844	$2,413,180	$2,573,782	$2,749,371	$2,941,439
Gross margin	$1,975,839	$2,171,983	$2,330,782	$2,504,369	$2,694,838
Gross margin %	47.14%	47.37%	47.52%	47.67%	47.81%
Operating Expenses					
Servers payroll	$278,400	$278,400	$232,500	$234,500	$212,600
Advertising/promotion	$0	$0	$0	$0	$0
Other servers expenses	$0	$0	$0	$0	$0
Total servers expenses	$278,400	$278,400	$232,500	$234,500	$212,600
Servers %	6.64%	6.07%	4.74%	4.46%	3.77%
General and Administrative Expenses					
General and administrative payroll	$96,000	$96,600	$99,000	$100,000	$101,000
Marketing/promotion	$12,000	$0	$0	$0	$0
Depreciation	$0	$0	$0	$0	$0
Rent	$180,000	$0	$0	$0	$0
Utilities	$13,200	$0	$0	$0	$0
Insurance	$22,000	$0	$0	$0	$0
Payroll taxes	$74,160	$74,340	$67,950	$68,550	$65,565
Other general and administrative expenses	$0	$0	$0	$0	$0
Total general and administrative expenses	$397,360	$170,940	$166,950	$168,550	$166,565
General and administrative %	9.48%	3.73%	3.40%	3.21%	2.96%
Other Expenses					

Pro Forma Profit and Loss	2011	2012	2013	2014	2015
Other payroll	$0	$0	$0	$0	$0
Consultants	$0	$0	$0	$0	$0
Other expenses	$0	$0	$0	$0	$0
Total other expenses	$0	$0	$0	$0	$0
Other %	0.00%	0.00%	0.00%	0.00%	0.00%
Total operating expenses	$675,760	$449,340	$399,450	$403,050	$379,165
Profit before interest and taxes	$1,300,079	$1,722,643	$1,931,332	$2,101,319	$2,315,673
EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization)	$1,300,079	$1,722,643	$1,931,332	$2,101,319	$2,315,673
Interest expense	$43,755	$34,995	$30,980	$30,980	$30,980
Taxes incurred	$376,897	$506,294	$570,106	$621,102	$685,408
Net profit	$879,427	$1,181,354	$1,330,246	$1,449,237	$1,599,285
Net profit/sales	20.98%	25.76%	27.12%	27.58%	28.37%

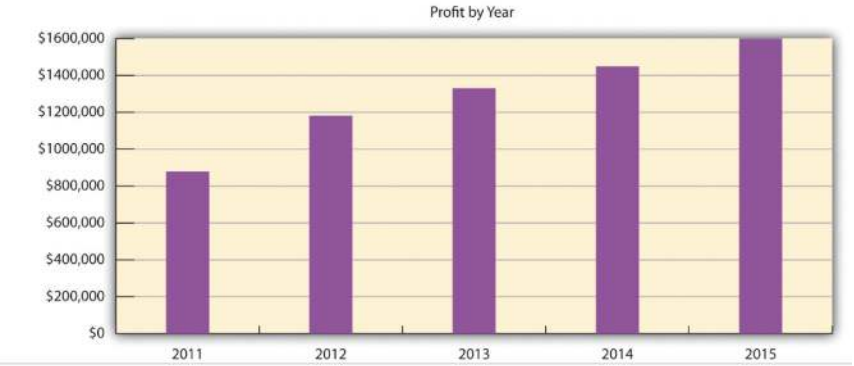


Figure 10.1.8: Yearly Profits

Projected Cash Flow

Table 10.1.9 is a five-year forecast of cash flows for Frank's All-American BarBeQue. The forecast shows extremely strong and positive cash flows for each year.

Table 10.1.9: Cash Flow Forecast

Pro Forma Cash Flow					
Cash Received	**2011**	**2012**	**2013**	**2014**	**2015**
Cash from Operations					
Cash sales	$4,191,683	$4,585,163	$4,904,564	$5,253,740	$5,636,277
Subtotal cash from operations	$4,191,683	$4,585,163	$4,904,564	$5,253,740	$5,636,277
Subtotal cash received	$4,366,683	$4,585,163	$4,904,564	$5,253,740	$5,636,277
Expenditures	**2011**	**2012**	**2013**	**2014**	**2015**
Expenditures from Operations					
Cash spending	$494,400	$495,600	$453,000	$457,000	$437,100
Bill payments	$2,500,504	$2,911,392	$3,085,406	$3,338,682	$3,587,794
Subtotal spent on operations	$2,994,904	$3,406,992	$3,538,406	$3,795,682	$4,024,894
Other liabilities principal repayment	$54,000	$54,000	$54,000	$0	$0
Long-term liabilities principal repayment	$87,600	$87,600	$0	$0	$0
Subtotal cash spent	$3,296,504	$3,548,592	$3,592,406	$3,795,682	$4,024,894
Net cash flow	$1,070,179	$1,036,571	$1,312,158	$1,458,058	$1,611,383
Cash balance	$1,172,844	$2,209,415	$3,521,573	$4,979,631	$6,591,014

Projected Balance Sheet

Table 10.1.10 is a balance sheet forecast for Frank's All-American BarBeQue.

Table 10.1.10 Balance Sheet Forecast

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Pro Forma Cash Flow					
Assets	**2011**	**2012**	**2013**	**2014**	**2015**
Current Assets					
Cash	$1,172,844	$2,209,415	$3,521,573	$4,979,631	$6,591,014
Inventory	$72,421	$79,197	$109,296	$117,245	$125,954
Other current assets	$278,372	$278,372	$278,372	$278,372	$278,372
Total current assets	$1,523,636	$2,566,983	$3,909,241	$5,375,249	$6,995,341
Long-Term Assets					
Long-term assets	$583,675	$583,675	$583,675	$583,675	$583,675
Accumulated depreciation	$145,765	$145,765	$145,765	$145,765	$145,765
Total long-term assets	$437,910	$437,910	$437,910	$437,910	$437,910
Total assets	$1,961,546	$3,004,893	$4,347,151	$5,813,159	$7,433,251
Liabilities and Capital	**2011**	**2012**	**2013**	**2014**	**2015**
Current Liabilities					
Accounts payable	$189,416	$193,009	$259,021	$275,791	$296,597
Current borrowing	$135,000	$135,000	$135,000	$135,000	$135,000
Other current liabilities	$20,329	($33,671)	($87,671)	($87,671)	($87,671)
Subtotal current liabilities	$344,745	$294,338	$306,350	$323,120	$343,926
Long-term liabilities	$262,400	$174,800	$174,800	$174,800	$174,800
Total liabilities	$607,145	$469,138	$481,150	$497,920	$518,726
Paid-in capital	$75,000	$75,000	$75,000	$75,000	$75,000
Retained earnings	$399,975	$1,279,402	$2,460,755	$3,791,002	$5,240,239
Earnings	$879,427	$1,181,354	$1,330,246	$1,449,237	$1,599,285
Total capital	$1,354,402	$2,535,755	$3,866,002	$5,315,239	$6,914,524
Total liabilities and capital	$1,961,546	$3,004,893	$4,347,151	$5,813,159	$7,433,251
Net worth	$1,354,402	$2,535,755	$3,866,002	$5,315,239	$6,914,524

These figures clearly demonstrate that the proposed opening of a second restaurant is more than economically viable; it is an extremely lucrative project that promises to increase the net worth of the firm by 500 percent in five years.

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