Small Business Management

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Contents

This textbook is a general introduction to managing a small business authored/edited by Jason Anderson, Lecturer/Academic Program Associate at the University of Kansas. It is an adaptation of Small Business Management in the 21st Century authored by **David Cadden,** Professor Emeritus, Quinnipiac University and **Sandra L. Lueder,** Associate Professor Emeritus at Southern Connecticut State University. **This work was created with support from the University of Kansas Libraries.**

The textbook is meant to be a general, and simplified, introduction to the subject matter. This textbook treats small business management as a practical human activity rather than as an abstract theoretical concept. The hope is to teach concepts that can be immediately applied to "real world" experiences and case studies.

This book incorporates the use of **technology and e-business** as a way to gain a competitive advantage over larger rivals. Technology is omnipresent in today's business world and small businesses must use it to their advantage. Practical discussions and examples of how a small business can use these technologies without having extensive expertise or expenditures are found within the readings.

Cash flow is extremely important to small businesses. This book explicitly acknowledges the constant need to examine how decisions affect cash flow by incorporating cash flow impact content. As the lifeblood of all organizations, cash flow implications must be a factor in all business decision-making.

Finally, this textbook recognizes the need to clearly identify sources of **customer value** and bring that understanding to every decision. Decisions that do not add to customer value should be seriously reconsidered.

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1. Chapter 1 - Foundations of Small Business

Small Business in the U.S. 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."[1]

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*. That is not the focus of this text. We will instead focus on *running a small business*.

1. "Small Business by the Numbers," National Small Business Administration, accessed October 7, 2011, www.nsba.biz/docs/bythenumbers.pdf.

Small Business Defined

The **Small Business Administration (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."[2] 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.

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

2. Mansel Blackford, The History of Small Business in America, 2nd ed. (Chapel Hill, NC: University of North Carolina Press, 2003), 4.

to target 23 percent of this value for small firms. The SBA can also assist with financial aid following a disaster.

GDP

In 1958, small businesses 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**.[3]

Size

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.

Innovation and Competitiveness

One area where the public has a better understanding of the

3. Katherine Kobe, "The Small Business Share of GDP, 1998–2004," Small Business Research Summary, April 2007, accessed October 7, 2011, http://archive.sba.gov/advo/research/rs299tot.pdf.

strength of small business is in the area of innovation. Evidence dating back to the 1970s indicates that small businesses disproportionately produce innovations.[4] 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.[5]

Small Business Advantages

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.

4. 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.
5. "Small Business by the Numbers," National Small Business Administration, accessed October 7, 2011, www.nsba.biz/docs/bythenumbers.pdf.

- **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.[6]

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. 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.[7]

6. 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/.
7. "Small Business by the Numbers," National Small Business Administration, accessed October 7, 2011, www.nsba.biz/docs/bythenumbers.pdf.

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 in the footnotes[8]

Job Creation

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.[9] 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

8. US Census Bureau, “Statistics of U.S. Business,” accessed October 7, 2011, http://www.census.gov/econ/susb.
9. “Statistics of U.S. Businesses,” US Census Bureau, April 13, 2010, accessed October 7, 2011, www.census.gov/econ/susb.

times as many jobs were created through new business formation than through job expansion in small businesses.[10] 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 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.[11] Women and Hispanics are also employed by small businesses at a higher rate than the national average.

Key Takeaways

- Small businesses have always played a key role in the US economy.
- Small businesses are responsible for more than half the

10. 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.
11. "Statistics of U.S. Businesses," US Census Bureau, April 13, 2010, accessed October 7, 2011, www.census.gov/econ/susb.

employment in the United States.
- Small businesses have a prominent role in innovation and minority employment.

Success and Failure in Small Businesses

There are no easy answers to questions about success and failure in a small business. Why? Because the definition of "success" and "failure" is subjective. For instance, "success" could be:

1. An artisan whose intrinsic satisfaction comes from performing the business activity
2. The entrepreneur who seeks growth
3. The owner who seeks independence.[12]

Success

Ask the average person what the purpose of a business is or how

12. K. J. Stanworth and J. Curran, "Growth and the Small Firm: An Alternative View," Journal of Management Studies 13, no. 2 (1976): 95–111.

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.[13] 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.[14] Oftentimes, financial

13. 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.
14. "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,

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.[15]

Failure

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.[16] 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.[17] is often measured by the cessation of a firm's operation, but this can be brought about by several things:

Entrepreneurship and Enterprise Development (Englewood Cliffs, NJ: Prentice Hall, 2002), 33.

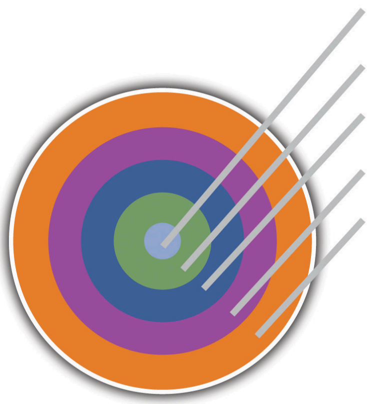
15. Terry L. Besser, "Community Involvement and the Perception of Success Among Small Business Operators in Small Towns," Journal of Small Business Management 37, no 4 (1999): 16.
16. Roger Dickinson, "Business Failure Rate," American Journal of Small Business 6, no. 2 (1981): 17–25.
17. A. B. Cochran, "Small Business Failure Rates: A Review of the Literature," Journal of Small Business Management 19, no. 4, (1981): 50–59.

- 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 "Types of Business Failures"). There are even times when small business owners involved in a closure consider the firm successful at its closing. [18] 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.[19]

Types of Business Failures

18. 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.
19. "Equifax Study Shows the Ups and Downs of Commercial Credit Trends," Equifax, 2010, accessed October 7, 2011, www.equifax.com/PR/pdfs/CommercialFactSheetFN3810.pdf.



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.[20] 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.[21] 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.[22] It appears that the

20. 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.
21. 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.
22. Anita Campbell, "Business Failure Rates Is Highest in First Two Years," Small Business Trends, July 7, 2005,

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.[23] 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."[24] This observation remains true today.

The second most common explanation cites **financial inadequacy**

accessed October 7, 2011, smallbiztrends.com/2005/07/business-failure-rates-highest-in.html.

23. T. C. Carbone, "The Challenges of Small Business Management," Management World 9, no. 10 (1980): 36.
24. John Argenti, Corporate Collapse: The Causes and Symptoms (New York: McGraw-Hill, 1976), 45.

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.[25] 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.[26] 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.[27]

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

25. Graham Beaver, "Small Business: Success and Failure," Strategic Change 12, no. 3 (2003): 115–22.
26. Sharon Nelton, "Ten Key Threats to Success," Nation's Business 80, no. 6 (1992): 18–24.
27. Robert N. Steck, "Why New Businesses Fail," Dun and Bradstreet Reports 33, no. 6 (1985): 34–38.

to planning.[28] Formal approaches to planning are seen as a waste of time,[29] or they are seen as too theoretical. [30] The end result is that many small business owners fail to conduct formal strategic planning in a meaningful way.[31] In fact, many fail to conduct any planning; [32] others may fail to conduct operational planning, such as marketing strategies.[33] The evidence appears to clearly indicate

28. 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.
29. Christopher Orpen, "Strategic Planning, Scanning Activities and the Financial Performance of Small Firms," Journal of Strategic Change 3, no. 1 (1994): 45–55.
30. 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.
31. 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.
32. 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.
33. Rubik Atamian and Neal R. VanZante, "Continuing

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.[34] 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.[35] The failure to understand what customers value and being able to adapt to changing customer needs often leads to business failure.[36]

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.[37] This may explain why most small firms that fail

Education: A Vital Ingredient of the 'Success Plan' for Business," Journal of Business and Economic Research 8, no. 3 (2010): 37–42.

34. T. Carbone, "Four Common Management Failures—And How to Avoid Them," Management World 10, no. 8 (1981): 38–39.
35. Anonymous, "Top-10 Deadly Mistakes for Small Business," Green Industry Pro 19, no. 7 (2007): 58.
36. 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.
37. Howard Upton, "Management Mistakes in a New Business," National Petroleum News 84, no. 10 (1992): 50.

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.[38] 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.[39] For very small businesses, this translates into having an owner who has at least a fundamental familiarity with accounting and finance.[40] In addition, the small firm will need either an in-house or an outsourced accountant.[41] Unfortunately, many owners fail to fully use their accountants' advice to manage their businesses.[42]

38. 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.
39. Roger Brown, "Keeping Control of Your Credit," Motor Transportation, April 2009, 8.
40. Arthur R. DeThomas and William B. Fredenberger, "Accounting Needs of Very Small Business," The CPA Journal 55, no. 10 (1985): 14–20.
41. Hugh M. O'Neill and Jacob Duker, "Survival and Failure in Small Business," Journal of Small Business Management 24, no. 1 (1986): 30–37.
42. Arthur R. DeThomas and William B. Fredenberger,

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.[43] 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.[44] The potential impact of these external economic variables might be that small business owners need to be either planner 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 below). 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

"Accounting Needs of Very Small Business," The CPA Journal 55, no. 10 (1985): 14–20.

43. Jim Everett and John Watson, "Small Business Failures and External Risk Factors," Small Business Economics 11, no. 4 (1998): 371–90.
44. Jim Everett and John Watson, "Small Business Failures and External Risk Factors," Small Business Economics 11, no. 4 (1998): 371–90.

guidance on how the small business owner can minimize these threats through proactive leadership.

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:[45]

45. Roger Ehrenberg, "Monitor 110: A Post Mortem—Turning Failure into Learning," Making It!, August 27, 2009,

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**

Key Takeaways

- 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.

accessed June 1, 2012, http://www.makingittv.com/Small-Business-Entrepreneur-Story-Failure.htm.

Evolution of a 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."[46] 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

46. "Organizational Life Cycle," Inc., 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html.

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.[47] A classic study by Churchill and Lewis identified five stages of small business growth: existence, survival, success, take-off, and resource maturity.[48] Each stage has its own challenges.

- **Stage I: Existence**.[49] 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.[50] 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**.[51] The business is now a viable operation.

47. 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.
48. 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.
49. 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.
50. Darrell Zahorsky, "Find Your Business Life Cycle," accessed October 7, 2011, sbinformation.about.com/cs/marketing/a/a040603.htm.

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**.[52] 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.[53] 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

51. 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.
52. 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.
53. 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.

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**.[54] 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**.[55] The company has arrived. It has the staff and financial resources to engage in detailed operational and strategic planning. The management structure

54. 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.
55. 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.

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 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.[56] "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."[57] The changes that occur

56. Carter McNamara, "Basic Overview of Organizational Life Cycles," accessed October 7, 2011, http://managementhelp.org/organizations/life-cycles.htm.
57. "Organizational Life Cycle," Inc., 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html.

in organizations have a predictable pattern,[58] 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.[59] 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.[60]

Four OLC stages can be observed: birth, youth, midlife, and maturity. [61] In the **birth cycle**, a small business will have a very

58. 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.
59. "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.
60. "Organizational Life Cycle," Inc., 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html.
61. Carter McNamara, "Basic Overview of Organizational

simple organizational structure, one in which the owner does everything. There are few, if any, subordinates. As the business moves through the **youth cycle** and the **midlife cycle**, more sophisticated structures will be adopted, and authority will be decentralized to middle- and lower-level managers. At the **maturity cycle**, 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 the following table:

Organizational Life Cycle Features

Life Cycles," accessed October 7, 2011, http://managementhelp.org/organizations/life-cycles.htm.

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 in the footnotes[62]

62. 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 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 (ILC)** 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.[63] 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. The

63. "Industry Life Cycle," Inc., 2010, accessed June 1, 2012, www.inc.com/encyclopedia/industry-life-cycle.html.

introduction stage[64] 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**[65] 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**[66]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

64. "Organizational Life Cycle," Inc., 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html.
65. "Organizational Life Cycle," Inc., 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html.
66. "Organizational Life Cycle," Inc., 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html.

more dominant. Many small businesses may move into the ranks of midsize or big businesses.

The **decline stage**[67] 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.

Key Takeaways

- 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

67. "Organizational Life Cycle," Inc., 2010, accessed October 7, 2011, www.inc.com/encyclopedia/organizational-life-cycle.html.

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.

The Big Two: Customer Value and Cash Flow

#1 Creating 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.[68]

68. 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.[69] 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.[70] 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."[71] This will certainly be true for the small business that is much closer to its customers than the large business.

69. Philip Kotler and Kevin Lane, Marketing Management (Upper Saddle River, NJ: Pearson Prentice-Hall, 2009), 121.
70. 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.
71. Earl Nauman, Creating Customer Value: The Path to Sustainable Competitive Advantage (New York: Free Press, 1995), 16.

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.

#2 Cash Flow

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." [72]

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.

72. "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.

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.[73] Cash flow can be a sign of the health—or pending death—of a small

73. 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, http://www.articlesezinedaily.com/dont-question-the-importance-of-cash-flow/.

business. The need to ensure that cash is properly managed must therefore be a top priority for the business.[74] 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."[75]

Key Takeaways

- 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.

Please email any errors in this – or subsequent – chapters to Jason Anderson at jason.anderson@ku.edu.

74. 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, http://www.articlesezinedaily.com/dont-question-the-importance-of-cash-flow/.
75. Fred Adler, QuotationsBook.com, accessed October 7, 2011, quotationsbook.com/quote/18235.

2. Chapter 2 - The Quest for Value

Defining the Customer's Concept of Value

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."[1] A recent study put it this

1. "Why Customer Satisfaction Fails," Gale Consulting,

way, “These firms have been successful…by consistently creating superior **customer value**—and profiting handsomely from that customer value.”[2]

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.[3] 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

accessed December 2, 2011, www.galeconsulting.com/index.php?option=com_content&view=article&id=18&Itemid=23.

2. George Day and Christine Moorman, Strategy from the Outside In (New York: McGraw Hill, Kindle Edition, 2010), 104–10.
3. Forler Massnick, The Customer Is CEO: How to Measure What Your Customers Want—and Make Sure They Get It (New York: Amacom, 1997), 76.

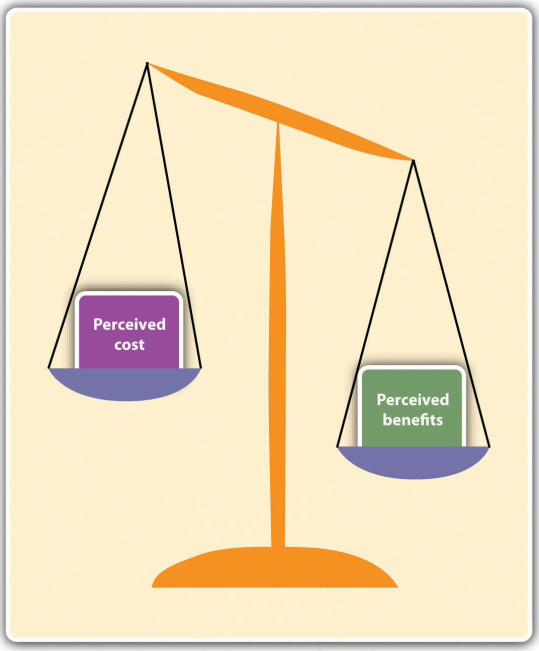
following: the business may change elements that are important to the customer value calculation, customers' preferences and perceptions may change over time, and competitors may change what they offer to customers. One author states that the challenge is to "understand the ever-changing customer needs and innovate to gratify those needs."[4]

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. This concept is often expressed as a straightforward equation that measures the difference between these two values:

customer value = perceived benefits – perceived cost

Perceived Cost versus Perceived Benefits

4. Sudhakar Balachandran, "The Customer Centricity Culture: Drivers for Sustainable Profit," Course Management 21, no. 6 (2007): 12.



Some researchers express this idea of customer value not as a difference but as a ratio of these two factors.[5] 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

5. M. Christopher, "From Brand Value to Customer Value," Journal of Marketing Practice: Applied Marketing Science 2, no. 1 (1996): 55.

superior customer value outperform their competitors on ROI and market share gains.[6]

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.[7] provided five types of value, as did Woodall (2003), although he did

6. Robert D. Buzzell and Bradley T. Gale, The PIMS Principles—Linking Strategy to Performance (New York: Free Press, 1987), 106.
7. 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.

not identify the same five values.[8]. To add to the confusion, Heard (1993–94)[9] identified three factors, while Ulaga (2003)[10] specified eight categories of value; and Gentile, Spiller, and Noci (2007) mentioned six components of value.[11] 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."[12] 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.

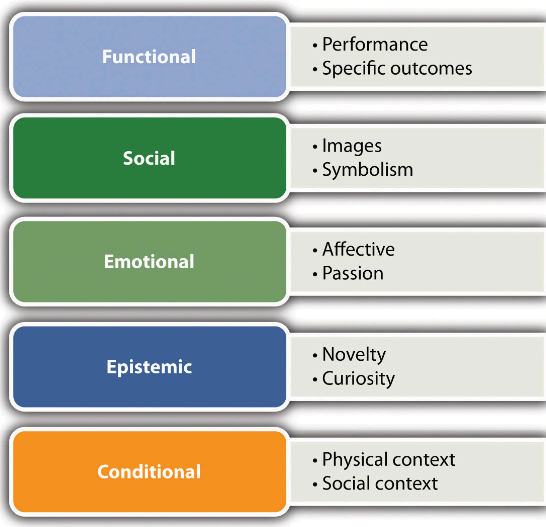
From the standpoint of small businesses, what sense can be made

8. 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.
9. Ed Heard, "Walking the Talk of Customers Value," National Productivity Review 11 (1993–94): 21.
10. Wolfgang Ulaga, "Capturing Value Creation in Business Relationships: A Customer Perspective," Industrial Marketing Management 32, no. 8 (2003): 677.
11. 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.
12. J. Brock Smith and Mark Colgate, "Customer Value Creation: A Practical Framework," Journal of Marketing Theory and Practice 15, no. 1 (2007): 7.

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. 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.)

Five Types of Value

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.[13] 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

13. Robert B. Woodruff, "Customer Value: The Next Source of Competitive Advantage, Journal of the Academy of Marketing Science 25, no. 2 (1997): 139.

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.[14]
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

14. "Maturalism," Trendwatching.com, accessed June 1, 2012, http://trendwatching.com/trends/maturialism/.

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.[15] 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

15. "Company Story," Stew Leonards, accessed October 7, 2011, www.stewleonards.com/html/about.cfm.

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:

Components of Customer Value

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.[16]

In summary, business owners need to constantly consider how they can enhance the benefits component while reducing the cost components of the value equation. The table below 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.

Components of Perceived Benefit and Perceived Cost

16. Calvin L. Hodock, Why Smart Companies Do Dumb Things (Amherst, NY: Prometheus Books, 2007), 65.

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

Component	Aspects	Activities to Deliver
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

Component	Aspects	Activities to Deliver
Psychic	• Simplified use • "Comfortable" feeling with regard to product or service use	• Superior design • Ability to write clear instructions

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.[17] 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

17. "Market Segmentation," NetMBA Business Knowledge Center, accessed October 7, 2011, www.netmba.com/marketing/market/segmentation.

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.

Key Takeaways

- 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.

Knowing Your Customers

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.

Research

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?

Finding Your Customer

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 (CLV)**, 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.[18]

This concept is popular enough that there are lifetime value calculator templates available on the web. These calculators look at the cost of acquiring a customer and then compute 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 of conducting customer lifetime value analysis is combining it with the notion of market segmentation. The use of market segmentation allows for

18. Jack Schmid, "How Much Are Your Customers Worth?," Catalog Age 18, no. 3 (2001): 63. Jonathon Lee and Lawrence Feick, "Cooperating Word-of-Mouth Affection Estimating Customer Lifetime Value," Journal of Database Marketing and Customer Strategy Management 14 (2006): 29.

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 to 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.[19] 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.[20] 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

19. "Loyalty Promotions," Little & King Integrated Marketing Group, accessed December 5, 2011, www.littleandking.com/white_papers/loyalty_promotions.pdf.
20. "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.

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.[21]

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.[22] 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

21. Claudio Marcus, "A Practical yet Meaningful Approach to Customer Segmentation," Journal of Consumer Marketing 15, no. 5 (1998): 494.
22. Malcolm Goodman, "The Pursuit of Value through Qualitative Market Research," Qualitative Market Research: An International Journal 2, no. 2 (1999): 111.

1983. It sold over 240 million units.[23] 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.[24]

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

23. "What Are Wacky WallWalkers?," DrFad.com, accessed December 2, 2011, www.drfad.com/fad_facts/wallwalker.htm.
24. Susan Smith Hendrickson, "Mining Her Peas and Carrots Wins Investors," Mississippi Business Journal 32, no. 21 (2010): S4.

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.'"[25]

The Voice of the Customer—QFD

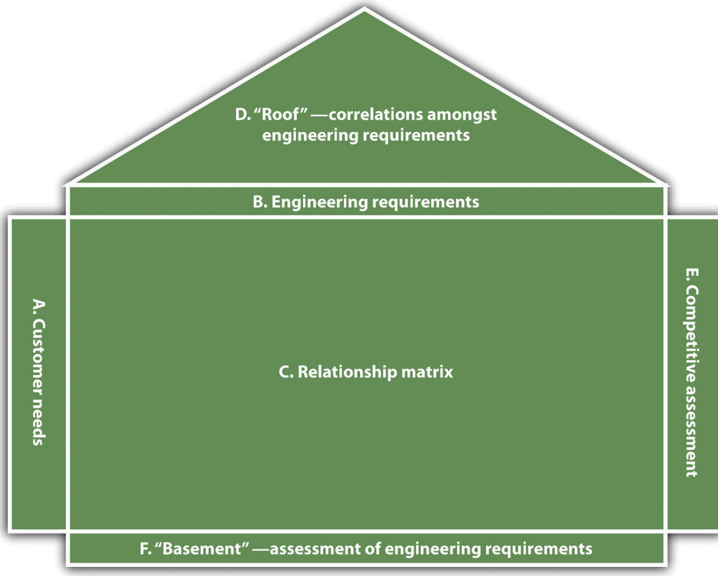
Quality function deployment (OFD) is an approach that is meant to take the VOC concept seriously and uses it to help design new products and services or improve existing ones. It is an approach that was initially developed in Japan for manufacturing applications. It seeks "to transform user demands into 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."[26] 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 below, which is known as the house of quality. The

25. 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.
26. Yoji Akao, Quality Function Deployment: Integrating Customer Requirements into Product Design (New York: Productivity Press, 1990), 17.

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.

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.[27]

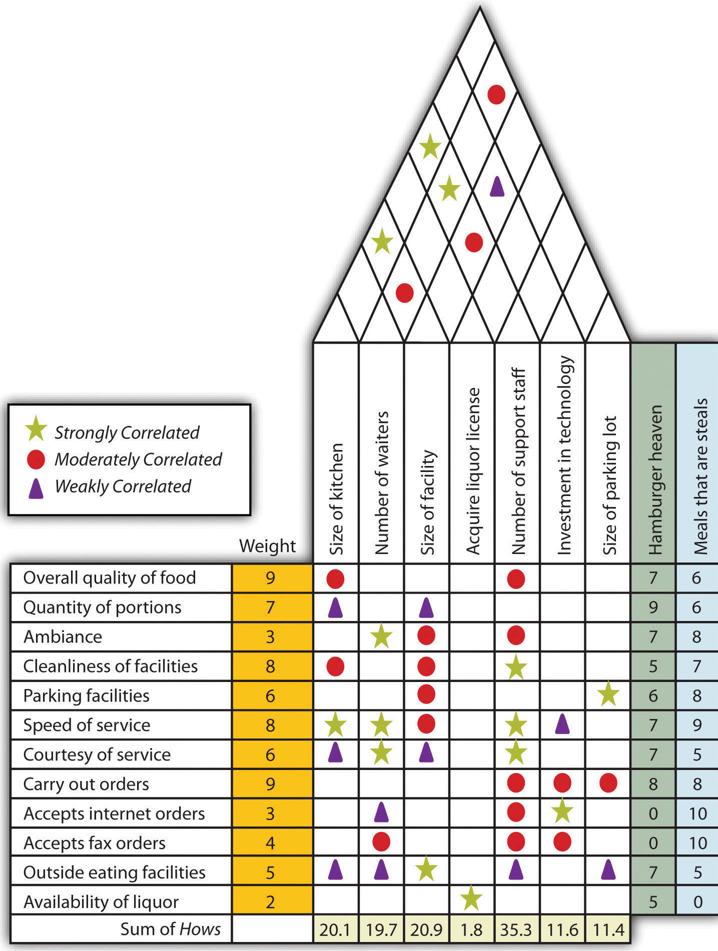
Unfortunately, QFD is most often associated with manufacturing. Few realize that it has found wide acceptance in many other areas—software development, services, education, amusement parks, restaurants, and food services. (For examples of these applications of QFD, go to http://www.mazur.net/publishe.htm.) Further, company size should not be seen as a limitation to its

27. 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).

possible application. The QFD approach, in a simplified form, can be easily and successfully used by any business regardless of its size.[28] 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.

Simplified House of Quality for a Restaurant

28. 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).



Gathering Feedback and Listening to the Customer

Although some succeed by listening to their instincts—their inner voices—it is highly advisable for 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.[29] To some extent, this is changing with the introduction of powerful, yet relatively low cost, web-based tools, and social media. 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.[30]

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. 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

29. David Carson, Stanley Cromie, Pauric McGowan, Jimmy Hill, Marketing and Entrepreneurship in Small and Midsize Enterprises (Hemel Hempstead, UK: Prentice-Hall, 1995), 108.
30. Malcolm Goodman, "The Pursuit of Value through Qualitative Market Research," Qualitative Market Research: An International Journal 2, no. 2 (1999): 111.

programs are used by 81 percent of US households.[31] Social media options 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.

Key Takeaways

- Businesses must become proactive in attempting to identify the value proposition of their customers. They must know how to listen to the VOC.
- Businesses must make every effort to identify the unmet needs of their customers.
- Businesses should recognize that customer segmentation would enable them to better provide customer value to their various customers.
- Businesses should think in terms of computing the customer lifetime value within different customer segments.
- Intuition can play an important role in the development of new products and services.
- Tools and techniques such as QFD assist in the design of products and services so that a business may be better able to meet customer expectations.
- Innovation can play a key role in creating competitive advantage for small businesses.
- Innovation does not require a huge investment; it can be done by small firms by promoting creativity throughout the organization.
- Small businesses must be open to new social and consumer trends. Readily available technology can help them in

31. Shallee Fitzgerald, "It's in the Cards," Canadian Grocer 118, no. 10 (2004/2005): 30.

identifying such trends.

Sources of Business Ideas

Small businesses have always been a driver of new products and services. Many products and inventions that we might commonly associate with large businesses were originally created by small businesses, including air-conditioners, Bakelite, the FM radio, the gyrocompass, the high resolution computed axial tomography scanner, the outboard engine, the pacemaker, the personal computer, frozen food, the safety razor, soft contact lenses, and the zipper.[32] This creativity and innovative capability probably stems from the fact that smaller businesses, which may lack extensive financial resources, bureaucratic restraints, or physical resources, may find a competitive edge by providing customers value by offering new products and services. It is therefore important to consider how small businesses can foster a commitment to creativity and innovation.

32. Jerry Katz and Richard Green, Entrepreneurial Small Business, 2nd ed. (New York: McGraw-Hill, 2009), 17.

Creativity and Innovation

One way smaller firms may compete with their larger rivals is by being better at the process of innovation, which involves creating something that is new and different. It need not be limited to the creation of new products and services. **Innovation** can involve new ways in which a product or a service might be used. It can involve new ways of packaging a product or a service. Innovation can be associated with identifying new customers or new ways to reach customers. To put it simply, innovation centers on finding new ways to provide customer value.

Although some would argue that there is a difference between creativity and innovation, one would be hard-pressed to argue that creativity is not required to produce innovative means of constructing customer value. An entire chapter, even an entire book, could be devoted to fostering creativity in a small business. This text will take a different track; it will look at those factors that might inhibit or kill creativity. Alexander Hiam (1998) identified nine factors that can impede the creative mind-set in organizations:[33]

1. **Failure to ask questions.** Small-business owners and their employees often fail to ask the required *why*-type questions.
2. **Failure to record ideas.** It does not help if individuals in an organization are creative and produce a large number of ideas but other members of the organization cannot evaluate these ideas. Therefore, it is important for you to record and share ideas.
3. **Failure to revisit ideas.** One of the benefits of recording ideas is that if they are not immediately implemented, they may become viable at some point in the future.

33. Alexander Hiam, Creativity (Amherst, MA: HRD Press, 1998), 6.

4. **Failure to express ideas.** Sometimes individuals are unwilling to express new ideas for fear of criticism. In some organizations, we are too willing to critique an idea before it is allowed to fully develop.
5. **Failure to think in new ways.** This is more than the cliché of "thinking outside the box." It involves new ways of approaching and looking at the problem of providing customer value.
6. **Failure to wish for more.** Satisfaction with the current state of affairs or with the means of solving particular problems translates into an inability to look at new ways of providing value to customers.
7. **Failure to try to be creative.** Many people mistakenly think that they are not at all creative. This means you will never try to produce new types of solutions to the ongoing problems.
8. **Failure to keep trying.** When attempting to provide new ways to create customer value, individuals are sometimes confronted with creative blocks. Then they simply give up. This is the surest way to destroy the creative thinking process.
9. **Failure to tolerate creative behavior.** Organizations often fail to nurture the creative process. They fail to give people time to think about problems; they fail to tolerate the "odd" suggestions from employees and limit creativity to a narrow domain.

One of the great mistakes associated with the concept of innovation is that innovation must be limited to highly creative individuals and organizations with large research and development (R&D) facilities.[34] The organization's size may have no bearing on its ability to produce new products and services. More than a decade ago,

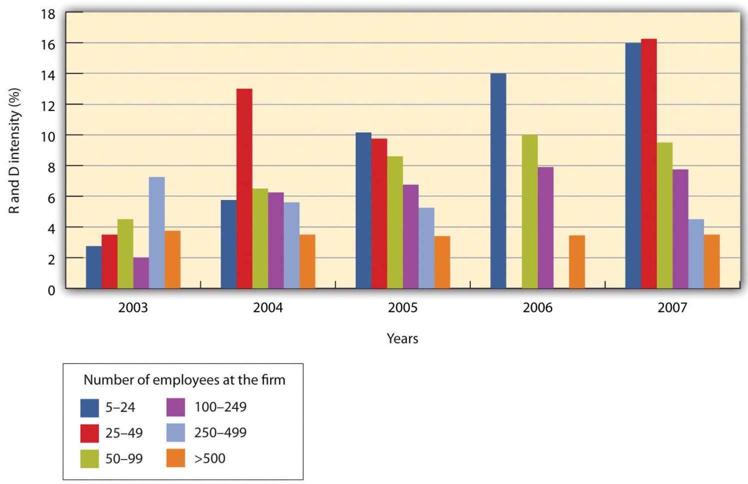
34. "Innovation Overload," Trendwatching.com, accessed December 2, 2011, trendwatching.com/trends/pdf/2006_08_innovation_overload.pdf.

studies began to indicate that small manufacturing firms far exceeded their larger counterparts with respect to the number of innovations per employee.[35]

A more recent study, which covered the period from 2003 to 2007, showed that R&D performance by small US companies grew slightly faster than the comparable performance measures for larger US firms. During that period, small firms increased their R&D spending by more than 40 percent, compared to an approximate 33 percent increase for large companies. These smaller firms also increased their employment of scientists and engineers at a rate approximately 75 percent greater than larger companies. Further, the results of this study, which are presented in "R&D Intensity by Firm Size", illustrate that particularly since 2004, smaller businesses have outpaced their larger rivals with respect to R&D intensity. The term R&D intensity refers to the current dollars spent on R&D divided by a company's reported sales revenue.<[36]

R&D Intensity by Firm Size

35. A. Roy Thurik, "Introduction: Innovation in Small Business," Small Business Economics 8 (1996): 175.
36. L. Rausch, "Indicators of U.S. Small Business's Role in R&D," National Science Foundation (Info Brief NSF 10–304), March 2010.



It cannot be overemphasized that innovation should not be limited to the creation of products or services. The following are just a few examples of innovation beyond the development of new products:

- In 1965, Thomas Angove, an Australian winemaker, developed the idea of packaging wine in boxes that had a polyethylene bladder. The package was not only more convenient to carry but also kept the wine fresher for a longer period of time.[37]
- Apple's iPod was certainly an innovative product, but its success was clearly tied to the creation of the iTunes website that provided content.
- Baker Tweet alerts customers via Twitter any time a fresh batch of baked goods emerge from a participating baker's oven.[38]

37. Jancis Robinson, "The Oxford Companion to Wine," 2nd ed., Wine Pros Archive, accessed October 8, 2011, www.winepros.com.au/jsp/cda/reference/oxford_entry.jsp?entry_id=430.

- Patrons at Wagaboo restaurants in Madrid can book specific tables online.[39]
- Restaurants often mark up bottles of wine by 200 percent to 300 percent. Several restaurants in New York, Sydney, and London have developed relationships with wine collectors. The collectors may have more wine than they can possibly drink, so they offer the wine for sale in the restaurant, with the restaurant selling it at a straightforward markup of 35 percent. This collaboration with customers is beneficial for the wine collector, the restaurant, and the customer.

Social and Consumer Trends

Not all businesses have to concern themselves with social and consumer trends. Some businesses, and this would include many small businesses, operate in a relatively stable environment and provide a standard good or service. The local luncheonette is expected to provide standard fare on its menu. The men's haberdasher will be expected to provide mainline men's clothing. However, some businesses, particularly smaller businesses, could greatly benefit by recognizing an emerging social or consumer trend. Small businesses that focus on niche markets can gain sales if they can readily identify new social and consumer trends.

Trends differ from fads. Fads may delight customers, but by their

38. "Innovation Jubilation," Trendwatching.com, accessed December 2, 2011, trendwatching.com/trends/innovationjubilation.
39. "Transparency Triumph," Trendwatching.com, accessed December 2, 2011, trendwatching.com/trends/transparencytriumph.

very nature, they have a short shelf life. Trends, on the other hand, may be a portend of the future.[40] Smaller businesses may be in a position to better exploit trends. Their smaller size can give them greater flexibility; because they lack an extensive bureaucratic structure, they may be able to move with greater rapidity. The great challenge for small businesses is to be able to correctly identify these trends in a timely fashion. In the past, businesses had to rely on polling institutes for market research as a way of attempting to identify social trends. Harris Interactive produced a survey about the obesity epidemic in America. This study showed that the vast majority of Americans over the age of 25 are overweight. The percentage of those overweight has steadily increased since the early 1980s. The study also indicated that a majority of these people desired to lose weight. This information could be taken by the neighborhood gym, which could then create specialized weight-loss programs. Recognizing this trend could lead to a number of different products and services.[41]

In the past, the major challenge for smaller businesses to identify or track trends was the expense. These firms would have to use extensive market research or clipping services. Today, many of those capabilities can be provided online, either at no cost or a nominal cost.[42] Google Trends tracks how often a particular topic

40. MakinBacon, “Why and How to Identify Real Trends,” HubPages, accessed October 8, 2011, hubpages.com/hub/trendsanalysisforsuccess.
41. “Identifying and Understanding Trends in the Marketing Environment,” BrainMass, accessed June 1, 2012, http://www.brainmass.com/library/viewposting.php?posting_id=51965.
42. Rocky Fu, “10 Excellent Online Tools to Identify Trends,” Rocky FU Social Media & Digital Strategies, May 9, 2001,

has been searched on Google for a particular time horizon. The system also allows you to track multiple topics, and it can be refined so that you can examine particular regions with these topics searched. The data are presented in graphical format that makes it easy to determine the existence of any particular trends. Google Checkout Trends monitors the sales of different products by brand. One could use this to determine if seasonality exists for any particular product type. Microsoft's AdCenter Labs offers two products that could be useful in tracking trends. One tool—Search Volume—tracks searches and also provides forecasts. Microsoft's second tool—Keyword Forecast—provides data on actual searches and breaks it down by key demographics. Facebook provides a tool called Lexicon. It tracks Facebook's communities' interests. (Check out the Unofficial Facebook Lexicon Blog for a description on how to fully use Lexicon.) The tool Twist tracks Twitter posts by subject areas. Trendpedia will identify articles online that refer to particular subject areas. These data can be presented as a trend line so that one can see the extent of public interest over time. The trend line is limited to the past three months. Trendrr tracks trends and is a great site for examining the existence of trends in many areas.

Online technology now provides even the smallest business with the opportunity to monitor and detect trends that can be translated into more successful business ventures.

Websites

- Google Trends: www.google.com/trends
- Trendpedia: www.attentio.com
- Trendrr: www.trendrr.com

accessed October 8, 2011, www.rockyfu.com/blog/10-excellent-online-tools-to-identify-trends.

- Google Analytics: https://analytics.google.com/

Key Takeaways

- 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.

3. Chapter 3 - The Family Business

Family Business: An Overview

There is no agreed-on definition of a family business. **The percentage of ownership, the strategic control, the involvement of multiple generations, and the intention for the business to remain in the family** are among the many criteria that experts use to distinguish family businesses from other types of businesses.[1]< For the purposes of this chapter, however, a **family business** is defined as a business that is actively owned and/or managed by more than one member of the same family.[2] A family business can also be defined as the result of someone's dream.

The story of every successful family business starts with someone

1. Joseph H. Astrachan and Melissa Carey Shanker, "Family business's Contribution to the U.S. Economy: A Closer Look," Family Business Review 16, no. 3 (2003): 211–19.
2. "Family Businesses," Entrepreneur, 2010, accessed October 8, 2011, www.entrepreneur.com/encyclopedia/term/82060.html.

who has the passion, confidence, and courage to put his [or her] money where his [or her] mouth is…[These entrepreneurs] work incredibly hard, make things happen, are positive without being unrealistic and possess the resourcefulness to overcome all sorts of hurdles. They are also socially adept, capable of communicating effectively, and good at inspiring others."[3]

Family business owners know that their roles are different from that of shareholders in companies owned by many public investors. In addition, "employees in family businesses know the difference that family control makes in their work lives, the company culture, and their career. Marketers appreciate the advantage that the image of a family business presents to customers. And families know that being in business together is a powerful part of their lives."[4]

Market and Employment Presence

Because of the private nature of most family businesses, it is difficult to obtain accurate information about them.[5] Complicating the

3. "Making a Difference: The PricewaterhouseCoopers Family Business Survey 2007/08," PriceWaterhouseCoopers, November 2007, accessed October 8, 2011, www.pwc.com/en_TH/th/publications/assets/pwc_fbs_survey.pdf.
4. Kelin E. Gersick et al., Generation to Generation: Life Cycles of the Family Business (Cambridge, MA: Owner Managed Business Institute, Harvard Business School Press, 1997), 1.
5. Joseph H. Astrachan and Shanker, "Family business's

situation is that most data sources do not distinguish between small family businesses, such as the local pizza parlor or deli, and large family businesses, such as Walmart, Mars, and Ford. "The reality is that family-based operations are represented across the full spectrum of American companies, from small businesses to large corporations."[6] Within this context, the following has been observed:[7]

- Family businesses account for a staggering 50 percent of the gross domestic product (GDP).
- Although it may seem that this GDP contribution comes from thousands of small operations, 35 percent of the *Fortune* 500 companies are family companies.
- Family businesses account for 60 percent of US employment and 78 percent of the new jobs created.
- Family businesses represent one of the fastest-growing sectors of the economy because their new job requirements outpace their current employment rates when compared to other types of businesses.

Contribution to the U.S. Economy: A Closer Look," Family Business Review 16, no. 3 (2003): 211–19.

6. "Family Business Statistics," Gaebler.com: Resources for Entrepreneurs, October 10, 2010, accessed October 8, 2011, www.gaebler.com/Family-Business-Statistics.htm.
7. "Family Business Statistics," Gaebler.com: Resources for Entrepreneurs, October 10, 2010, accessed October 8, 2011, www.gaebler.com/Family-Business-Statistics.htm; and Stacy Perman, "Taking the Pulse of Family Business," February 13, 2006, accessed October 8, 2011, www.BusinessWeek.com/smallbiz/content/feb2006/sb20060210_476491.htm.

What this means is that family businesses continue to be a powerful economic force, no matter what their size and no matter how they are defined. "Family firms are the most common form of business structure; they employ many millions of people, and they generate a considerable amount of the world's wealth."[8]

The focus of this chapter is on the small family business.

Advantages and Disadvantages of the Family Business

There are benefits to a family business, but there are disadvantages that must be considered as well. Starting a family business is not for everyone.

Advantages

A family business offers the following advantages:

- One of the popular misconceptions about family businesses is that they are unable to adapt easily to increasing competitiveness and technological progress. The reality is that family businesses frequently have the advantage of entrepreneurial spirit, flexibility, and opportunism.[9]

8. "Making a Difference: The PricewaterhouseCoopers Family Business Survey 2007/08," PriceWaterhouseCoopers, November 2007, accessed October 8, 2011, www.pwc.com/en_TH/th/publications/assets/pwc_fbs_survey.pdf.

- It is believed by some that family firms are "too soft" and rarely reach their potential. The reality is that family businesses actually outperform public companies. Oftentimes, the marketplace forces public companies to make short-term decisions, whereas a family business has the advantage of having more freedom to make its decisions. Family businesses can adapt to market fluctuations more easily because they can afford to be patient. They have common goals, shared values, and a commitment to brand building.[10]
- Family-owned businesses are often seen as ideal because family members form a "grounded and loyal foundation" for the company, and family members tend to exhibit more dedication to their common goals. "Having a certain level of intimacy among the owners of a business can help bring about familiarity with the company and having family members around provides a built-in support system that should ensure teamwork and solidarity."[11]
- The culture of a family business is very different from that of a company you will find on Wall Street. "Family businesses frequently take a very long-term point of view. They'll make investments that they don't expect to pay off for 5 or 15 or 25

9. "Myths and Realities of Family Business," 2002, accessed October 8, 2011, www.insead.edu/discover_insead/publications/docs/IQ03.pdf.
10. "Myths and Realities of Family Business," 2002, accessed October 8, 2011, www.insead.edu/discover_insead/publications/docs/IQ03.pdf.
11. Alexis Writing, "Pros and Cons of Family Business," Chron.com, 2010, accessed October 8, 2011, smallbusiness.chron.com/pros-cons-family-business-409.html.

years…Culture in a family business is more frequently based on very personal and emotional values. It's stronger because there are deeper roots and closer connections to the history of the company."[12]

- Family businesses are becoming more and more attractive to undergraduate business students who face a bleak job and salary outlook for new grads. These undergrads are choosing to return to their family businesses directly after graduation instead of trying to find a job in corporate America or on Wall Street.[13]
- There is a common misperception that family businesses are less professional and rigorous in their behavior because of the relational nature of the businesses.[14] However, like all other businesses, family businesses face global competition and rapidly changing markets. This creates more pressure on those who join to make sure that they produce. "This emphasis on professionalism has made family businesses both more daunting and more attractive—and has created new interest in them, from family members, outsiders, and business school

12. Margaret Steen, "The Decision Tree of Family Business," Stanford Graduate School of Business, August 2006, accessed June 21, 2012, www-prd-0.gsb.stanford.edu/news/bmag/sbsm0608/feature_familybiz.html.
13. Alison Damast, "Family Inc.: The New B-School Job Choice," Bloomberg BusinessWeek, April 12, 2010, accessed October 8, 2011, www.BusinessWeek.com/print/bschools/content/apr2010/bs20100412_706043.htm.
14. "American Family Business Survey," Mass Mutual Financial Group, 2007, accessed October 8, 2011, www.massmutual.com/mmfg/pdf/afbs.pdf.

students."[15]

- Many family-owned businesses tend to be stable and optimistic, even when economic times are uncertain. They seem to be better able to weather economic difficulties and stabilize the economy than their non-family counterparts.[16]
- In general, family businesses feel that they are stronger because family members are involved in their activities. Family owners believe that their family members can be trusted, will work harder, and care more.[17]
- Family businesses may be more open to flexible or part-time schedules or choosing your hours. This presents a very attractive work environment for people who need to tend to children, parents, or other family members in need.[18]

15. Margaret Steen, "The Decision Tree of Family Business," Stanford Graduate School of Business, August 2006, accessed June 21, 2012, www-prd-0.gsb.stanford.edu/news/bmag/sbsm0608/feature_familybiz.html.
16. "American Family Business Survey," Mass Mutual Financial Group, 2007, accessed October 8, 2011, www.massmutual.com/mmfg/pdf/afbs.pdf. However, this is a function of the industry and the size of the business.
17. "The Family Business Survey 2008/2009," Praxity, 2009, accessed October 8, 2011, http://praxityprod.awecomm.com/News/2009/Pages/UKFamilyBusinessSurvey.aspx. This can help create competitive advantage in the marketplace.
18. Alexis Writing, "Pros and Cons of Family Business," Chron.com, 2010, accessed October 8, 2011, smallbusiness.chron.com/pros-cons-family-

- Family businesses tend to operate more ethically. In fact, many family businesses believe that their ethical standards are more stringent than those of their competitors. In addition, family businesses are often deeply embedded in their communities, and this proximity is seen as an important factor that increases the likelihood of ethical decision-making and moral behavior.[19] As members of the local community, any ethical problems with a family business will be quickly visible.
- Family businesses also exhibit more social responsibility than their competitors. This has been attributed to their concern about image and local reputation[20] as well as their closeness to the community.
- Family businesses may incur lower costs because of the greater willingness of family members to make financial sacrifices for the sake of the business. Accepting lower pay than they would get elsewhere to help the business in the longer-term or deferring wages in a cash-flow crisis are examples of family altruistic behavior.[21]
- Family businesses, in general, have greater independence of action because they have less (or no) pressure from the stock

business-409.html.

19. "American Family Business Survey," Mass Mutual Financial Group, 2007, accessed October 8, 2011, www.massmutual.com/mmfg/pdf/afbs.pdf.
20. "American Family Business Survey," Mass Mutual Financial Group, 2007, accessed October 8, 2011, www.massmutual.com/mmfg/pdf/afbs.pdf.
21. "Advantages of Family Businesses," Business Link, accessed October 8, 2011, www.businesslink.gov.uk/bdotg/action/detail?itemId=1073792650&type=RESOURCES.

market and less (or no) takeover risk.[22]

- Family businesses tend to be more resilient in hard times because they are willing to plow profits back into the business.[23]
- Family businesses are less bureaucratic and less impersonal, which allows for greater flexibility and quicker decision-making.[24]
- Family businesses offer the possibility of great financial success.[25] This can manifest itself in interesting ways. "As the family of a media conglomerate once mentioned, 'The name I have has certainly helped me to get access to top executives of companies, persons who under other circumstances would have kept their doors shut.'"[26]
- Family members have the chance to learn the business early. This extensive expertise can create an important competitive

22. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
23. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
24. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
25. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
26. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.

advantage.[27] "One executive recalled how as a child he would take long walks with his father, during which they would visit stores to look at competitor's products. Afterward, his father would ask him which products he liked most, and this would lead to lengthy arguments about each product's quality. This man felt that the expertise he gained during those informal outings proved invaluable later in life."[28]

Why Family Businesses Are So Special

"If family businesses are so common, how can they also be special? When Freud was asked what he considered to be the secret of a full life, he gave a three-word answer: '*Lieben und arbeiten* [to love and to work].' For most people, the two most important things in their lives are their families and their work. It is easy to understand the compelling power of organizations that combine both. Being in a family firm affects all the participants. The role of chairman of the board is different when the company was founded by your father and when your mother and siblings sit around the table at board meetings, just as they sat around the dinner table. The job of a CEO is different when the vice president in the next office is also a younger sister. The role of partner is different when the other partner is a spouse or a child. The role of sales representative is different when you cover the same territory that your parent did

27. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
28. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.

twenty-five years earlier, and your grandparent twenty-five years before that. Even walking through the door on your first day of work on an assembly line or in a billing office is different if the name over the door is your own."[29]

Disadvantages

As attractive as family businesses are on many fronts, they have the following disadvantages:

- Family businesses tend to be stable organizations. Although this is a good thing in many instances, stability can also make it difficult to change. A new, younger family member coming into the business will find tradition and structure. Changing that is not simple. The key to changing a family business lies in defining tradition in terms of the company's core values, not in specific ways of doing things.[30]
- Family closeness can lead to sibling rivalry or problems when both the parent and the child want control. By the third or fourth generation, with many cousins possibly sharing ownership, governance can become very complicated.[31]
- There may be times when the interests of a family member

29. Kelin E. Gersick et al., Generation to Generation: Life Cycles of the Family Business (Cambridge, MA: Owner Managed Business Institute, Harvard Business School Press, 1997), 2–3.
30. Margaret Steen, "The Decision Tree of Family Business," Stanford Graduate School of Business, August 2006, accessed June 21, 2012, www-prd-0.gsb.stanford.edu/news/bmag/sbsm0608/feature_familybiz.html.

conflict with the interests of the business. One family member may want to expand the business, but other family members may not share this person's desire. The needs of the business are not in sync with the needs of the family.

- Family ties have a downside. Family members will frequently be expected to work harder, make more of a commitment, and get paid less than other employees in the business.[32]
- Family business owners may automatically promote someone from the family or give family members a job even if they do not have adequate skills for the job. A nonfamily employee may be better qualified.[33] This can cause dissension and resentment among other employees.
- Relationships between parents and children or among siblings have a tendency to deteriorate due to communication problems. "This dysfunctional behavior can result in judgments, criticism and lack of support."[34]

31. Margaret Steen, "The Decision Tree of Family Business," Stanford Graduate School of Business, August 2006, accessed June 21, 2012, www-prd-0.gsb.stanford.edu/news/bmag/sbsm0608/feature_familybiz.html.
32. "The Family Business Survey 2008/2009," Praxity, 2009, accessed October 8, 2011, http://praxityprod.awecomm.com/News/2009/Pages/UKFamilyBusinessSurvey.aspx.
33. Alexis Writing, "Pros and Cons of Family Business," Chron.com, 2010, accessed October 8, 2011, smallbusiness.chron.com/pros-cons-family-business-409.html.
34. Alexis Writing, "Pros and Cons of Family Business," Chron.com, 2010, accessed October 8, 2011,

- The family business may be a breeding ground for jealousy, resentment, anger, and sabotage. Family problems may spill over into the workplace."[35]
- The business may be plagued with managerial incompetence, the lack of exposure to other businesses, and the inability to separate family and work.[36]
- Some family businesses may have difficulty attracting and keeping highly qualified managers. "Qualified managers may avoid family firms due to the exclusive **succession**, limited potential for professional growth, lack of perceived professionalism, and limitations on wealth transfer."[37]
- Family businesses have limited sources of external capital because they tend to avoid sharing equity with nonfamily members.[38] Having less access to capital markets may curtail

smallbusiness.chron.com/pros-cons-family-business-409.html.

35. Advantages and Disadvantages of a Family Business," September 6, 2009, accessed October 8, 2011, pinoynegosyo.blogspot.com/2009/09/advantages-and-disadvantages-of-family.html.
36. "Advantages and Disadvantages of a Family Business," September 6, 2009, accessed October 8, 2011, pinoynegosyo.blogspot.com/2009/09/advantages-and-disadvantages-of-family.html.
37. David G. Sirmon and Michael A. Hitt, "Managing Resources: Linking Unique Resources, Management, and Wealth Creation in Family Firms," Entrepreneurship Theory and Practice, Summer 2003, 339–58. Succession refers to passing the business to the next generation.
38. David G. Sirmon and Michael A. Hitt, "Managing

growth.[39]

- Not all children of owner-managers may want to join the business. According to one study,[40] 80 percent of those who did not work in the family business did not intend to go into the business. This reluctance comes from several directions, such as the following:
    - My parents would not want me to join.
    - I could not work for my parents.
    - There are already too many family members in the business.
    - I am not interested in this particular business.
    - The business is too small for me.
    - The business would not allow me to use my talents.
    - The business would not allow me to use my training.
    - I can earn more elsewhere.
    - I am not interested in a business career.[41]

Resources: Linking Unique Resources, Management, and Wealth Creation in Family Firms," Entrepreneurship Theory and Practice, Summer 2003, 339–58.

39. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
40. Sue Birley, "Attitudes of Owner-Managers' Children towards Family and Business Issues," Entrepreneurship Theory and Practice, Spring 2002, 5–19.
41. Sue Birley, "Attitudes of Owner-Managers' Children towards Family and Business Issues," Entrepreneurship Theory and Practice, Spring 2002, 5–19.

In Their Own Words

Why Some Children of Owner-Managers Do Not Want to Join the Business[42]

I see the pressure my dad is under—this does put me off slightly. I want to enjoy my job as well as enjoying life outside work. A larger factor when working under a relative is the problem of self-worth. It is hard to feel like you are worth something when your father is an MD. A business relationship with your father makes your family relationship harder. I do not look to go into the family business straight away, as I feel this is giving a commitment to work there for the rest of my life. I would join only because I am genuinely qualified, not because I am the owner's daughter. The difference in my father's education and mine is a factor affecting why I have decided not to go into the business. I have more choice over what I want to do as a career, and my personal interests would not be met by my father's company. I am sure it would not have been his choice had he had the same educational choices as me. As much as the route into the family business is seen by outsiders as an "easy route to wealth and inheritance," in my case it was also a liability. At 17, was I to be the fourth generation after 100 years that could not keep the company going?

- The "spoiled kid syndrome" often occurs in a family business. The business owner may feel guilty because his devotion to the business takes away from the attention he should be giving to his children. Out of a sense of guilt, he or she starts to bribe the children, "a kind of pay-off for not being available emotionally or otherwise."[43]

42. Sue Birley, "Attitudes of Owner-Managers' Children towards Family and Business Issues," Entrepreneurship Theory and Practice, Spring 2002, 5–19.

- Financial strain emanating from "family members milking the business and a disequilibrium between contribution and compensation."[44] can have a significant negative impact on the business.
- Nepotism that results in the "tolerance of inept family members as managers, inequitable reward systems, [and] greater difficulties in attracting professional management"[45] can easily lead to low morale among nonfamily members of the business, and it can ultimately result in business failure.
- Family businesses frequently have a confusing organization, with "messy structure and no clear division of tasks." Authority and responsibility lines are unclear; jobs may overlap; executives may hold a number of different jobs; and the decision-making hierarchy may be completely ignored, existing only to be bypassed.[46] This can create a dysfunctional working environment.
- Family businesses frequently have paternalistic or autocratic rule that is characterized by a resistance to change, secrecy, and the attraction of dependent personalities.[47]

43. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
44. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
45. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
46. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.

Key Takeaways

- Family businesses account for 50 percent of the GDP, 60 percent of US employment, and 78 percent of the new jobs that are created.
- A family business offers both advantages and disadvantages. It is important to understand both.

Family Business Issues

Looking at the vision and hard work of the founders, family businesses "take on their unique character as new members of the family enter the business. At best, the environment can be inspiring and motivating. At worst, it can result in routine business decisions becoming clouded by emotional issues."[48]

The owners and managers of family businesses face many unique

47. Manfred F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good and the Bad News," Organizational Dynamics 21, no. 3 (1993): 59–71.
48. "Focusing on Business Families," BDO, November 2009, accessed October 8, 2011, static.staging.bdo.defacto-cms.com/assets/documents/2010/04/Focusing_on_business_families.pdf.

challenges. These challenges stem from the overlap of family and business issues and include communication, employing family and nonfamily members, professional management, employment qualifications, salaries and compensation, and succession.

Communication

Communication is important in any business, but the complexities of communication in a family business are particularly problematic. Experts say that communication is one of the most difficult parts of running a family business.[49] The approach to communication needs to include commitment, the avoidance of secrecy, and an understanding of the risks of bad communication.

Commitment

In a family business, it is critical that there be a commitment to communicate effectively with family and nonfamily members of the business. "Business leaders should be open about their awareness of the potential for communication issues to evolve and their willingness to accept feedback and input from all employees about opportunities for improvement and areas of concern."[50]

49. Christine Lagorio, "How to Run a Family Business," Inc., March 5, 2010, accessed October 8, 2011, www.inc.com/guides/running-family-business.html.
50. Leigh Richards, "Family Owned Business and Communication," Chron.com, 2010, accessed June 1,

One important issue is whether there should be a line drawn between family and business discussions. Some suggest that setting up strict guidelines from the start that draw a clear line between the different types of discussions is a good approach.[51] By contrast, the Praxity Family Business Survey[52] found that it is considered OK to talk about the business anywhere and at any time, whether at work or at home:

- Nineteen percent of the family businesses in the survey reported talking about business at home.
- Thirty-seven percent talk about it in the workplace.
- Forty-four percent talk about it when and wherever.

Secrecy

In family businesses, it is particularly important not to convey the impression that family members are more in the know than other employees. "…Even when this is not the case, the potential for the perception of exclusivity may exist. Steps should be taken to

2012, http://smallbusiness.chron.com/family-owned-business-communication-3165.html.

51. Leigh Richards, "Family Owned Business and Communication," Chron.com, 2010, accessed October 8, 2011, smallbusiness.chron.com/family-owned-business-communication-3165.html.
52. "The Family Business Survey 2008/2009," Praxity, 2009, accessed October 8, 2011, http://praxityprod.awecomm.com/News/2009/Pages/UKFamilyBusinessSurvey.aspx.

address any issues that may arise openly, honestly, and without preference for family members."[53]

Risks of Bad Communication

If good communication channels are not in place, the following can occur:

- "Family members assume they know what other family members feel or want."
- "Personal ties inhibit honest opinions being expressed."
- "The head of the family may automatically assume control of the business even if they don't have the best business skills."
- "One family member ends up dominating the business."
- "Family-member shareholders not active in the business fail to understand the objectives of those who are active and vice versa."
- "Personal resentments become business resentments and vice versa."[54]

These difficulties can be overcome if the family business makes a concerted effort to create and maintain an environment of open

53. Leigh Richards, "Family Owned Business and Communication," Chron.com, 2010, accessed October 8, 2011, smallbusiness.chron.com/family-owned-business-communication-3165.html.
54. "Communication and Family Businesses," Business Link, 2010, accessed October 8, 2011, www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId= 1073792652.

communication where people feel comfortable voicing opinions and concerns. It is important that family and nonfamily members have an equal opportunity to express their views.

Employing Family and Nonfamily Members

It is natural for a family business to employ family members, especially in management positions. Family members tend to be the first people hired when a small business gets started, and as the business grows, so do their roles.[55] There are both pros and cons to hiring family members. Both need to be considered carefully. Who to hire may well be the biggest management challenge that a family business owner faces.

Pros

On the positive side of things, several advantages can be identified for hiring family members:[56]

55. Philip Keefe, "Hiring Family Members for the Family Business," March 30, 2010, accessed October 8, 2011, philip-keeffe.suite101.com/hiring-family-members-for-the -family-business-a220028.
56. Dean Fowler and Peg Masterson Edquist, "Evaluate the Pros and Cons of Employing Family Members," Business Journal, June 6, 2003, accessed October 8, 2011, www.bizjournals.com/milwaukee/stories/2003/06/09/smallb6.html; and Philip Keefe, "Hiring Family

- Improved customer relations through family contact
- Intergenerational continuity
- Long-term stability
- Shared values
- Loyalty and commitment
- Inherent trust
- Willingness to sacrifice for the business
- Emotional attachment to the business; more willing to contribute to its success
- Share the same culture

"A family whose members work well together can also give the business a welcoming and friendly feel. It can encourage employees who aren't in the immediate family to work harder to gain acceptance by those employees who are."[57]

Cons

There are also quite a few disadvantages to hiring family members:[58]

Members for the Family Business," March 30, 2010, accessed October 8, 2011, philip-keeffe.suite101.com/hiring-family-members-for-the-family -business-a220028.

57. Philip Keefe, "Hiring Family Members for the Family Business," March 30, 2010, accessed October 8, 2011, philip-keeffe.suite101.com/hiring-family-members-for-the -family-business-a220028.
58. Dean Fowler and Peg Masterson Edquist, "Evaluate the

- Families are not perfect, so a dispute among family members can spill from home into the workplace.
  - There is always the possibility of managerial incompetence.
  - It may not be possible to separate family and work.
  - Patterns of conflict will be rooted in early family experiences.
  - Communication may break down.
  - Sibling rivalry may create problems.
- Newly hired family members may feel that they do not have to earn their positions; their success will be seen as linked to their name instead of their abilities.
  - The company may be subject to charges of discriminatory hiring practices if job openings are not published.
  - Nonfamily members of the business may feel that family

Pros and Cons of Employing Family Members," Business Journal, June 6, 2003, accessed October 8, 2011, www.bizjournals.com/milwaukee/stories/2003/06/09/smallb6.html; Philip Keefe, "Hiring Family Members for the Family Business," March 30, 2010, accessed October 8, 2011, philip-keeffe.suite101.com/hiring-family-members-for-the-family-business -a220028; Annika Hall and Mattias Nordqvist, "Professional Management in Family Businesses: Toward an Extended Understanding," Family Business Review 21, no. 1 (2008): 51–69; and Margaret Steen, "The Decision Tree of Family Business," Stanford Graduate School of Business, August 2006, June 21, 2012, www-prd-0.gsb.stanford.edu/news/bmag/sbsm0608/feature_familybiz.html.

members get hiring preference.
  - Nonfamily members may feel that they will be automatically outvoted in decision-making.
  - Hiring primarily family members for management positions may lead to hiring suboptimal people who cannot easily be dismissed. This could lead to greater conflict because of promotion criteria that are not based on merit.

Hiring Nonfamily Members

There will be times when the better decision may be to hire a non-family person for a particular job. Experience has shown that a family business is less likely to be successful if it employs only family members; bringing in the fresh thinking that comes with external expertise can be valuable at all levels of a business.[59] In addition, nonfamily members can offer stability to a family business by offering a fair and impartial perspective on business issues. The challenge is in attracting and retaining non-family employees because these employees "may find it difficult to deal with family conflicts on the job, limited opportunities for advancement, and the special treatment sometimes accorded family members. In addition, some family members may resent outsiders being brought into the firm and purposely make things unpleasant for nonfamily employees."[60] Because it is likely that a growing family business

59. "Focusing on Business Families," BDO, November 2009, accessed October 8, 2011, static.staging.bdo.defacto-cms.com/assets/documents/2010/04/Focusing_on_business_families.pdf.
60. "Family Owned Businesses Law and Legal Definition,"

will need to hire people from the outside, it is important that the business come to terms with that necessity. Policies and procedures can help with the transition, but the most important thing is to prepare the family culture of the business to accept a nonfamily member. Not surprisingly, this is much easier said than done.

Professional Management

The decision to hire a **professional manager** is likely one of the most important and difficult hiring decisions that a family business owner will have to make. The typical definition of professional managers equates them with external, nonfamily, nonowner managers, thus declaring professional management and family management as mutually exclusive.[61] "A typical argument…is that professional non-family managers should be brought in to provide 'objectivity' and 'rationality' to the family firm."[62]

There are several problems with this way of thinking. **First, it perpetuates the outdated notion that family members are not**

USLegal.com, 2010, accessed October 8, 2011, definitions.uslegal.com/f/family-owned-businesses.

61. Annika Hall and Mattias Nordqvist, "Professional Management in Family Businesses: Toward an Extended Understanding," Family Business Review 21, no. 1 (2008): 51–69.
62. Annika Hall and Mattias Nordqvist, "Professional Management in Family Businesses: Toward an Extended Understanding," Family Business Review 21, no. 1 (2008): 51–69.

professional, that the smartest thing for a family business to do is to bring in professional management—as quickly as possible.[63]

Second, professional managers are not always prepared to deal with the special nature of family-owned businesses. "The influence of families on businesses they own and manage is often invisible to management theorists and business schools. The core topics of management education—organizational behavior, strategy, finance, marketing, production, and accounting—are taught without differentiating between family and nonfamily businesses."[64] This does an injustice to the unique workings of a family-owned business.

Third, a professional manager from the outside is not always prepared, perhaps not even most of the time, to deal with the special nature of family companies. The dominant view on professional management downplays the importance of the social and cultural context. "This is a problem in family firms where family relations, norms, and values are crucial to the workings and development of the business."[65] It is argued that the meaning

63. Annika Hall and Mattias Nordqvist, "Professional Management in Family Businesses: Toward an Extended Understanding," Family Business Review 21, no. 1 (2008): 51–69.
64. Kelin E. Gersick et al., Generation to Generation: Life Cycles of the Family Business (Cambridge, MA: Owner Managed Business Institute, Harvard Business School Press, 1997), 4.
65. Annika Hall and Mattias Nordqvist, "Professional Management in Family Businesses: Toward an Extended Understanding," Family Business Review 21, no. 1 (2008): 51–69.

business families attach to their businesses is guided by family values and expectations—so much so that "anything or anyone that interrupts this fragility could send the business into chaos."[66]

The hiring of an outside manager, therefore, should include an assessment of both **formal competence** and **cultural competence**. Formal competence refers to formal education, training, and experience outside the family business. Although it is certainly helpful and appropriate, formal competence is not sufficient for managerial effectiveness. It needs to be supplemented with cultural competence, an understanding of the culture of a specific firm. Interestingly, most family businesses look only to formal competence when selecting a CEO.[67]

Culture and Nonfamily CEOs

It is extremely important to understand the culture of the family firm. It means that as a leader you have to be sensitive to the organization's reactions on the things you say and do. I have a long-term employee on my management team, and she is my guide in these issues. She can tell me how the organization will react and how things are likely to be received. We have to build on the past even though we have to do a lot of things in new and different ways.

66. Annika Hall and Mattias Nordqvist, "Professional Management in Family Businesses: Toward an Extended Understanding," Family Business Review 21, no. 1 (2008): 51–69.
67. Annika Hall and Mattias Nordqvist, "Professional Management in Family Businesses: Toward an Extended Understanding," Family Business Review 21, no. 1 (2008): 51–69.

But because of the culture, this might be very sensitive. (The words of a nonfamily CEO in a family business.)

As a non-family CEO, you have to have in-depth respect for the invisible forces among the employees in the family firm. You cannot escape the fact that there will always be special bonds between the family firm and the owner. Always. (The words of a nonfamily CEO in a family business.)[68]

One concern of family businesses may be that the hiring of a nonfamily manager will result in the loss of their "familiness." However, one study found that, even with nonfamily managers bringing nonfamily management activities, styles, and characteristics, "the special and unique aspects and forces of the system of the family, its individual family members, and the business itself provide a synergistic force that offsets the outside influences of the [nonfamily managers]."[69] This same study acknowledged, however, that their research did not focus on understanding at what point or percentage of nonfamily members, the feeling of "familiness" will begin to erode.[70]

68. Annika Hall and Mattias Nordqvist, "Professional Management in Family Businesses: Toward an Extended Understanding," Family Business Review 21, no. 1 (2008): 51–69.
69. Matthew C. Sonfield and Robert N. Lussier, "Family-Member and Non-family-Member Managers in Family Businesses," Journal of Small Business and Enterprise Development 16, no. 2 (2009): 196–209.
70. Matthew C. Sonfield and Robert N. Lussier, "Family-Member and Non-family-Member Managers in Family Businesses," Journal of Small Business and Enterprise Development 16, no. 2 (2009): 196–209.

Employment Qualifications

One of the more difficult challenges that a family business must face is determining employment qualifications for employees, both family and nonfamily. The lack of a clear employment policy and process can lead to major conflicts in the company. Unfortunately, it would appear that, despite their benefit, most family businesses have a family employment policy.[71] As a result, many family businesses may end up with more employees from the family than the company needs, and some of these people may not even be qualified or suitable for the jobs they have been given. "Some family businesses even find themselves acquiring businesses that have no relationship with their original business or keeping some unprofitable business lines just to make sure that everybody in the family gets a job within the company."[72] This kind of situation benefits no one.

A written family-business employment policy can solve a myriad of problems because it spells out the specific terms for family and nonfamily members with respect to recruiting, hiring, promoting,

71. "GARBAGE IN—GARBAGE OUT: Family Employment Policies," ReGENERATION Partners, May 2002, accessed October 8, 2011, www.regeneration-partners.com/artman/uploads/20-2002-may-news.pdf.
72. "Family Member Employment Policies (Case Study 1: SABIS)," IFC Corporate Governance, 2006, accessed October 8, 2011, www.smetoolkit.org/smetoolkit/en/content/en/6742/Family-Member-Employment-Policies-Case-Study-1 -SABIS%C2%AE-.

compensating, and terminating. One recommendation is that an ideal family employment policy should include the following:[73]

- “Explain the family employment policy’s purpose and philosophy.”
- “Describe how family members will apply and be considered for positions.”
- “Cover the general conditions of employment, including compensation and supervision.”
- “Outline the approach to be taken in developing and promoting family business members.”
- Make clear that family members will be completing the same applications that other candidates will complete.
- Include an inspiring and upbeat reminder that the policy’s purpose is to help the family business succeed and to support, develop, and motivate family members to lead successful and productive lives.
- Have all family business owners sign the policy, indicating they have read and agreed to it.

Others have recommended “that family members meet three qualifications before they are allowed to join the family business on a permanent basis: an appropriate educational background; three to five years’ outside work experience; and an open, existing position in the firm that matches their background.”[74]

73. “GARBAGE IN—GARBAGE OUT: Family Employment Policies,” ReGENERATION Partners, May 2002, accessed October 8, 2011, www.regeneration-partners.com/artman/uploads/20-2002-may-news.pdf.
74. Craig E. Aronoff and John L. Ward, Family Business Succession: The Final Test of Greatness (Marietta, GA: Business Owner Resources, 1992), as cited in “Nepotism,”

There are no rules that dictate the content of a family business employment policy, so differences from one family business to another can be expected. However, it is very important "to set employment conditions that do not discriminate against or favor family members. This would help establish an atmosphere of fairness and motivation for all employees of the family business."[75]

The benefits of an employment policy notwithstanding, the idea may be met with resistance. There may be the feeling that hiring decisions for family members should be separate from the hiring decisions for nonfamily members because being a family member provides special qualifications that cannot be matched by someone outside the family. How to proceed will ultimately fall on the shoulders of the family business owner.

Salaries and Compensation

As difficult as hiring decisions may be for the family business, decisions about salaries and compensation are probably even worse. No matter how well-intentioned and well-designed the company's compensation plan may be, there will still be jealousies, hard feelings, severed sibling relationships, and even lawsuits, particularly among those family members who feel they have been

Reference for Business.com, 2010, accessed October 8, 2011, www.referenceforbusiness.com/small/Mail-Op/Nepotism.html.

75. "Family Member Employment Policies (Case Study 1: SABIS)," IFC Corporate Governance, 2006, accessed October 8, 2011, www.smetoolkit.org/smetoolkit/en/content/en/6742/Family-Member-Employment-Policies-Case-Study-1-SABIS%C2% AE-.

treated unfairly.[76] This presents a daunting challenge: how to develop a compensation plan that will be fair to family members and good for the business:

One of the greatest struggles of operating a family business is separating the family from the business. Oh yes, there are many great benefits to having family in the business and to being a family member in a family business, but the most difficult problems result when "family values" and issues take over, leaving business values and needs wanting. There is no greater source for family business problems–nor more fertile ground for their cure–than the family business compensation systems.[77]

Some of the Problems

Family businesses often make several common mistakes when developing their compensation plans.

- They consider fair compensation to be equal compensation for all family members, sometimes even for the owner. This creates a very sticky situation because all family members are not created equal. "It is sometimes difficult to assess and compare the talents of family members who are also

76. "Family Owned Businesses: Compensation in Family Businesses," Gaebler.com Resources for Entrepreneurs, 2010, accessed October 8, 2011, www.gaebler.com/Compensation-in-Family-Businesses.htm.
77. Bernard J. D'Avella Jr. and Hannoch Weisman, "Why Compensation for Family Members Should Be at Market Value," Fairleigh Dickinson University, 2010, accessed October 8, 2011, view.fdu.edu/default.aspx?id=2344.

employees. Nor do all family members contribute equally to the business. As a result of the stress that this causes, many family business owners ignore the problem and let compensation become a breeding ground for dissension in the family."[78]

- They do not compensate wives for the work they do. The reason often given? It saves on taxes. Not surprisingly, this approach leaves wives isolated from the business, invisible in the decision-making process, and unappreciated. This problem extends to the compensation of sons and daughters as well. A survey by Mass Mutual Insurance Company Referenced in Kathy Marshack,[79] reported a big discrepancy among the salaries of sons and daughters in family businesses across America. The average salary of the typical son in a family business was $115,000, while his sister earned only $19,000. This may be due to the tendency of sons being groomed for leadership, while daughters are groomed for the supportive roles that command lower salaries.
- The compensation for family members is higher than that for nonfamily members, but the differential is not tied to the actual job requirements or performance. This situation can lead to anger, reduced motivation, resentment, and eventual departure of the nonfamily member from the firm.

78. Kathy Marshack, "How to Arrive at Fair Compensation in a Family Business," American Chronicle, February 29, 2008, accessed October 8, 2011, www.americanchronicle.com/articles/view/53757.
79. "How to Arrive at Fair Compensation in a Family Business," American Chronicle, February 29, 2008, accessed October 8, 2011, www.americanchronicle.com/articles/view/53757.

- The business overpays family members—for a variety of reasons:[80]
    - “Guilt, because mom & pop were so busy working when the kids were young.”
    - “Fear of conflict, because someone’s wife threatens not to come to the family picnic.”
    - “Resistance to change, because ‘That’s the way we’ve always done it.’”
    - “Inability to confront family members who feel ‘entitled’ to inflated salaries.”
    - “Determination to minimize estate taxes by transferring wealth through compensation.”
- Emotional pressures are allowed to determine compensation policies. What this means is that compensation is not correctly determined by job requirements and performance in those jobs. When this happens, small problems develop centrifugal force:[81]
    - “Fighting between sibling/cousin partners increases.”

80. Ellen Frankenberg, “Equal Isn’t Always Fair: Making Tough Decisions about Transmitting Family Assets,” Frankenberg Group, 2010, accessed October 8, 2011, www.frankenberggroup.com/equal-isnt-always-fair-making-tough-decisions-about -transmitting-family-assets.html.
81. Ellen Frankenberg, “Equal Isn’t Always Fair: Making Tough Decisions about Transmitting Family Assets,” Frankenberg Group, 2010, accessed October 8, 2011, www.frankenberggroup.com/equal-isnt-always-fair-making-tough-decisions-about -transmitting-family-assets.html.

- "Hard-working family members and employees lose morale."
- "Well-motivated competent employees leave the company."
- "The company loses its competitive edge and growth potential."
- "Family harmony decreases."
- "The value of the company declines, or it is sold—for the wrong reasons."

Some of the Solutions

Developing a fair compensation plan for the family business is not easy. It requires good faith, trust, and good business sense. The dollar amounts offered to family members will be critical, but the more pressing issue is fairness.[82] Unfortunately, fairness is often construed as equality. This must be avoided.

There is no template for designing a compensation plan for family businesses, but there are several recommendations:[83]

82. Dean Fowler and Peg Masterson Edquist, "Evaluate the Pros and Cons of Employing Family Members," Business Journal, June 6, 2003, accessed October 8, 2011, www.bizjournals.com/milwaukee/stories/2003/06/09/smallb6.html.
83. Bernard J. D'Avella Jr. and Hannoch Weisman, "Why Compensation for Family Members Should Be at Market Value," Fairleigh Dickinson University, 2010, accessed October 8, 2011, view.fdu.edu/default.aspx?id=2344.

- Develop accurate job descriptions for each employee that include responsibilities, level of authority, technical skills, level of experience and education required for the job, and goals for an annual performance review. In a performance-based company, the amount of stock owned by a family member will not be related to his or her compensation.
- Develop a clear philosophy of compensation so that everyone understands the standards that are used to pay people. The following is a sample of a written compensation plan philosophy that was developed by one family.

Family members employed in the business will be paid according to the standards in our region, as reported by our trade association, for a specific position, in companies of our size. In order to retain good employees we will pay all employed family members and other managers within the top quartile of our industry's standards. Additional compensation will be based on success in reaching specific company goals, with bonuses shared among all members of the management team. Individual incentives will be determined according to measurable goals for job performance determined each year, and reviewed by the appropriate manager.[84]

- Gather information about the salaries of similar positions in the industry of the family business in the applicable region of the country. Look at companies that are similar in the number of employees, revenue, and product. If possible, obtain salary

84. Ellen Frankenberg, "Equal Isn't Always Fair: Making Tough Decisions about Transmitting Family Assets," Frankenberg Group, 2010, accessed October 8, 2011, www.frankenberggroup.com/equal-isnt-always-fair-making-tough-decisions-about -transmitting-family-assets.html.

and benefit information.

- Have the base salary for each position be consistent with the salaries and wages paid for comparable positions at similarly sized businesses. Paying at this market value will have an excellent effect on nonfamily members because they will feel that they are on an even playing field. There will be a positive effect on business morale.
- The family business owner might consider seeking outside help in determining compensation levels for individual family members. However, this assistance must be seen as truly objective, with no reason to favor one viewpoint over another.

Sleepless Nights

A recent family business survey[85] reported that the following things keep family business owners awake at night.

85. "The Family Business Survey 2008/2009," Praxity, 2009, accessed October 8, 2011, http://praxityprod.awecomm.com/News/2009/Pages/UKFamilyBusinessSurvey.aspx.

Rank	The Nightmare	Percentage Citing as a Significant Concern (%)
1	Family members can never get away from work.	18
2	Business disagreements can put strain on family relationships.	17
3	Emotional aspects can get in the way of important business decisions.	16
4	Transition to the next generation is more difficult than a third-party sale.	10
5	There can often be conflicts regarding the fairness of reward for effort.	9
6	The business rewards are not necessarily based on merit.	8
7	Family members find it difficult to be individuals in their own right.	5
8	Difficulties arise in attracting professional management.	5
9	Children can be spoiled through inequitable rewards.	4
10	Outside shareholders do not contribute but take payouts from the business.	3
11	The family is always put before the business and therefore can be less efficient.	3
12	Past deeds are never forgotten and are brought up at inappropriate times.	2

Other urgent issues identified by a different family business survey included, in order of importance, the following:[86]

- Labor costs

86. "American Family Business Survey," Mass Mutual Financial Group, 2007, accessed October 8, 2011, www.massmutual.com/mmfg/pdf/afbs.pdf.

- Health-care costs
- Finding qualified employees
- Foreign competition
- Labor union demands
- Domestic competition
- Oil prices
- Availability of credit from lenders
- Estate taxes

Succession Planning

Another important issue that is particularly difficult for family businesses is **succession**. As mentioned earlier in this chapter, succession is about passing the business to the next generation. Decisions have to be made about who will take over the leadership and/or ownership of the company when the current generation dies or retires.[87] Interestingly, "only a third of all family businesses successfully make the transition to the second generation largely because succeeding generations either aren't interested in running the business or make drastic changes when they take the helm."[88] There are family businesses that manage the transition across generations quite easily because the succession process chooses only the children willing and able to join and work with the prevailing family, business values, and goals. Unfortunately, there

87. "Family Owned Businesses Law and Legal Definition," USLegal.com, 2010, accessed October 8, 2011, definitions.uslegal.com/f/family-owned-businesses.
88. "Family Business Statistics," Gaebler.com: Resources for Entrepreneurs, October 10, 2010, accessed October 8, 2011, www.gaebler.com/Family-Business-Statistics.htm.

are also instances in which children have had to leave school as soon as legally allowed, not equipped to manage either the business, their lives, or their family. These children spend many resentful years in the business until it fails.[89]

Passing the family business to the next generation is a difficult thing to do, but succession is a matter of some urgency because 40 percent of US businesses are facing the issue of succession at any given point in time.[90] This urgency notwithstanding, there are several forces that act against succession planning:[91]

1. Founder
    - Fear of death
    - Reluctance to let go of power and control
    - Personal loss of identity

89. Sue Birley, "Attitudes of Owner-Managers' Children Towards Family and Business Issues," Entrepreneurship Theory and Practice, Spring 2002, 5–19.
90. Nancy Bowman-Upton, "Transferring Management in the Family-Owned Business," Small Business Administration, 1991, accessed October 8, 2011, www.sbaonline.sba.gov/idc/groups/public/documents/sba_homepage/serv_sbp _exit.pdf.
91. Ivan Lansberg, "The Succession Conspiracy," Family Business Review 1 (1981): 119–44, as cited in Nancy Bowman-Upton, "Transferring Management in the Family-Owned Business," Small Business Administration, 1991, accessed October 8, 2011, www.sbaonline.sba.gov/idc/groups/public/documents/sba_homepage/serv_sbp _exit.pdf.

- Fear of losing work activity
- Feelings of jealousy and rivalry toward successor

2. Family

- Founder's spouse's reluctance to let go of role in firm
- Norms against discussing family's future beyond lifetime of parents
- Norms against favoring siblings
- Fear of parental death

3. Employees

- Reluctance to let go of personal relationship with founder
- Fears of differentiating among key managers
- Reluctance to establish formal controls
- Fear of change

4. Environmental

- Founder's colleagues and friends continue to work
- Dependence of clients on founder
- Cultural values that discourage succession planning

These are powerful forces working against succession planning, but they need to be overcome for the good of the founder, the family, and the business. It will be tricky to balance the needs of all three and fold them into a good succession plan.

The Succession Plan

Voyageur Transportation, a company in London, calls its successful succession planning program, "If you got hit by a beer truck, what would happen to your department?"[92] As a family business owner, you should pose this question in terms of yourself and your business. Hopefully, this will provide the impetus you need to develop a succession plan.

A good succession plan outlines how the succession will occur and what criteria will be used to judge when the successor is ready to take on the task. It eases the founder's concerns about transferring the firm to someone else and provides time in which to prepare for a major change in lifestyle. It encourages the heirs to work in the business, rather than embarking on alternative careers because they can see what roles they will be able to play. And it endeavors to provide what is best for the business; in other words, it recognizes that managerial ability is more important than birthright and that appointing an outside candidate may be wiser than entrusting the company to a relative who has no aptitude for the work.[93]

A good succession plan will recognize and accept people's differences, not assume that the next generation wants the business; determine if heirs even have enough experience to run the business; consider fairness; and think and act like a business. The plan should also include a timetable of the transition stages, from the identification of a successor to the staged and then full transfer of responsibilities, and a contingency plan in case the unforeseen

92. "Sample Succession Planning Policy," accessed October 8, 2011, www.experienceworks.ca/pdf/succession policy.pdf.
93. "Making a Difference: The PricewaterhouseCoopers Family Business Survey 2007/08," PriceWaterhouseCoopers, November 2007, accessed October 8, 2011, www.pwc.com/en_TH/th/publications/assets/pwc_fbs_survey.pdf.

should happen, such as the departure or death of the intended successor or the intended successor declining the role.[94] It would also be helpful to get some good professional advice—from company advisors who have expertise in the industry as well as other family-run businesses.[95]

Although each succession plan will be different, the following components should be seen as necessary for a good succession plan:[96]

1. **Establish goals and objectives.** As the family business owner, you must establish your personal goals and vision for the business and your future role in its operation. You should include your retirement goals, family member goals, goals of other stakeholders (e.g., partners, shareholders, and employees), and goals relating to what should happen in the case of your illness, death, or disability.
2. **Family involvement in the decision-making process.** If the family and stakeholders who are involved in the decision-making process are kept informed of the decisions being made,

94. "Family-Run Businesses: Succession Planning in Family Businesses," Business Link, accessed October 8, 2011, www.businesslink.gov.uk/bdotg/action/detail?type =RESOURCES&itemId=1074446767.
95. "Avoid Feuds When Handing Down the Family Business," 2010, AllBusiness.com, 2010, accessed October 8, 2011, www.allbusiness.com/buying-exiting-businesses/ exiting-a-business/2975479-1.html.
96. "Components of a Good Business Succession Plan," April 18, 2011, accessed October 8, 2011, www.entrepreneurshipsecret.com/components-of-a-good-business -succession-plan.

many of the problems related to inheritance, management, and ownership issues will be alleviated. Communication, the process for handling family change and disputes, the family vision for the business, and the relationship between the family and the business should be addressed. The surest path to family discord is developing the succession plan on your own and then announcing it.[97]

3. **Identify successor(s).** This section of the plan will address the issue of who takes over ownership and management of the business. Identification of the potential successor(s), training of the successor(s), building support for the successor(s), and teaching the successor(s) to build vision for the business are included here. Working with your successor(s) for a year or two before you hand over the business will increase the chances for success.[98]
4. **Estate planning.** Estate planning is important if you are planning to retire or want to take precautionary measures regarding the future of the business in the event you are unable to continue operation of the family business due to illness, disability, or death. You should consult a lawyer, an accountant, a financial/estate planner, and a life insurance representative so that your benefits will be maximized. You will need to consider taxation, retirement income, provisions for

97. Susan Ward, "Six Business Succession Planning Tips," About.com, 2011, accessed October 8, 2011, sbinfocanada.about.com/cs/buysellabiz/a/succession1_2.htm.
98. Susan Ward, "Six Business Succession Planning Tips," About.com, 2011, accessed October 8, 2011, sbinfocanada.about.com/cs/buysellabiz/a/succession1_2.htm.

other family members, and active/nonactive family members.

5. **Contingency planning.** Contingency planning is about unforeseen circumstances. It is about strategizing for the most likely "what if" scenarios (e.g., your death or disability). By thinking in terms of the unforeseen, you will be taking a proactive rather than reactive approach.
6. **Company structure and transfer methods.** This section of the succession plan involves the review and updating of the organizational and structural plan for the organization taking into account the strengths and weaknesses of the successor. The following needs to be identified: the roles and the responsibilities of the successor, the filling of key positions, structuring of the business to fit the successor, the potential roles for the retiring owner, any legal complications, and financial issues.
7. **Business valuation.** This section is relevant only if the business is being sold. Passing the business to a family member would not involve a business valuation.
8. **Exit strategy.** With any succession, ownership will be transferred, and you will remove yourself from the day-to-day operations of the business. Alternatives will be compared, and a framework for making your final choices will be developed. The transfer method and the timelines are decided. The exit plan should then be published and distributed to everyone who is involved in the succession process.
9. **Implementation and follow-up.** The succession plan should be reviewed regularly and revised as situations change. It should be a dynamic and a flexible document.

As difficult as the planning process can be, the goal should be a succession plan that will be in the best interests of all—or most—of the parties involved. Business interests should be put ahead of family interests, and merit should be emphasized over family position.[99]

The Family Business and Technology

In 2008, when R. Michael Johnson—Mikee to everyone who knows him—took over the pressure-treated lumber company his grandfather founded in 1952, he had a great idea: laptops for all managers and sales staff.

"'You would have thought the world was coming apart," says Johnson, CEO and president of Cox Industries in Orangeburg, South Carolina. One salesman—convinced that the computer would be used to track his movements outside the office—up and quit. A buyer who had been with the company for thirty-five years said he would like a fax machine but could not see why he needed a computer when he had managed just fine without one for so long.

And that was just the beginning. In an industry where some businesses still write delivery tickets by hand and tote them up on calculators, Johnson recently led the company through an ERP (enterprise resource planning) software conversion and distributed iPhones to the sales team so they can use the company's new customer relationship management (CRM) system.

"'Let's just say I have spent quite a few Sunday lunches after church explaining technology acronyms to Granddad and Grandmom," Johnson says.

The resistance to new technology quieted, however, after

99. "Family Succession Plan First Then the Succession Plan for the Family's Business," Family Business Experts, 2011, accessed October 8, 2011, www.family-business-experts.com/family-succession-plan.html.

Johnson was able to point to market share growth of 35 percent at the $200 million business in the past year. "The numbers are starting to resonate," he says. "Five years ago, I couldn't even say what our market share was because we didn't have the technology to figure it."[100]

Key Takeaways

- Important family issues include communication, employing family and non-family members, professional management, employment qualifications, salaries and compensation, and success. Each issue can create conflict.
- It is very important to understand the culture of the family business, especially by non-family CEOs.
- Succession planning is critical to the success of passing a business to family members.

100. Karen E. Klein, "When the Third Generation Runs the Family Biz," Bloomberg BusinessWeek, April 9, 2010, accessed October 8, 2011, www.BusinessWeek.com/smallbiz/content/apr2010/sb2010049_806426.htm.

Conflict

All businesses have conflict. It can be a good thing or it can be a bad thing. **Positive or constructive conflict** can be beneficial to a family business when it increases opportunity recognition, produces high-quality decisions, encourages growth, strengthens groups and individuals, increases the learning necessary for entrepreneurial behavior, and increases the levels of commitment to the decisions being made.[101] An example of positive conflict is a disagreement between family members on the strategic direction of the family business, the result being a much-needed rethinking of the business plan and a new agreed-on vision for the company.[102]

101. George Ambler, "Constructive Conflict Is Essential for Creating Commitment to Decisions," May 15, 2007, accessed October 8, 2011; Kimberly A. Eddleston, Robert F. Otondo, and Franz Willi Kellermanns, "Conflict, Participative Decision-Making, and Generational Ownership Dispersion: A Multilevel Analysis," Journal of Small Business Management 46, no. 3 (2008): 456–84; and Suzi Quixley, "Understanding Constructive & Destructive Conflict," May 2008, accessed June 1, 2012, http://www.suziqconsulting.com.au/free_articles_files/CON%20-%20Constructive%20&%20Destructive%20-%20May08.pdf.
102. "Managing Conflict in Family Businesses," Business Link, 2010, accessed October 8, 2011,

By contrast, **negative or destructive conflict** can hurt a business by damaging the harmony and relationships of family members in the family business, discouraging learning, causing ongoing harm to groups and individuals in the business, frustrating adequate planning and rational decision making, and resulting in poor quality decisions.[103] "The absence of good conflict makes it that much harder to accurately evaluate business ideas and make important decisions…But conflict does not mean browbeating."[104] An example of a negative conflict would be arguments over the successor to the business. Ultimately, the failure to adequately control negative conflict may contribute to the high mortality rate of family-owned businesses.[105]

www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId= 1073792653.

103. Kimberly A. Eddleston, Robert F. Otondo, and Franz Willi Kellermanns, "Conflict, Participative Decision-Making, and Generational Ownership Dispersion: A Multilevel Analysis," Journal of Small Business Management 46, no. 3 (2008): 456–84; and Suzi Quixley, "Understanding Constructive & Destructive Conflict," May 2008, accessed June 1, 2012, http://www.suziqconsulting.com.au/free_articles_files/CON%20-%20Constructive%20&%20Destructive%20-%20May08.pdf.
104. Professor Michael Roberto from Harvard Business School, quoted in George Ambler, "Constructive Conflict Is Essential for Creating Commitment to Decisions," May 15, 2007, accessed October 8, 2011.
105. Nigel Finch, "Identifying and Addressing the Causes of Conflict in Family Business," Working Paper Series:

Because of the clash between business and emotional concerns in a family business, the potential for negative conflict can be greater than for other businesses.[106] The tension that exists among the personal lives and career pursuits of family members creates an **interrole conflict** (occurring when a family member has simultaneous roles with conflicting expectations) in which the role pressures from work and home are incompatible.[107] This conflict is difficult—if not impossible in some instances—to resolve. "Due to the interconnection and frequent contact among family members working in the business with those who are not but may still have an ownership stake, recurring conflict is highly probable in family firms."[108]

University of Sydney, May 2005, accessed October 8, 2011, papers.ssrn.com/sol3/papers.cfm?abstract_id=717262.

106. "Managing Conflict in Family Businesses," Business Link, 2010, accessed October 8, 2011, www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId= 1073792653.
107. Nigel Finch, "Identifying and Addressing the Causes of Conflict in Family Business," Working Paper Series: University of Sydney, May 2005, accessed October 8, 2011, papers.ssrn.com/sol3/papers.cfm?abstract_id=717262.
108. Kimberly A. Eddleston, Robert F. Otondo, and Franz Willi Kellermanns, "Conflict, Participative Decision-Making, and Generational Ownership Dispersion: A Multilevel Analysis," Journal of Small Business Management 46, no. 3 (2008): 456–84.

Sources of Conflict

The specific causes of conflict in a family business are many. Because the typical understanding of conflict in family businesses is that conflict refers to negative conflict that is unhealthy and disruptive, negative conflict is the focus of this section.

The PricewaterhouseCoopers Family Business Survey[109] identified a core group of issues that are likely to cause tension.

109. "Making a Difference: The PricewaterhouseCoopers Family Business Survey 2007/08," PriceWaterhouseCoopers, November 2007, accessed October 8, 2011, www.pwc.com/en_TH/th/publications/assets/pwc_fbs_survey.pdf.

Issue Causing Tension	Causes Some Tension (%)	Causes a Lot of Tension (%)
Discussion about the future strategy of the business	25	9
Performance of family members actively involved in the business	19	8
Decisions about who can and cannot work in the business	19	7
Failure of family members actively involved in the business to consult the wider family on key issues	16	7
Decisions about the reinvestment of profits in the business versus the payment of dividends	15	7
The setting of remuneration levels for family members actively involved in the business	14	7
The role in-laws should or should not play in the business	14	7
Decisions about who can and cannot hold shares in the business	13	6
Discussions about the basis on which shares in the business should be valued	12	5
Rejection of chosen successor by other family members	10	5

Add to this the fact that "family firms are prone to psychodynamic effects like sibling rivalry, children's desire to differentiate themselves from their parents, marital discord, identity conflict, and succession and inheritance problems that nonfamily businesses do not suffer from,"[110] and it's easy to see how the family business is a fertile field for negative conflict.[111]

Several other sources of conflict can occur in a family-owned business. A sampling of those sources is discussed here. All have the potential to adversely impact family relationships, business operations, and business results.

- **Rivalry.** Harry Levinson from the Harvard Business School maintains that, "the fundamental psychological conflict in family businesses is rivalry, compounded by feelings of guilt, when more than one family member is involved."[112] This rivalry can occur between father and son, siblings, husband and wife, father and daughter, and in-laws with members of the family that own the business.
- **Differing vision.** Family members will often disagree with the founder and with each other about the vision and strategy for

110. Kimberly A. Eddleston, Robert F. Otondo, and Franz Willi Kellermanns, "Conflict, Participative Decision-Making, and Generational Ownership Dispersion: A Multilevel Analysis," Journal of Small Business Management 46, no. 3 (2008): 456–84.
111. Michael Harvey and Rodney E. Evans, "Family Business and Multiple Levels of Conflict," Family Business Review 7, no. 4 (1994): 331–48, as cited in Kimberly A. Eddleston, Robert F. Otondo, and Franz Willi Kellermanns, "Conflict, Participative Decision-Making, and Generational Ownership Dispersion: A Multilevel Analysis," Journal of Small Business Management 46, no. 3 (2008): 456–84.
112. Harry Levinson, "Conflicts That Plague Family Businesses," Harvard Business Review 71 (1971): 90–98.

the business. These differences “can create fear, anger, and destructive attempts to control decisions that are divisive and counter-productive to making and implementing sound decisions.”[113]. Rivalries that spill into the workplace can get nasty, leading to destructive behaviors.

- **Jealousy.** There is always the potential for jealousy in the family business. It can arise from feelings of unfairness in such things as compensation, job responsibilities, promotions, “having the ear” of the business founder, and stock distributions. It can also arise with respect to the planned successor when there is a difference of opinion about who it should be. If it is not resolved, jealousy has the potential to divide the family and destroy the business.[114]
- **Succession.** Succession is always a big obstacle for a family business. In some cases, the founder may feel that his or her children are not capable of running the business. This will cause obvious tension between the parent and the child/children, such that the child or children may leave the business in frustration.[115]< This, in turn, becomes problematic for

113. "Common Sources of Dysfunctional Conflict in Family Businesses,” RJW Consulting, accessed October 8, 2011, www.rjweissconsulting.com/businessDevelopmentNewsDetail.asp?ID=2
114. Nigel Finch, “Identifying and Addressing the Causes of Conflict in Family Business,” Working Paper Series: University of Sydney, May 2005, accessed October 8, 2011, papers.ssrn.com/sol3/papers.cfm?abstract_id=717262.
115. Nigel Finch, “Identifying and Addressing the Causes of Conflict in Family Business,” Working Paper Series: University of Sydney, May 2005, accessed October 8,

succession. “Who gets what type of equity, benefit, title, or role can be major sources of explicit conflict or implicit but destructive behaviors.”[116] It is also true that while the founder of the business wants to continue family ownership and leadership of the business, this may not be true of his or her immediate family or later-generation family members.[117] This can create substantive conflict during succession planning.

- **Playing by different rules.** This cause of negative conflict “often presents itself as a form of elitism or entitlement that exists simply by virtue of being in a family that owns a business. Examples show up in allowing one or more family members to exhibit deficient standards of conduct or performance that violate sound business practices or important requirements that all other employees are expected to follow. Such behaviors can be divisive and demoralizing to all employees and customers as well as harmful to the reputation of the business.”[118]
- **Decision making.** If roles and responsibilities are not clearly

2011, papers.ssrn.com/sol3/papers.cfm?abstract_id=717262.

116. “Common Sources of Dysfunctional Conflict in Family Businesses,” RJW Consulting, accessed October 8, 2011, www.rjweissconsulting.com/businessDevelopmentNewsDetail.asp?ID=2.
117. Peter S. Davis and Paula D. Harveston, “The Phenomenon of Substantive Conflict in the Family Firm: A Cross-Generational Study,” Journal of Small Business Management 39, no. 1 (2001): 14–30.
118. “Common Sources of Dysfunctional Conflict in Family Businesses,” RJW Consulting, accessed October 8, 2011, www.rjweissconsulting.com/

defined, conflict will arise over who can make decisions and how decisions should be made. This will lead to confusion, uncertainty, and haphazard decisions that will put the company at risk.

- **Compensation and benefits.** "This is one of the most frequent sources of conflict, especially among members of the younger generation." A person's compensation is inextricably linked to his or her feelings of importance and self-worth. Compound that with the emotions associated with being a member of the family that owns the business, and you have the potential for explosive negative conflict. Clearly, this is not in the best interests of the business.[119]

Avoiding Conflict

Some measure of family squabbling is expected in a family business. Some of the arguments will be logical and necessary. However, "it's important that they remain professional and not personal, because squabbling among family members in a work environment can make the employees and customers feel extremely uncomfortable, and

businessDevelopmentNewsDetail.asp?ID=2.

119. Wayne Rivers, "Top 15 Sources of Conflict in Family Businesses," Family Business Institute, 2009, accessed October 8, 2011, www.familybusinessinstitute.com/index.php/volume-6-articles/top-15-sources-of-conflict-in-family-businesses.html

can give them grounds for legal claims against the business."[120] The negative effects of family squabbling are as follows:[121]

- **Unprofessional image.** Family squabbling conjures up images of children—immaturity and pettiness. This sends a signal to customers and other employees that they are not in a professional environment that focuses on the right things.
- **Uncomfortable environment.** It is embarrassing to witness squabbling. No one likes to be in an awkward atmosphere; squabbling can cost you customers and employees, and it may result in expensive and unpleasant lawsuits. This can affect your bottom line very quickly.
- **Discrimination.** Nepotism is one of the biggest dangers of working in a family business. Arguing with relatives will only reinforce to other employees that they are in a family business. This can quickly lead to feelings of disparate treatment which, in turn, can lead to discrimination charges.
- **Legal troubles.** In the worst cases of family squabbling, disagreements over business can lead to lawsuits. If one family member's role is minimized and his or her authority is restricted, this is violating the person's rights as a shareholder.

120. "How Family Squabbling Affects Other Employees—and Customers," National Federation of Independent Business, 2010, accessed October 8, 2011, www.nfib.com/business-resources/business-resources-item?cmsid=52150.
121. "How Family Squabbling Affects Other Employees—and Customers," National Federation of Independent Business, 2010, accessed October 8, 2011, www.nfib.com/business-resources/business-resources-item?cmsid=52150.

> This can lead to an oppressed minority shareholder suit against the family business. This would be expensive, it would be ugly, and it could lead to the demise of the company.

Avoiding conflict is no easy feat. However, there are several things that a family business should consider. F**irst, there are consultants who engage in conflict resolution for a living.** The possibilities should be checked out. If the budget can handle the costs of a consultant, it could be the best choice. A consultant, having no reason to take one side or the other, will bring the necessary objectivity to the resolution of the conflict.

Second, emotional reactions should be differentiated from problem-solving reactions. Family members need to take a professional perspective rather than that of an irritated sibling, parent, son, or daughter.[122] It will probably be difficult to do this, but it is important that it be done.

Third, focus on the professional role instead of the family role. "Make sure it's clear what the expectations and attitudes of all your employees are…Because you're a small business, you might not have as strict a policy as a large corporation, but it would still be helpful to put it in writing, such as in an employee handbook, which carries legal responsibilities to both family and outside employees."[123]

122. "How Family Squabbling Affects Other Employees—and Customers," National Federation of Independent Business, 2010, accessed October 8, 2011, www.nfib.com/business-resources/business-resources-item?cmsid=52150.
123. "How Family Squabbling Affects Other Employees—and Customers," National Federation of Independent Business, 2010, accessed October 8, 2011,

Fourth, encourage honesty from the beginning. When first starting to work together, it is important that family members sit down together to talk about potential conflicts that might arise. Acknowledging that it will be more difficult to work together because of being family is a good beginning. Treating family members and the professional environment with respect and expecting honesty when someone steps over the line should make for a smoother process.[124]

Last, the founder should try to keep the conflict constructive. This means stimulating task-oriented disagreement and debate while trying to minimize interpersonal conflicts.[125]This will require a fair decision-making process.

- "Have ample opportunity to express their views and to discuss how and why they disagree with other [family] members";
- "Feel that the decision-making process has been transparent, i.e., deliberations have been relatively free of secretive, behind-the-scenes maneuvering";
- "Believe that the leader listened carefully to them and considered their views thoughtfully and seriously before making a decision";

www.nfib.com/business-resources/business-resources-item?cmsid=52150.

124. "How Family Squabbling Affects Other Employees—and Customers," National Federation of Independent Business, 2010, accessed October 8, 2011, www.nfib.com/business-resources/business-resources-item?cmsid=52150.
125. George Ambler, "Constructive Conflict Is Essential for Creating Commitment to Decisions," May 15, 2007, accessed October 8, 2011.

- "Perceive that they had a genuine opportunity to influence the leader's final decision"; and
- "Have a clear understanding of the rationale for the final decision."

Key Takeaways

- Conflict can be either positive or negative. Negative conflict can potentially harm the business.
- There are many sources of negative conflict in a family business. The fundamental psychological conflict in family businesses is rivalry.
- It is important to avoid negative conflict. In particular, family squabbling that is witnessed by others can cause damage to the firm. Employees and customers will feel uncomfortable, and there may ultimately be grounds for a lawsuit.

4. Chapter 4 - E-Business and E-Commerce

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. These advances now give small firms the capability and opportunity to participate in global supply chains, thus broadening their customer base.

Broad Schematic of an ERP System

E-business

E-business is a term that is often used interchangeably with e-commerce, but this is not accurate. E-business uses the Internet and online technologies to create operational efficiencies, thereby increasing value to the customer.[1] Its focus is internal—for example, online inventory control systems; accounting systems; procurement processes; supplier performance evaluation processes; tools to increase supply chain efficiency; processing requests for machine repairs; and the integration of planning, sourcing, and manufacturing. Critical business systems are connected to critical constituencies—customers, vendors, and suppliers—via the Internet, extranets, and intranets.[2] No revenue is generated, but "e-business applications turn into e-commerce precisely when an exchange of value occurs."[3]

E-business processes should be introduced wherever there is a process that is currently working but is costing unnecessary time and money to implement via paper. This would certainly apply to the small business that finds itself drowning in paperwork. Small businesses should always consider that e-business processes could

1. Kelly Wright, "E-Commerce vs. E-Business," Supply Chain Resource Cooperative, November 27, 2002, accessed October 7, 2011, scm.ncsu.edu/public/lessons/less021127.html.
2. Elias M. Awad, Electronic Commerce: From Vision to Fulfillment (Upper Saddle River, NJ: Pearson Education, 2004), 4.
3. Kenneth C. Laudon and Carol Guercio Traver, E-commerce: Business, Technology, Society (Upper Saddle River, NJ: Pearson Prentice Hall, 2007), 11.

improve their operational and cost efficiencies overall, so thinking about e-business implications should be part of many decisions. E-business can work for any small business "because it involves the whole business cycle for production, procurement, distribution, sales, payment, fulfillment, restocking, and marketing. It's about relationships with customers, employees, suppliers, and distributors. It involves support services like banks, lawyers, accountants, and government agencies."[4] The way you do business and your future profitability will be affected by e-business. Converting your current business into e-business may require some redesign and reshaping, depending on the size of your company. However, e-business integration should be seen as an essential element in the efforts of a small business to increase its agility in responding to customer, market, and other strategic requirements.[5]

E-Business Components

E-business involves several major components:[6] business

4. "Making Money on the Internet," BizBeginners.biz, accessed October 23, 2011, bizbeginners.biz/e_business.html.
5. William M. Ulrich, "E-Business Integration: A Framework for Success," Software Magazine, August 2001, accessed October 7, 2011, findarticles.com/p/articles/mi_m0SMG/is_4_21/ai_78436110.
6. Terri C. Albert and William B. Sanders, e-Business Marketing (Upper Saddle River, NJ: Prentice-Hall, 2003), 2–4; and Efraim Turban et al., Electronic Commerce: A

intelligence (BI), customer relationship management (CRM), supply chain management (SCM), enterprise resource planning (ERP), e-commerce, conducting electronic transactions within the firm, collaboration, and online activities among businesses.

Business intelligence is about the activities that a small business may undertake to collect, store, access, and analyze information about its market or competition to help with decision making. When conducted online, BI is efficient and quick, helping companies to

Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 4.

identify noteworthy trends and make better decisions faster. BI has been described as "the crystal ball of the 21st century."[7]

Customer relationship management (CRM) refers to "…a customer service approach that focuses on building long-term and sustainable customer relationships that add value for the customer and the company."[8] It is a company-wide strategy that brings together information from all data sources within an organization (and sometimes from external data sources) to give one holistic view of each customer in real-time. The goal is to reduce costs and increase profitability while providing customer satisfaction.[9] CRM applications are available for even the smallest businesses.

Every small business has a supply chain, a network of vendors that provide the raw components that are needed to make a product or deliver a service. The management of this network is known as **supply chain management (SCM)**. SCM is about efficiently and effectively improving the way that a company finds those raw components and then delivers the product or the service to the

7. Lena L. West, "Business Intelligence: The Crystal Ball of Champions," Small Business Computing.com, April 11, 2006, accessed October 10, 2011, www.smallbusinesscomputing.com/biztools/article.php/3598131/Business -Intelligence-The-Crystal-Ball-of-Champions.htm.
8. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 759.
9. "What Is CRM?," cestinationCRM.com, February 19, 2010, accessed October 10, 2011, www.destinationcrm.com/Articles/CRM-News/Daily-News/What-Is-CRM-46033.aspx.

customer.[10] SCM applications are now available for small businesses.

Enterprise resource planning (ERP) is about integrating all departments and functions across a company (sales, marketing, human resources, finance, accounting, production, engineering, etc.) into a single computer system that can serve the particular needs of each department. The objective is to provide information quickly and efficiently to those who need it. Small businesses have many vendor choices for ERP systems. There are more than thirty vendors in the field, and they are looking to small and midsize businesses as their primary growth market.[11]

E-commerce (a big focus of this chapter) is the marketing, selling, and buying of goods and services online. It generates revenue, which e-business does not. E-commerce is typically associated with e-marketing, but most of this chapter is dedicated to the operational, nonmarketing dimensions of e-commerce.

Conducting electronic transactions within a firm can occur through an **intranet**, e-mail, and instant messaging. An intranet is a private network within a business that is used for information sharing, processing, and communication. The goal is to "streamline

10. Thomas Wailgum and Ben Worthen, "Supply Chain Management Definition and Solutions," CIO, November 20, 2008, accessed October 10, 2011, www.cio.com/article/40940/Supply_Chain_Management_Definition_and_Solutions.
11. Mary O. Foley, "ERP for Small Business: The Time is Ripe," Inc., October 1, 2007, accessed October 10, 2011, technology.inc.com/2007/10/01/erp-for-small-business -the-time-is-ripe.

the workplace and allow easy information exchange within an organization."[12]

Collaboration can occur internally or externally, and it often involves business partners. The goal is to help teams or business partners communicate with each other more effectively and efficiently, manage projects and shared materials, save companies the costs of travel, and reduce travel-related productivity losses.[13] E-mail, instant messaging, newsgroups, bulletin boards, discussion boards, virtual team rooms, online meetings, and wikis are common means of collaboration. A **wiki** is a web page that can be viewed and modified by anybody with a web browser and access to the Internet unless it is password protected.[14]

Online activities between businesses focus on information sharing and communication via e-mail, online meetings, instant messaging, and extranets. An **extranet** is the part of an intranet that is made available to business partners, vendors, or others outside a company. It allows a business "to share documents, calendars, and project information with distributed employees, partners, and

12. Dachary Carey, "What Is Intranet Technology Used For?," Life123, accessed October 10, 2011, www.life123.com/technology/internet/intranet/what-is-intranet.shtml.
13. Gerry Blackwell, "Altogether Now: Comparing Collaboration Software," Small Business Computing.com, January 28, 2008, accessed October 10, 2011, www.smallbusinesscomputing.com/buyersguide/article.php/10729_3724501_/Altogether-Now-Comparing-Collaboration-Software.htm.
14. "7 Things You Should Know about Wikis," Educause Learning Initiative, July 2005, accessed October 10, 2011, net.educause.edu/ir/library/pdf/ELI7004.pdf. The most well-known wiki is Wikipedia.

customers" and "it enables 24/7 private, secure access to collaborative tools with just an Internet connection."[15] They make communication easier, eliminate redundant processes, reduce paperwork, increase productivity, provide immediate updates and information, and provide quick response times to problems and questions.[16] The result is money and time saved for employees, the company, vendors, and your customers. Commercial transactions typically do not take place on extranets.

As integral as e-business may be to many small businesses, however, there will be small businesses that choose not to go the e-business route. Small businesses that are nonemployers and/or are very small operations that choose to stay that way—for example, local delis, gift shops, restaurants, dry cleaners, and ice cream shops can be and are successful without having to make a commitment to e-business. Therefore, a small business can choose to incorporate all, some, or none of the e-business components. Given the ways in which the Internet continues to transform small businesses, however, it would be virtually impossible for a small business to operate totally outside the realm of e-business.

15. "Communicate Quickly and Efficiently Through Intranets, Extranets and Portals," Gozapit Interactive, 2009, accessed October 10, 2011, www.gozapit.com/intranet-extranet.htm.
16. "Communicate Quickly and Efficiently Through Intranets, Extranets and Portals," Gozapit Interactive, 2009, accessed October 10, 2011, www.gozapit.com/intranet-extranet.htm.

E-Commerce

E-commerce is the marketing, selling, and buying of goods and services online. **It is a subset of e-business**. **It generates revenue, whereas other areas of e-business do not**. E-commerce has experienced extraordinary and rapid growth and will continue to grab more market share.[17] The moment that an exchange of value occurs, e-business becomes e-commerce.[18]

E-commerce is the revenue generator for businesses that choose to use the Internet to sell their goods and services. Some small businesses rely on the Internet to grow and survive. Many small businesses also look to e-commerce for their own business needs, such as computers and office technology, capital equipment, and supplies, office furnishings, inventory for online sale, or other business-related goods.[19] This is not surprising considering the

17. Heather Green, "US Ecommerce Growth to Pick up in 2010, But Hit Mature Stride," Bloomberg BusinessWeek, February 2, 2009, accessed June 1, 2012, http://www.businessweek.com/the_thread/the_thread_05272011/blogspotting/archives/2009/02/us_ecommerce_gr.html.
18. Elias M Awad, Electronic Commerce: From Vision to Fulfillment (Upper Saddle River, NJ: Pearson Education, 2005), 4.
19. "E-commerce: Small Businesses Become Virtual Giants on the Internet," accessed October 10, 2011, www.score.org/system/files/become_a_virtual_giant.pdf.

pervasiveness of the Internet for business transactions of all shapes and sizes.

In a survey of 400 small businesses, each with fewer than 100 employees, it was reported that the Internet had significantly improved growth and profitability while helping to reduce costs. Some businesses even indicated that they rely on the Internet to survive. Interestingly, the survey participants themselves took advantage of e-commerce to purchase computers and office technology online (54 percent), capital equipment and supplies (48 percent), and office furnishings (21 percent); one third bought inventory for online resale, and 59 percent purchased other business-related goods online.[20] E-commerce offers many benefits to small businesses, including the following:[21]

- **Lower business costs.** It may not be necessary to maintain as much physical space and staff.
- **Greater accessibility.** Customers can shop when they want to.
- **The ability to provide customized service.** Like Amazon.com, companies can address their customers on a personal level by recognizing and greeting repeat shoppers.
- **Increased customer loyalty.** Companies can give information to customers while offering something of value (e.g., a coupon for use on the next purchase or helpful hints about using a

20. Robyn Greenspan, "Net Drives Profits to Small Biz," ClickZ, March 25, 2004, accessed October 7, 2011, www.clickz.com/clickz/stats/1719145/net-drives-profits-small-biz.
21. "E-commerce: Small Businesses Become Virtual Giants on the Internet," SCORE, accessed October 7, 2011, www.score.org/system/files/become_a_virtual_giant.pdf.

product).

These benefits make it possible for a small business to compete with, perhaps even overtake, larger companies that do not have the agility and innovation of a smaller company. The realities of Internet usage make a strong case for small businesses to integrate e-commerce into their operations, including the following:

- Seventy-four percent of American adults use the Internet.
- Eighty-one percent use the Internet for information online about a service or product they are thinking of buying.
- Seventy-one percent buy products online.[22]
- Sixty-six percent of adults have home broadband.[23]
- American small businesses have embraced broadband.[24]
- Fifty-five percent of American adults connect to the Internet wirelessly.[25]
- All income groups have high Internet usage, from 65 percent

22. "Trend Data: What Internet Users Do Online," Pew Internet & American Life Project, May 1, 2011, accessed June 1, 2012, http://www.pewinternet.org/Trend-Data-%28Adults%29/Online-Activites-Total.aspx.
23. "Home Broadband Adoption Since 2000," Pew Internet & American Life Project, 2010, accessed June 1, 2012, http://www.pewinternet.org/Static-Pages/Trend-Data-(Adults)/Home -Broadband-Adoption.aspx.
24. Robyn Greenspan, "Small Biz Gets Up to Speed," ClickZ.com, January 26, 2004, accessed October 7, 2011, www.clickz.com/clickz/stats/1704631/small-biz -gets-up-to-speed.
25. Lee Rainie, "Internet, Broadband, and Cell Phone Statistics," Pew Internet & American Life Project, January

(less than $30,000 per year) to 98 percent ($75,000 per year or more).[26]

- Forty-six percent of small business owners plan to grow their businesses by creating or improving their company's online presence.[27]
- Almost half (49 percent) of online adults have used online classified ads.[28]

We live in a society of 24/7 immediacy, where the equivalent of foot traffic is increasingly becoming eyeballs on a website.[29] People and businesses turn to the Internet to solve problems and address the

5, 2010, accessed October 7, 2011, pewinternet.org/~/media/Files/Reports/2010/PIP_December09_update.pdf.

26. "Demographics of Internet Users," Pew Internet & American Life Project, 2012, accessed June 21, 2012, http://www.pewinternet.org/Static-Pages/Trend-Data-%28Adults%29/Whos-Online.aspx.
27. "Small Biz Plans to Grow with Social," eMarketer.com, 2010, accessed October 7, 2011, www.emarketer.com/Article.aspx?R=1007706.
28. Sydney Jones, "Online Classifieds," Pew Internet & American Life Project, 2010, accessed June 1, 2012, http://www.pewinternet.org/Reports/2009/7--Online-Classifieds/1-Overview.aspx.
29. Sramana Mitra, "The Promise of E-Commerce," Forbes.com, April 9, 2010, accessed October 7, 2011, www.forbes.com/2010/04/08/retailing-entreprenuers-online -intelligent-technology-ecommerce.html.

needs that they have. Embracing this change and moving existing small business practices to include e-commerce would not seem to be an option. Rather, it is increasingly becoming a requirement for survival. Even so, small business must think carefully about how to enter the e-commerce world or, if already there, how to best take advantage of the opportunities. Both situations will require careful and deliberate decision making that takes e-commerce implications into consideration regularly.

Key Takeaways

- 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.

Types of E-Commerce

Every Internet business is either **pure-play** or **brick-and-click**. A pure-play business, such as Amazon and Zappos, has an online presence only and uses the capabilities of the Internet to create a new business. Brick-and-click businesses, such as Barnes and Noble and Vermont Country Store, combine a physical presence with an online presence. These businesses use the Internet to supplement their existing businesses.[30] There are several different types of e-commerce. A common classification system is with respect to the nature of transactions or the relationships among participants.[31] There are seven major types of e-commerce:

1. **Business-to-business (B2B)**, where e-commerce businesses focus on selling to other businesses or organizations, is the largest form of e-commerce.[32] Cisco, Staples, and Spiceworks (information technology [IT] and IT networks for the small- and medium-sized business) are all B2B companies.
2. **Business-to-consumer (B2C)** is the earliest form of e-commerce, but it is second in size to B2B. It refers to retail sales between businesses and individual consumers. Consumers gather information; purchase physical goods, such

30. Sandeep Krishnamurthy, E-Commerce Management: Text and Cases (Mason, OH: South-Western, 2003), 73.
31. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 8.
32. Kenneth C. Laudon and Carol G. Traver, E-commerce: Business, Technology, Society (Upper Saddle River, NJ: Prentice Hall, 2007), 58; Turban et al., 2008, 8.

as books and clothing; purchase information goods, such as electronic material or digitized content, such as software; and, for information goods, receive products over an electronic network.[33]

3. **Consumer-to-consumer (C2C)** e-commerce is where consumers sell products and personal services to each other with the help of an **online market maker** to provide catalog, search engine, and transaction-clearing capabilities so that products can be easily displayed, discovered, and paid for. The most well-known C2C business is eBay, but there are many other online market makers as well. Craigslist is an extremely popular small e-commerce business for placing classified ads.
4. **Business-to-government (B2G)** e-commerce can generally be defined as transactions with the government. The Internet is used for procurement, filing taxes, licensing procedures, business registrations, and other government-related operations. This is an insignificant segment of e-commerce in terms of volume, but it is growing.
5. **Consumer-to-business (C2B)** e-commerce is between private individuals who use the Internet to sell products or services to organizations and individuals who seek sellers to bid on products or services.[34] Elance is an example of C2B where a

33. Zorayda Ruth Andam, "e-Commerce and e-Business," Asia and Pacific Training Centre for Information and Communication Technology for Development, May 2003, accessed June 21, 2012, http://www.unapcict.org/ecohub/resources/e-commerce-and-e-business/at_download/attachment1.
34. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 8.

consumer posts a project with a set budget deadline and within hours companies and/or individuals review the consumer's requirements and bid on the project. The consumer reviews the bids and selects the company or individual that will complete the project. Elance empowers consumers around the world by providing the meeting ground and platform for such transactions.[35] Priceline.com is a well-known example of C2B e-commerce.

6. **Mobile commerce (m-commerce)** refers to the purchase of goods and services through wireless technology, such as cell phones, and handheld devices, such as Blackberries and iPhones. Japan has the lead in m-commerce, but it is expected to grow rapidly in the United States over the next several years. eMarketer predicts mobile content revenues will grow to more than $3.53 billion in 2014, a compound annual growth rate of nearly 20 percent for the period 2009–2014, with the fastest growth coming from mobile music.[36]
7. **Peer-to-peer (P2P) technology** makes it possible for Internet users to share files and computer resources directly without having to go through a central web server. P2P began with Napster offering free music downloads via a file-sharing system. Tomago [37] launched the world's first P2P commerce

35. "Ecommerce Definition and Types of Ecommerce," DigitSmith, accessed October 10, 2011, www.digitsmith.com/ecommerce-definition.html.
36. "Mobile Content Soars Thanks to Device and Network Advances," eMarketer, August 31, 2010, accessed October 10, 2011, www.emarketer.com/Articles/Print.aspx?1007899.
37. Free Encyclopedia of Ecommerce, "Peer-to-Peer Technology (P(2P)," accessed June 1, 2012,

> system in 2005, which allowed people to sell every type of digital media directly from their computers to customers all over the world. People who publish videos, photos, music, e-books, and so forth can earn royalties, while buyers earn commissions for distributing media to others.[38]

E-Commerce Business Models

The decision to engage in e-commerce is an important one. The advantages are clear: lower business costs; 24/7 accessibility anywhere; the potential for stronger customer service; the ability to introduce a niche product; the ability to reach global markets on a more equalized basis with larger firms, making mass customization possible; and greater customer loyalty. But the risks are there as well. Internet problems, website problems, security and privacy breaches, intellectual property theft, legal liability, product and/or service failure, customer deceit, and customer dissatisfaction are but a few of the risks. Therefore, the choice of an e-commerce business model must be made carefully. Each model will have different implications in terms of business planning and strategy. An **e-commerce business model** is the method that a business uses to generate revenue online. "The business model spells out how a company makes money by specifying where it is positioned in the value chain. Some models are quite simple. A company produces a good or service and sells it to customers. If all goes well, the

http://ecommerce.hostip.info/pages/840/Peer-Peer-Technology-P2P.html

38. "Tamago Launches First Peer-to-Peer eCommerce System," PR Leap, October 15, 2006, accessed October 10, 2011, www.prleap.com/pr/51931.

revenues from sales exceed the cost of operation and the company realizes a profit. Other models can be more intricately woven."[39] Another way to look at a business model is that it "reflects management's hypothesis about what customers want, how they want it, and how the enterprise can organize to best meet those needs, get paid for doing so, and make a profit."[40] There are many models to choose from, and new models will continue to emerge as technology evolves and businesses look for new and creative ways to generate revenue. Some of the many e-commerce business models are as follows:[41]

- The **virtual merchant model** is used by online retailers that operate over the Internet only. FreshDirect is a small business that offers fresh food and brand-name groceries for home delivery in New York. Amazon is another example of a virtual

39. Michael Rappa, "Business Models on the Web," DigitalEnterprise.org, January 17, 2010, accessed October 10, 2011, digitalenterprise.org/models/models.html.
40. David J. Teece, "Business Models, Business Strategy and Innovation," Long Range Planning 43, no. 2–3 (2010): 172–94.
41. For additional discussions of business models, see Michael Rappa, "Business Models on the Web," DigitalEnterprise.org, January 17, 2010, accessed October 10, 2011, digitalenterprise.org/models/models.html; and Robert D. Atkinson et al., "The Internet Economy 25 Years After .Com: Transforming Commerce & Life," Information Technology & Innovation Foundation, March 2010, accessed October 10, 2011, www.itif.org/files/2010-25-years.pdf.

merchant.

- The **brokerage model** brings buyers and sellers together and facilitates transactions. Mint.com (now part of Intuit) is a business that connects users to companies that provide financial services.
- The **incentive marketing model** is a "customer loyalty program that provides incentives to customers such as redeemable points or coupons for making purchases from associated retailers."[42] The long-standing Entertainment Book (now online) would be a good example.

Because the business model will be at the center of the business plan, the model must be designed carefully. If a successful model is to be built, the model should effectively address the eight key elements seen in the table below. Although value proposition and the revenue model may be the most important and easily identifiable aspects of a company's business model, the other six elements are equally important.[43]

42. Michael Rappa, "Business Models on the Web," DigitalEnterprise.org, January 17, 2010, accessed October 10, 2011, digitalenterprise.org/models/models.html.
43. Kenneth C. Laudon and Carol G. Traver, E-Commerce: Business, Technology, Society (Upper Saddle River, NJ: Prentice Hall, 2007), 58; Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 8.

Components	Key Questions
Value proposition	Why should the customer buy from you?
Revenue model	How will you earn your money?
Market opportunity	What market space do you intend to serve, and what is its size?
Competitive environment	Who else occupies your intended market space?
Competitive advantage	What special advantages does your firm bring to the market space?
Market strategy	How do you plan to promote your products or services to attract your target audience?
Organizational development	What types of organizational structures within the firm are necessary to carry out the business plan?
Management team	What kinds of experiences and background are important for the company's leaders to have?

Source in the footnotes[44]

E-Commerce Trends

For businesses already engaged in e-commerce and for those that are thinking about it, being aware of the latest e-commerce trends is important because they could have a long-term influence on the future of a company's market. This influence, in turn, could mean life or death for your e-commerce operations. Several general e-commerce trends can be identified, and they are relevant to all e-commerce operations.

44. Kenneth C. Laudon and Carol G. Traver, E-commerce: Business, Technology, Society (Upper Saddle River, NJ: Prentice Hall, 2007), 59.

- E-commerce will continue to grab more market share.[45]
- It is expected that, in some way, the web will influence 53 percent of all purchases made in 2014.[46]
- The lines between online and offline commerce will become less defined. If somebody buys from a mobile device in your store, is that a web sale or a store sale? Retailers need to think of some new ways that they can take the web's influence into account.[47]
- B2B e-commerce will continue to significantly outpace B2C e-commerce, representing more than 85 percent of all e-commerce.
- M-commerce is the fastest-growing segment of visitors to e-commerce websites. If a business does not allow customers to both browse its catalog and conduct transactions on a mobile device, customers will seek out other brands that offer such an

45. Heather Green, "US Ecommerce Growth to Pick Up in 2010, But Hit Mature Stride," Bloomberg BusinessWeek, February 2, 2009, accessed October 10, 2011, www.BusinessWeek.com/the_thread/blogspotting/archives/2009/02/us _ecommerce_gr.html.
46. Geoffrey A. Fowler, "E-Commerce Growth Slows, But Still Out-Paces Retail," Wall Street Journal, March 8, 2010, accessed October 10, 2011, blogs.wsj.com/digits/2010/03/08/e-commerce-growth-slows-but-still-out-paces-retail.
47. Geoffrey A. Fowler, "E-Commerce Growth Slows, But Still Out-Paces Retail," Wall Street Journal, March 8, 2010, accessed October 10, 2011, blogs.wsj.com/digits/2010/03/08/e-commerce-growth-slows-but-still-out-paces-retail.

experience.[48]

- Many businesses have increased their social marketing initiatives through a combination of Facebook pages, Twitter tweets, YouTube fan videos, and blogs. Any business that sells its products or services online without having a social strategy will suffer.[49]

The following e-commerce trends specifically apply to small businesses:

- The Internet will continue to create opportunities for small businesses. It is now possible to buy a wide range of specialized products and services that are not available elsewhere. The Internet has provided a lifeline for many small producers and has allowed entrepreneurs to enter retailing without having to invest heavily in physical outlets.[50] Small businesses can easily enter the e-commerce arena as pure-play businesses. Take Socrata, an online service that makes it easy to share data—anything from crime statistics to football schedules. This small start-up business discovered that federal agencies were the site's biggest users. "It became clear that a

48. Frank Gruber, "Exploring the Latest E-Commerce Industry Trends," Tech Cocktail, June 3, 2010, accessed October 10, 2011, techcocktail.com/exploring-the-latest-e -commerce-industry-trends-2010-06.
49. "Recap of Ecommerce Trends from the Internet Retailer 2010 Conference," Tealeaf, June 22, 2010, accessed October 10, 2011, tealeaf.typepad.com/blog/2010/06/recap-of-ecommerce-trends.html.
50. "E-Commerce Industry," QFinance, accessed October 10, 2011, www.qfinance.com/sector-profiles/e-commerce.

really good place for our technology was helping government organizations share data in the interest of transparency."[51]

- Broadband and wireless networks will be everywhere. Small businesses will need to factor in the effect of the broadband revolution on their businesses.[52] Consider the case of the small, ten-person shop in Seattle that engraves plaques and trophies. Today, 60 percent of its business is conducted online, with customers who live outside the Seattle area.[53]
- The Internet will continue to be a platform that provides small businesses with a wide range of new tools, services, and capabilities. Small businesses will find new ways to use the Internet, contributing to the blurred distinctions between the physical and the virtual worlds.[54]

51. John Tozzi, "Gov 2.0: The Next Internet Boom," Bloomberg BusinessWeek, May 27, 2010, accessed October 10, 2011, www.BusinessWeek.com/smallbiz/content/may2010/sb20100526_721134.htm.
52. Steve King et al., "INTUIT Future of Small Business Report: Technology Trends and Small Business," Intuit, June 2007, accessed October 10, 2011, http-download.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/SR-1037B_intuit_tech_trends.pdf.
53. Secretary of Commerce Gary Locke, "Remarks at Organization for Economic Cooperation and Development (OECD) Conference," December 9, 2009, accessed October 10, 2011, www.commerce.gov/news/secretary-speeches/2009/12/09/remarks-organization-economic-cooperation-and-development-oecd-conference.html.

- Small business relationships will become increasingly virtual as online social networks expand.[55] Many small businesses are promoting their presence on Facebook and Twitter. Westbrook Lobster and Arisco Farms are both small businesses in Connecticut that have an online social presence. Naked Pizza in New Orleans has a presence on Twitter that has proven to be a boon to its business.[56]

Is E-Commerce for All Small Businesses?

Despite the popularity and pervasiveness of e-commerce, not all

54. Steve King et al., "INTUIT Future of Small Business Report: Technology Trends and Small Business," Intuit, June 2007, accessed October 10, 2011, http-download.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/SR-1037B _intuit _tech_trends.pdf.
55. Steve King et al., "INTUIT Future of Small Business Report: Technology Trends and Small Business," Intuit, June 2007, accessed October 10, 2011, http-download.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/SR-1037B _intuit_tech_trends.pdf.
56. Abbey Klaasen, "Twitter Proves Its Worth as a Killer App for Local Businesses," Advertising Age, May 18, 2009, accessed October 10, 2011, adage.com/article/digital/twitter-proves-worth-a-killer-app-local-businesses/136662.

small businesses may be interested in pursuing e-commerce as a part of their businesses. Many small businesses survive without an online presence. However, business analysts have agreed for a long time “that for any company larger than a local mom and pop store, e-commerce is now a business requirement.”[57]

Key Takeaways

- E-business and e-commerce are not synonymous terms. E-commerce generates revenue. E-business does not.
- E-business and/or e-commerce may not be of interest to all small businesses. However, using technology well is proving to be one of the most prominent drivers of business success.
- E-business consists of several major components, one of which is e-commerce.
- Every Internet business is either pure-play (an Internet presence only) or brick-and-click (having both a physical and an online presence).
- The seven major types of e-commerce are B2B, B2C, C2C, B2G, C2B, m-commerce, and P2P.
- An e-commerce business model is the method that a business uses to generate revenue online. Some models are very simple; others are more complicated. New business models are being introduced all the time.
- E-commerce will continue to grab more market share, and the line between online and offline commerce will become less defined.

57. Beverly Kracher and Cynthia L. Corritore, “Is There a Special E-Commerce Ethics?,” Business Ethics Quarterly 14, no. 1 (2004): 71–94.

Other E-commerce Issues

Legal

There is nothing easy about the law. It is complex under the best of circumstances, but it is necessary to protect the rights and privileges of people and businesses. Companies that choose to engage in e-commerce must be aware of the legal environment because "a lack of awareness…can lead to missteps as well as missed opportunities…."[58] However, the focus here is on three areas: electronic transactions, intellectual property, and jurisdiction.

58. Kathleen Mykytn and Peter P. Mykytn, "The Importance of the Law for E-Commerce Strategies," Information Systems Management 22, no. 2 (2005): 50–56.

Issue	Description
Jurisdiction	The ability to sue in other states or countries.
Electronic transactions	All transactions that take place online.
Liability	The use of multiple networks and trading partners makes documenting responsibility difficult. How can liability for errors, malfunctions, or fraudulent use of data be determined?
Identity fraud	The Identity, Theft, and Assumption Deterrence Act of 1998 makes identity fraud a federal felony carrying a three- to twenty-five-year prison sentence.
Defamation	Is the Internet service provider liable for material published on the Internet because of services it provides or supports? (Usually not.) Who else is liable for defamation? What if the publisher is in another country?
Intellectual property law	Protects creations of the human mind.
Digital signatures	Digital signatures are recognized as legal in the United States and some but not all other countries.
Regulation of consumer	The United States allows the compilation and sale of customer databases. The European Union does not.
Time and place	An electronic document signed in Japan on January 5 may have the date January 4 in Los Angeles. Which date is considered legal if a dispute arises?
Electronic contracts	If all the elements to establish a contract are present, an electronic contract is valid and enforceable.
Taxation	Taxation of sales transactions by states is on hold in the United States and some but not all other countries. Expect this issue to be revived because the potential for increased revenue to the states is significant.

Source in footnotes[59]

59. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 795.

Electronic transactions are the many kinds of transactions that take place online, including contractual dealings, buying and selling of goods and services, information exchange, financial transactions (credit card payments; payor services, such as PayPal; and money transfers), and communications. When developing a website, the small business owner must ensure that all online business transactions will be secure, particularly those involving money. This discussion must take place with whomever is developing your website.

Intellectual property is "a creation of the mind, such as inventions, literary and artistic works, and symbols, names, images, and designs, used in commerce."[60] Music, photos, videos, digital news, and artwork are forms of intellectual property that can be transmitted over the Internet. All small business owners need to be concerned about the theft of intellectual property. They are afforded multiple protections, which are summarized in the table below:

60. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 774.

Law	Protection Provided by the Law
Intellectual property law	Protects creations of the human mind
Patent law	Protects inventions and discoveries
Copyright law	Protects original works of authorship, such as music and literary works and computer programs
Trademark law	Protects brand names and other symbols that indicate source of goods and services
Trade secret law	Protects confidential business information
Law of licensing	Enables owners of patents, trademarks, copyrights, and trade secrets to share them with others on a mutually agreed-on basis
Law of unfair competition dealing with counterfeiting and piracy	Protects against those who try to take a free ride on the efforts and achievements of creative people

Source in footnotes[61]

It is important to protect intellectual property because businesses will not realize the full benefits of their inventions and would be inclined to focus less on research and development. Additionally, without intellectual property protections, "exporters face unfair competition abroad, non-exporters face counterfeit imports at home, and all businesses face legal, health and safety risks from

61. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 779.

the threat of counterfeit goods entering their supply chains."[62] Unfortunately, US small businesses are at a disadvantage because:[63]

- They may lack the knowledge, expertise, or resources necessary to prevent the theft of their ideas and products.
- Many small businesses do not have personnel and operators overseas, so they do not have the necessary eyes and ears needed to be vigilant. The theft of their ideas and products often goes undetected.
- Small businesses generally do not have the kinds of access and resources that are likely available to larger companies (e.g., specialized legal counsel).

Because of the complexities of intellectual property protections, this area requires the services of an attorney, preferably one experienced and knowledgeable in cyberlaw.

Jurisdiction refers to the right and power that a court has to interpret and apply the law in a particular geographic location.[64] "A court must have jurisdiction over the litigants and the claims before it entertains a lawsuit. In the context of Internet commerce,

62. "Why Protect Intellectual Property?," StopFakes.gov, accessed June 1, 2012, http://origin.www.stopfakes.gov/learn-about-ip/ip/why-should-i-protect-my-ip.
63. "Why Protect Intellectual Property?," StopFakes.gov, accessed June 1, 2012, http://origin.www.stopfakes.gov/learn-about-ip/ip/why-should-i-protect-my-ip.
64. Peter LaSorsa, "Selling Products Online: What Legal Jurisdiction," Practical eCommerce, November 5, 2008, accessed October 10, 2011, www.practicalecommerce.com/articles/860-Selling-Products-Online-What-Legal -Jurisdiction-Applies-.

this issue erupts when a dispute arises between businesses from different states [or countries]."[65] Many small businesses will be selling products online in other states and in other countries, so it is important to understand the jurisdictions that might be applicable to any online transaction. "In many cases, laws from the customer's state are the ones that will apply in the event a problem arises. This is equally true regarding the laws of other countries."[66] From the perspective of any business, but particularly a small business, it would be much easier from both a time and a money perspective to have an issue litigated in the home state of a business. Although there are no guarantees, these steps can be taken to increase the chances of a dispute being settled in the home state of a business:[67]

1. If using a contract with another party, make sure the contract says that any dispute must be filed in your home state and that both parties to the contract agree to jurisdiction in that state.
2. When a customer is purchasing an item on the website of a business, one of the terms and conditions of the transaction

65. Elias M. Awad, Electronic Commerce: From Vision to Fulfillment (Upper Saddle River, NJ: Prentice-Hall, 2005), 387.
66. Peter LaSorsa, "Selling Products Online: What Legal Jurisdiction," Practical eCommerce, November 5, 2008, accessed October 10, 2011, www.practicalecommerce.com/articles/860-Selling-Products-Online-What-Legal -Jurisdiction-Applies-.
67. Peter LaSorsa, "Selling Products Online: What Legal Jurisdiction," Practical eCommerce, November 5, 2008, accessed October 10, 2011, www.practicalecommerce.com/articles/860-Selling-Products-Online-What-Legal -Jurisdiction-Applies-.

should be that the customer agrees to jurisdiction in the home state of that business. This can be done with a check box next to the statement. Make the customer check it off before completing the purchase.

3. A less effective way is to include a disclaimer on the website that any transaction will convey jurisdiction to the home state of a business, and any dispute must be heard by a court of competent jurisdiction in the home state of the business.

All these steps should also be considered when selling to other countries. However, the laws in other countries will undoubtedly introduce complications into protecting the US-based business. Take the example of Yahoo! and the sale of Nazi memorabilia on one of its auction websites. A French court ruled that such sales breached French law against the display of Nazi items. Yahoo! took steps to remove and ban all such hate paraphernalia from its auction sites, but it continued to fight jurisdiction of the French ruling in American courts.[68] It would be very easy for a small business to inadvertently find itself in a similar situation. That is why a business needs to be careful when selling outside its home country. Be familiar with foreign laws. This is not an easy task because the minute a business website goes live, the business goes global. The laws of the world suddenly become relevant.

Security and Privacy

Website security (the protection of a company, its suppliers, its customers, and its employees from criminal activity) is a critical

68. Kathleen Mykytn and Peter Mykytn, "The Importance of the Law For E-Commerce Strategies," Information Systems Management 22, no. 2 (2005): 50–56.

consideration for any small business engaged in e-commerce. The Internet is a global playground for criminals. It is less risky to steal online because "the potential for anonymity on the Internet cloaks many criminals in legitimate-looking identities, allowing them to place fraudulent orders with online merchants, steal information by intercepting e-mail,…shut down e-commerce sites by using software viruses,"[69] and steal financial information and money. This new type of crime is referred to as cybercrime, and it is a serious threat to e-commerce.

Cybercrime refers to any criminal activity that is done using computers and the Internet,[70] and it includes a wide range of offenses. Downloading illegal music, stealing from online bank accounts, stealing credit card numbers and personal information, stealing identities, posting confidential business information on the Internet, and creating and distributing viruses on other computers are only some of the thousands of crimes that are considered cybercrimes.[71] Cybercrimes can take place anytime and anyplace. It has cost American companies a median loss of $3.8 million a year, and data protection and information technology (IT) practitioners from 45 US organizations from various sectors reported that, across their companies, 50 successful attacks were experienced over a four-week period.[72]

69. Kenneth C. Laudon and Carol G. Traver, E-commerce: Business, Technology, Society (Upper Saddle River, NJ: Prentice Hall, 2007), 248.
70. "Cybercrime," TechTerms.com, accessed October 10, 2011, www.techterms.com/definition/cybercrime.
71. "Cybercrime," TechTerms.com, accessed October 10, 2011, www.techterms.com/definition/cybercrime.
72. Alejandro Martinez-Cabrera, "Cybercrime Costs Firms $3.8 Million Yearly," Computer Crime Research Center,

Trust

Trust is about believing—believing that someone will do what they say and that they will not intentionally do something to hurt you. Trust is an important part of all business relationships. Without trust, all e-commerce would come to a halt. "Trust is central to establishing successful e-commerce ventures and to ensure the continued success of this business paradigm into the future."[73] Trust will improve competitiveness, reduce the costs of doing business, build loyalty, and increase the effectiveness of websites. In short, trust can be an important source of competitive advantage. Trust is essential. In the physical world, trust is much easier to develop. Physical cues from spaces and buildings, face-to-face voice and body language, and salesperson effectiveness can translate easily into trust relationships. In the online world, however, trust develops as a result of the complex interaction of multiple factors that have design implications for the website. Here are some examples of trust: [74]

August 3, 2010, accessed October 10, 2011, www.crime-research.org/news/03.08.2010/3807.

73. Albert J. Marcella, Establishing Trust in Virtual Markets (Altamonte Springs, FL: The Institute of Internal Auditors, 1999), as cited in Beverly Kracher and Corritore, "Is There A Special E-Commerce Ethics?," Business Ethics Quarterly 14, no. 1 (2004): 71–94.
74. Avshalom Adam, Avshalom Aderet, and Arik Sadeh, "Do Ethics Matter to E-Consumers?," Journal of Internet Commerce 6, no. 2 (2007): 19–34; Andrea Everard and Dennis F. Galletta, "How Presentation Flaws Affect Perceived Site Quality, Trust, and Intention to Purchase

- The customer observes the seller to be honest, fair, responsible, and benevolent.
- The customer expects that the company behind the website will not engage in opportunistic behavior.
- The customer is confident about the site's security and privacy protection (security and privacy having been shown to be an important determinant of a customer's willingness to buy online).
- The customer perceives the company's website as appealing (linked to layout, typography, font size, and color choices)—the belief being that an appealing website reflects a company has the capabilities and resources to fulfill its promises.
- The customer experiences a site that is easy to use (i.e., easy to navigate, easy to search, easy to gather information) and has relevant content, interactivity, site consistency, and site reliability.
- The customer perceives presentation flaws (e.g., poor style, incompleteness, language errors, conflicting colors, delay, and confusing terminology) as indicators of a low-quality, untrustworthy website.

from an Online Store," Journal of Management Information Systems 22, no. 3 (2005–6): 55–95; William Hampton-Sosa and Marios Koufaris, "The Effect of Web Site Perceptions on Initial Trust in the Owner Company," International Journal of Electronic Commerce 10, no. 1 (2005): 55–81; Beverly Kracher and Cynthia L. Corritore, "Is There a Special E-Commerce Ethics?," Business Ethics Quarterly 14, no. 1 (2004): 71–94; and Sergio Roman, "The Ethics of Online Retailing: A Scale Development and Validation from the Consumers' Perspective," Journal of Business Ethics 72 (2007): 131–48.

Another element of trust is **order fulfillment**. Order fulfillment is all about meeting expectations, and some argue that this is the most important element of trust.[75] Delays in the delivery of a product, the delivery of the wrong product, and the hassles of returning merchandise are stresses that can contribute to a less-than-satisfactory Internet buying experience. Such experiences contribute to a lack of trust. In contrast, satisfied consumers express themselves this way:[76]

- "Products at this site are a bit pricey, but it is worth purchasing from this site since you get what you order and within the promised delivery time."
- "I keep purchasing from this site because they always have the items I want in stock."

Buying some products online, such as clothing, furniture, and toys, does not offer buyers the opportunity to touch and feel the product before buying. As a result, order fulfillment becomes even more important to customer satisfaction. Linked closely to order fulfillment is **product reliability**. Product reliability refers to "the accurate display and description of a product so that what customers receive is what they thought they ordered."[77] Online

75. Terry Newholm et al., "Multi-Story Trust and Online Retailer Strategies," International Review of Retail, Distribution and Consumer Research, 14, no. 4 (2004): 437–56.
76. Sergio Roman, "The Ethics of Online Retailing: A Scale Development and Validation from the Consumers' Perspective," Journal of Business Ethics 72 (2007): 131–48.
77. Sergio Roman, "The Ethics of Online Retailing: A Scale

retailers should provide a complete and realistic description of the product and its benefits—with high-quality pictures and perhaps even demonstration videos if possible, appropriate, and affordable—along with product availability and likely ship dates. Customers should be notified by e-mail of order acceptance, and the anticipated delivery date with phone and e-mail contacts for any needed assistance.

Cybercrime

Cybercrime is more profitable than the illegal drug trade (more than $100 billion globally per year). Every three seconds an identity is stolen, and without security, an unprotected PC can become infected within four minutes of connecting to the Internet.[78] A Microsoft security intelligence report maintains that cybercrime is fast maturing as a profession, with cybercriminals becoming more sophisticated and packaging online threats that can be sold to others.[79]

Development and Validation from the Consumers' Perspective," Journal of Business Ethics 72 (2007): 131–48.

78. "What Is Cybercrime?," Symantec, accessed October 10, 2011, us.norton.com/cybercrime/definition.jsp; and "Cyber Crime 'More Profitable Than Drugs'," 9News, June 9, 2009, accessed October 10, 2011, news.smh.com.au/breaking-news-national/cyber-crime-more-profitable-than-drugs-20090609-c1qm.html.
79. Rudolph Muller, "Cybercrime Getting More Sophisticated," Mybroadband, June 24, 2010, accessed

The Computer Crime & Intellectual Property Section of the US Department of Justice keeps a running list of press releases related to cybercrimes. Here are three examples.

1. A Miami man pled guilty to one count of conspiracy to traffic in and possess unauthorized credit card numbers with intent to defraud, and one count of trafficking in unauthorized credit card numbers.
2. A Rhode Island man pleaded guilty to Internet sales of unregistered, unlabeled pesticides for cats and dogs while infringing on the trademark of two well-known national brand names, “Frontline” and “Frontline Plus.” The man-made more than 3,500 sales through eBay.
3. A Canadian man was sentenced to 33 years in prison for selling counterfeit cancer drugs using the Internet.

Cybercrime hurts the bottom line of any business, but small and medium-sized businesses are the new cybercrime target. “Hackers and computer criminals…are taking a new aim—directly at small and midsize businesses…Smaller businesses offer a much more attractive target than larger enterprises that have steeled themselves with years of security spending and compliance efforts.”[80] Small businesses are potentially very lucrative targets for several reasons:

October 10, 2011, mybroadband.co.za/news/internet/13279-Cybercrime-getting-more-sophisticated.html.

80. Tim Wilson, “Small Business: The New Black in Cybercrime Targets,” Dark Reading, March 19, 2009, accessed October 10, 2011, www.darkreading.com/security/perimeter-security/215901301/small-business-the-new-black-in-cybercrime -targets.html.

- Nearly one-fifth of small businesses do not use antivirus software.
- Two-thirds of small businesses do not have a security plan in place.
- Sixty percent of small businesses do not use encryption on their wireless links.
- Only about 60 percent of mom-and-pop shops have met the credit card industry's data security standards for protecting credit card data. Compliance at the smallest businesses is even worse.
- Two-thirds of small and medium-sized businesses believe that large companies are the main target for cybercrime,…yet 85 percent of the fraud seen in business occurs in small and medium-sized businesses.[81]

The cybercriminal is looking to steal and disrupt. Securing a website should be a top priority for any company—small, medium, or large—that uses the Internet to conduct its business.

The scope of failure in protecting customers' personal information can be potentially devastating because of the global reach of the Internet; the effect can easily reach millions of people.[82] Heartland is a payment processor responsible for handling about 100 million credit card transactions every month. They disclosed in June 2009 that thieves had used malicious

81. Tim Wilson, "Small Business: The New Black in Cybercrime Targets," Dark Reading, March 19, 2009, accessed October 10, 2011, www.darkreading.com/security/perimeter-security/215901301/small-business-the-new-black-in-cybercrime -targets.html.
82. Beverly Kracher and Cynthia L. Corritore, "Is There a Special E-Commerce Ethics?," Business Ethics Quarterly 14, no. 1 (2004): 71–94.

software in its network in 2008 to steal an unknown number of credit card numbers.[83] Fortunately, the theft of credit card and other personal information originating from websites accounted for only about 11 percent of the identity theft or fraud that affected 11 million Americans in 2009.[84] This is why the act of providing credit card information on a website for a purchase is still considered by some people to be so risky that they refuse to conduct any Internet transactions. This has obvious implications for any small company that hopes to do business online. Fortunately, there is a very straightforward way to provide the security and privacy that online customers seek: the use of **Secure Sockets Layer (SSL)**, a security protocol that is used by web browsers and web servers to help users protect their data during transfer.[85] Companies like VeriSign offer SSL protection certificates and the placement of its icon on a website can offer security and privacy assurances to online customers. The inclusion of SSL protection should be discussed with your website designer.

83. Eric Larkin, "Massive Theft of Credit Card Numbers Reported," PCWorld, January 20, 2009, accessed October 10, 2011, www.pcworld.com/article/158003/massive _theft_of_credit_card_numbers_reported.html.
84. "Javelin Study Finds Identity Fraud Reached New High in 2008, but Consumers Are Fighting Back," Javelin Strategy and Research, February 10, 2010, accessed October 10, 2011, www.javelinstrategy.com/news/831/92/Javelin-Study-Finds-Identity-Fraud -Reached-New-High-but-Consumers-are-Fighting-Back/d,pressRoomDetail.
85. "FAQ: SSL Basics," VeriSign Authentication Services, 2011, accessed October 10, 2011, www.verisign.com/ssl/ssl-information-center/ssl-basics.

Payment Options

Nowhere are security, privacy, and trust more necessary than at the point of payment. Without this transaction, there is no e-commerce, so it is imperative that small businesses selling online take the necessary steps to reduce customer concerns about shopping online. A recent survey found that retailers operating online may have lost more than $44 billion dollars over a one-year period as a result of transaction problems on their websites; in addition, 27 percent of online shoppers would turn to an offline or online competitor if they encountered an online transaction issue.[86] More specifically, online shoppers who encountered a transaction problem would react as follows:[87]

- Sixty-six percent would contact customer service, including
  - Fifty-three percent calling customer service; and
  - Thirty-six percent e-mailing or logging a web complaint with customer service.

86. "Tealeaf Survey Reveals That Online Retailers Potentially Lost More Than $44 Billion Due to Transaction Problems on Their Sites," Tealeaf, September 27, 2010, accessed October 10, 2011, www.tealeaf.com/news/news-releases/2010/Tealeaf-Survey -Reveals-Online-Retailers-Potentially-Lost.php.
87. "Tealeaf Survey Reveals That Online Retailers Potentially Lost More Than $44 Billion Due to Transaction Problems on Their Sites," Tealeaf, September 27, 2010, accessed October 10, 2011, www.tealeaf.com/news/news-releases/2010/Tealeaf-Survey -Reveals-Online-Retailers-Potentially-Lost.php.

- Thirty-two percent would abandon the transaction entirely, including
    - Twenty-seven percent turning to an online or offline competitor.

To make matters even worse, the potential for lost revenue when customers have a negative online shopping experience is amplified by the rising use of social media like Facebook and Twitter; the voicing of displeasure on social networks can significantly damage a company's reputation.[88] The message is clear. Online transactions must run smoothly. But there is another important issue: the number of payment options that are offered to the customer. Research shows that the more payment options customers have, the more likely they will complete their purchase.[89]

88. "Tealeaf Survey Reveals That Online Retailers Potentially Lost More Than $44 Billion Due to Transaction Problems on Their Sites," Tealeaf, September 27, 2010, accessed October 10, 2011, www.tealeaf.com/news/news-releases/2010/Tealeaf-Survey -Reveals-Online-Retailers-Potentially-Lost.php.
89. Delilah Obie, "Choosing a Vendor to Process Your Online Transactions," SCORE, accessed October 10, 2011, www.score.org/resources/online-transactions-vendor; "How to Increase Sales with Online Payment Options," March 22, 2010, accessed October 10, 2011, www.openforum.com/idea-hub/topics/money/article/how-to -increase-sales-with-online-payment-options-thursday-bram; "More Payment Options Can Mean More Business," MivaCentral, 2009, accessed October 10, 2011, mivacentral.com/articles/payment.mv;

- Merchants offering multiple payment methods have lower cart abandonment rates.
- If you can afford it and maintain your profit margin, offering multiple payment options is a means to increase your sales by increasing customer confidence and convenience.
- North American online businesses with four or more options for payment see an average sales conversion rate of 72 percent. The **sales conversion rate** is the percentage of site visitors that make a purchase.
- Each new payment option added at the point of checkout results in a sales increase of 5–20 percent.

Customers shopping online expect convenience and a variety of payment options. Credit cards are by far the most popular means for making an online payment, with one survey indicating that 70 percent of online consumers used this payment method.[90] Any small business that does not have its website set up to accept credit cards will lose 60–80 percent of its potential orders. Further, offering a credit card option will increase the number of orders,

T. Brandon, "Multiple Payment Processing Options Increase Sales," eZine Articles, October 21, 2007, accessed October 10, 2011, ezinearticles.com/?Multiple-Payment-Processing-Options-Increase-Sales&id=793303; and Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008).

90. "Online Retail Payments Forecast 2010–2014: Alternative Payments Growth Strong but Credit Card Projected for Comeback," Javelin Strategy and Research, February 2010, accessed October 10, 2011, www.javelinstrategy.com/research/Brochure-171.

and those orders will be substantially larger because credit cards enable impulse buying, reassure customers of your legitimacy, and simplify your billing.[91] Consistent with credit cards being the online payment method of choice, it has been reported that 99 percent of online businesses offer a general-purpose credit card, which includes Visa, MasterCard, American Express, and Discover.[92] However, debit cards are growing in popularity ahead of other payment alternatives.

Payment Options Consumers Used to Make Online Purchases in 2009

Payment Option	% Used
Major credit card usable anywhere	70
Major debit card usable anywhere	55
Online payment service, such as PayPal or Google Checkout	51
Gift card good only at a specific merchant	41
Store-branded credit card good only at the merchant that issued the card	27
Prepaid card or payroll card usable anywhere	17
Online credit service such as BillMeLater	17
Store-branded debit card good only at merchant that issued the card	16

The implications of this for small business are that credit cards should be the first payment method that should be set up for online

91. Delilah Obie, "Choosing a Vendor to Process Your Online Transactions," SCORE, accessed October 10, 2011, www.score.org/resources/online-transactions-vendor.
92. "More Payment Options Can Mean More Business," MivaCentral, 2009, accessed October 10, 2011, mivacentral.com/articles/payment.mv.

sales. Additional payment methods should be added as quickly as the budget allows because it is clear that more payment options translate into a greater likelihood of purchase. However, the choice of alternative payment methods should be in keeping with the growth strategy of the business. It may be that offering one method of payment provides a satisfactory level of sales, thereby eliminating the need for additional methods for sales growth.

Key Takeaways

- It is important to protect intellectual property.
- Ethics influence consumer purchases.
- Small businesses are the new target for cybercrime. As a result, small businesses must pay attention to their website security because it will protect the business and influence customer trust.

E-commerce Platforms

An **e-commerce platform** is the software that makes it possible for a business to sell online. In general, the core e-commerce platform should support basic requirements such as custom styling, search engine optimization (SEO), credit card processing, promotions, catalog management, analytics, product browsing, checkout, and order management. Additionally, e-commerce platforms should provide self-service content management systems (CMS), support multiple languages, and support multiple stores.[93] These

93. "Ecommerce Integration," Treehouse Logic, May 20,

requirements may vary slightly depending on which type of e-commerce is being conducted. **Analytics** refer to the tools that can track the different ways people use your website and then make sense of the data.[94]

The **all-in-one e-commerce platform solution** has become more popular with online merchants. This solution provides everything: the core e-commerce platform plus hosting, accounting, analytics, and marketing tools such as e-mail management. Because all the tools are integrated, they work together.[95] It has also been reported that e-commerce platforms are now enabling online retailers to better reach consumers through mobile devices and social media sites.[96] This is great news for the small business that wants to tap into these growing markets.

The list of e-commerce software providers is always growing,

2010, accessed October 10, 2011, blog.treehouselogic.com/2010/05/20/ecommerce-integration.

94. Justin Whitney, "What Is Web Analytics?," AllBusiness.com, 2010, accessed October 10, 2011, www.allbusiness.com/marketing-advertising/marketing-advertising/11382028 -1.html.
95. James Macguire, "Starting Your Own E-Business, Pt 2: Choosing a Platform," ecommerce-guide.com, September 26, 2005, accessed October 10, 2011, www.ecommerce-guide.com/solutions/building/article.php/3551461.
96. "E-commerce Platforms Offer Retailers New Social and Mobile Features, Internet Retailer, April 22, 2010, accessed October 10, 2011, www.internetretailer.com/ECTR/article.asp?id=34549.

but there are many products that are tailored specifically for small to medium-sized businesses. Some of the names that come up frequently for small business are BigCommerce, Magento, Affinity Internet, ProStores (for the smaller merchant), and Miva Merchant. However, this list is not exhaustive, and new products enter the marketplace all the time.

Customer Relationship Management

Customer Relationship Management (CRM) refers to "a customer service approach that focuses on building long-term and sustainable customer relationships that add value for the customer and the company."[97] Some small businesses may wonder whether they really need the added complexity of a small business CRM solution. The answer will depend to a large extent on the size of the business and its growth objectives. However, it has been observed that there is no small business out there that, "sometimes in spite of themselves, didn't benefit from implementing a…CRM or its watered-down equivalent—a simpler Contact Management software

97. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson/Prentice Hall, 2008), 75.

solution."[98] Recent studies have revealed that CRM applications account for the following:[99]

- Revenue increases of up to 41 percent per salesperson
- Decreased sales cycles of over 24 percent
- Lead conversion rate improvements of over 300 percent
- Customer retention improvements of 27 percent
- Decreased sales and marketing costs by 23 percent
- Improved profit margins of over 2 percent

It has also been noted that companies can boost their profits by almost 100 percent by retaining just 5 percent of their customers.[100] What does this mean for the small business that chooses to go with a CRM solution? As long as the solution is well implemented and actually used, there should be an immediate payoff and productivity improvement throughout the company. Additionally, choosing to engage in e-commerce makes the selection of a CRM solution even more important because the quality of customer relationships is so important to online success.

Although there was a time when CRM solutions were not feasible for small businesses, they are available today for even the smallest businesses. These CRM solutions are priced and designed with the small business in mind.

98. Perry Norgarb, "Does Your Small Business Even Need a CRM Software Solution?," SmallBizCRM, accessed October 10, 2011, www.smallbizcrm.com/does-your-small-business-need-a-software-solution.html.
99. Peter Norgarb, "So Where Do You Start? How Do You Start?," 2010, www.smallbizcrm.com.
100. Peter Norgarb, "So Where Do You Start? How Do You Start?," 2010, www.smallbizcrm.com.

Going Mobile

As defined earlier in this chapter, **mobile e-commerce (m-commerce)** refers to the purchase of goods and services through wireless technology, such as cell phones and handheld devices. It consists of two primary components: "…the ability to use a wireless phone or other mobile device to conduct financial transactions and exchange payments over the Internet…and the ability to deliver information that can facilitate a transaction—from making it easy for your business to be 'found' via a mobile Web browser to creating mobile marketing campaigns such as text promotions and loyalty programs."[101]< It is predicted that in 2015 m-commerce revenues will make up 8.5 percent of all US e-commerce revenue and 20 percent of global e-commerce revenue. In the United States, that will represent only one-half of 1 percent of all retail revenues.[102] However, even though m-commerce is lagging behind other mobile uses, wireless devices and m-commerce are expected to create another revolution in e-commerce. The most important thing that

101. Laurie McCabe, "Mobile Commerce: Coming to Ecommerce Sites Near You," ecommerce-guide.com, September 14, 2010, accessed October 10, 2011, www.ecommerce-guide.com/news/trends/article.php/3903526/Mobile-Commerce -Coming-to-Ecommerce-Sites-Near-You.htm.
102. Ian Mansfield, "US Mobile Ecommerce Revenues Set to Rise to $23.8bn in 2015, Cellular-News, April 14, 2010, accessed October 10, 2011, www.cellular-news.com/story/42841.php.

online retailers can do is to "…take action soon because the mobile environment is adapting much more quickly than the web."[103]

Small businesses need to sort out the hype from what's real. What's real are the facts and the trends.[104]

103. Brendan Gibbons, "To Tap Mobile Buyers, First Determine Their Needs," Practical eCommerce, March 16, 2010, accessed October 10, 2011, www.practicalecommerce.com/articles/1732-To-Tap-Mobile-Buyers-First-Determine -Their-Needs.
104. Jim Jansen, "Online Product Research: 58% of Americans Have Researched a Product or Service Online," September 29, 2010, accessed October 10, 2011, http://pewinternet.org/Reports/2010/Online-Product-Research.aspx; "Majority of Online Retailers Plan to Have Mobile Ecommerce Websites by 2011," Deluxe for Business, August 20, 2010, accessed October 10, 2011, http://deluxesmallbizblog.com/web-design/search-marketing/majority-of-online-retailers-plan-to-have-mobile-ecommerce-websites-by-2011; Laurie McCabe, "Mobile Commerce: Coming to Ecommerce Sites Near You," ecommerce-guide.com, September 14, 2010, accessed October 10, 2011, www.ecommerce-guide.com/news/trends/article.php/3903526/Mobile-Commerce -Coming-to-Ecommerce-Sites-Near-You.htm; Ian Mansfield, "Mobile Internet Devices Expected to Surpass One Billion by 2013," Cellular-News, December 9, 2009, accessed October 10, 2011, www.cellular-news.com/story/40997.php; John Lawson,

1. From the second quarter 2009 through the second quarter 2010, Amazon's customers around the world used mobile devices to buy more than $1 billion in products. This is a trend that any small business with an e-commerce website should watch closely.
2. Mobile devices connected to the Internet are reshaping the way people are going about their personal and professional lives.
3. One of the fastest growth areas in e-commerce will be using mobile devices to make online purchases.
4. Close to 80 percent of organizations plan to have mobile websites by the end of 2011. Online retailers without an m-commerce strategy will be in the minority.
5. Handheld devices are increasingly being used to research products, compare prices, and buy online while shopping.
6. A central driver to m-commerce growth is smartphone ownership and the corresponding mobile Internet use.
7. Nearly 58 percent of Americans have researched a product or a service online.
8. Among cell phone owners, 11 percent purchased a product or a

"75% of Online Retailers Are Ramping Up Mobile Strategies," ColderICE, accessed June 1, 2012, http://colderice.com/75-of-online-retailers-are-ramping-up-mobile-strategies/; Aaron Smith, "Mobile Access 2010," Pew Internet & American Life Project, July 7, 2010, accessed October 10, 2011, www.pewinternet.org/Reports/2010/Mobile-Access-2010.aspx; and Ian Mansfield, "US Mobile Ecommerce Revenues Set to Rise to $23.8bn in 2015, Cellular-News, April 14, 2010, accessed October 10, 2011, www.cellular-news.com/story/42841.php.

service using their phones.

Web 2.0

There is no agreement about an exact definition of **Web 2.0** but, in general, it refers to websites that are more interactive, engaging, and interesting than before. A Web 2.0 site is one where visitors can engage with you, your business, and your site by doing things like the following:[105]

- Posting comments on your blog or your articles or chatting in a forum
- Retweeting your content, sharing it on Facebook, or Digging it
- Watching a video, listening to a podcast, or participating in a webinar
- Taking a quiz or responding to a poll

Web 2.0 is about having a conversation with your customers. This is very different from **Web 1.0**, where websites were static and all you could do was read. Web 2.0 sites are collaborative and interactive. The small business that creates a site that engages and interacts with people, that makes people want to stick around, will be giving people more of a chance to create a connection with the business.[106] These closer ties will increase customer awareness

105. Steve Strauss, "Maximizing Your Web Presence Is Key to Building Your Small Business," USA Today, April 11, 2010, accessed October 10, 2011, www.usatoday.com/money/smallbusiness/columnist/strauss/2010-04-11-building-web-presence_N.htm.
106. Steve Strauss, "Maximizing Your Web Presence Is Key to

and consideration of the company's products and services, improve customer satisfaction, increase the chances of loyalty, increase the chances for sales, and add to the bottom line. There will also be significant benefits realized between the small business and its suppliers and partners: lowering the costs of communication and doing business.

A much smaller percentage of small businesses have adopted elements of Web 2.0 as compared to large enterprises and midsize companies.[107] However, many small businesses are using Web 2.0 in a variety of positive ways.[108]

- One business owner operated a Facebook group, attracted interest in the business, and developed loyalty through the group.
- Another business routinely put press releases online and

Building Your Small Business," USA Today, April 11, 2010, accessed October 10, 2011, www.usatoday.com/money/smallbusiness/columnist/strauss/2010-04-11-building-web-presence_N.htm.

107. Heather Claney, "Small Businesses Apparently Slow to Adopt Web 2.0 Philosophies," IT Knowledge Exchange, June 29, 2008, accessed October 10, 2011, itknowledgeexchange.techtarget.com/channel-marker/small-businesses-apparently -slow-to-adopt-web-20-philosophies.
108. Anita Campbell, "Real Life Examples of Business Owners Using Social Media," Small Business Trends, July 3, 2008, accessed October 10, 2011, smallbiztrends.com/2008/07/real-life-examples-of-business-owners-using-social-media.html.

attested to their value at getting the company's website found in search engines.
- The owner of a product company reported good results with videos that were loaded on YouTube and on the company's website. The video attracted people to the site and also engaged existing visitors on the site.
- A small real-estate company has a Facebook page, a blog, and a property value calculator that allows homeowners to calculate an approximation of their home's value without having to speak with a realtor. The information is then sent via e-mail.

As Web 2.0 keeps evolving, the value and opportunities it will bring to small businesses will continue to grow. "The increased flow of two-way information between business and customer, the increase in information distribution through blogs and wikis, and the increased participation of customers in product improvement and even design will continue. By adopting Web 2.0 technologies and tools, small businesses can improve market share, profit, and reputation, now and in the future."Sang-Heui Lee, David DeWester, and So Ra Park, "Web 2.0 and Opportunities for Small Businesses," *Service Business* 2, no. 4 (2008): 335–45.

Key Takeaways

- E-commerce platforms make it possible for businesses to sell online. The all-in-one platform solution has become more popular with online merchants. There are many platforms that are tailored specifically for small and medium-sized businesses.
- Small businesses should think about CRM. CRM solutions are now available for even the smallest of businesses.
- Even though m-commerce is lagging behind other mobile uses, wireless devices and m-commerce are expected to create

another revolution in e-commerce.

- Web 2.0 is important. It is about having a conversation with your customers. Small businesses need to learn about it and strongly consider incorporating it into their e-commerce strategies.
- Web 2.0 keeps evolving, so the value and opportunities it will bring to small businesses will continue to grow.

5. Chapter 5 - The Business Plan

Developing Your Strategy

As mentioned in Chapter 2, 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*."[1]

1. Kenneth Arrow, The Concept of Corporate Strategy (Homewood, IL: Irwin, 1971), 28.

> *"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."*[2]
>
> *"What business strategy is all about, in a word, is competitive advantage."*[3]

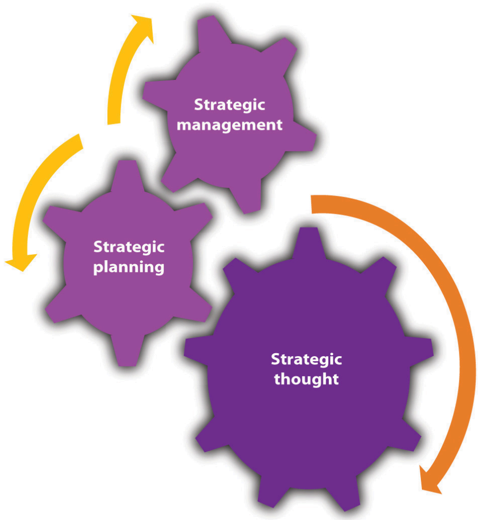
We define the strategy of a business as follows: A firm's strategy is the path by which it seeks to provide its customers with value, given the competitive environment and within the constraints of the resources available to the firm.

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.[4] 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

2. Alfred Chandler, Strategy and Structure (Cambridge, MA: MIT Press, 1962), 13.
3. Kenichi Ohmae, The Mind of the Strategist (Harmondsworth, UK: Penguin Books, 1983), 6.
4. Henry Mintzberg, Joseph Lampel, and Bruce Ahlstrand, Strategic Safari: A Guided Tour through the Wilds of Strategic Management (New York: Free Press, 1998).

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 (see "Strategy Troika") of the entire process. This concept is often forgotten in large bureaucratic organizations.

Strategy Troika



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.[5] 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

5. 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.

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.

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."[6]

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.[7] However, you should

6. 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.
7. Stephen C. Perry, "An Exploratory Study of U.S. Business Failures and the Influence of Relevant Experience and Planning," (Ph.D. diss., George Washington University,

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.”[8] These ad hoc (realized) strategies may be at odds with the planned (intended) strategies to guide a firm.[9] 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

1998; dissertation available through UMI Dissertation Services, Ann Arbor, MI), 42.

8. David A. Curtis, Strategic Planning for Smaller Businesses: Improving Corporate Performance and Personal Reward (Cambridge, MA: Lexington Books, 1983), 29.
9. Henry Mintzberg, The Rise and Fall of Strategic Planning (New York: Free Press, 1994), 46.

they can do it without any strategy, or without any guiding roadmap." Harry Tucci, comment posted to the following blog:[10]

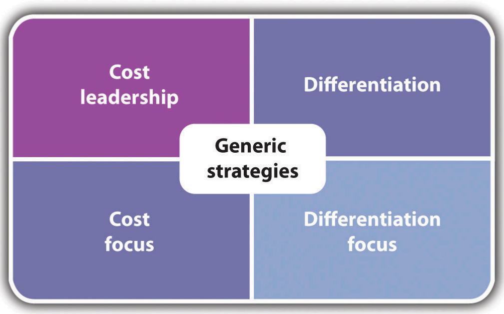
Types of Strategies

In 1980, Michael Porter a professor at Harvard Business School published a major work in the field of strategic analysis—*Competitive Strategy*.[11] 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,

10. 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.
11. Michael Porter, Competitive Strategy: Techniques for Analyzing Industries and Competitors (New York: Free Press, 1980), 21.

but one of them can be bifurcated. **These four strategies are as follows (see "Generic Strategies"): 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.

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."[12] They further

12. Kogi Truck Schedule," Kogi BBQ, accessed October 10, 2011, kogibbq.com.

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.[13]

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."[14] 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 "Summary of Generic Strategies").

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.

Summary of Generic Strategies

13. Max and Mina's Ice Cream, accessed October 10, 2011, www.maxandminasicecream.com.
14. Michael Porter, Competitive Strategy: Techniques for Analyzing Industries and Competitors (New York: Free Press, 1980), 21.

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

Generic Strategy	Required Activities	Issues
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

Generic Strategy	Required Activities	Issues
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

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.

The Necessity for a Business 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 Chapter 1, 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.[15] The overwhelming consensus is that a well-developed plan is essential for the survival of any small (or large) business.[16]

15. 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.
16. 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

Perry found that firms with more than five people benefit from having a well-developed business plan.[17]

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."[18]

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.

17. 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.
18. 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,

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?

smallbiztrends.com/2010/06/business-plan-success-twice-as-likely.html.

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.[19] Fortunately, this situation has changed rather significantly in the last decade. As we will illustrate, 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

19. 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.

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.[20] 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

20. 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.

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.[21]

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

21. Marc Mays, "Small Business Venture Capital Strategies," eZine Articles, 2010, accessed October 10, 2011, ezinearticles.com/?Small-Business-Venture-Capital-Strategies &id=4714691.

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 investor 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.[22]

22. "The Importance of Angel Investing in Financing the

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.

Growth of Entrepreneurial Ventures," Small Business Notes, September 2008, accessed October 10, 2011, www.smallbusinessnotes.com/aboutsb/rs331.html.

Building a 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?[23]

23. 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.

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/statstatab.
- *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.

"Overview of Forecasting Methods" 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.

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.

Technique	Description	Strength	Weakness
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.

Technique	Description	Strength	Weakness
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.
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

Technique	Description	Strength	Weakness
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.

Technique	Description	Strength	Weakness
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.

Technique	Description	Strength	Weakness
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 advertising expenditures, which are independent variables.	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.

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.

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.
- **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.[24] 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."[25] 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)?

24. Jeffry Timmons, Andrew Zachary, and Stephen Spinelli, Business Plans That Work—A Guide for Small Business (New York: McGraw-Hill, 2004), 113.
25. Carolyn Brown, "The Dos and Don'ts of Writing a Winning Business Plan," Black Enterprise, April 1996, 114–122.

- 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 businesspeople, 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."[26] 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."[27]

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 skill sets: your financial capabilities (e.g., the ability to control costs); or the personnel that make up the company.

26. "Inc. 500 Mission Statements," MissionStatements.com, accessed October 10, 2011, www.missionstatements.com/inc_500_mission_statements.html.
27. "Mission Statement," Ben & Jerry's, accessed October 10, 2011, www.benjerry.com/activism/mission-statement.

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.”[28]

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

28. “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.

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.[29]

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

29. 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.

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 Chapter 9.

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 Chapter 10) 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 Chapter 10.

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.[30]

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

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

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.[31]

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 Chapter 2, 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

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

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.[32]

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

32. Ashlee Vance, "A Technology Sets Inventors Free to Dream," New York Times, September 14, 2010.

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.[33] 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,

33. "2012 Business Plan Software Product Comparisons," TopTenReviews.com, accessed October 10, 2011, business-plan-software-review.toptenreviews.com.

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:

- **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.
- **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.

6. Chapter 6 - Marketing Basics

What Marketing Is All About

> *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.* -Peter Drucker[1]

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."[2] Putting this

1. 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.
2. "AMA Definition of Marketing," American Marketing Association, December 17, 2007, accessed December 1,

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.[3]

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.[4] The concept holds that the focus of all company

2011, www.marketingpower.com/Community/ARC/Pages/Additional/Definition/default.aspx.

3. Adapted from Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 6–7.
4. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 19.

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.[5] "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."[6]

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

5. 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.
6. Charles W. Lamb, Joseph F. Hair, and Carl McDaniel, Essentials of Marketing (Mason, OH: South-Western, 2004), 8.

money somewhere else."[7] 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"[8] 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.

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,

7. "You Don't Say?," Sales and Marketing Management, October 1994, 111–12.
8. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 12.

comprehensive, and cohesive approach that goes beyond the traditional applications of the marketing concept.[9] 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."[10] 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

9. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 19.
10. Charles S. Mack, "Holistic Marketing," Association Management, February 1, 1999, accessed January 19, 2012, www.asaecenter.org/Resources/AMMagArticleDetail.cfm?ItemNumber=880.

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.[11] **Market segmentation**

11. Center for Business Planning, "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 the table below.

LifeLock, a small business that offers identity theft protection services, practices customer type segmentation by separating its market into business and individual consumer segments.

Market Segmentation

Business Resource Software, Inc., accessed December 1, 2011, www.businessplans.org/segment.html.

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

Consumer Segmentation Examples	Business Segmentation Examples
	Purchasing Approaches: Which to Choose?
Psychographic Segmentation • Personality • Lifestyle • Behavioral occasions (regular or special occasion) • Values	• 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 in footnotes[12]

Market segmentation requires some marketing research. The marketing research process is discussed in the section on marketing research.

Target Market

Market segmentation should always precede the selection of a target market. A **target market** is one or more segments (e.g., income or income + gender + occupation) that have been chosen as the focus for business operations. The selection of a target market is important to any small business because it enables the business to be more precise with its marketing efforts, thereby being more cost-effective. This will increase the chances for success. The idea behind a target market is that it will be the best match for a company's products and services. This, in turn, will help maximize the efficiency and effectiveness of a company's marketing efforts:

It is not feasible to go after all customers, because customers have different wants, needs and tastes. Some customers want to be style leaders. They will always buy certain styles and usually pay a high price for them. Other customers are bargain hunters. They try to find the lowest price. Obviously, a company would have difficulty targeting both of these market segments simultaneously with one

12. Adapted from "Market Segmentation," Business Resource Software, Inc., accessed December 2, 2011, http://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.

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.[13]

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 paint that transforms any smooth surface into a high-performance dry-erase writing surface or 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

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

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 Chapter 7. A brief overview is presented here.

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.[14]

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,

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

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.[15]

15. 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.

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."[16] Segmentation, target market, differentiation, and positioning are discussed in greater detail in Chapter 7.

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

16. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 170.

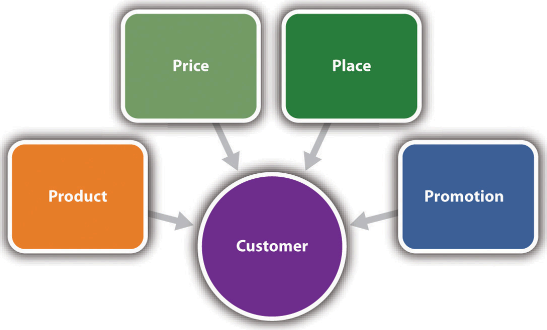
1950s.

- 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.

The Customer

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.

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.[17] 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

17. "History of Ivory Soap," Essortment.com, accessed December 1, 2011, www.essortment.com/history-ivory-soap-21051.html.

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 (individual consumer 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.[18] 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.

18. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 182.

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.

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"[19]—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

19. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 182.

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).[20] 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

20. Adapted from Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 155.

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 ("Five Stages of the Consumer Buying Process"), 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.[21] Knowing and understanding the consumer decision process provides a small business with better tools for designing and implementing its marketing mix.

Five Stages of the Consumer Buying Process

21. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 112.

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.

Stage	Description	Example
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 that should be every small business's nightmare.

Source in footnotes[22]

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,[23] and

22. 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.
23. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of

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.”[24]

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.”[25] 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.[26] One person could play multiple roles, there could

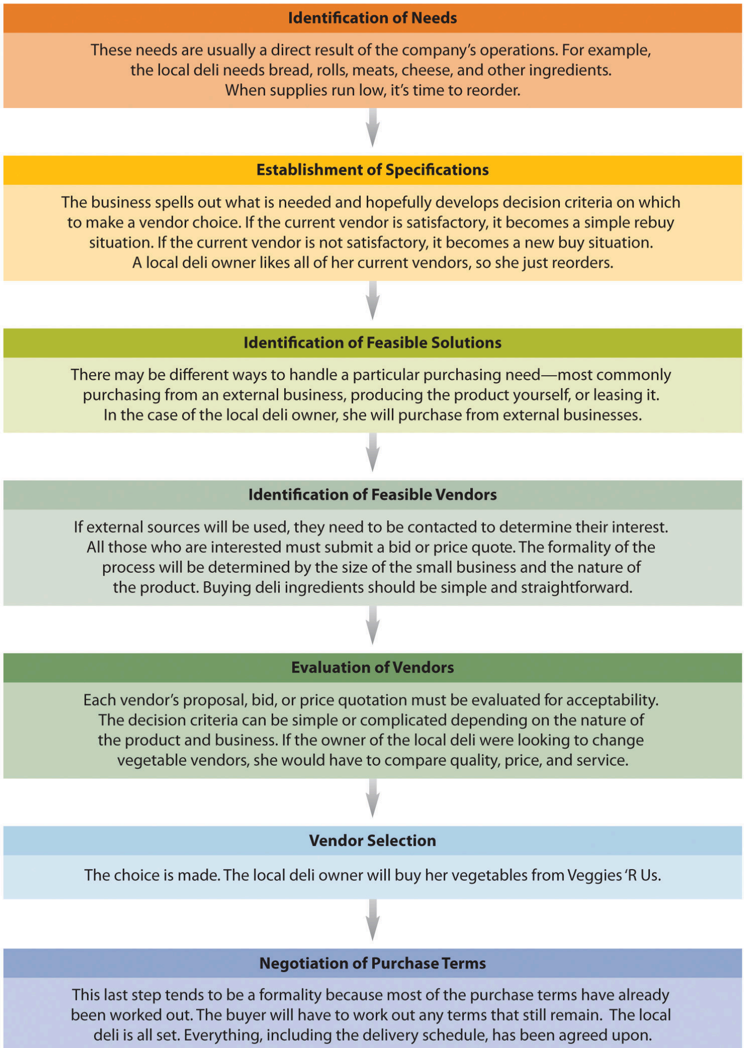
Marketing (Mason, OH: Atomic Dog Publishing, 2007), 137.

24. Bill Furlong, “How the Internet Is Transforming B2B Marketing,” BrandNewBusinesses.com, accessed December 1, 2011, www.brandnewbusinesses.com/NewsletterAugust2008A1.aspx.
25. 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.
26. 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.

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.

The B2B Buying Process



Source in footnotes[27]

27. Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow,

The B2B purchasing process for any small business will be some variation of the process described in "The B2B Buying Process". 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 employees.

The Customer Experience

> *Customer experience is one of the great frontiers for innovation.* – Jeneanne Rae[28]

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.[29]

Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 148–55.

28. 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.
29. Fran ONeal, "'Customer Experience' for Small Business: When Does It Start?," Small Business Growing, August 23, 2010, accessed December 1, 2011,

Customer Experience in the B2C Market

Customers will experience multiple **touchpoints** (i.e., all the communication, human, and physical interactions that customers experience during their relationship life cycle with a small business)[30] 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.

smallbusinessgrowing.com/2010/08/23/what-is-the-customer-experience-for-small -business.

30. 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.

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)."[31] A customer experience can be a one-time occurrence with a particular company, but experiences are more likely to happen across many time frames.[32] The experience begins at the point of need awareness and ends at need extinction.[33]

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.[34]

31. 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=.
32. 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=.
33. Lynn Hunsaker, Innovating Superior Customer Experience (Sunnyvale, CA: ClearAction, 2009), e-book, accessed December 1, 2011, www.clearaction.biz/ innovation.
34. "Grow Customers and Referrals!" Small Business Growing, accessed December 1, 2011,

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.[35] "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."[36]

Small businesses should learn and think about how to market a great B2C customer experience, not just a product or a service.[37] Design an experience that is emotionally engaging by mapping the customer's journey[38]–and then think of ways to please, perhaps

smallbusinessgrowing.com/grow-customers-and-referrals.

35. 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.
36. 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.
37. 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.
38. Colin Shaw, "Engage Your Customers Emotionally to

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.[39]

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.[40]

Create Advocates," CustomerThink, September 17, 2007, accessed December 1, 2011, www.customerthink.com/article/engage_your_customers_emotionally.

39. 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.
40. 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.

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[41]

Creating customer relationships in the B2B environment is radically different from the B2C environment because customers face different challenges, resources, and suppliers.[42] In the B2B world, there will almost always be "multiple people across multiple functions who play major roles in evaluating, selecting, managing,

41. 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.
42. 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.

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."[43] 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.[44]

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."[45] The products that often represent B2B business's sole

43. 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.
44. 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.
45. Richard Tait, "What's Different about the B2B Customer

value proposition are rarely emotionally engaging or visually appealing. Think bolts, wires, copy paper, shredding machines, bread for a restaurant, and machinery. How engaging can these items be?

There are touchpoints in B2B processes[46] 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

Experience," Winning Customer Experiences, August 16, 2010, accessed December 1, 2011, winningcustomerexperiences.wordpress.com/2010/08/16/whats-different-about -the-b2b-customer-experience.

46. adapted 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.

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.[47]

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."[48] 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.[49] 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.

47. 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.
48. "What Is Customer Loyalty?," Customer Loyalty Institute, accessed December 1, 2011, www.customerloyalty.org/what-is-customer-loyalty.
49. Adapted from "Why Measure—What Is Loyalty?," Mindshare Technologies, accessed December 1, 2011, www.mshare.net/why/what-is-loyalty.html.

The benefits of loyal customers are numerous:[50]

- 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

50. 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/.

over time through the collection of positive experiences.[51] 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.[52] 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.

51. Jeffrey Gangemi, "Customer Loyalty: Dos and Don'ts," BusinessWeek, June 29, 2010, accessed December 1, 2011, www.BusinessWeek.com/smallbiz/tipsheet/06/29.htm.
52. 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.

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.[53]

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.

53. Paul Gauvreau, "Making Customers Feel Special Brings Loyalty," Pharmacy Post 11, no. 10 (2003): 40.

- 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.

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."[54] 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

54. 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.

a particular marketing decision facing a company."[55] 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.[56] 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:[57] 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

55. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, Ohio: Atomic Dog Publishing, 2007), 191.
56. "Market Research Basics," SmallBusiness.com, October 26, 2009, accessed December 1, 2011, smallbusiness.com/wiki/Market_research_basics.
57. 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.

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:[58]

- 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?

58. 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 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."[59]

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."[60] 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.

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

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.[61] 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.[62] 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

61. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 91.
62. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson, Prentice Hall, 2009), 93.

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,[63] 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.[64] Secondary research would also be

63. 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.
64. Joy Levin, “How Marketing Research Can Benefit a Small Business,” Small Business Trends, January 26, 2006, accessed December 1, 2011, smallbiztrends.com/2006/

appropriate when looking for things such as economic trends, online consumer purchasing habits, and competitor identification.

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

Source in footnotes[65]

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

01/how-marketing-research-can-benefit-a-small-business.html.

65. Adapted from Marcella Kelly and Jim McGowen, BUSN (Mason, OH: South-Western, 2008), 147.

framework.[66] Effective marketing research follows the following six steps:[67]

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

66. “Market Research Basics,” SmallBusiness.com, October 26, 2009, accessed December 1, 2011, smallbusiness.com/wiki/Market_research_basics.
67. Adapted from Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 91–103.

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.[68]

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 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.[69] The latter two options, of course, presume the existence of an e-commerce operation. Even given the inexpensive options that are

68. "Market Research Basics," SmallBusiness.com, October 26, 2009, accessed December 1, 2011, smallbusiness.com/wiki/Market_research_basics.
69. 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.

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."[70]

Common Marketing Research Mistakes

Before deciding on a marketing research path, it is important for

70. 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.

a small-business owner or manager to be aware of the following common pitfalls that small businesses encounter:[71]

- **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

71. 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.

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.

7. Chapter 7 - Marketing Strategy

The Importance of a Marketing Strategy

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.[1] (See Chapter 6 "Marketing Basics" for a discussion of marketing principles.) Small businesses cannot compete with the marketing budgets of big companies. As

1. 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.

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 so as to minimize the losses in case the strategy fails."[2]

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.[3] 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

2. 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.
3. 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.

market real time in ways that cannot be matched by big businesses. Smaller can actually end up being more powerful.[4]

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."[5]

4. 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.
5. 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.

The Marketing Strategy Process

The focus of this text is on the management of the small business that is up and running as opposed to a start-up operation. As a result, the considerations of marketing strategy are twofold: (1) to modify or tweak marketing efforts already in place and (2) to add products or services as the business evolves. In some instances, it may be appropriate and desirable for a small business to backfit its marketing activities into a complete marketing strategy framework.

The marketing strategy process consists of several components. Each component should be considered and designed carefully:

company vision, company mission, marketing objectives, and the marketing strategy itself.

Marketing Strategy Process

Source in footnote. [6]

Vision and Mission

> *It is awfully important to know what is and what is not your business.* -Gertrude Stein Jay Ebben[7]

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.[8] The **mission statement** looks to articulate the more

6. 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/starting-a-business/marketing-plan-marketing-objectives-and-strategies.html.
7. "Developing Effective Vision and Mission Statements," Inc., February 1, 2005, accessed December 1, 2011, www.inc.com/resources/startup/articles/20050201/missionstatement.html.
8. Jay Ebben, "Developing Effective Vision and Mission Statements," Inc., February 1, 2005, accessed December

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."[9] 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."[10]
- **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

1, 2011, www.inc.com/resources/startup/articles/20050201/missionstatement.html.

9. 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.
10. Susan Ward, "Sample Vision Statements," About.com, accessed December 1, 2011, sbinfocanada.about.com/od/businessplanning/a/samplevisions.htm.

want fair profit for the owners and a rewarding place to work for the employees."[11]

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.[12] If a small business has multiple marketing objectives, they will have to be evaluated to ensure that they do not conflict with each other.

11. "Organic Restaurant Business Plan: Studio67," Bplans, accessed December 1, 2011, www.bplans.com/organic_restaurant_business_plan/executive_summary_fc.cfm.
12. "How to Choose Marketing Plan Objectives," accessed January 24, 2012, www.hellomarketing.biz/planning-strategy/marketing-plan-objectives.php.

The company should also determine if it has the resources necessary to accomplish all its objectives.[13]

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."[14] 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 onground). 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;[15] provide a strong positive customer experience; and contribute to brand loyalty. The ultimate objective, however, will be "the comprehensive

13. 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.
14. Judy Strauss and Raymond Frost, E-Marketing (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 6.
15. Bobette Kyle, "Marketing Objectives for Your Website," WebSiteMarketingPlan.com, December 10, 2010, accessed December 1, 2011, www.websitemarketingplan.com/marketing_management/marketingobjectivesarticle.htm.

integration of e-marketing and traditional marketing to create seamless strategies and tactics."[16]

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.[17] These steps are discussed in the sections "Segmentation and the Target Market" through "Marketing Strategy and Promotion". 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."[18]

16. Judy Strauss and Raymond Frost, E-Marketing (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 5.
17. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 179.
18. John Jantsch, "The Cycle of Strategy," Duct Tape Marketing, March 29, 2010, accessed December 1, 2011,

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.

www.ducttapemarketing.com/blog/2010/03/29/the-cycle-of -strategy.

Segmentation and the Target Market

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 the table below called "Market Segmentation". The challenge is knowing which group(s) to select. Many small business owners have a good intuitive sense of the segments that make sense for the business, and they choose to go with that intuition in devising their marketing strategy. However, that intuition may not be precise or current enough to be of the most help in planning a marketing strategy. Marketing research can be of help here, even to the smallest of businesses.

Marketing research can help the small business identify and refine the segments that offer the greatest opportunities. Part of that process will be to identify segments that meet the requirements of **measurability**, **substantiality**, **stability**, **accessibility**, **actionability**, and **differential** response.[19] Meeting these requirements will increase the chances for successful segmentation.

19. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 175–76.

- **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?[20]
- **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[21]
- **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

20. Check out Happy Hearts Dog Cookies, formerly at http://www.happyheartsdogcookies.com/
21. see www.ralphlauren.com

where "Made in Virginia, USA" worked very well with customers and retailers.[22]

- **Differential response.** The extent to which market segments are easily distinguishable from each other and respond differently to company marketing strategies.[23] 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 Chapter 6 "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

22. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 176.
23. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 176.

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:[24]

- **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.

24. 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.

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."[25] 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.[26] 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.

25. Susan Ward, "Niche Market," About.com, accessed December 1, 2011, sbinfocanada.about.com/cs/marketing/g/nichemarket.htm.
26. see, for example www.cocoadolce.com/about.php

- A niche market is a small, more narrowly defined target market that is not being served well or at all by other businesses.

Differentiation and Positioning

Differentiation

Differentiation, setting yourself apart from the competition, is one of the most important and effective marketing tools available to small business owners.[27] 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.[28] A successful differentiation

27. 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.
28. Kim T. Gordon, “Dare to Be Different,” April 1, 2005, accessed December 1, 2011, www.entrepreneur.com/article/76736.

strategy cannot be imitated by competitors—but it can bring you great success with consumers.[29]

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.[30] 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:[31]

- How do people become aware of their needs for a product or a service?

29. 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?.
30. 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.
31. 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 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.

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.[32]

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.[33]

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."[34] This notwithstanding, an understanding of positioning should be in every small business owner's tool kit.

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:[35]

32. Al Ries and JackTrout, Positioning: The Battle for Your Mind (New York: McGraw-Hill, 2001), 3.
33. David A. Aaker and Gary Shansby, "Positioning Your Product," Business Horizons, May–June 1982, 56–62.
34. "Product Positioning," Inc., accessed December 1, 2011, www.inc.com/encyclopedia/product-positioning.html.
35. 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).
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."[36] 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.
6. **Positioning with respect to a competitor.** Comparing a small business brand to its competitors. Some comparisons will be

36. "Our Story," KIND Healthy Snacks, accessed December 8, 2011, www.kindsnacks.com/our-story.

very direct; others will be subtle.[37] 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.[38]

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.[39]

The challenge for a small business is to decide which approach to

37. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 181.
38. Lisa Nielsen, "Product Positioning and Differentiation Strategy," Chron.com, accessed June 1, 2012, http://smallbusiness.chron.com/product-positioning-strategy-3350.html.
39. "Positioning Strategy Statement," Business Owner's Toolkit, accessed December 1, 2011, www.toolkit.com/small_business_guide/sbg.aspx?nid=P03_7003.

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."[40] 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.[41]

- **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"[42]

40. David A. Aaker and Gary Shansby, "Positioning Your Product," Business Horizons, May–June 1982, 56–62.
41. 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:
42. Andy LaPointe, "Is Your Positioning Statement Confusing Your Customers?," Small Business Branding, May 13, 2007, accessed December 1, 2011,

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.

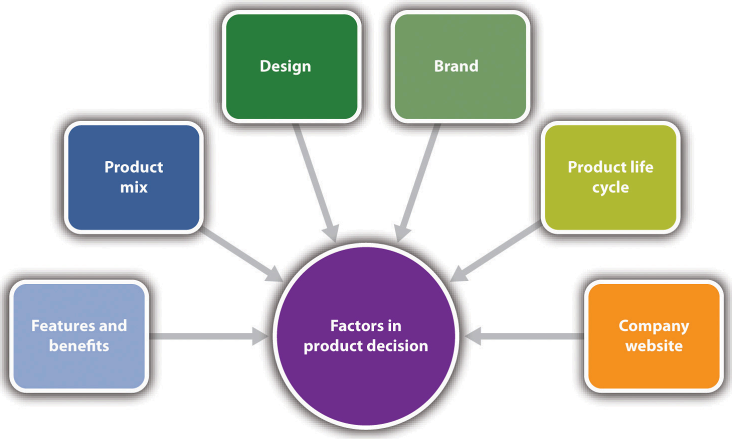
www.smallbusinessbranding.com/714/is-your-positioning-statement-confusing -your-customers.

Marketing Strategy and Product

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).

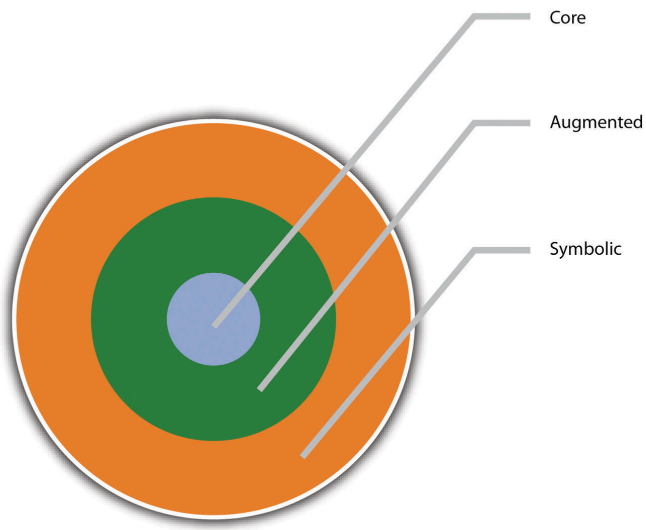
Factors in Product or Service Decisions



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.

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.[43] 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.[44] 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

43. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 226.
44. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 117.

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.[45] 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

45. Rick Suttle, "What Is a Product Mix?," Chron.com, accessed December 1, 2011, smallbusiness.chron.com/product-mix-639.html.

online than others.[46] 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.[47] 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.[48]

Product Design

In his book, *Re-imagine! Business Excellence in a Disruptive Age*,[49] 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

46. Jan Zimmerman, Web Marketing for Dummies, 2nd ed. (Hoboken, NJ: Wiley, 2009), 101.
47. Jan Zimmerman, Web Marketing for Dummies, 2nd ed. (Hoboken, NJ: Wiley, 2009), 101.
48. Jan Zimmerman, Web Marketing for Dummies, 2nd ed. (Hoboken, NJ: Wiley, 2009), 101–2.
49. Tom Peters, *Re-imagine! Business Excellence in a Disruptive Age* (London: Dorling Kindersley Limited, 2003), 132–46.

that design is the "fundamental soul of a man-made creation."[50] This is true whether the product comes from a big business or a small business.

Product design involves aesthetic properties such as color, shape, texture, and entire form, but it also includes a consideration of function, ergonomics, technology, and usability[51] 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[52]

Design offers a powerful way to differentiate and position a company's products and services, often giving company a competitive edge.[53] Improved profit margins from increased sales

50. 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.
51. Dana-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.
52. "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.
53. Philip Kotler and Kevin Lane Keller, Marketing

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.[54]

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.[55]

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,"[56] Quirky recently secured $6 million in venture

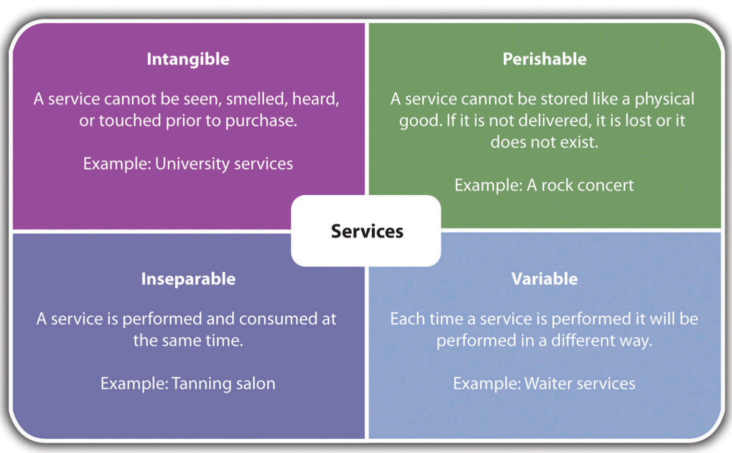
Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 325.

54. 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.
55. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 325.
56. Cliff Kuang, "Product-Design Startup Quirky Gets $6 Million in VC Funding," Fast Company, April 7, 2010, accessed December 1, 2011, www.fastcompany.com/

financing. A company like this could be very helpful to a small business that is looking to introduce a new product.

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 the figure below) present design challenges that are different from those faced by physical products.

The Characteristics of Services



1609737/product-design-startup-quirky-gets-6-million-in-vc-funding.

Source in footnotes[57]

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."[58] 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."[59] 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

57. Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 264–68.
58. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 239.
59. Randall Frost, "Packaging Your Brand's Personality," Brandchannel, October 3, 2005, accessed December 1, 2011, www.brandchannel.com/features_effect.asp?pf_id=283.

drive sales.[60] A poorly designed package can turn the customer off and can lead to wrap rage—the anger and frustration that results from not being able to readily access a product, which often leads to injuries. Although difficult-to-open packaging may be seen as necessary by the manufacturers and retailers, it does not do much for a positive customer experience.

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."[61] 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.

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.[62]

60. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 339.
61. "Brand," American Marketing Association, accessed December 1, 2011, www.marketingpower.com/_layouts/Dictionary.aspx?dLetter=B.
62. Miranda Brookins, "How to Brand a Business,"

The brand needs to reach people on an emotional level[63] 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."[64] 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:[65]

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

Chron.com, accessed December 1, 2011, smallbusiness.chron.com/brand-business-211.html.

63. Marc Gobe, Emotional Branding: The New Paradigm for Connecting Brands to People (New York: Allworth Press, 2001), xv.
64. Martin Lindstrom, Brand Sense: Build Powerful Brands through Touch, Taste, Smell, Sight, and Sound (New York: Free Press, 2005), 10.
65. 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.

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.[66]

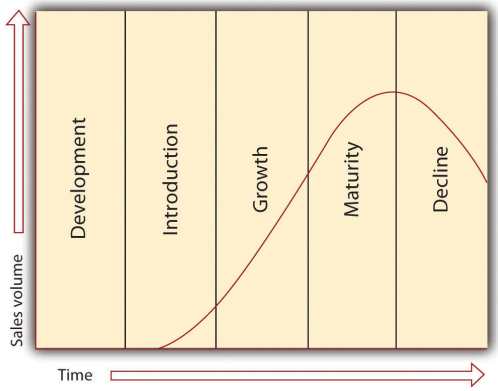
Product Life Cycle

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).[67]

66. 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.
67. "Top 25 Biggest Product Flops of All Time," Daily Finance,

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."[68] The traditional PLC is shown in the figure below.

The Traditional Product Life Cycle



Source in footnotes[69]

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

accessed December 1, 2011, www.dailyfinance.com/photos/top-25-biggest-product-flops-of-all-time.

68. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 244.
69. "The Product Life Cycle," NetMBA, accessed December 2, 2011, http://www.netmba.com/marketing/product/lifecycle.

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.[70] 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.[71] Rapid growth must be managed carefully so that the company does not succeed into failure. The **product**

70. 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.
71. 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.

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.[72] 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.

72. 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 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.[73]

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.[74]—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.[75]

73. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 239–43.
74. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 751.
75. 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.[76] "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).[77]

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.

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."[78] **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,

76. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 22–23.
77. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 23.
78. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 751.

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.[79] Whichever objective or combination of objectives is chosen, each objective should meet the criteria discussed in the section called "The Marketing Strategy Process". Clear-cut objectives will increase the chances that a company's website design and content will work to achieve those objectives.[80]

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),[81] and the

79. "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.
80. Ottavio Storace, "How to Build a Web Site That Achieves Objectives," Webmaster Resources @ Suite 101, July 13, 2009, accessed December 1, 2011.
81. "Glossary of Web Terminology: Website Layout," April 5, 2010, accessed January 24, 2012, www.azurewebdesign.com/glossary-of-web-

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."[82]

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."[83] 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

terminology; Sue A. Conger and Richard O. Mason, Planning and Designing Effective Web Sites (Cambridge, MA: Course Technology, 1998), 96.

82. Jakob Nielsen, "Horizontal Attention Leans Left," Useit.com, April 6, 2010, accessed December 1, 2011, www.useit.com/alertbox/horizontal-attention.html.
83. "Welcome to Color Voodoo Publications," Color Voodoo, accessed December 1, 2011, www.colorvoodoo.com.

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."[84]

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.[85] The wrong choice could adversely affect a visitor's experience at the site,[86] which could adversely affect a company's sales and image.

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

84. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 751.
85. Jacci Howard Bear, "The Meaning of Color," About.com, accessed December 1, 2011, desktoppub.about.com/od/choosingcolors/p/color_meanings.htm?p=1.
86. Joanne Glasspoole, "Choosing a Color Scheme," Metamorphosis Design, accessed December 1, 2011, www.metamorphozis.com/content_articles/web_design/Choosing_A_Color_Scheme.php.

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."[87]

87. 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." [88] 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.[89] 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).[90] It is possible to blow away more than 50 percent of website visitors and readers by choosing the wrong typeface.[91]

88. Colin Wheildon, Type & Layout: How Typography and Design Can Get Your Message Across—or Get in the Way (Berkeley, CA: Strathmoor Press, 1996), 19.
89. 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.
90. 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.
91. 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."[92] 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.[93]

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."[94] The key for any

92. Lena Claxton and Alison Woo, How to Say It: Marketing with New Media (New York: Prentice Hall, 2008), 35.
93. "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.
94. Dave Young, "Quality Images Boost Sales," Practical

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.[95]

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.[96] "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?"[97]

eCommerce, March 14, 2007, accessed December 1, 2011, www.practicalecommerce.com/articles/436-Quality -Images-Boost-Sales.

95. Jennifer Kyrnin, "Basics of Web Layout," About.com, accessed December 1, 2011, webdesign.about.com/od/ layout/a/aa062104.htm.
96. Steve Krug, Don't Make Me Think: A Common Sense Approach to Web Usability (Berkeley, CA: New Riders Publishing, 2000), 51.
97. Efraim Turban et al., Electronic Commerce: A Managerial

Site navigation must be easy, predictable, consistent, and intuitive enough so that visitors do not have to think about it.[98] "Designing effective navigation can also entice your visitors to try out the other things you offer on your site."[99] 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."[100] Website usability measures the quality of a user's experience when interacting with a website,[101] and it works hand

Perspective (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 754.

98. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 754.
99. "Website Navigation Tips," Entheos, accessed December 1, 2011, www.entheosweb.com/website_design/website_navigation_tips.asp.
100. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 38.
101. "Usability Basics," Usability.gov, accessed December 1, 2011, www.usability.gov/basics/index.html.

in hand with site navigation. According to usability.gov, usability is a combination of five factors:[102]

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.[103]
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,[104] 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

102. "Usability Basics," Usability.gov, accessed December 1, 2011, www.usability.gov/basics/index.html.
103. "Definition of User Interface," accessed December 1, 2011, www.pcmag.com/encyclopedia_term/0,2542,t=user+interface&i=53558,00.asp.
104. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 756.

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.[105] 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.[106]

There are many ways in which a small business can provide interactivity on its site. The following are some examples:[107]

- Free calculators for calculating payments when something is

105. "Web Development Glossary for Small Businesses," Lightwave Communications, accessed December 1, 2011, www.lightwavewebdesign.com/web-development -glossary/website-glossary-g-i.html.
106. 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.
107. "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.

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

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.[108]

Content

Content refers to all the words, images, products, sound, video, interactive features, and any other material that a business puts on its website.[109] It is the content that visitors are looking for,

108. "Importance of Interactive Websites," Thunder Data Systems, accessed December 1, 2011, www.thunderdata.com/thunder_bits/ importance_of_interactive_websites .html.
109. Efraim Turban et al., Electronic Commerce: A Managerial Perspective (Upper Saddle River, NJ: Pearson Prentice

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."[110]

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.[111] If a company's content does not fit its target audience(s), the website will not generate good results.[112]

Most small businesses may think that they must generate all

Hall, 2008), 744; Jan Zimmerman, Web Marketing for Dummies, 2nd ed. (Hoboken, NJ: Wiley, 2009), 67.

110. 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.
111. Jan Zimmerman, Web Marketing for Dummies, 2nd ed. (Hoboken, NJ: Wiley, 2009), 73.
112. 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.

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. [113] User-generated content includes the following:[114]

- 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."[115]

There are many factors that will contribute to the success of a

113. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 55.
114. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 55.
115. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 56.

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.[116]

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).[117]

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

116. "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.
117. Jan Zimmerman, Web Marketing for Dummies, 2nd ed. (Hoboken, NJ: Wiley, 2009), 103.

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.[118]

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.[119] Google claims that the amount of site traffic drops by 20 percent for every 0.5 seconds of load time.[120]

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.[121] There are ways

118. "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.
119. Imad Mouline, "Is Your Website Fast Enough for Your Customers?," CNN Money, August 27, 2010, accessed June 1, 2012, http://tech.fortune.cnn.com/2010/04/27/is-your-website-fast-enough-for-your-customers/#more-24083.
120. "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.
121. Efraim Turban et al., Electronic Commerce: A Managerial

around this, known by any credible website designer. The impact of "slow down" features should be tested before the site launches and monitored afterwards.[122] 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.[123] Once the problem areas have been identified, steps can be taken to make improvements. The goal is to have an interesting and speedy site.

Perspective (Upper Saddle River, NJ: Pearson Prentice Hall, 2008), 755.

122. Imad Mouline, "Is Your Website Fast Enough for Your Customers?," CNN Money, August 27, 2010, accessed June 1, 2012, http://tech.fortune.cnn.com/2010/04/27/is-your-website-fast -enough-for-your-customers/#more-24083.
123. "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.

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.

Marketing Strategy and Price

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."[124] Ultimately, the meaning of price will depend on the viewpoints of the buyer and the seller.[125]

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.[126]

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,

124. Judy Strauss and Raymond Frost, E-Marketing (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 233.
125. Judy Strauss and Raymond Frost, E-Marketing (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 233.
126. "Pricing a Product or Service," Small Business Notes, accessed June 1, 2012, http://www.smallbusinessnotes.com/marketing-your-business/pricing-a-product-or-service.html.

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.[127]

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.[128] 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.[129]

127. Judy Strauss and Raymond Frost, E-Marketing (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 233.
128. Darrell Zahorsky, “Pricing Strategies for Small Business,” About.com, accessed December 1, 2011, sbinformation.about.com/cs/bestpractices/a/aa112402a.htm.
129. Dana Griffin, “Pricing Strategy Theory,” Chron.com, accessed December 1, 2011, smallbusiness.chron.com/pricing-strategy-theory-1106.html. However, pricing

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. [130] 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.[131]

- **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

objectives must be formulated before a pricing strategy can be selected.

130. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 383.
131. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 358–59.

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.[132] How goods and services are priced tells consumers a lot about what to expect from a small business.

Discount Pricing

A small business might choose a **discount pricing** strategy.[133] if it

132. Judy Strauss and Raymond Frost, E-Marketing (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 247.
133. Diane Watkins, "What Is Discount Pricing Strategy?," Chron.com, accessed December 1, 2011,

is looking to drive traffic and sales short term or if it wants to be permanently seen as the value leader in an industry.[134] 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.[135] 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.[136]

smallbusiness.chron.com/discount-pricing-strategy-794.html.

134. Rick Suttle, "Industry Pricing Strategy," Chron.com, accessed December 1, 2011, smallbusiness.chron.com/industry-pricing-strategy-4684.html.
135. Diane Watkins, "What Is Discount Pricing Strategy?," Chron.com, accessed December 1, 2011, smallbusiness.chron.com/discount-pricing-strategy-794.html.
136. 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. 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.[137]

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.[138]

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

137. "Cost-Based Pricing," Small Business Notes, accessed December 1, 2011, www.smallbusinessnotes.com/marketing-your-business/cost-based-pricing.html.
138. "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.

that products below a particular price will have inferior quality and will not convey a desired status and image."[139] 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.[140]

Even-Odd Pricing

Also known as the "nine and zero effect,"[141] **even-odd pricing** can be used to communicate quality or value. It assumes that consumers

139. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing), 358–59.
140. Lisa Magloff, "What Is Premium Pricing Strategy?," Chron.com, accessed December 1, 2011, smallbusiness.chron.com/premium-pricing-strategy-1107.html.
141. 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.

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.[142] 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

142. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing), 369.

small businesses.

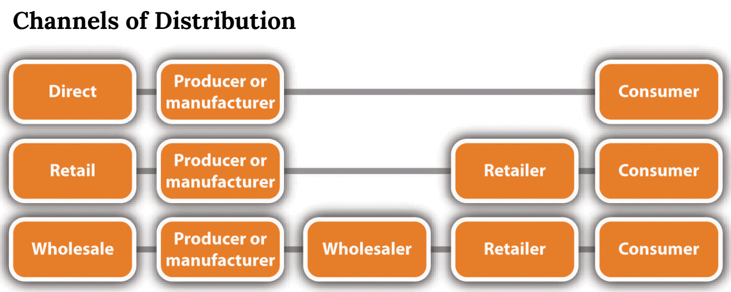
- Price accounts for revenue.
- Determining a price for its products or services is one of the most important decisions that a small business will make.
- There are many factors involved in choosing the right pricing strategy.
- Having the lowest price is not typically a strong position for small businesses.
- 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.

Marketing Strategy and Place

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.



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.[143] 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

143. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 300.

dorm room, and the founders of Nantucket Nectars began their business by selling their home-brewed fruit drinks to boaters in Nantucket Harbor. Many B2B sellers also use the direct channel. Consolidated Industries, Inc., for example, sells helicopter parts directly to Sikorsky Aircraft and airline parts directly to Boeing. (See Chapter 5 "The Business Plan" for more information on Consolidated Industries, Inc.)

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.

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)."[144] A small business that

144. "Monthly & Annual Wholesale Trade Definitions," US

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.[145]

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.[146] 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.[147]

Census Bureau, October 22, 2010, accessed December 1, 2011, www.census.gov/wholesale/definitions.html.

145. 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.
146. Philip Kotler and Kevin Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 458–59.
147. 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.[148] The multichannel approach offers three important advantages:[149]

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

148. 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.
149. Philip Kotler and Kevin Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 429.

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."[150] 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.[151] 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.[152]

150. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 306.
151. 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.
152. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of

Logistics involve the following four primary functions: transportation, warehousing, inventory control, and order processing.[153]

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. The table called "Characteristics of Different Modes of Transportation" below 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.
2. **Warehousing.** [154] 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

Marketing (Mason, OH: Atomic Dog Publishing, 2007), 307.

153. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 307.
154. Philip Kotler and Kevin Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 464.

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.[155] 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.[156]

4. **Order processing.** [157] 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

155. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 312.
156. "How to Run a Small Business: Inventory Management," StartupNation LLC, accessed December 1, 2011, www.startupnation.com/business-articles/899/1/AT_InventoryMgt.asp.
157. Philip Kotler and Kevin Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 464.

should be a priority.

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 in the footnotes[158]

There are several things that small businesses can do to increase the efficiency and the effectiveness of their logistics.[159] For example, a business can select a logistics company that is industry-specific (e.g., wine or clothing) because that company will understand the

158. Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 308.
159. 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.

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 Chapter 11 "Supply Chain Management".

Place and the Website

For small businesses that sell online or hope to sell online, the company website "places" the product or the service in the hands of the customer. As a result, there are several decisions that must be made to facilitate the process so that customers can have a good online experience[160] 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 "E-Business and E-Commerce" for a discussion of

160. Adapted 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.

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.[161] An understanding of why shoppers are abandoning their carts should lead to some serious thinking during website design and operation. The table below gives examples of why shoppers abandon a

161. "Digital Window Shopping: The Long Journey to 'Buy'" McAfee, Inc., accessed December 1, 2011, www.mcafeesecure.com/us/resources/whitepapers/digital_window _shopping.jsp.

purchase. Because shipping is the number one reason why shoppers abandon their shopping carts, think very carefully about what the shipping charges will be.[162]

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%[163]

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.

162. Jan Zimmerman, Web Marketing for Dummies, 2nd ed. (Hoboken, NJ: Wiley, 2009), 118.
163. "Digital Window Shopping: The Long Journey to 'Buy'" McAfee, Inc., accessed December 1, 2011, www.mcafeesecure.com/us/resources/whitepapers/digital_window _shopping.jsp.

- 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.

Marketing Strategy and Promotion

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."[164] 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."[165] Small-business owners should be familiar and comfortable with all three

164. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 470.
165. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 380.

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.[166] 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),[167] and brand

166. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 393.
167. Adapted from Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 393–96.

recognition. As with all objectives, IMC objectives must meet the SMART (specific, measurable, achievable, realistic, and time-based) criteria.

Marketing Communications Mix

The **marketing communications mix** for a small business, either pure-play or brick-and-click, will consist of some combination of the following major modes of communication: advertising, sales promotion, events and experiences, public relations (PR) and publicity, direct marketing, interactive marketing, word-of-mouth communication, and personal selling.[168] Each mode of communication has its own advantages and disadvantages, which should all be considered carefully before any final selections should be made.

The Marketing Communications Mix

168. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 470.

Source listed in the footnotes[169]

Advertising

Advertising is "any paid form of nonpersonal presentation and

169. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 473.

promotion of ideas, goods, or services by an identified sponsor."[170] 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 their 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," [171] Even advertising in the big leagues is

170. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472.
171. 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.

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.[172]

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*,[173] 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.)[174] Another possibility is Google AdWords. A small business can promote itself alongside

172. 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.
173. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 157.
174. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 159–61.

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.[175]

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.[176] 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

175. "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/gaiaauth?apt%3DNone%26ltmpl%3Dregionalc&sacu=1&sarp=1&sourceid=awo& subid=us-en-et-bizsol.
176. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 487.

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.[177] These promotions can be used by and offer several advantages to small businesses:[178]

- **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

177. 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.
178. Chris Joseph, “Sales Promotion Advantages,” Chron.com, accessed December 1, 2011, smallbusiness.chron.com/sales-promotion-advantages-1059.html.

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, 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.

Events and Experiences

Events and experiences are "company-sponsored activities and programs designed to create daily or special brand interactions."[179] A small business could choose to sponsor a Halloween costume event for pets[180] 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:[181] (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 "Marketing Basics".

179. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472.
180. 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.
181. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 489.

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."[182] By having special events, a small business will stand out from the rest,[183] 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.[184] 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.")[185] Traditional PR tools include press releases and press kits that are sent to the media to generate positive press on behalf

182. Bernd H. Schmitt, Experiential Marketing (New York: The Free Press, 1999), 22, 24.
183. 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.
184. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472.
185. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 382.

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.[186] (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.[187] 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 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."[188] 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.

186. "Developing a Press Kit for Your Small Business," AllBusiness, accessed December 1, 2011, www.allbusiness.com/print/445-1-22eeq.html.
187. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472.
188. 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.

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."[189]

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.[190]

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:[191]

- **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.

189. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 444.
190. 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.
191. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 488–489.

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."[192] Common direct marketing platforms include catalogs; direct mailing; telemarketing; television shopping; electronic shopping; fax mail; voice mail; blogs; websites;[193] e-mail; direct response radio, television, and Internet;[194] 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.[195]

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

192. 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.
193. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 473.
194. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 505.
195. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 504.

one another,[196] 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."[197]

Direct marketing offers several advantages to both the business-to-consumer (B2C) and B2B small businesses:[198]

- **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.

196. 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.
197. 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.
198. Kris Carrie, "Advantages of Direct Marketing," Article Dashboard, accessed December 1, 2011, www.articledashboard.com/Article/Advantages-of-Direct-Marketing/587894.

- **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."[199] Everything is personalized and individualized—from the website content to the products being promoted.[200] The audience is engaged with the brand, with customers getting the chance to reshape and market it in their own unique way.[201] Forrester Research forecasts that interactive

199. Philip Kotler and David Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 472.
200. Dana-Nicoleta Lascu and Kenneth E. Clow, Essentials of Marketing (Mason, OH: Atomic Dog Publishing, 2007), 558.
201. Mike Yapp, "10 Best Interactive Marketing Practices,"

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.[202]

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.[203] 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.[204] According to Ad-ology's 2011 Small Business Marketing

iMedia Connection, January 9, 2006, accessed December 1, 2011, www.imediaconnection.com/content/7764.asp.

202. 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.
203. Karen Scharf, "Small Business Marketing with Video," Business Know-How, accessed December 1, 2011, www.businessknowhow.com/internet/videomarketing.htm.
204. Sean Rasmussen, "Using Online Videos to Increase

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.[205] 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.[206]

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

Popularity," Aussie Internet Marketing Blog, July 30, 2009, accessed December 1, 2011, seanseo.com/internet-marketing/using-online-videos.

205. 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.
206. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 73–74.

where bloggers (and the blogging community) have grown in size, stature, and impact to eclipse all but the largest media outlets."[207] 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."[208] 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."[209]

The top four social media networks are Twitter, Facebook, LinkedIn, and YouTube. This is true in general and for small businesses in particular.[210] Overall, small businesses use social

207. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 72.
208. Robbin Block, Social Persuasion: Making Sense of Social Media for Small Business (Breinigsville, PA: Block Media, December 2010), 2.
209. Lorrie Thomas, Online Marketing (New York: McGraw-Hill, 2011), 99.
210. 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.

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.[211] 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.[212]

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

211. 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.
212. 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.

can bet they're using it to gain attention over you."[213] This will undoubtedly continue to be the case.

Personal Selling

A small business owner needs to connect with customers before a sale can take place. Sometimes personal selling is the best way to do that. **Personal selling**, "the process of communicating with a potential buyer (or buyers) face-to-face with the purpose of selling a product or service,"- is absolutely essential in the marketing communications mix of a small business. History has shown that the most successful entrepreneurs have been skilled salespeople who were able to represent and promote their companies and products in the marketplace.[214]– 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.[215] Regardless of the

213. 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.
214. "Personal Selling," eNotes, accessed December 1, 2011, enotes.com/personal -selling-reference/personal-selling-178681.
215. John M. Ivancevich and Thomas N. Duening, Business

type of customer or consumer, however, the objectives of personal selling are the same:[216]

- **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,

Principles, Guidelines, and Practices (Mason, OH: Thomson Learning, 2007), 431.

216. "Objectives of Personal Selling," KnowThis.com, accessed December 1, 2011, www.knowthis.com/principles-of-marketing-tutorials/personal-selling/objectives-of-personal-selling.

particularly in the B2B market, and it is the most practical promotional method for reaching customers who are not easily reached through other methods.[217] 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.[218] Then there are the costs of training the sales staff on product knowledge, industry information, and perhaps selling skills.[219] Depending on the size of the company, small businesses will have varying numbers of salespeople, so some of the costs will vary as well.

217. "Advantages of Personal Selling," KnowThis.com, accessed December 1, 2011, www.knowthis.com/principles-of-marketing-tutorials/personal-selling/advantages -of-personal-selling.
218. "Disadvantages of Personal Selling," KnowThis.com, accessed December 1, 2011, www.knowthis.com/principles-of-marketing-tutorials/personal-selling/disadvantages-of-personal-selling.
219. "Disadvantages of Personal Selling," KnowThis.com, accessed December 1, 2011, www.knowthis.com/principles-of-marketing-tutorials/personal-selling/disadvantages-of-personal-selling.

The traditional sales process is typically seen as a series of six steps:[220]

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

220. 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.

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.[221] The traditional process just

221. Thomas Young, "A Selling Revolution: How the Internet Changed Personal Selling (Part 1)," Executive Street, accessed December 1, 2011, blog.vistage.com/

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.[222]

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,

marketing/a-selling-revolution-how-the-internet-changed-personal-selling.

222. 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.

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.

8. Chapter 8 - The Marketing Plan

The Need for a Marketing Plan

> *Let's face it, as a small business owner, you are really in the business of marketing.* -John Jantsch [1]

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.[2]

There are many reasons why so many small businesses do not have marketing plans. Among the reasons are the following:[3]

1. John Jantsch, Duct Tape Marketing: The World's Most Practical Small Business Marketing Guide (Nashville, TN: Thomas Nelson, Inc., 2006sig), back cover copy.
2. 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.
3. Adapted from Danielle MacInnis, "74% of Small Business [sic] Have No Marketing Plan!" Marketing Blog for Small

- 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,

Businesses, February 7, 2011, accessed December 2, 2011, www.daniellemacinnis.com/small-business-marketing/74-of-small-business -have-no-marketing-plan.

practical instructions that are designed to ensure that resources are properly applied.[4]

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,[5] 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.[6] 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.[7]

4. "How to Write Small Business Marketing Plans," SmallBusiness-Marketing-Plans.com, accessed December 2, 2011, www.smallbusiness-marketing-plans.com.
5. "How to Write Small Business Marketing Plans," SmallBusiness-Marketing-Plans.com, accessed December 2, 2011, www.smallbusiness-marketing-plans.com.
6. 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.
7. "How to Write Small Business Marketing Plans," SmallBusiness-Marketing-Plans.com, accessed

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.[8]

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.[9]

December 2, 2011, www.smallbusiness-marketing-plans.com.

8. "How to Create a Marketing Plan," Entrepreneur, August 7, 2001, accessed June 1, 2012, http://www.entrepreneur.com/article/186830.
9. "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.[10] There are many good reasons for developing a marketing plan, including the following:[11]

10. 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.
11. "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.

The Marketing Plan

Although there is no universally accepted format for a marketing plan, the requirements can be grouped into the seven sections identified in the figure below. 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,[12] 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.[13]

The Marketing Plan

12. 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.
13. "An Online Marketing Plan for the Small Business Owner," WebMarketingNow, accessed December 1, 2011, www.webmarketingnow.com/who/who_business_owner.html.

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.[14]< The executive summary is for the people who lack the time and interest to read

14. "How to Write a Marketing Plan," Arizona Office of Tourism, accessed December 1, 2011, www.azot.gov/documents/Marketing_Tool_Kit.pdf.

the entire marketing plan but who need a good basic understanding of what it is about.[15]

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.[16]

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15. "Marketing Plan: The Executive Summary," Small Business Notes, accessed December 1, 2011, www.smallbusinessnotes.com/starting-a-business/marketing-plan-the -executive-summary.html.
16. 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.[17]

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."[18]

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

17. 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.
18. "Sample Marketing Plan," MoreBusiness.com, accessed December 1, 2011, www.morebusiness.com/templates_worksheets/bplans/printpre.brc.

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."[19]

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.[20] 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

19. "Restaurant Marketing Plan: Neon Memories Diner," MPlans.com, accessed December 2, 2011, www.mplans.com/restaurant_marketing_plan/marketing_vision_fc.php.
20. Corte Swearingen, "Writing a Mission Statement," SmallBiz Marketing Tips, accessed December 2, 2011, www.small-biz-marketing-tips.com/writing-a-mission-statement.html.

"To make people happy."[21]

Coca-Cola

"To Refresh the World…in body, mind, and spirit."[22]

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."[23]

Sigmund's Gourmet Pasta (Small Business)

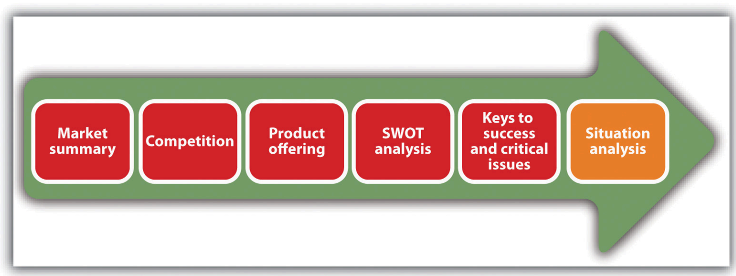
"Sigmund's Gourmet Pasta's mission is to provide the customer the finest pasta meal and dining experience. We exist to attract and maintain customers. When we adhere to this maxim, everything else will fall into place. Our services will exceed the expectations of customers."[24]

21. Corte Swearingen, "Writing a Mission Statement," SmallBiz Marketing Tips, accessed December 2, 2011, www.small-biz-marketing-tips.com/writing-a-mission -statement.html.
22. Corte Swearingen, "Writing a Mission Statement," SmallBiz Marketing Tips, accessed December 2, 2011, www.small-biz-marketing-tips.com/writing-a-mission -statement.html.
23. 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.
24. "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. 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.

Situation Analysis



Market Summary

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.

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.[25]

25. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," Mplans.com, accessed December 1, 2011,

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:[26]

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.
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.
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

www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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

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.

4. An identification of market needs and how a business plans to meet them.[27] 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.
5. An identification of market trends.[28] 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.

27. “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.
28. 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.

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[29]

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[30]

Geographics for Sigmund's Gourmet Pasta

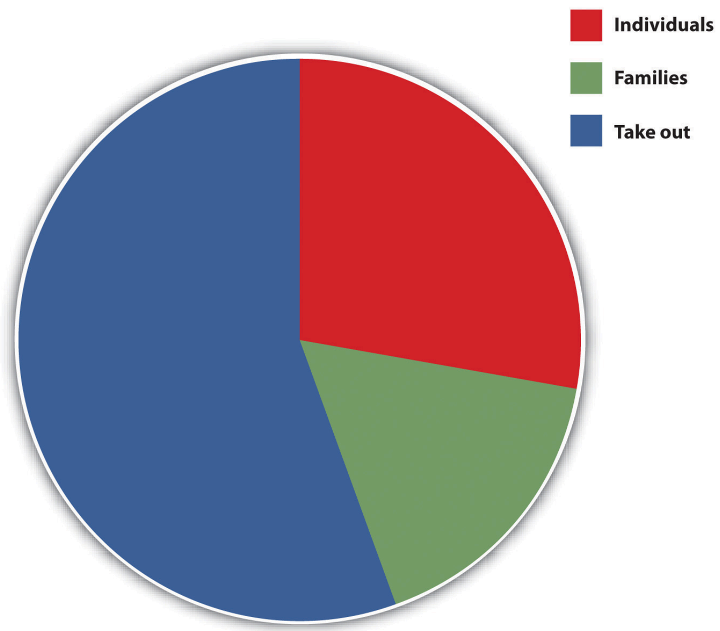
- Sigmund's immediate geographic target is the city of Eugene with a population of 130,000.
- A 15-mile geographic area is in need of Sigmund's services.[31]

Market Size for Sigmund's Gourmet Pasta

- The total targeted population is estimated at 46,000.
- The target markets are individuals, families, and takeout.[32]

Target Markets–Sigmund's Gourmet Pasta

29. “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.
30. “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.
31. “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.
32. “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.



Source in footnotes[33]

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.[34]

33. “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.
34. 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.

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 in footnotes[35]

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.

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.[36] Think of the market as a

35. Adapted from "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," Mplans.com, accessed December 1, 2011, http://www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.
36. "Market Share," BusinessDictionary.com, accessed

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,[37] 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 (Home Bistro). Many if not most small business marketing plans address only direct competition.

December 1, 2011, www.businessdictionary.com/definition/market-share.html.

37. "Market Share," QuickMBA, accessed December 1, 2011, www.quickmba.com/marketing/market-share.

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.[38]

38. "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.[39]

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:[40]
- Employees: six to seven full time
- Seating: 35–45
- Types of transactions: 80 percent dine in, 20 percent takeout

Sigmund's website

This 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:[41] 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

39. “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.
40. 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.
41. “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.

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.[42] 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.[43] Examples of strengths are the quality of employees,

42. Tim Berry, "How to Perform a SWOT Analysis," MPlans.com, accessed December 2, 2011, articles.mplans.com/how-to-perform-a-swot-analysis.
43. "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

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[44]

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.

December 2, 2011, articles.mplans.com/how-to-perform-a-swot-analysis.

44. "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.

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.[45] 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.[46]

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.[47] 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.

45. "The Language of Branding: Brand Equity," Branding Strategy Insider, January 20, 2008, accessed December 2, 2011, www.brandingstrategyinsider.com/brand_equity.
46. "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.
47. Tim Berry, "How to Perform a SWOT Analysis," MPlans.com, accessed December 2, 2011, articles.mplans.com/how-to-perform-a-swot-analysis.

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.[48]

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.[49] 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

48. "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.
49. Tim Berry, "How to Perform a SWOT Analysis," MPlans.com, accessed December 2, 2011, articles.mplans.com/how-to-perform-a-swot-analysis.

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[50]<

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.[51]

Keys to Success and Critical Issues

The **keys to success** are those factors that, if achieved, will lead

50. "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.
51. Corte Swearingen, "Marketing SWOT Analysis," SmallBiz Marketing Tips, accessed December 2, 2011, www.small-biz-marketing-tips.com/marketing-swot-analysis .html.

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.[52] 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,[53] a cutting edge manufacturing process, and customer service.

52. 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.
53. 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.

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[54]

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[55]

54. "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.
55. "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.[56]

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 have had their restaurants featured in the *Register Guard* have seen a dramatic increase of sales immediately after the article was published.[57]

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56. Bobette Kyle, "Internet Marketing Strategy: Developing a Website Marketing Plan," WebSiteMarketingPlan.com, accessed December 1, 2011, www.websitemarketingplan.com/marketing_management/MarketingPlanningArticle.htm.
57. Adapted from "Pasta Restaurant Marketing Plan:

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.[58]<
5. Achieve one thousand Facebook fans in six months.[59]
6. Achieve a Twitter follower base of five hundred people in six months.[60]

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.

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

58. Adapted from "Pasta Restaurant Marketing Plan:

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.

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

59. 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.
60. 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.

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 businesspeople 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[61]

Positioning

The **Positioning** section of the marketing plan reflects the decisions that have been made about how a company plans to "place" its

61. "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.

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.[62]

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62. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," Mplans.com, accessed December 1, 2011,

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.[63]

Marketing Strategy Pyramid

www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

63. 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.

Source in footnotes[64]

The strategy at the top of the pyramid 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.[65] 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.

64. 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/what-is-the-marketing-strategy-pyramid-where-did-it-come-from.
65. 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.

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.[66]

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*.[67]

66. 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.
67. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," Mplans.com, accessed December 1, 2011,

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.[68]

www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

68. 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.[69]
- **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.[70]

69. 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_marketing_plan/marketing_vision_fc.php. Holiday specials will be offered on Valentine's Day, Easter, Mother's Day, and Father's Day.
70. The Facebook plan was drawn from the following two

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.

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_marketing_plan/marketing_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.

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.[71]

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

71. "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.

analysis, a sales forecast, and an expense forecast and how they link to the marketing strategy.[72]

Breakeven Analysis

A **breakeven analysis** is used to determine the amount of sales volume a company needs to start making a profit.[73] 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.[74]

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,

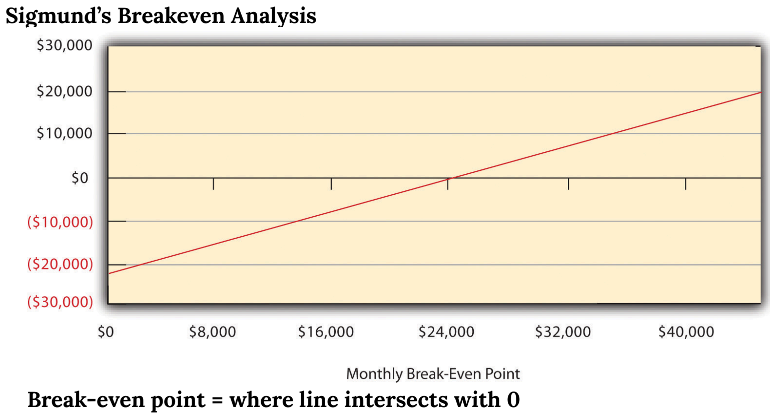
72. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," Mplans.com, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.
73. Susan Ward, "Breakeven Analysis," About.com, accessed December 1, 2011, sbinfocanada.about.com/cs/startup/g/breakevenanal.htm.
74. Daniel Richards, "How to Do a Breakeven Analysis," About.com, accessed December 1, 2011, entrepreneurs.about.com/od/businessplan/a/breakeven.htm.

and computers would be considered fixed costs because they are outlays that must occur before a company makes its first sale.[75]

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.[76] Labor costs and the cost of materials are examples of variable costs.

75. 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.
76. 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.

Breakeven Analysis for Sigmund's Gourmet Pasta



Source in the footnotes[77]

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.[78]

77. "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.
78. "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

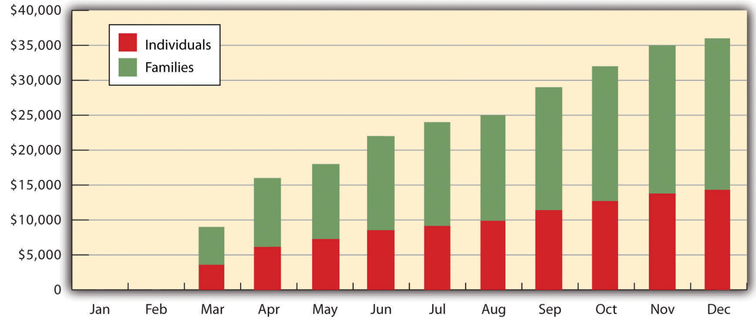
A company's **sales forecast** is the level of sales that a company expects based on a chosen marketing plan and an assumed marketing environment. The sales forecast does not establish a basis on which to decide how much should be spent on marketing. Rather, it is the result of an assumed marketing expenditure plan.[79] 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.[80]

79. Philip Kotler and Kevin Lane Keller, Marketing Management (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 112.
80. "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.[81]

Sigmund's Sales Forecast



Source in footnotes[82]

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 in footnotes[83]

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.[84]< If a company is not sure what to include in its expense forecast, there are online templates that

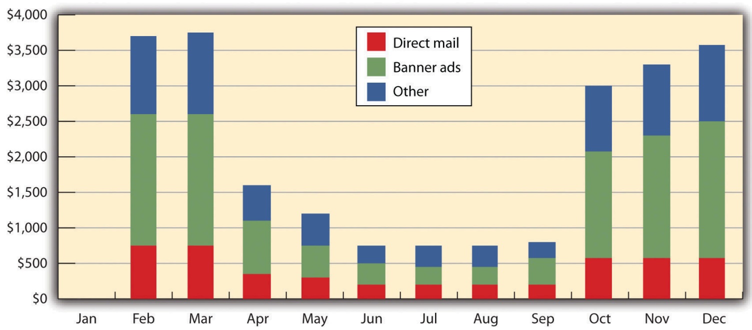
81. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," Mplans.com, accessed December 1, 2011, www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.
82. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 2, 2011, http://www.mplans.com/pasta_restaurant_marketing_plan/situation_analysis_fc.php. Reprinted by permission of Palo Alto Software.
83. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 1, 2011, http://www.mplans.com/pasta_restaurant_marketing_plan/situation_analysis_fc.php.
84. "Expense and Sales Forecasting," Chic-CEO.com, accessed December 2, 2011, www.chic-ceo.com/expense-and-sales-forecasting.

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.[85]

Sigmund's Expense Forecast



Source in footnotes[86]

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 in the footnotes[87]

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.[88]

85. "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.
86. "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.
87. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 1, 2011, http://www.mplans.com/pasta_restaurant_marketing_plan/situation_analysis_fc.php.
88. 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?[89] 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.[90] 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.[91]

Several steps are recommended for the proper implementation of a marketing plan.[92]

89. 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.
90. "Implementing Your Marketing Plan," Marketing Plan Success, accessed December 2, 2011, www.marketing-plan-success.com/articles/controls-implementation.php.
91. 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.
92. Examples include the following:"Implementing Your

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.

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.

Implementation Milestones for Sigmund's Gourmet Pasta

The following milestones identify the key marketing programs. It is important to accompl

Sigmund's Implementation Milestones

Milestones	**St**
Advertising	
Marketing plan completion	1/
Banner ad campaign #1	2/
Banner ad campaign #2	10
Total advertising budget	
Direct Marketing	
Direct mail campaign #1	2/
Insert campaign #1	2/
Direct mail campaign #2	10
Insert campaign #2	10
Total direct marketing budget	
Web development	
Totals	
Note: The authors of this textbook added the web development milestone to acknowledge that th would also be included.	

Source in the footnotes[94]

93. "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.
94. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta: Situation Analysis," Mplans.com, accessed December 1, 2011, http://www.mplans.com/

Evaluation

You can't manage what you don't measure. -Peter Drucker[95]

The evaluation section of the marketing plan is about assessing the strengths and weaknesses of a marketing plan to improve its effectiveness.[96] 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.[97]

There are many ways to evaluate how well a company is doing. The following are some of the ways:[98]

pasta_restaurant_marketing_plan/situation_analysis_fc.php.

95. "Measuring Brand Performance," Branding Strategy Insider, February 22, 2011, accessed December 2, 2011, www.brandingstrategyinsider.com/brand_equity.
96. "About Us," American Evaluation Association, accessed December 2, 2011, www.eval.org/aboutus/organization/aboutus.asp.
97. "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.
98. Adapted from Stuart Ayling, "7 Ways to Evaluate Your

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.

To best evaluate the effectiveness of a marketing plan, it will be necessary to track each type of marketing activity in the plan. The

Marketing Plan," WebSiteMarketingPlan.com, accessed December 2, 2011, www.websitemarketingplan.com/mplan/evaluateplan.htm.

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.[99]
- **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.[100]
- **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

99. John Vencil, "The Marketing Plan VII–Evaluation," VPI Strategies, 2003, accessed December 2, 2011, www.vpistrategies.com/articles_pdf/Mktg7_Eval.pdf.
100. John Vencil, "The Marketing Plan VII–Evaluation," VPI Strategies, 2003, accessed December 2, 2011, www.vpistrategies.com/articles_pdf/Mktg7_Eval.pdf.

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.[101]

- **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.[102] 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.[103] It is also important to tap into

101. Justin Whitney, "What Is Web Analytics," AllBusiness.com, accessed December 2, 2011, www.allbusiness.com/marketing-advertising/marketing-advertising/11382028 -1.html.
102. 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.
103. Anoop George Joseph, "Twitter Metrics," Web Technology and Softwares—A Technical Blog, December 16, 2011, accessed June 1, 2012, http://webtechsoftwares.wordpress.com/2011/12/16/

the analytics provided by LinkedIn and Facebook.[104] 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.

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.[105]

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twitter-metrics/

104. Viveka Von Rosen, "ROI and Measuring your LinkedIn Presence," #LinkedInChat, February 21, 2012, accessed May 30, 2012, http://linkedintobusiness.com/roi-and-measuring-your-linkedin-presence/; Jenn Deering Davis, Ph.D., "5 Most Essential Facebook Marketing Metrics," AllFacebook, April 17, 2012, accessed May 30, 2012, http://allfacebook.com/facebook-metrics-essentials_b86156.
105. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," Mplans.com, accessed December 1, 2011,

Controls

There is no planning without control, the process of monitoring a proposed plan as it proceeds and adjusting it when necessary.[106] 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?[107]

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.

www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

106. "Marketing Controls," MarketingTeacher.com, accessed December 2, 2011, www.marketingteacher.com/lesson-store/lesson-control.html.
107. "How to Write a Marketing Plan," Arizona Office of Tourism, accessed December 1, 2011, www.azot.gov/documents/Marketing_Tool_Kit.pdf.

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.[108] 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[109]

108. 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.
109. "Pasta Restaurant Marketing Plan: Sigmund's Gourmet Pasta," Mplans.com, accessed December 1, 2011,

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

www.mplans.com/pasta_restaurant_marketing_plan/marketing_strategy_fc.php.

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.

9. Chapter 9 - Accounting and Cash Flow

Understanding the Need for Accounting Systems

> *The older I get, the more interesting I find lawyers and accountants.* – Alex James[1]

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

1. Independent (London), April 21, 2010, quoted in "Accounting Quotes," Qfinance, accessed February 14, 2012, www.qfinance.com/finance-and-business-quotes/accounting.

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.

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."[2] Put more simply, it is essentially an information system. Accounting provides critical information to potential investors and business 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.[3] Archaeologists have discovered clay tokens, dating

2. 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.
3. Denise Schmandt-Besseart, "An Ancient Token System:

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.[4]

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.[5] The most famous monograph on accounting dates to Renaissance Italy. Luca Pacioli, a Franciscan

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.

4. 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.
5. John R. Alexander, History of Accounting (Princeville, HI: Association of Chartered Accountants in the United States, 2002), 4.

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.[6] 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.

6. John R. Alexander, History of Accounting (Princeville, HI: Association of Chartered Accountants in the United States, 2002), 9.

Hiring an accountant or an accounting firm is an important decision for a small business. Employing an accountant does not translate into this individual being a full-time employee of the business. At the start, most small businesses will use the accountant as a consultant or a contract employee. As they grow, some small businesses might benefit from acquiring the services of full-service accounting firm. Although some start-ups, particularly those that might be cash-strapped, use the services of the bookkeeper only, but this is ill-advised. Most small businesses will need the services of a CPA. Another type of accountant a small business might employ is known as an enrolled agent. These are accountants who have passed a tax test from the Internal Revenue Service (IRS).

When looking for an accountant, there are some issues that you should consider. Try to find an accountant who has some working familiarity with a particular type of business or industry. Hopefully, you will be able to find an accountant with whom you have some rapport. This is important because a good accountant is more than simply someone who balances the books. You should consult an accountant before determining what type of accounting system you intend to employ—cash versus accrual. Remember that an accountant will play an important role in assisting you in the creation, purchase, and development of an accounting information system for the business. This system is important in providing the appropriate information to the external community (for this audience the term **financial accounting** is often used)—bankers, angel investors, venture capitalists, and/or the government. The same accounting information system will also be an important component of internal controls (in this case the term **managerial accounting** is used)—the systems and policies by which you make a firm more efficient. In this role, an accountant can help develop appropriate policies with respect to cash control and inventory control. An accountant can play a critical role in developing business plans, particularly with respect to budgets and financial statements. As highlighted in a future section, 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.[7]

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[8]

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.

7. Jean Murray, "Finding Help with Bookkeeping and Accounting Tasks," About.com, accessed December 2, 2011, biztaxlaw.about.com/od/businessaccountingrecords/a/findacpa.htm.
8. "Edwin T. Freedley," Cyber Nation, accessed February 14, 2012, www.cybernation.com/victory/quotations/authors/quotes_freedley_edwint.html.

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.[9] The major benefit of cash basis accounting is its simplicity. It greatly reduces the demand on bookkeeping. The

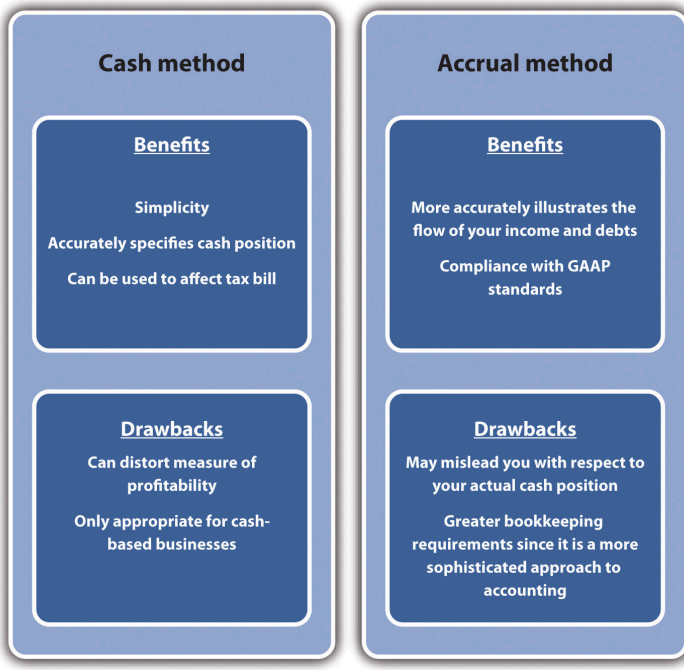
9. "Comparison of Cash and Accrual Methods of Accounting," Wikipedia, accessed December 2, 2011, en.wikipedia.org/wiki/comparison_of_cash_method _and_accrual method of accounting.

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.[10] 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.[11] A summary of the pros and cons of the two systems is provided below.

Comparative Accounting Systems

10. 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.
11. "Cash vs. Accrual Accounting," Nolo.com, accessed December 2, 2011, www.nolo.com/legal-encyclopedia/cash-vs-accrual-accounting-29513.html.



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.

Financial Accounting Statements

> *It sounds extraordinary, but it's a fact that balance sheets can make fascinating reading.* -Mary, Lady Archer of Weston[12]

As discussed in Chapter 5, 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

12. "Accounting Quotes," Qfinance, accessed February 14, 2012, www.qfinance.com/finance-and-business-quotes/accounting.

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."[13] **Liabilities** are the amount of money owed to outside claims (i.e., money owed to people outside the business).

13. Walter Harrison, Charles Lungren, and Bill Thomas, Financial Accounting, 8th ed. (Boston, MA: Prentice Hall, 2010), 63.

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."[14] 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

14. "Work in Process," BusinessDictionary.com, accessed December 2, 2011, www.businessdictionary.com/definition/work-in-process.html.

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.

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.[15] **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.[16]

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

The Balance Sheet


Assets
Current Assets
Cash
+ Marketable securities
+ Accounts receivable
+ Prepaid expenses
+ Inventory
Total current assets
Long-Term Assets
Investment
+ Fixed assets
– Accumulated depreciation
+ Intangible assets
Total long-term assets
Total Assets
Current assets
+ Long-term assets
Liabilities and Owner's Equity
Current Liabilities
Notes payable
+ Accounts payable
+ Other items payable
+Dividends payable
+ Current portion of long-term debt
Total current liabilities
Long-Term Liabilities
Long-term debt
+ Pension liabilities
+ Long-term lease
Total long-term liabilities
Owner's Equity
Paid in capital
+ Retained earnings
Liabilities and Equity
Current liabilities
+ Long-term liabilities
+ Owner's equity

Below you can see six years' worth of balance sheet statements for a hypothetical small business—Acme Enterprises. It is obviously important to have such information, but what exactly might this tell us in terms of the overall success and operation of the business? We will return to these statements later in this chapter to show how those questions can be addressed with ratio analysis.

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

	December 31					
Paid in capital	$–	$–	$–	$–	$–	$–
Retained earnings	$112.0	$207.3	$300.3	$397.2	$489.3	$583.3
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

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 at our depreciation calculations table, 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)**:

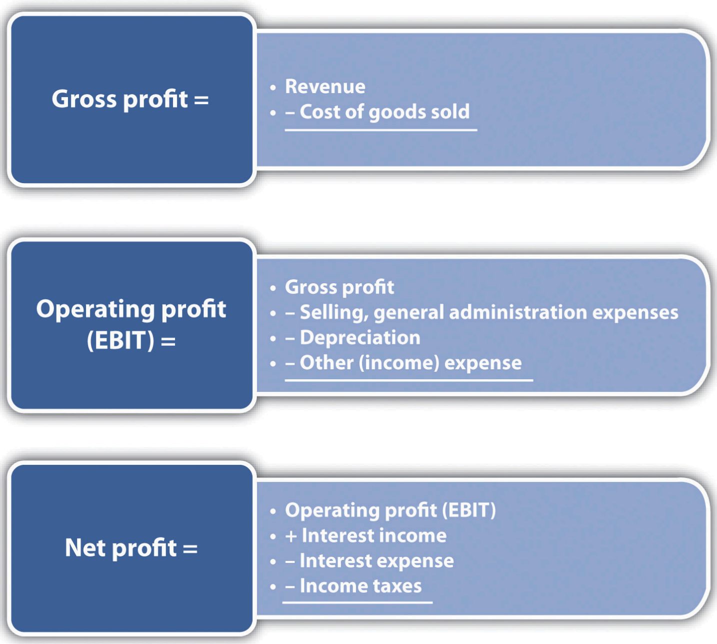
EBT = operating profit – other revenues and expenses.

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 below. The income statement is the item that most individuals look at to determine the success of business operations.

The Income Statement



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

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

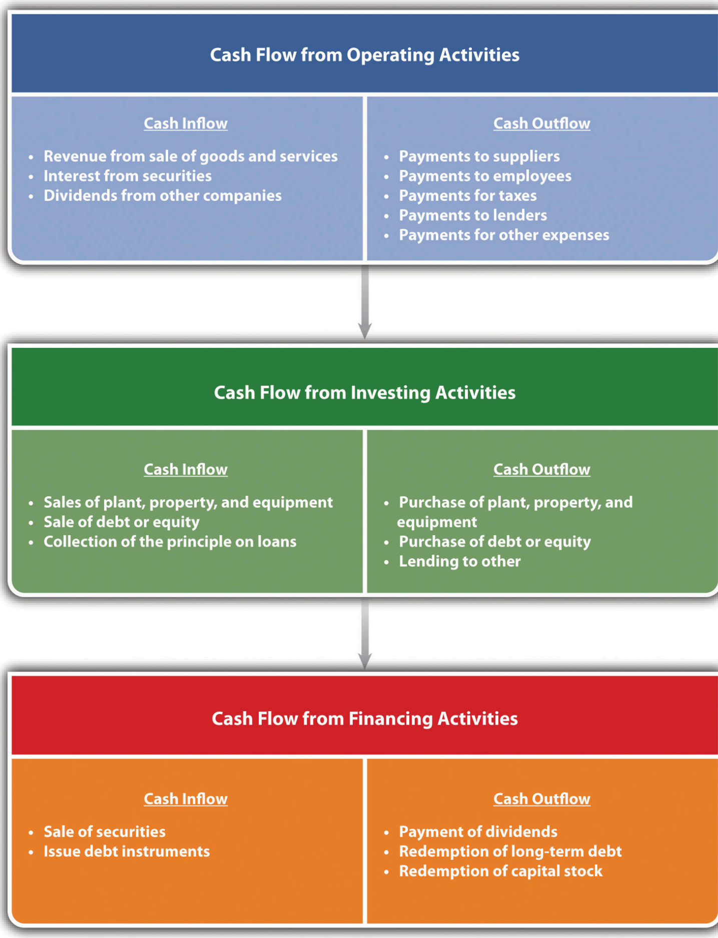
- Cash received from the sale of equity investments
- Cash received from collections on a debt instrument

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 the table below:

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.[17]

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 the table below.

Sales Data for Soft Serve Services

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

	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.

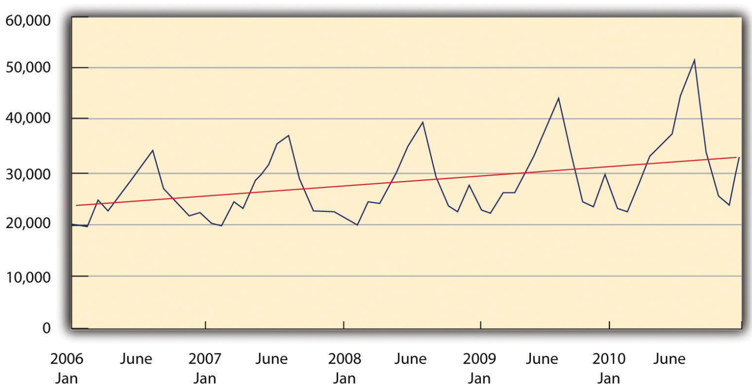
Although the average of the four annual growth rates was 6.8 percent (the annual growth rates were 4.14 percent in 2007, 4.71 percent in 2008, 8.34 percent in 2009, and 9.99 percent in 2010, thus having an average of 6.8 percent), Alex believes that the last two years were unusually good, and the growth 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 below. 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.

Seasonality in Sales



This table shows the analysis for each month in each of the five years and the averages for each month:

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 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.)

November 2010 sales = \$23,466 December 2010 sales = \$33,583 January 2011 sales = \$26,737 cash inflow from November 2010 sales = (\$23,466) × 15 percent = \$3,520 cash inflow from December 2010 sales = (\$33,583) × 35 percent = \$11,754 cash inflow from January 2011 sales = (\$26,737) × 50 percent = \$13,368 total cash inflows from operations = sum of cash inflows for three months = \$28,642.

Alex then estimates his cash outflows from operations. From past experience, he knows that the purchases of parts and materials run approximately 50 percent of the dollar value of his sales. However, because of delays in acquiring parts and materials, he must order them in advance. He has to anticipate what sales would be the following month and has to place a purchase order predicated on that value. Further, 60 percent of that dollar value is in that month and the remaining 40 percent is in the following month. This can be illustrated for January 2011. To determine the purchases of parts and materials in January, he begins with his forecast for sales in February 2011.

February 2011 sales = \$25,637 parts and materials purchases in January 2011 = 50 percent of February 2011 sales = 50 percent × \$25,637 = \$12,819.

He is obligated to pay 60 percent of this amount in January 2011 and the remaining 40 percent in February 2011. This also means that his cash outlay in January 2011 must include a payment for 40 percent of December's purchases.

parts and materials purchases in December 2011 = 50 percent of January 2011 sales = 50 percent × \$26,737 = \$13,369 parts and materials cash outlay in January 2011 = 60 percent of purchases January 2011 + 40 percent of purchases December 2010 parts and materials cash outlay in January 2011 = (60 percent × \$12,819) + (40 percent × \$13,369) = \$13,038.

In addition to purchasing parts and materials, Alex has to consider his operational expenses, which include wages, payroll taxes, office supplies, repairs, advertising, and expenses related to automobiles, phone bills, rent, utilities, expenses associated with accounting services, and taxes. These are itemized in the table below. 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. 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.

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

	November	December	January	February	March
Auto, delivery, and travel			$120	$150	$180
Accounting and legal			$200	$200	$200
Rent			$1,650	$1,650	$1,650
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			$–	$–	$–

	November	December	January	February	March
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
Required borrowing			$–	$–	$(950)

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.

Financial Ratio Analysis

> *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. -Fred Schwed[18]

We previously discussed 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

18. “Accounting Quotes,” Qfinance, accessed February 14, 2012, www.qfinance.com/finance-and-business-quotes/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**, **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 its 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, we can compute the current ratio and the quick ratio.

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.[19] 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 below. 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

19. "Debt/Equity Ratio," Investopedia, accessed December 2, 2011, www.investopedia.com/terms/D/debtequityratio.asp.

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.

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 below. 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.

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

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.

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.

10. Chapter 10 - Financial Management

The Importance of Financial Management in Small Business

Chapter 9 "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.[1]

1. "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.[2] Others have argued that both accounting and finance should be seen as subdisciplines of economics. Not surprisingly, others have argued in favor of the primacy of accounting. If we get beyond this debate, we can see that accounting is involved with the precise reporting of the financial position of a firm through the financial statements. The accounting function is expected to collect, organize, and present financial information in a systematic fashion. **Finance** can be seen as "the science of money management" and consists of three major activities: financial planning, financial control, and financial decision making. Financial planning deals with the acquisition of adequate funds to maintain the operations of a business and making sure that funds are available when needed. Control seeks to assure that assets are being efficiently used. Decision-making is associated with determining how to acquire funds, where to acquire funds, and how those funds should be used and within the context of the risk assessment of the aforementioned decisions. As an academic discipline, finance has grown tremendously over the last four decades.

Much of the work produced during this period possessed both an esoteric analytical quality and profound practical consequences. One only has to look at newspapers and the business press, during the last few years, to see how financial theory (efficient market hypothesis) and financial models (options pricing, derivatives, and arbitrage models) have played a dominant role in the global economy. Fortunately, most small businesses have no need to

www.differencebetween.net/business/difference-between -accounting-and-finance.

2. "Difference between Accounting and Finance," DifferenceBetween.net, accessed February 1, 2012, www.differencebetween.net/business/difference-between -accounting-and-finance.

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.

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.

Sources of Capital

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.[3] 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

3. "Financing," Small Business Notes, accessed December 2, 2011, www.smallbusinessnotes.com/business-finances/financing.

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.[4] 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.[5]

Chapter 5 "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

4. "Checklist: Issuing Stock," San Francisco Chronicle, accessed December 2, 2011, allbusiness.sfgate.com/10809-1.html.
5. "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.

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.[6] Bank lending can take many forms. The most common loan specifies the amount of money to be repaid within a specific time frame for a specific interest rate. These loans can be either secured or unsecured. Secured loans involve pledging some assets—such as a home, real estate, machinery, and plant—as collateral. Unsecured loans provide no such collateral. Because they are riskier for the bank, they generally have higher interest rates.

The Small Business Administration (SBA) has a large number of programs designed to help small businesses. These include the business loan programs, investment programs, and bonding programs. The SBA operates three different loan programs. It should be understood that the SBA does not make the loan itself to a small business but rather guarantees a portion of the loan to its partners that include private lenders, microlending institutions, and community development organizations. To secure one of these loans, the borrower must meet criteria set forth by the SBA. It should be recognized that these SBA loan rules and guidelines can be altered by the US Congress and are dependent on prevailing economic and political conditions. The following subsections briefly describe some of the loan programs used by the SBA.

Loan Programs

This class of loans may be used for a variety of reasons, including the purchase of land, buildings, equipment, machinery, supplies, or

6. "How Will a Credit Crunch Affect Small Business Finance?," Federal Reserve Bank of San Francisco, March 6, 2009, accessed December 2, 2011, www.frbsf.org/publications/economics/letter/2009/el2009-09.html.

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.[7] 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." data-url="http://www.youtube.com/v/Jsek3PQypzw">

7. 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.

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.[8] Neither the cost of issuing stock nor dividend payments is tax deductible.

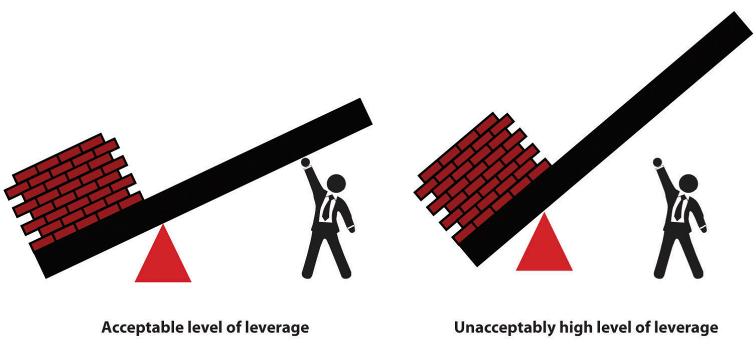
Larger businesses have many more options available to them than smaller enterprises. Although this is not always true, larger businesses can often arrange for larger loans at more favorable rates than smaller businesses.[9] Larger businesses often find it easier to raise capital through the issuance of stock (equity).

By increasing a business's proportion of debt, its financial leverage can be increased. There are many reasons for attempting

8. Gavin Cassar, "The Financing of Business Startups," Journal of Business Venturing 19 (2004): 261–83.
9. 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.

to increase a business's financial leverage. First, one is growing the business with someone else's money. Second, there is the deductible nature of interest on debt. Third, increasing one's financial leverage can have a positive impact on the business's return on equity. For all these benefits, however, there is the inescapable fact that increasing a business's debt level also increases a business's overall risk. The term *financial leverage* can be seen as being comparable to the base word—lever. Levers are tools that can amplify an individual's power. A certain level of debt can amplify the "lifting" power of a business. However, beyond a certain point, the debt may be out of reach, and therefore the entire lifting power of financial leverage may be lost. 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.

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.[10] 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.[11]

A recent research paper[12] examined the relationship between

10. 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.
11. 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.
12. Rowena Ortiz-Walters and Mark Gius, "Performance of Newly Formed Micro Firms: The Role of Capital Financing Structure and Entrepreneurs' Personal Characteristics" (unpublished manuscript), 2011.

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.

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.

Financial Control

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*.[13]

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

13. “The Benefits of Making Your Banker Your Friend,” Small Business Administration, accessed December 2, 2011, www.sbaonline.sba.gov./smallbusinessplanner/start/financestartup/SERV_BANKERFRIEND.html.

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.

Financial Decision-Making

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.[14] 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

14. "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.

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.

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.

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	$(19,25
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	$35,75
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	$104,5

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.

Capital Structure Issues in Practice

The need to balance debt and equity, with respect to financing a firm's operations, is briefly discussed in a previous section. 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 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.[15] A major breakthrough occurred with the works of Franco

15. David Durand, "Cost of Debt and Equity Funds for Business: Trends and Problems of Measurement,"

Modigliani and Merton Miller.[16] 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

Conference on Research in Business Finance (New York: National Bureau of Economic Research, 1952), 220.

16. 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.

below. 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.

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

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

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.

The table below presents the income statement for these five scenarios. 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.

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

Abbreviated Balance Sheet for the Five Scenarios

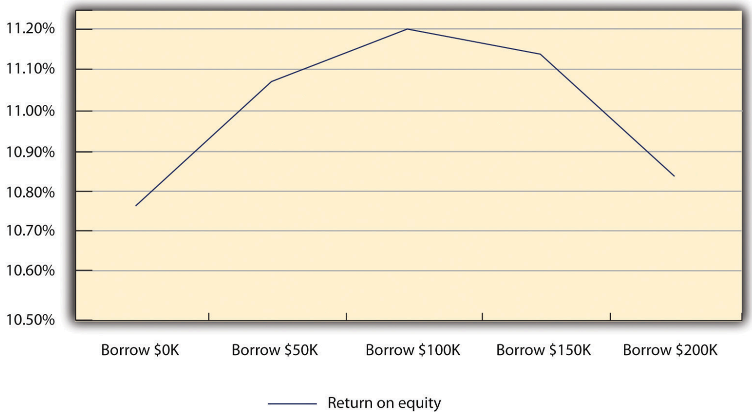
	Borrow $0	**Borrow $50,000**	**Borrow $100,000**	**Borrow $150,000**	**Borrow $200,000**
Total assets	$965,000	$965,000	$965,000	$965,000	$965,000
Long-term debt	$–	$50,000	$100,000	$150,000	$200,000
Owners' equity	$965,000	$915,000	$865,000	$815,000	$765,000
Total debt and equity	$965,000	$965,000	$965,000	$965,000	$965,000

The owners then calculated the ROA and the ROE for the five scenarios. When they examined these results, they noticed that the greatest ROA occurred when the new machinery was financed exclusively by equity capital. The ROA declined as they began to fund new machinery with debt: the greater the debt, the lower the ROA. However, they saw a different situation when they looked at the ROE for each scenario. The ROE was greater in each scenario where the machinery was financed either exclusively or to some extent by debt. In fact, the lowest ROE (the firm borrowed the entire $200,000) was 50 percent higher than if the firm did not acquire the new equipment. A further examination of the ROE results provides a very interesting insight. The ROE increases as the firm borrows up to $100,000 of debt. When the firm borrows more money ($150,000 or $200,000), the ROE declines. This is a highly simplified example of optimal capital structure. There is a level of debt beyond which the benefits measured by ROE begins to decline. Small businesses must be able to identify their "ideal" debt-to-equity ratio.

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%

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 the following table. 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.

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

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%

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.

11. Chapter 11 - Supply Chain Management

The Supply Chain and a Firm's Role in It

> *No man is an island, entire of itself.* – John Donne[1]

Given the almost daily exposure and coverage of modern business theories or concepts in the popular press, one of the great challenges for both small business owners and corporate executives is the need to separate the wheat from the chaff. In the last four or five decades, businesspeople have heard and read about the next great idea that will revolutionize business as we know it. One almost feels obligated to run out and buy a book that lays out the general principles of concepts such as **management by objectives**, **business process reengineering**, transactional versus transformational leadership, management by walking around, the **learning organization**, matrix management, **benchmarking**, lean

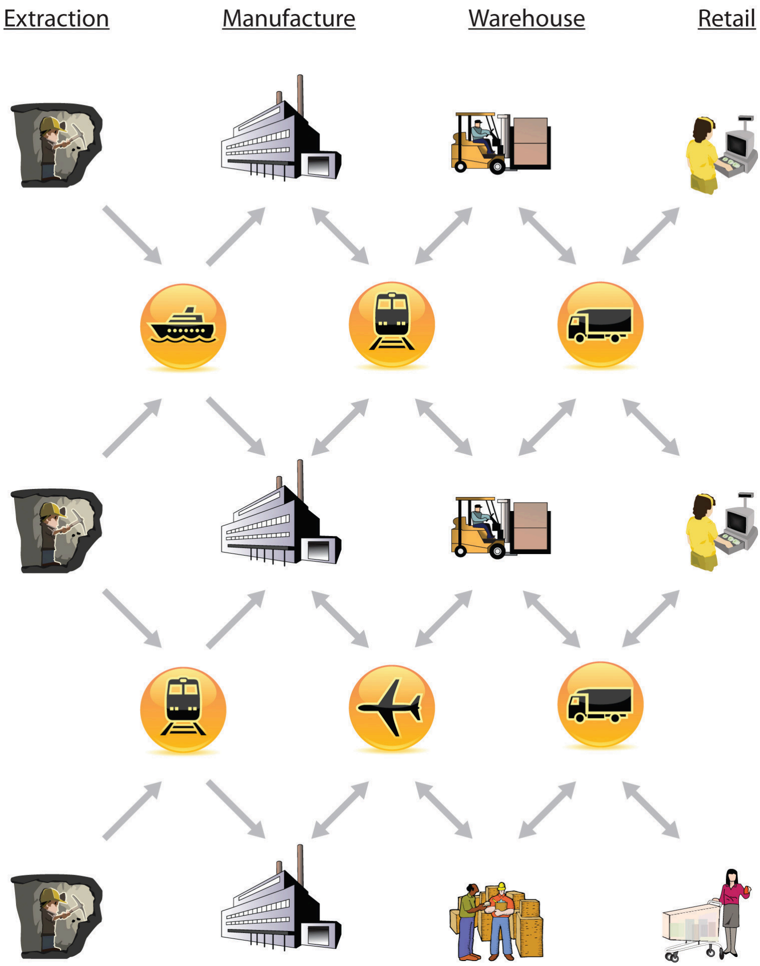
1. John Donne, "XVII. Meditation," The Literature Network, accessed February 4, 2012, www.online-literature.com/donne/409.

methodologies, and several quality systems—total quality management, the Deming method, and Six Sigma. Some of these have proven to be business fads and have run their course—sometimes with poisonous effects.[2] Others, such as lean methodologies and some quality systems, have proven to be solid bases on which to improve an organization's efficiency and effectiveness.

A modern concept that has been popularized over the last two decades is that of supply chain management. In one sense, supply chain management is as old as business itself. One has to look only at the traffic along antiquity's Silk Road trade route. This route was used to move goods across Asia's vast steppes between China and the Middle East and as far west as ancient Rome. It possessed most of the fundamental elements of today's supply chain: goods were produced (make), transported (move), deposited in warehouses (store), purchased by merchants (buy), and sold to customers. As will be seen, these five activities are the core of any supply chain.[3] If these activities have been universal dimensions of business, then what is different about supply chain management? That question will now be addressed.

Material Flows in a Supply Chain

2. John Mickletwait and Adrian Woodridge, Witch Doctors: Making Sense of the Management Gurus (New York: Time Books, 1996), 22.
3. Scott Webster, Principles and Tools for Supply Chain Management (Boston: McGraw-Hill, 2008), 62.



What Is a Supply Chain?

The owners of many small businesses may pride themselves on knowing many—if not all—of their employees. Other small businesses may have some degree of familiarity with most of their customers. They may have professional contacts with someone at the office of their immediate suppliers. Beyond those contacts, the daily demands of operations may mean that they have failed to see their firm's position in the larger context known as the supply chain. What precisely do we mean when we use the term **supply chain management**? Industrial organizations and academics provide several different definitions of supply chain management.

The Council of Supply Chain Management Professionals provides the following definition: "Supply chain management encompasses the planning and management of all activities involved in sourcing and procurement, conversion, and all logistics management activities. Importantly, it also includes coordination and collaboration with channel partners, which can be suppliers, intermediaries, third party service providers, and customers. In essence, supply chain management integrates supply and demand management within and across companies."[4]

The Association for Operations Management (APICS) defines a supply chain as "a total systems approach to designing and managing the entire flow of information, materials, and services—from raw material suppliers, through factories and warehouses, and finally to the customer…The chain comprises many links, such as links between suppliers that provide inputs, links to manufacturing and service support operations that transform the input into products and services, and links to the distribution and local service providers that localized the product."[5]

In a seminal article on the subject, supply chain management was defined as follows: "Supply chain management is the systemic,

4. "CSCMP Supply Chain Management Definitions," Council of Supply Chain Management Professionals, accessed February 1, 2012, cscmp.org/aboutcscmp/definitions.asp.
5. APICS—Operations Management Body of Knowledge Framework, 2nd ed. (Chicago: APICS, 2009).

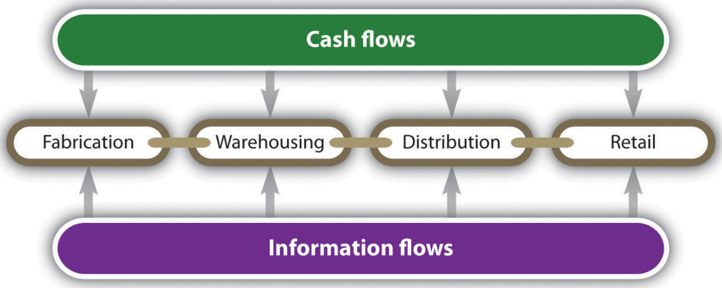
strategic coordination of the traditional business functions and the tactics across these business functions within a particular company and across businesses within the supply chain, for the purposes of improving the long-term performance of the individual companies and the supply chain as a whole."[6]

For our purpose, we define the supply chain as follows: "It is a systematic and integrated flow of materials, information, and money from the initial raw material supplier through fabricators, manufacturers, warehouses, distribution centers, retailers, and the final customer. Its ultimate objective is the improvement of the entire process, which means an increase of economic performance of all participants and an increase in value for the end customer."

If we examine these definitions, several common themes stand out. Supply chain management is not limited to the flow of goods and materials. The successful supply chain requires a consideration of both financial flows and information flows across the entire chain. A second theme is that organizations must overcome myopia of just being concerned with their immediate suppliers and customers. They must take into consideration their suppliers' suppliers and their customers' customers. To be able to do this, organizations must expand the flow of communication and information.

Additional Flows in a Supply Chain

6. John Mentzer, William DeWitt, James Keebler, Soonhong Min, Nancy Nix, Carlo Smith, and Zach Zacharia, "Defining Supply Chain Management," Journal of Business Logistics 22, no. 2 (2001): 7.



One might easily pose the following question: How has the concept of supply chain management taken off in the last twenty years? The proliferation of supply chain management is a core concept for businesses that can be attributed to several major factors, including the following:

- **The increasing importance of globalization.** Global trade has seen a spectacular increase in the last half century. It is estimated that international trade has increased by 100 percent increase since 1955.[7] The end of the Cold War in the early 1990s produced a political environment conducive to the promotion of the notion of free trade. Free trade advocates that nations lower or eliminate trade barriers and tariffs so that countries might develop some particular competencies so that they can participate in the global economy. Several trading blocs have been built during the last three decades that facilitate trade among their partners, including the European Union, which currently consists of twenty-seven countries with a total population in excess of five hundred million and a gross domestic product (GDP) greater than that of the United

7. Steve Schifferes, "Globalisation Shakes the World," BBC News, January 21, 2007, accessed February 1, 2012, news.bbc.co.uk/2/hi/business/6279679.stm.

States. The European Union shares a common currency, and there are no trade barriers among its member states. NAFTA stands for the North American Free Trade Agreement and encompasses Canada, the United States, and Mexico. With respect to the combined GDP of these three countries, NAFTA represents the largest trading bloc in the world. Two other trading blocs in the Western Hemisphere are the Dominican Republic-Central American Free Trade Agreement and MERCOSUR (Common Southern Agreement), which promotes trade among Argentina, Brazil, Paraguay, and Uruguay. The spectacular growth of international finance should also be considered when examining the growth of globalism in recent history.

- **Changes in consumer demands.** Across the world, consumers are becoming progressively more demanding. They expect better quality products with more options and at a lower cost. One has to look only at the global market for cell phones for an example. Even in countries that might be classified as Third World countries, consumers expect to be able to buy cell phones with cutting-edge capability at reasonable prices. This results in a great need for new products, which in turn requires a reduction in life cycle development times. Normally, increasing the product development time would generally result in higher cost, something that is unacceptable today. To meet increasing and often conflicting demands, businesses find that they must work closely with members of their supply chain.

- **Organizations that have recognized the need to change.** Increasingly, more and more businesses recognize that old models may no longer function. In the past, many businesses strove to be vertically integrated. This meant that they wanted to control as many aspects of their operations as possible. Large oil companies exhibit vertical, industry-wide integration. A firm such as Exxon-Mobil has the capacity to carry out almost all the functions associated with the petroleum industry. Exxon-Mobil has units that can explore for oil, drill for oil, transport oil, refine oil into gasoline, and sell it directly to consumers. In this way, it has almost complete control over the entire supply chain. This approach—total vertical integration—may work in some industries where firms recognize that it is economically advantageous to outsource noncore activities. Firms are making the decision whether to make or buy, and they are finding it financially attractive to have other businesses make components or products for them. As outsourcing became more popular, there was immediate recognition that businesses had to pay careful attention to all the elements of their supply chains. They had to develop working relationships with their suppliers and their customers. Successful supply chain management requires new approaches for dealing with suppliers. Those businesses that have successfully made this transition can fully exploit the benefits of supply chain management.

Another area where businesses have learned to change, which has greatly impacted the acceptance of supply chain management, is the change from a push philosophy to a pull philosophy. A push philosophy means that a business produces goods and services and pushes it into the marketplace. A push-based system will forecast demand in the market, produce the required amount, push the product out the door, and hope that the forecast was correct. In contrast, a pull philosophy means that the production of goods and services is initiated only when the marketplace or the consumer demands it. Production is initiated by actual demand.

- **Technical innovations.** Today's approach to supply chain management would be impossible without technological revolutions in the fields of communication and computer software. It would be impossible to operate in a global supply chain without the Internet.

Key Elements of a Supply Chain

What precisely makes up a supply chain management system? Various authors identify the different components or elements of such a system.[8] The simple list would include four core elements: procurement, operations, distribution, and integration.

The Core Elements of a Supply Chain Management System

8. Martin Murray, “Introduction to Supply Chain Management,” About.com, accessed February 1, 2012, logistics.about.com/od/supplychainintroduction/a/into_scm.htm; Phillip Edwards, “Supply Chain for Small Businesses and Its Benefit,” Small and Medium Business Corner, April 22, 2011, accessed February 1, 2012, smb-corner.com/2011/04/supply-chain-management-small-business; Joel D. Wisner, G. Keong Leong, and Keah-Choon Tan, Principles of Supply Chain Management: A Balanced Approach (Mason, OH: South-Western, 2004), 13.

The first of the four elements—**procurement**—begins with the purchasing of parts, components, or services. However, it does not end with the purchase. Procurement must ensure that the right items are delivered in the exact quantities at the correct location on the specified time schedule at minimal cost. This means that procurement must concern itself with the determination of who should supply the parts, the components, or the services. It must address the question of assurance that these suppliers will deliver as promised. The opening phrase of this question is often as follows: should the business make or buy a particular part or service? The make-or-buy question can have both strategic significance and economic significance. Some businesses will choose not to have others make or provide services because they believe they may lose control over particular technologies or skill sets. Will it benefit a business to have lower cost in the short run yet lose its source of competitive advantage in the long run to another competitor? Overseas outsourcing may pose difficulties with respect to communication difficulties, extended transportation distances, and timelines. The inability to ensure the overall quality of the outsourced item may be a deciding factor in not having another business make the part or provide the service. Recent difficulties with the quality assurance of products made in China have given many American manufacturers second thoughts about outsourcing.

There are, however, reasons for businesses to outsource production or services. The most obvious reason is associated with lower costs. Read the business press and discover the phrase *the China price*. This refers to the low cost of products produced in China given its low wages. One should not think that outsourcing is associated only with overseas manufacturing. Many firms will domestically outsource certain in-house service activities. The firm ADP specializes in preparing businesses payrolls, employee benefits, and tax compliance. ADP has been successful because it is able to provide a high-quality product at lower cost than many firms could produce in-house. Another reason why a business may outsource production or other activities is that the business is currently unable to meet particular demand levels.

If one were to exclude strategic considerations and merely look at economic issues, many make-or-buy decisions could be fairly straightforward variations of breakeven analysis. Imagine a firm is thinking about outsourcing the manufacture of a particular part to a Chinese firm. The plot is not unique from a technical standpoint, so outsourcing would have no strategic significance.

Data for Domestic Production versus Chinese Outsourcing Option

Costs	Domestic Production ($)	Outsourcing to China ($)
Fixed costs	40,000	4,000
Labor cost per unit	9.90	4.25
Material cost per unit	7.20	7.20
Transportation cost per unit	0.40	3.80
Tariff duty per unit	0.00	1.50
Total cost per unit	17.50	16.75

With these figures, there is no need to conduct a breakeven analysis. Outsourcing to China produces a lower total unit cost, and the fixed costs are significantly lower. The total cost reduction would dictate that China is the preferred location to produce the part. But now envision another scenario, one in which the transportation cost increases by $2.55 (increasing the transportation cost per unit to $6.35) and the tariff duty per unit increases by $1 per unit.

Revised Data for Domestic Production versus Chinese Outsourcing Option

Costs	Domestic Production ($)	Outsourcing to China ($)
Fixed costs	40,000	4,000
Labor cost per unit	9.90	4.25
Material cost per unit	7.20	7.20
Transportation cost per unit	0.40	6.35
Tariff duty per unit	0.00	2.50
Total cost per unit	17.50	19.30

Given these changes, we can now conduct a breakeven analysis.

Domestic Production Total Costs		Outsourced to China Total Costs
Fixed costs + total variable costs	=	Fixed costs + total variable costs
$40,000 + $17.50 * Q	=	$4,000 + $19.30 * Q
($40,000 – $4,000)	=	($19.30 – $17.50) * Q
$36,000	=	$1.80 * Q
break-even point Q	=	20,000 units
Q = Quantity		

This simply means that if the demand for the part is fewer than 20,000 units, then it is cheaper to produce the part in China; however, if the demand is greater than 20,000 units, it is cheaper to produce the part domestically.

The key issue in procurement is how one goes about selecting and maintaining a supplier, which can be approached from two directions. The first centers on how a firm might evaluate a potential supplier. The second is how a firm evaluates those businesses that are already suppliers to an operation. When looking at the potential suppliers of a business, a firm may be aided by examining those suppliers with some form of certification. Perhaps the most globally recognized certification program is ISO 9000, a program designed to ensure that suppliers are certified and fully committed to quality production. A supplier that is ISO 9000 certified may mean that incoming goods need not be tested. In examining suppliers, one might also look at the number of employees of the potential supplier who have received certification in the area of supply chain management. The Association for Operations Management, formerly known as the American Production and Inventory Control Society (APICS), has a program to certify professionals in supply chain management. After selecting a supplier, one must have a program that continuously evaluates the capability of the supplier. Some of the capabilities that may be considered include on-time delivery, the accuracy of delivery (i.e., correct items in the correct quantities are shipped), the ability to handle fluctuations in demand, and the ability to hold inventory until needed by the customer. One needs a comprehensive set of metrics to perform such an analysis. In addition, one must think about developing a new type of relationship with suppliers, one that is not adversarial but develops a close working relationship bordering on being an alliance.

The second major element of supply chain management system is **operations**. Having received raw materials, parts, components, assemblies, or services from suppliers, the firm now must transform them and produce the products or the services that meet the needs of its consumers. It must conduct this transformation in an efficient and effective manner for the benefit of the supply chain management system. We will briefly overview those operational activities that most directly relate to supply chain management.

One element is demand management. This involves attempting to match demand with capacity. In a manufacturing environment, this may entail a better and more detailed production schedule. In a service environment, it may entail rescheduling customer appointments to better match service provider availability. A key element is improvements in inventory control, which may be done by using **materials requirement planning** software or instituting a **just-in-time** program. Just-in-time attempts to create an inventory system where the inventory arrives exactly when it is needed. Another way of achieving operational efficiency to improve the supply chain management system is by adopting **lean methodologies**. The essence of lean is attempting to eliminate all forms of waste from a production or service system.

The third element of the supply chain management system is **distribution**. Distribution involves several activities—transportation (**logistics**), warehousing, and **Customer relationship management (CRM)**. The first and most obvious is logistics—the transportation of goods across the entire supply chain. The need to efficiently transport goods has led to a hierarchy of logistics providers. Some argue that it now consists of a four-party hierarchy. First-party logistics providers are those who wish to ship goods to a particular location. Second-party logistics providers are those businesses that provide the means of transportation, including shipping freight by air, rail, or truck. Second-party logistics providers may also offer warehousing services to temporarily store goods. Third-party logistics providers specialize in offering an array of services to simplify transportation. They offer services that synthesize a variety of services, including the shipping of goods, warehousing, inventory management, and packaging. They also may offer services associated with facilitating customs operation and the resolution of problems associated with international transportation. The range of services can be so extensive that the literature segments third-party logistics providers into four groups.[9] They range from those businesses that pick up and deliver goods to those businesses that essentially perform the entire logistics function for a customer. In the last fifteen years, a fourth level of logistics providers was added to this hierarchy. Although there is some argument as to what distinguishes sophisticated third-party logistics providers from fourth-party logistics providers, the essential distinction is that fourth-party logistics providers function as consultants for supply chain management logistics issues. They are non-asset-based integrators[10]—firms do not own shipping assets or warehouses; they simply provide consulting services.

The CRM component of the distribution element represents an attempt to automate interactions with customers and facilitate the development of sales prospects through software packages. Most small businesses will start using CRM as a means of contacting

9. Susanne Hertz and Monica Alfredsson, "Strategic Development of Third-Party Logistics Providers," Industrial Marketing Management 32, no. 2 (2003): 139.
10. "Fourth-Party Logistics," Business Dictionary.com, accessed February 27, 2012, www.businessdictionary.com/definition/fourth-party-logistics-4PL.html.

current customers and future prospective customers. They then move on to software that automates the entire sales process. The ultimate goal of CRM is the greater connection with customers, thus providing them with greater value.

The last element of supply chain management is the need for **integration**. At the beginning of this chapter, we mentioned that many small businesses are unfamiliar with their immediate customers and their immediate suppliers; however, they may be part of a much larger chain. It is critical that all participants in the service chain recognize the entirety of the service chain. A failure to overcome the myopia of just being concerned with the immediate customer and the immediate supplier can produce significant disruptions in the entire chain. These disruptions can significantly increase costs and destroy value.

The impact of the failure to adopt a system-wide perspective—that is, examining the totality of the chain—is most clearly seen in what is known as the "bullwhip" effect. This effect illustrates how a narrow perspective can produce unexpected consequences. Envision a classic supply chain composed of a retailer—who is supplied by a wholesaler—who in turn is supplied by a distributor with a product coming from the manufacturer. Each element of this chain must forecast its anticipated demand and determine the appropriate levels of inventory. Because no element of this chain wishes to "stock out"—having insufficient inventory to meet a customer's demand—each element will carry what is known as safety stock. In many cases, the more certain the demand, the greater the need for such safety stock. If demand at the retail level increases, then it follows that demand will also increase at each level further up the supply chain. If demand decreases at the retail level, the demand will likewise decrease further up the chain. The rate at which demand and inventory levels fluctuate is dependent on the lead time at each level in the chain. The delay between an increase for the retail level and the corresponding increase or decrease at the manufacturing level will be a function of this lead time. The bullwhip effect recognizes that the amplitude of inventory swings increases as one travels up the supply chain because each element of the supply chain is a relatively narrow focus of just trying to meet the needs of their customers. If the forecast for “shared” demand across the entire chain could be made simultaneously or if the lead time could be significantly reduced, then this phenomenon would not be quite as dramatic or problematic. The bullwhip effect calls for integrating information across the entire supply chain.

An **Enterprise resource planning (ERP)** system can successfully integrate information across the entire supply chain. An ERP system is an integrated set of computer programs that brings information about a firm’s accounting, financial, sales, and operations into a common database.[11] One also needs a series of metrics that would indicate the overall performance of the supply chain. This should also be part of the integration process.

Key Takeaways

- The supply chain involves the integration of goods, finances, and information from the initial supplier to the final customer.
- A revolution in supply chain management has been produced by globalization, changes in consumer demand, organizations that recognize the need for changing ways of doing business, and technical innovations.
- Supply chains are composed of four major elements: procurement, operations, distribution, and integration.
- Supply chain management should not be seen as appropriate

11. Cecil C. Bozarth and Robert B. Handfield, Introduction to Operations and Supply Chain Management, 2nd ed. (Upper Saddle River, NJ: Pearson Prentice Hall, 2007), 519.

only for large businesses.

A Firm's Role in the Supply Chain

Developing New Relationships

Game theory is a branch of mathematics. Broadly stated, game theory examines competitive situations in which one's outcomes may be influenced or dictated by the decisions of other players. It has been applied to a variety of worldwide domains, including economics, military operations, political science, and business strategy. It has its own very large literature base, and work in this field has been recognized by several Nobel prizes in economics. To better understand some of the risk associated for small businesses participating in supply chain management, we will briefly look at two types of games: zero-sum games and non-zero-sum games.

Zero-sum games are those in which the total benefits for all participants total zero. Baseball can be seen as a zero-sum game. If one is told that the New York Yankees and the New York Mets played an exhibition game and the Yankees won, then one also knows that the New York Mets lost. Basketball and most games in professional football are also zero-sum games because there is a winner and a loser. Poker can also be seen as a zero-sum game. If your five friends have a Friday night game of poker and one player is up $100, then you also know that the other four players have suffered a cumulative loss of $100.

Non-zero-sum games, on the other hand, are those that potentially have net results other than zero. This simply means that the loss of one player does not directly correspond to the game of another player. In a non-zero-sum game, it is possible for all the players to win or for all the players to lose. The classic illustration of a non-zero-sum game is known as the prisoner's dilemma. The prisoner's dilemma hypothesizes that two criminals (prisoner A and prisoner B) are arrested and charged with the same crime. At the police station, they are separated, and each is given the following option: if you inform on the other prisoner, you will be set free, while the other prisoner will receive a five-year sentence. Both prisoners would instinctively recognize that if they both remained silent, the police would have insufficient evidence to convict both of the crime. At worst, they would be held in the jail for several months. If, however, both prisoners informed on each other, they would probably receive a two-year sentence. Assuming that both prisoners wish to serve the minimal amount of time, their individual decisions will be dictated by what they believe will be the other prisoner's decision. There are four possible outcomes to this scenario:

1. Prisoner A informs on prisoner B while prisoner B remains silent. This is a win for prisoner A and a loss for prisoner B. This is a win-lose outcome.
2. Prisoner B informs on prisoner A while prisoner A remains silent. This is a win for prisoner B and a loss for prisoner A. This is a win-lose outcome.
3. Both prisoner A and prisoner B inform on each other. This situation essentially represents a loss for both prisoner A and prisoner B. This is a lose-lose outcome.
4. Both prisoner A and prisoner B trust each other and remain silent. This results in both prisoners doing a minimal amount of time. In effect, this is a win-win for both individuals.

The point of this brief introduction to game theory is to highlight the possibility of creating a **win-win scenario**. In the prisoner's dilemma, the key to achieving a win-win outcome is that both parties must have complete trust in each other. This concept of mutual trust plays a critical role in successful supply chain management. Far too often, both the supplier and the customer perceive the relationship as a win-lose outcome only. Customers want suppliers to provide items at the lowest possible cost, with the highest quality, delivered exactly when needed. Customers often use multiple suppliers and play them off against each other to guarantee the lowest possible price. Suppliers want to provide customers with items of the highest possible price, with acceptable quality, and delivered when it is convenient for the supplier. These attitudes produce a "dance" between the customer and the supplier, where both are trying to win even if that means that the other loses. These attitudes often stem from the fact that there is no trust between the customer and the supplier.

W. Edwards Deming, the famous management guru who was most commonly associated with the quality movement, had several interesting insights into areas that would be associated with supply chain management. As one of the few management theorists whose ideas were comprehensive enough to be synthesized into a coherent business philosophy, Deming summarized his approach to management in fourteen points. One of these points is as follows: "End the practice of awarding business on the basis of price. Instead, minimize total cost. Move toward a single supplier for any one item, with a long-term relationship of loyalty and trust."[12]

Deming argued that the move toward a single supplier for a particular part could yield significant advantages. Using a single

12. Ken Boyer and Rohit Verma, Operations and Supply Chain Management for the 21st Century (Mason, OH: South-Western, 2009), 38.

supplier requires that a customer must sign a multiyear agreement with the supplier. This enables both the supplier and the customer to better understand each other's needs and capabilities. As this knowledge grows, the supplier can better serve the customer by improving quality, design, and service.[13] From these improvements, one can easily anticipate that there will be lower costs and higher profits. A multiyear contract with a supplier guaranteeing particular sales is invaluable to many suppliers because of the benefit of such a contract when that supplier must deal with its bank. Deming counters the argument for the need for multiple suppliers, in case a catastrophe or a disaster strikes that single supplier, by suggesting that a tight and trusting relationship will lead the supplier to develop sufficient contingency plans. Deming argues that a sense of joint responsibility comparable to a marriage comes from such trust.

Building such trust between two organizations is not easy. It will often require significant changes in one or both parties. Such change is best induced when it is clear to all participants that there is top-level management support for the new ways of doing business. Top management must articulate the shared vision between the two organizations. Top management must clearly identify the objectives and metrics to be used by both the supplier and the customer. People need to clearly understand the joint benefits from adopting the new way of business. In addition, even with electronic communication, it is highly advisable that members of both organizations meet on a regular basis and perhaps tour each other's facilities.

The new relationships that are required for the success of any supply chain management program are not easy to implement, but

13. W. Edwards Deming, The New Economics for Industry, Government, Education, 2nd ed. (Cambridge, MA: MIT Press, 2000), 232.

they are vital. Every effort must be made to adopt this win-win perspective.

Managing Information in New Ways

Cost, profits, and financial ratios can provide useful insights into the overall efficiency and effectiveness of any business. However, they do not always tell the full story. A sudden spike in the price of oil, a flood that destroys a low-cost supplier, an increase in interest rates, the closing of a large plant in a small town, or a national banking crisis are all external factors that can cripple the financial viability of any business. These external factors lie beyond the control of even the best management team. Sometimes we need to be very careful about what we measure and how we should measure. Although it adds a layer of complexity to a basic accounting system, measurements that are useful for evaluating processes that serve customers can be provided.

When evaluating the supply chain of a business, there is a great need to carefully consider what metrics should be employed. Such a consideration should include at least some of the following factors:

- **Total supply chain cost.** All the operational expenditures of a cost associated with the requisite information systems.
- **Cash-to-cash cycle time.** The time between when an organization purchases raw materials and when they are paid by the customer.
- **Delivery.** The percentage of orders delivered on or before customer due dates.
- **Flexibility.** The amount of time required to handle a significant ramp up in production.[14]

14. Joel D. Wisner, G. Keong Leong, and Keah-Choon Tan,

For those who are seriously committed to maximizing the benefits from successful supply chain management, study the **supply chain operations reference (SCOR) model**. This model enables businesses to benchmark their supply chain management systems. Developed in 1996 by the Supply Chain Council in conjunction with AMR Research and Pittiglio Rabin Todd and Rath,[15] the purpose of the SCOR model is to provide methods to measure and benchmark the performance of the supply chain management system of a business. Currently, one thousand firms, universities, and government agencies participate in the continuing evolution of the SCOR model. It is predicated on three major components: process modeling, performance measurement, and the determination of best practices.

The process-modeling component begins with five essential elements that link together the supply chain: plan, source, make, deliver, and return. Plan refers to those processes associated with the design of the supply chain, planning activities associated with the other four processes, and the implementation of all these plans. These plans should enable management to identify any significant gaps and determine how these gaps will be closed. Source refers to the ordering and the acquisition of goods and services to meet anticipated demand, including purchase orders, scheduling, receipts, and storage. Make refers to those processes used to create the product or the service, including, for example, make to stock, make to order, or engineer to order. Deliver refers to those processes associated with the development and the fulfillment of customer orders, including scheduling, packaging, and shipping all orders. Lastly, return refers to those processes associated with the

Principles of Supply Chain Management: A Balanced Approach (Mason, OH: South-Western, 2004), 442.

15. Scott Webster, Principles and Tools for Supply Chain Management (Boston: McGraw-Hill, 2008), 55.

return of finished products by a customer. The SCOR model attempts to be as inclusive as possible with respect to these five major processes. Each process can be broken down into subcomponents. Currently, there are thirty subcomponents for the plan element, twenty-seven subcomponents for the source element, thirty-one subcomponents for the make element, sixty-one subcomponents for the deliver element, and thirty-six subcomponents for the return element. This program then goes on to identify specific metrics for nearly every subcomponent. It is the most comprehensive system of evaluation for supply chain management.

Key Takeaways

- In game theory's non-zero-sum model, it is possible to produce win-win scenarios for multiple players.
- Win-win scenarios require mutual trust.
- Supply chain management success needs new levels of trust and respect for it to function properly in the long run.
- Supply chain management needs metrics to evaluate its performance.
- Existing models of supply chain metrics (SCOR) can handle the most complicated of supply chains.

The Benefits and the Risks of Participating in a Supply

Chain

The Benefits of Successful Supply Chain Management

For any small business, a commitment to developing a supply chain management system is not a small undertaking. It involves the commitment of significant financial resources for the acquisition of appropriate software. Policies and procedures must be changed in accordance with the needs of the new system. Personnel must be trained in not only using the new software but also adapting to new ways of doing business. Small businesses accept these challenges of adopting supply chain management systems because such systems are viewed as being important for long-term survival and because businesses anticipate substantial management and economic benefits.

The management benefits of supply chain management system include the following:

- **Silo busting.** By their very nature, supply chain management systems improve communication across all functions within a business. This leads to employees having a better understanding of the entire operations of a business and how their work relates to the overall benefits of the business.
- **Improve communications with suppliers and customers.** Improved communications with customers enhances the overall value provided to those customers. The improvement in customer satisfaction leads to longtime relationships, which yields significant economic benefits. Improved communications with suppliers improve the overall operational efficiency of both participants, reduce costs, and improve profits.

- **Supplier selection.** Supply chain management systems can help businesses evaluate prospective suppliers and monitor the performance of current suppliers. This capability can lead to strategic sourcing and significant cost savings plus improvement of the when- and where-needed variables.
- **Improvements in purchasing.** The automation of purchasing reduces errors and improves the economic efficiency of the purchasing function. Disciplined purchasing can allow for the full exploitation of available discounts.
- **Reduction of inventory costs.** Supply chain management systems can produce significant cost savings across all levels of inventory. Improved forecasting and scheduling will lead to increases in inventory turns and a corresponding reduction of costs.
- **Improvements in operations.** Improved quality control reduces the scrap rate, which in turn can have significant cost savings. Better production scheduling translates into producing what is needed when it is needed. The business does not have to spend additional money trying to expedite the production of particular orders to customers. The cost of goods sold is reduced in this manner. An additional benefit of supply chain management systems is that they lead to better utilization of plant and equipment. Great utilization translates into less likelihood that unneeded assets will be acquired, which has major financial benefits.
- **Error reduction.** By automating processes, billing errors and errors associated with purchasing and shipping quantities can be reduced. This not only saves money but also improves satisfaction with both suppliers and customers.
- **Improvements in transportation operations.** Accurate deliveries reduce returns and their associated costs. Sophisticated shipping models can reduce the overall cost of transportation.
- **Additional financial benefits.** Such systems can improve the collections process, which impacts customer relations,

reduces bad debts, and improves cash flow.

The Risks Associated with Supply Chain Management

The major risks associated with a supply chain management system fall into two categories: technical and managerial.

Michael Porter's five forces model is a model of the major factors that contribute to an industry's overall structure. It also points to factors that might affect the overall profitability of the particular business within that industry. The greater the strength of these forces, the greater the challenge to make above average return profits for businesses in that industry. It is useful to review two of those forces—the power of suppliers and the power of buyers—and reexamine how they might influence the profitability of any business in the supply chain.

Porter identifies the following factors that might contribute to the overall strength of each force. He argued that suppliers are powerful when the following occurs:

- **They are concentrated.** When an industry is dominated by only a few suppliers, these suppliers generally have a greater ability to dictate terms to their customers. The mining company DeBeers, which controls more than 50 percent of the world diamond production, is able to set the selling price of diamonds for most of the world's jewelers.[16] It should be pointed out, however, that in some cases concentration,

16. Mason A. Carpenter and William G. Sanders, Strategic Management and Dynamic Perspective (Upper Saddle River, NJ: Prentice Hall, 2008), 108.

particularly a duopoly, provides an opportunity for customers to force the two competing firms to compete more readily against each other. Think of the situation of Boeing and Airbus and their relationship to their customers—various airlines. At present, there are only two major producers of commercial aircraft, and airlines sometimes obtain better deals from one manufacturer because of their desire to maintain parity in market share.

- **The size of the suppliers is large relative to the buyers.** Suppliers are powerful when they are large and sell to a set of fragmented buyers. Think of the largest oil companies that sell gasoline to independent stations. The power in this scenario lies with the large oil companies.
- **Switching costs are high.** Suppliers have power when the cost of switching to an alternative supplier is expensive. Many businesses stay with Microsoft products because to do otherwise means that they would have to repurchase new hardware and software for the entire organization.

Problems may also arise from a heavier reliance on one customer in the supply chain. Even large companies need to be aware of their relative strength in the supply chain. Rubbermaid is the most admired corporation in America, as voted by *Fortune* magazine in 1993 and 1994, yet it had significant difficulties when dealing with one of its major customers—Walmart. In the early 1990s, Rubbermaid found that the cost for a key ingredient—resin—had increased by 80 percent.[17] Walmart's almost total focus on lowering its prices led it to drop many of Rubbermaid's products. This began a downward spiral for Rubbermaid, which led to its acquisition by

17. Mary Ethridge, "News about the Wal-Mart Struggle," accessed February 2, 2012, www.dsausa.org/lowwage/walmart/Dec17_03.html.

Newell Inc. Rubbermaid went from the status of the most admired corporation to being a basket case because it failed to recognize its excessive dependence on one customer.

Key Takeaways

- There are significant benefits for businesses that adopt supply chain management systems.
- The benefits stem from improved customer relations, cost cutting, and increased operational efficiencies.
- The adoption of a supply chain management perspective can pose risks.
- Businesses must consider the relative power of both their suppliers and their customers.

Appendix: A Sample Business Plan

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.

Executive Summary

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.

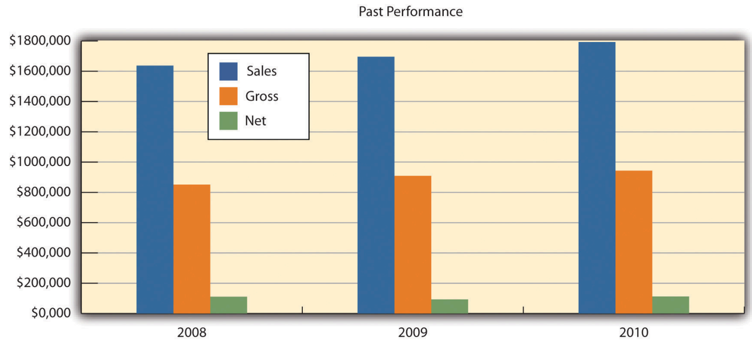
Frank's has won many awards at regional and national barbecue cook-offs (for both the food and the sauces), which is unusual for a barbecue business in New England. The restaurant has been written up, repeatedly, in the local and New York papers for the quality of its food and its four signature barbecue 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. "Past Performance of Frank's All-American BarBeQue" provides a summary of key financial figures for the last three years—2008 to 2010. "Past Performance Chart" illustrates these key numbers for that period of time.

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	**2008**	**2009**	**2010**
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

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 "Demographic Data for Selected Connecticut

Towns—Part 1" and "Demographic Data for Selected Connecticut Towns—Part 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.

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

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.

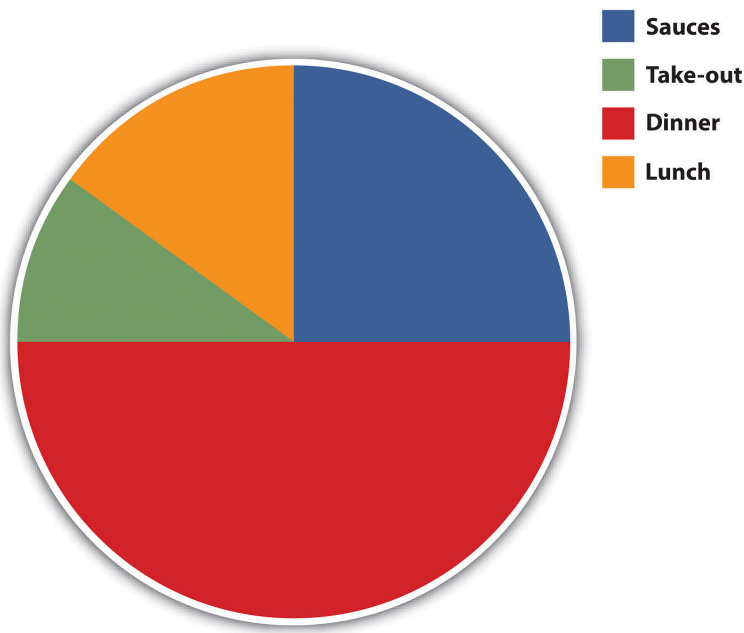
Market Segmentation

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. "Market Analysis 1" 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. "Market Analysis 2" illustrates the relative contributions.

Market Analysis 1

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

Market Analysis 2



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. “Market Analysis” 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. “Market Analysis” 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.

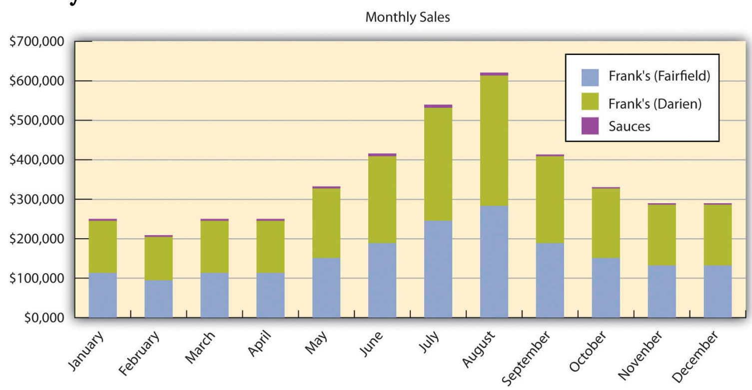
Sales Forecasts

We provide a five-year forecast of the dollar value of sales broken down by the two restaurants and the sauces in the following tables. "Sales"Monthly Sales for Two Restaurants and Sauces" illustrates a forecast for the breakdown of sales on monthly basis in 2011, and "Five-Year Forecast of Sales for Two Restaurants and Sauces" illustrates the breakdown of sales for the next five years.

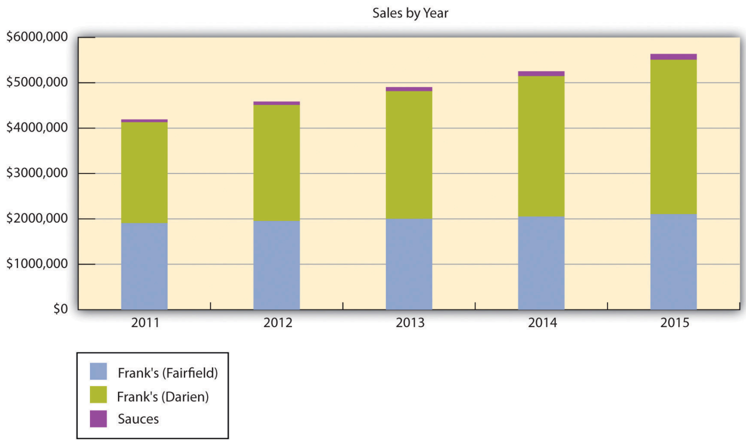
Sales Forecast

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

Monthly Sales for Two Restaurants and Sauces



Five-Year Forecast of Sales for Two Restaurants and Sauces



Management Summary

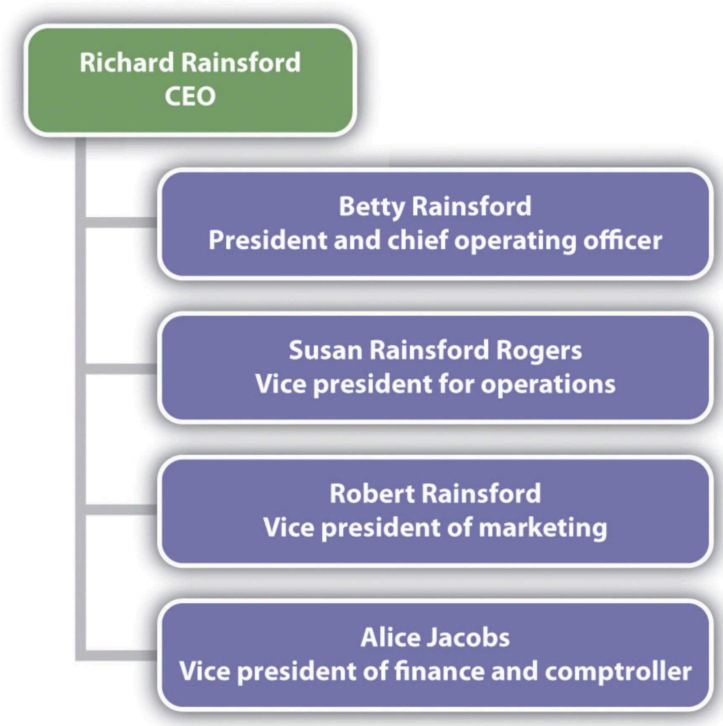
Currently, Frank Rainsford is the CEO and chief operating officer of Frank's All-American BarBeQue. He is also the restaurant manager at the Fairfield restaurant. During the week, his daughter (Susan Rainsford Rogers) often replaces Frank as the restaurant manager. The Fairfield restaurant has a full-time 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.

Organizational Chart



Personnel Plan

"Forecasts of Personnel" is a five-year breakdown of the types and costs of personnel.

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.

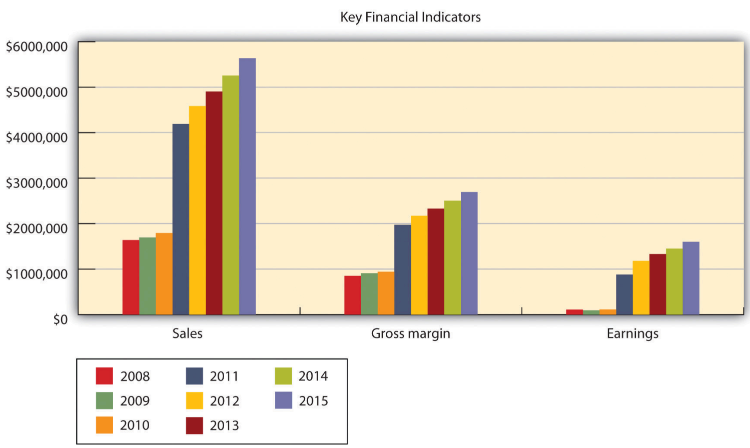
Important Assumptions

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

"Key Financial Indicators" provides historical (2008–2010) and forecasted (2011–2015) values for the key financial indicators.

Key Financial Indicators



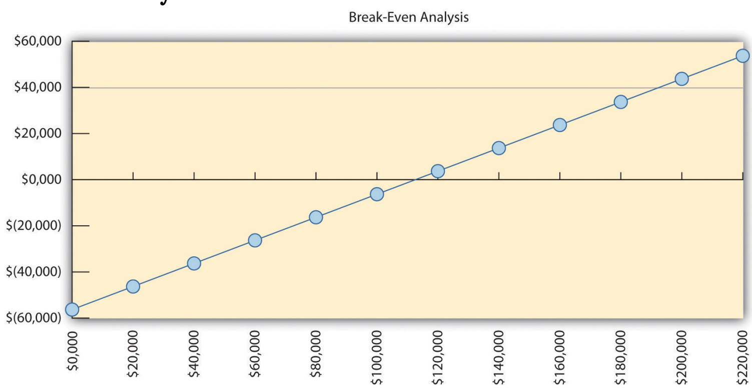
Breakeven Analysis

In “Breakeven Analysis 1” and “Breakeven Analysis 2”, 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.

Breakeven Analysis 1

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

Breakeven Analysis 2



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 “Profit and Loss”. The annual profits are illustrated in “Yearly Profits”.

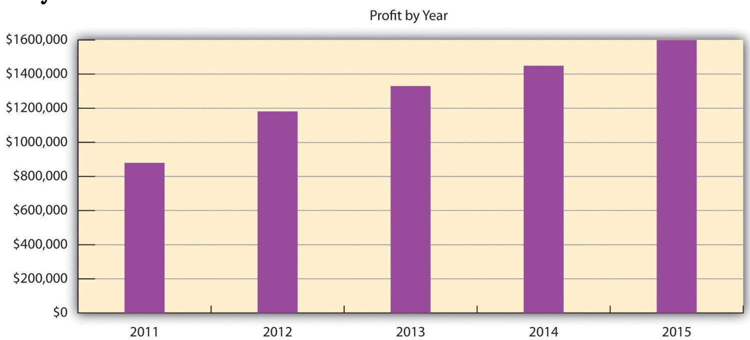
Profit and Loss

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

Pro Forma Profit and Loss	2011	2012	2013	2014	2015
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					
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

Pro Forma Profit and Loss	2011	2012	2013	2014	2015
Net profit/ sales	20.98%	25.76%	27.12%	27.58%	28.37%

Yearly Profits



Projected Cash Flow

"Cash Flow Forecast" 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.

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

"Balance Sheet Forecast" is a balance sheet forecast for Frank's All-American BarBeQue.

Balance Sheet Forecast

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

Pro Forma Cash Flow					
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.