

GLOBAL
EDITION



Entrepreneurship

and effective small business management

ELEVENTH EDITION



Norman M. Scarborough • Jeffrey R. Cornwall

Cases

Entrepreneurship and Effective Small Business Management, 11/E

Case #	Entrepreneur & Company Name	Related Topics	Chapter Reference
1	Michael Volpatt, Kate Larkin, and Crista Leudtke Big Bottom Market	<i>Industry: Restaurant, specialty food, and wine</i> <ul style="list-style-type: none"> • Bootstrap marketing and social media marketing • Managing cash flow 	9 15
2	Peter Justen MyBizHomepage	<i>Industry: Web-based financial services for small business owners</i> <ul style="list-style-type: none"> • Entrepreneurship • Buying/Selling a business • E-commerce • Sources of financing • Human resources management: staffing 	1 7 13 16 and 17 21
3	Jacqui Rosshandler Jacquii LLC	<i>Industry: All-natural breath-freshener</i> <ul style="list-style-type: none"> • Managing cash flow • Sources of equity financing • Sources of debt financing 	15 16 17
4	Lucy Cardenas and Bill Coker Red Iguana	<i>Industry: Restaurant</i> <ul style="list-style-type: none"> • Buying/Selling a business • Sources of debt financing • Management succession • Choosing a location 	7 17 18 22
5	Rachel Shein and Steve Pilarski Baked in the Sun	<i>Industry: Wholesale bakery</i> <ul style="list-style-type: none"> • Healthcare insurance and the Affordable Care Act 	22
6	Angela Crawford and Martin Rodriguez Bluffton Pharmacy	<i>Industry: Pharmacy</i> <ul style="list-style-type: none"> • Financial analysis 	14
7	Angela Crawford and Martin Rodriguez Bluffton Pharmacy – Part 2	<i>Industry: Pharmacy</i> <ul style="list-style-type: none"> • Managing cash flow 	15
8	Brian Linton United By Blue	<i>Industry: Apparel</i> <ul style="list-style-type: none"> • Ethics and social responsibility • Strategic management • Pricing 	2 4 11
9	Aseem Badshah and Kevin Yu Socedo	<i>Industry: Social media services</i> <ul style="list-style-type: none"> • Entrepreneurship • Sources of equity financing 	1 16
10	Kelly Lester EasyLunchboxes	<i>Industry: Lunchboxes</i> <ul style="list-style-type: none"> • Bootstrap marketing and social media marketing • E-commerce 	9 13

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**Eleventh Edition
Global Edition**

Entrepreneurship and Effective Small Business Management

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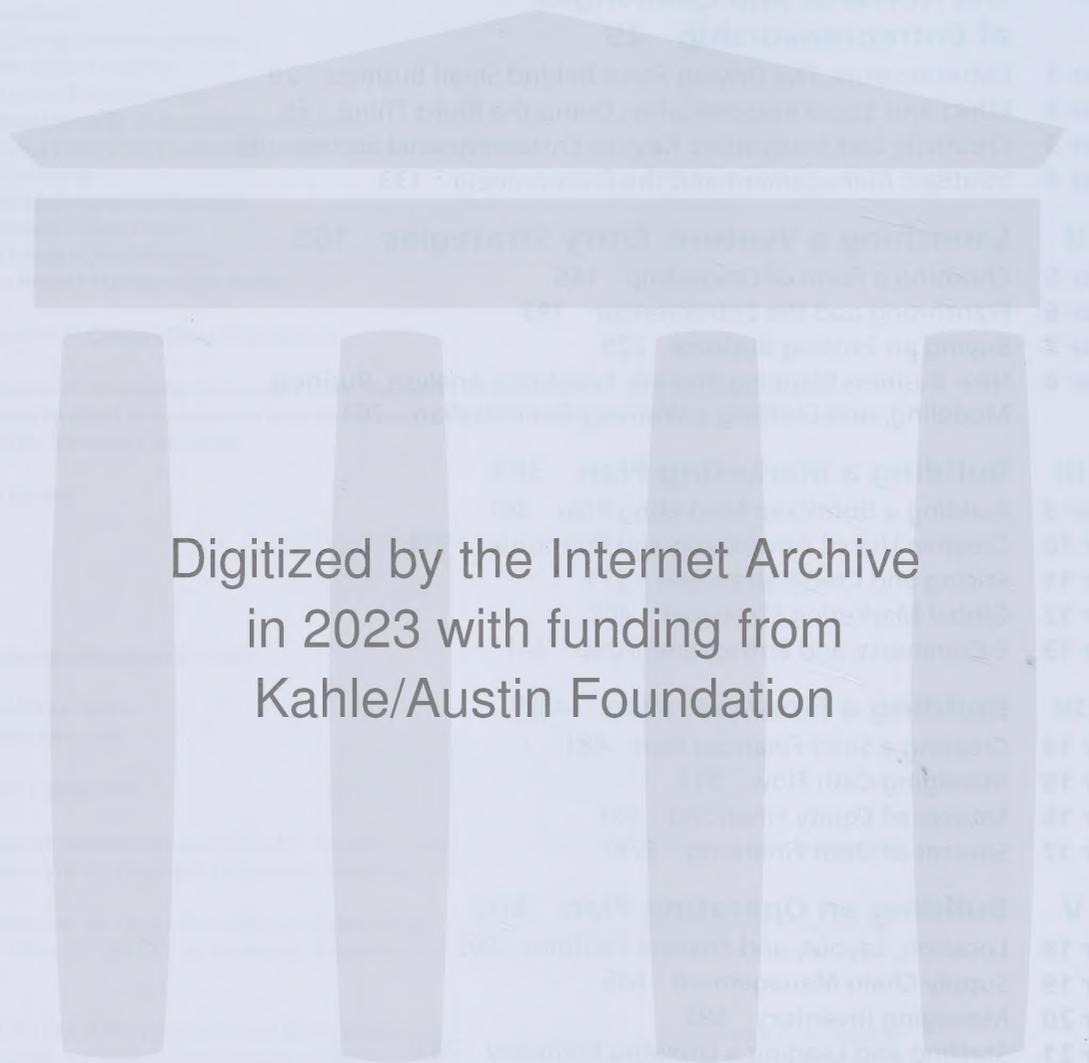
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In memory of Lannie H. Thornley and Mildred T. Myers

To Louise Scarborough and John Scarborough. Your love, support,
and encouragement have made all the difference.

—NMS

To my grandchildren Lucy Kuyper, Ellie Cornwall, and Isaac Cornwall.

—JRC

Preface

The field of entrepreneurship is experiencing incredible rates of growth, not only in the United States but around the world as well. People of all ages, backgrounds, and nationalities are launching businesses of their own and, in the process, are reshaping the global economy. Entrepreneurs are discovering the natural advantages that result from their companies' size—speed, agility, flexibility, sensitivity to customers' needs, creativity, a spirit of innovation, and many others—give them the ability to compete successfully with companies many times their size and that have budgets to match. As large companies struggle to survive wrenching changes in competitive forces by downsizing, merging, and restructuring, the unseen army of small businesses continues to flourish and to carry the nation's economy on its back. Entrepreneurs who are willing to assume the risks of the market to gain its rewards are the heart of capitalism. These men and women, with their bold entrepreneurial spirits, have led our nation into prosperity throughout its history. Entrepreneurship also plays a significant role in countries throughout the world. Across the globe, entrepreneurs are creating small companies that lead nations to higher standards of living and hope for the future.

In the United States, we can be thankful for a strong small business sector. Small companies deliver the goods and services we use every day, provide jobs and training for millions of workers, and lead the way in creating the products and services that make our lives easier and more enjoyable. Small businesses were responsible for introducing to the world the elevator, the airplane, FM radio, the zipper, the personal computer, and a host of other marvelous inventions. The imaginations of the next generation of entrepreneurs of which you may be a part will determine other fantastic products and services that lie in our future! Whatever those ideas may be, we can be sure of one thing: Entrepreneurs will be there to make them happen.

The purpose of this book is to open your mind to the possibilities, the challenges, and the rewards of owning your own business and to provide the tools you will need to be successful if you choose the path of the entrepreneur. It is not an easy road to follow, but the rewards—both tangible and intangible—are well worth the risks. Not only may you be rewarded financially for your business ideas, but also, like entrepreneurs the world over, you will be able to work at something you love! If you do not pursue a career as an entrepreneur, you still need to understand entrepreneurship because you most likely will be working in, doing business with, or competing against small businesses throughout your career.

Now in its eleventh edition, *Entrepreneurship and Effective Small Business Management* has stood the test of time by bringing to generations of students the material they need to launch and manage a small business successfully in a hotly competitive environment. In writing this edition, we have worked hard to provide you with plenty of practical, “hands-on” tools and techniques to make your business ventures successful. Many people launch businesses every year, but only some of them succeed. This book provides the tools to help you learn the *right* way to launch and manage a small business with the staying power to succeed and grow.

What's New to This Edition?

The first change you will notice is in the title of the book. We believe that the new title, *Entrepreneurship and Effective Small Business Management*, reflects this edition's emphasis on the entrepreneurial process. When we started writing this book nearly 35 years ago, small business management was the topic of choice on college campuses; today, the emphasis of college courses is on entrepreneurship. This edition reflects that change by including enhanced coverage of the entrepreneurial process, including the creative process and developing a business model, while retaining thorough coverage of traditional topics that are required for entrepreneurial success, such as e-commerce, managing cash flow, selecting the right location and designing the proper layout, and supply chain management.

Another important change is the addition of Jeff Cornwall as coauthor. Jeff, who holds the Jack C. Massey Chair of Entrepreneurship at Belmont University, is an experienced and successful

entrepreneur, a dedicated teacher, a respected author, and an acknowledged expert in the field of entrepreneurship. The United States Association for Small Business and Entrepreneurship has honored Jeff on numerous occasions for his contributions to the field of entrepreneurship, naming him a Longnecker/USASBE Fellow in 2006 and awarding the Center for Entrepreneurship that he headed at Belmont University the USASBE National Model Undergraduate Program of the Year Award in 2008. USASBE also recognized Jeff in 2013 with the prestigious Outstanding Educator of the Year award. He served as USASBE's president in 2010. Jeff's blog, *The Entrepreneurial Mind*, is one of the most popular small business blogs on the Internet, named by *Forbes* as a "Best of the Web" selection.

This edition of *Entrepreneurship and Effective Small Business Management* also includes many new pedagogical features that reflect the dynamic and exciting field of entrepreneurship.

- The addition of a chapter on the creative process that explores how the entrepreneurial mind works. This innovative chapter also explains how entrepreneurs can stimulate their own creativity and the creativity of the people in their organizations.
- Because your generation is keenly interested in ethics and social responsibility, we placed the updated chapter on ethics and social responsibility right up front (Chapter 2). This thought-provoking chapter gives you the opportunity to wrestle with some of the ethical dilemmas that entrepreneurs face every day in business. Encouraging you to think about and discuss these issues now prepares you for making the right business decisions later. We also have included more extensive coverage of social entrepreneurship in this edition, including new forms of ownership designed specifically for social entrepreneurs.
- This edition includes enhanced coverage of social media, such as Facebook, Twitter, Pinterest, YouTube, and others, throughout the entire book, including ways to use social media as a powerful bootstrap marketing technique; a fund-raising tool; a quick, inexpensive way to test business models; and many others.
- We have included more material on bootstrapping throughout the book because today's young entrepreneurs must be prepared to launch their ventures with limited resources and little access to outside funding.
- We have updated the chapters on financing small businesses to reflect the current state of financial markets. Included in these updates is discussion of the newest form of financing known as crowdfunding.
- We have revised the chapter on creating a business plan to reflect the modern view of the business planning process. In addition to retaining extensive coverage of how to write a business plan, we have expanded the section on conducting a feasibility analysis and added a section on using the business model canvas to develop a viable business model. This chapter also shows how to take the ideas that pass the feasibility analysis, build a business model around them, and create a business plan that serves as a guide to a successful launch.
- Almost all of the real-world examples in this edition are new and are easy to spot because they are highlighted by in-margin markers. These examples allow you to see how entrepreneurs are putting into practice the concepts that you are learning in the book and in class. The examples are designed to help you to remember the key concepts in the course. The business founders in these examples also reflect the diversity that makes entrepreneurship a vital part of the global economy.
- To emphasize the practical nature of this book, every chapter includes a new or updated "Lessons from the Street-Smart Entrepreneur" feature that focuses on a key concept and offers practical advice about how you can put it to practice in your own business. These features include topics such as "Questions to Spur the Imagination," "Thriving on Change," "How to Make Your Business Ready for Global E-Commerce," "E-Mail Ads That Produce Results," "How to Set Up an ESOP," and many others.
- We have updated all of the "Entrepreneurship in Action" features that have proved to be so popular with both students and professors. Every chapter contains at least one of these short cases that describes a decision that an entrepreneur faces and asks you to assume the role of consultant and advise the entrepreneur on the best course of action.

This feature includes the fascinating stories of entrepreneurs who see space as the next entrepreneurial frontier (including Elon Musk’s SpaceX and Richard Branson’s Virgin Galactic), professional athletes who have become successful franchisees (including Jamal Mashburn, Drew Brees, and Angelo Crowell), and using bootstrap marketing techniques to build a name in the music industry (Erin Anderson, founder of Olivia Management). Each one poses a problem or an opportunity, includes questions that focus your attention on key issues, and helps you hone your analytical and critical thinking skills.

- This edition includes 10 new brief cases that cover a variety of topics (see the Case Matrix that appears on the inside cover). All of the cases are about small companies, and most are real companies that you can research online. These cases challenge you to think critically about a variety of topics that are covered in the book—from managing cash flow in a seasonal business and choosing a location for a restaurant’s second branch to deciding how to deal with the Affordable Care Act and setting prices for a social entrepreneur’s eco-friendly apparel.
- Almost all of the “In the Entrepreneurial Spotlight” features are new to this edition as well. These inspirational true stories invite you to explore the inner workings of entrepreneurship by advising entrepreneurs who face a variety of real-world business issues. Topics addressed in these “Spotlights” include college students applying the entrepreneurial skills they are learning in their classes by starting businesses while they are still in school, entrepreneurs who discover that for them franchising is the ideal path to entrepreneurship, a television makeup artist who launched her own line of makeup and faces decisions about promoting it, entrepreneurs who are enhancing their companies’ e-commerce efforts with social media, and many others.
- The content of every chapter reflects the most recent statistics, studies, surveys, and research about entrepreneurship and small business management. Theory, of course, is important, but this book explains how entrepreneurs are *applying* the theory of entrepreneurship every day. You will learn how to launch and manage a business the *right* way by studying the most current concepts in entrepreneurship and small business management.
- A sample business plan for The Picturebooth Company serves as a model for you as you create plans for your own business ideas. Ross Hill wrote this plan for a business that sells and rents portable photo booths while he was a student and used it to launch his business. Not only has Ross used this plan to guide his successful company, but he also has used it to raise more than \$70,000 in start-up capital. Hill’s plan won three business plan competitions, including the national competition sponsored by Collegiate DECA.
- This edition features an updated, attractive, full-color design and layout that is designed to be user-friendly. Each chapter begins with learning objectives, which are repeated as in-margin markers within the chapter to guide you as you study.

Policymakers across the world are discovering that economic growth and prosperity lie in the hands of entrepreneurs—those dynamic, driven men and women who are committed to achieving success by creating and marketing innovative, customer-focused new products and services. Not only are these entrepreneurs creating economic prosperity, but many of them are also striving to make the world a better place in which to live by using their businesses to solve social problems. Those who possess this spirit of entrepreneurial leadership continue to lead the economic revolution that has proved repeatedly its ability to raise the standard of living for people everywhere. We hope that by using this book in your small business management or entrepreneurship class, you will join this economic revolution to bring about lasting, positive changes in your community and around the world. If your goal is to launch a successful business of your own, *Entrepreneurship and Effective Small Business Management* is the ideal book for you!

This eleventh edition of *Entrepreneurship and Effective Small Business Management* provides you with the knowledge you need to launch a business that has the greatest chance for success. One of the hallmarks of every edition of this book has been a very practical, “hands-on” approach to entrepreneurship. Our goal is to equip you with the tools you need for entrepreneurial success. By combining this textbook with your professor’s expertise and enthusiasm, we believe that you will be equipped to follow your dreams of becoming a successful entrepreneur.

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CHAPTER 1

Entrepreneurs: The Driving Force Behind Small Business



Learning Objectives

Upon completion of this chapter, you will be able to:

1. Define the role of the entrepreneur in the U.S. economy.
2. Describe the entrepreneurial profile.
3. Explain how entrepreneurs spot business opportunities.
4. Describe the benefits of owning a small business.
5. Describe the potential drawbacks of owning a small business.
6. Explain the forces that are driving the growth of entrepreneurship.
7. Discuss the role of diversity in small business and entrepreneurship.
8. Describe the contributions small businesses make to the U.S. economy.
9. Put business failure into the proper perspective.
10. Explain how small business owners can avoid the major pitfalls of running a business.

All our dreams can come true, if we have the courage to pursue them.

—Walt Disney

Success is the prize given to those who try and fail willingly.

—Jeffrey Bryant

The Role of the Entrepreneur

1.

Define the role of the entrepreneur in the U.S. economy.

Welcome to the world of the entrepreneur! Every year, entrepreneurs in the United States alone launch more than 6.5 million businesses.¹ These people, who come from diverse backgrounds, are striving to realize that Great American Dream of owning and operating their own businesses. Some of them have chosen to leave the security of the corporate hierarchy in search of independence, others have been forced out of large corporations as a result of downsizing, and still others have from the start chosen the autonomy that owning a business offers. The impact of these entrepreneurs on the nation's economy goes far beyond their numbers, however. The resurgence of the entrepreneurial spirit they are spearheading is the most significant economic development in recent business history. These heroes of the business world are introducing innovative products and services, pushing back technological frontiers, creating new jobs, opening foreign markets, and, in the process, sparking the U.S. economy.

Entrepreneurs, once shunned as people who could not handle a “real” job in the corporate world, now are the celebrities of the global economy. They create companies, jobs, wealth, and innovative solutions to some of the world's most vexing problems, from relief for sore feet to renewable energy sources. “The story of entrepreneurship entails a never ending search for new and imaginative ways to combine the factors of production into new methods, processes, technologies, products, or services,” says one government economist who has conducted extensive research on entrepreneurship's impact.² In short, small business is “cool,” and entrepreneurs are the rock stars of the business world.

The last several decades have seen record numbers of entrepreneurs launching businesses. One important indicator of the popularity of entrepreneurship is the keen interest expressed by students in creating their own businesses. According to a recent Gallup survey, 77 percent of students in grades 5 through 12 say that they “want to be their own bosses.”³ Growing numbers of young people are choosing entrepreneurship as a career (some of them while they are still in school) rather than joining the ranks of the pin-striped masses in major corporations. A recent poll by the Young Entrepreneur Council reports that 21 percent of recent college graduates started businesses out of necessity because they could not find jobs elsewhere.⁴ Many others choose to start their own companies because they prefer the autonomy of entrepreneurship to the hierarchy of corporate America. In fact, when many young people hear the phrase “corporate America,” they do not think of career opportunities; instead, images of the film *Office Space* come to mind. In short, the probability that you will become an entrepreneur at some point in your life has never been higher!

Research suggests that entrepreneurial activity remains vibrant not only in the United States but around the world as well. According to the Global Entrepreneurship Monitor, a study of entrepreneurial activity across the globe, 13 percent of the U.S. population aged 18 to 64, more than one in eight adults, is engaged in entrepreneurial activity. The level of entrepreneurial activity in the United States is the same as the global average of 13.0 percent and above the average (7.1 percent) for innovation-driven economies (see Figure 1.1).⁵

Entrepreneurship has been part of the fabric of the United States since its earliest days. Many of the nation's founding fathers were entrepreneurs. Thomas Jefferson started a nailery (a business that transformed iron into nails) in 1794 and purchased high-tech (at the time) nail-making machinery in 1796 to increase his company's production. Benjamin Franklin was an inventor and in 1729 at the age of 21, convinced several friends to finance his purchase of a newspaper that he renamed *The Pennsylvania Gazette*, a business that made him quite wealthy.⁶ That same entrepreneurial spirit remains strong today as it does in other countries. Entrepreneurs in every corner of the world are launching businesses thanks to technology that provides easy access to both local and global markets at start-up. Even countries that traditionally are not known as hotbeds of entrepreneurial activity are home to promising start-up companies. Despite decades of economic problems, Zimbabwe's economy is growing once again, and small businesses are driving much of its growth.



ENTREPRENEURIAL PROFILE: Divine Ndhlukula: Securio One of Zimbabwe's most successful entrepreneurs is Divine Ndhlukula, who in 1998 started a small security company, Securico, in her home with a modest investment and just four employees. Ndhlukula says that she dreamed of an entrepreneurial career while she was a student studying accounting. After brief stints in farming, broadcasting, and insurance, she saw an opportunity in the security services business and

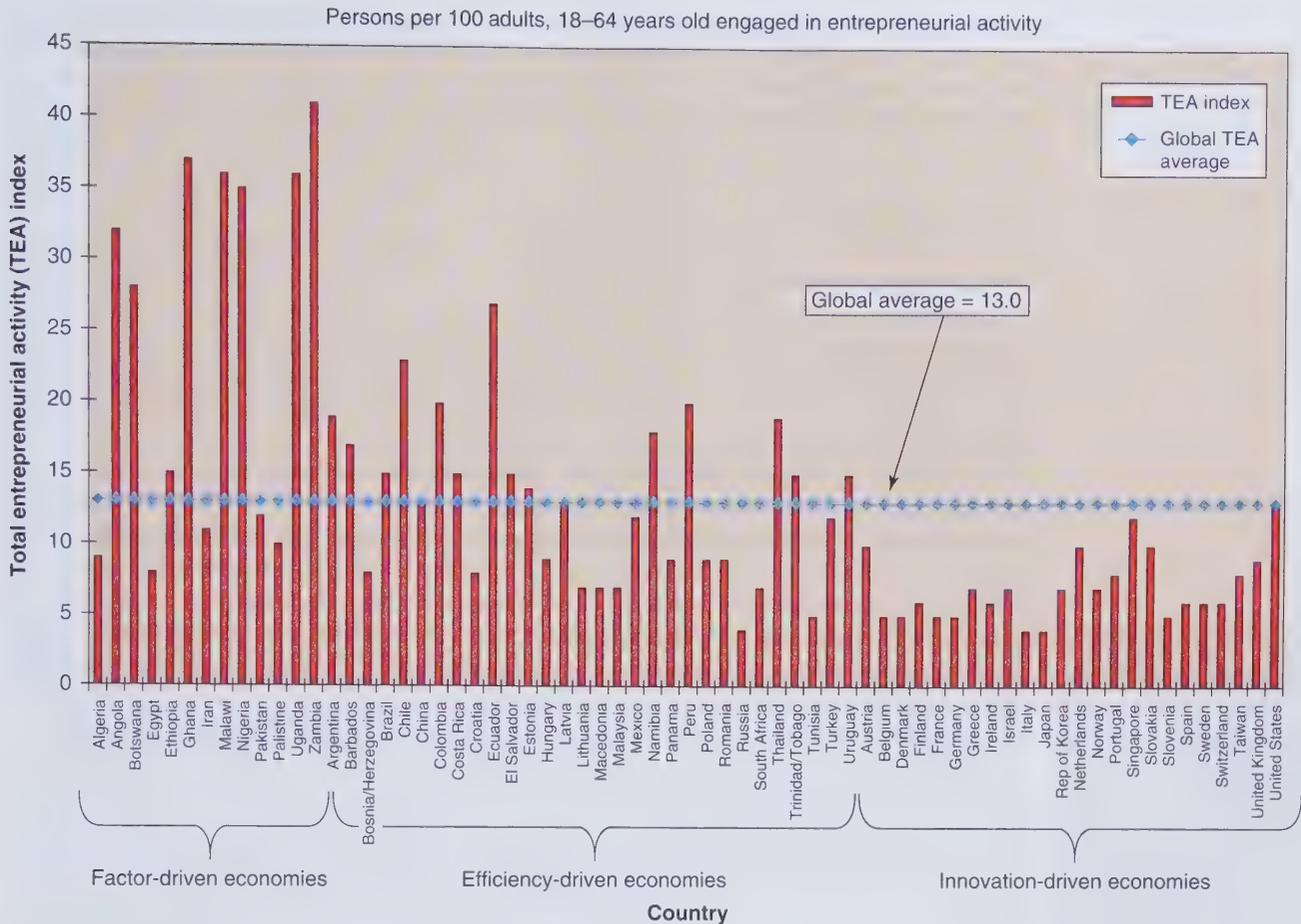


FIGURE 1.1

Entrepreneurial Activity Across the Globe

Source: Based on Siri Roland Xavier, Donna Kelley, Jacqui Kew, Mike Herrington, and Arne Vorderwülbecke, *Global Entrepreneurship Monitor 2012 Global Report*, Babson College, Universidad del Desarrollo, Universiti Tun Abdul Razak, and Global Entrepreneurship Research Consortium, 2012, pp. 58–59.

started Securico, which targets multinational companies operating in Zimbabwe. “People who aspire to be in business think that you have to have lots of money to start,” Ndhlukula says. “It’s not that. It’s really the passion.” Today Securico, which now provides a full range of security services, employs more than 3,500 people, generates sales of more than \$16 million, and was recently was recognized by Africa Awards for Entrepreneurship.⁷

In recent years, large companies in the United States and around the world have engaged in massive downsizing campaigns, dramatically cutting the number of managers and workers on their payrolls. This flurry of “pink slips” has spawned a new population of entrepreneurs—“castoffs” from large corporations (many of whom thought they would be lifetime ladder climbers in their companies) with solid management experience and many productive years left before retirement.

One casualty of this downsizing has been the long-standing notion of job security in large corporations, which all but destroyed the notion of loyalty and has made workers much more mobile. In the 1960s, the typical employee had worked for an average of four employers by the time he or she reached age 65; today, the average employee has had eight employers by the time he or she is 30.⁸ Members of Generation X (those born between 1965 and 1980) and Generation Y (those born between 1981 and 1995), in particular, no longer see launching a business as being a risky career path. Having witnessed large companies lay off their parents after many years of service, these young people see entrepreneurship as the ideal way to create their own job security and career success! They are eager to control their own destinies.

This downsizing trend among large companies also has created a more significant philosophical change in the current age in which “small is beautiful.” Thirty years ago, competing

conditions favored large companies with their hierarchies and layers of management; today, with the pace of change constantly accelerating, fleet-footed, agile, small companies have the competitive advantage. These nimble competitors dart into and out of niche markets as they emerge and recede, they move faster to exploit opportunities the market presents, and they use modern technology to create within a matter of weeks or months products and services that once took years and all of the resources a giant corporation could muster. The balance has tipped in favor of small entrepreneurial companies.

Entrepreneurship also has become mainstream. Although launching a business is never easy, the resources available today make the job much simpler today than ever before. Thousands of colleges and universities offer courses in entrepreneurship, the Internet hosts a sea of information on launching a business, sources of capital that did not exist just a few years ago are now available, and business incubators hatch companies at impressive rates. Once looked down on as a choice for people unable to hold a corporate job, entrepreneurship is now an accepted and respected part of our culture.

Another significant shift in the bedrock of our nation's economic structure is influencing this swing in favor of small companies. The nation is rapidly moving away from an industrial economy to a knowledge-based one. What matters now is not so much the traditional factors of production but *knowledge* and *information*. The final impact of this shift will be as dramatic as the move from an agricultural economy to an industrial one that occurred more than 200 years ago in the United States. A knowledge-based economy favors small businesses because the cost of managing and transmitting knowledge and information is very low, and computer and information technologies are driving these costs lower still.

No matter why they start their businesses, entrepreneurs continue to embark on one of the most exhilarating—and one of the most frightening—adventures ever known: launching a business. It's never easy, but it can be incredibly rewarding, both financially and emotionally. One successful business owner claims that an entrepreneur is “anyone who wants to experience the deep, dark canyons of uncertainty and ambiguity and wants to walk the breathtaking highlands of success. But I caution: Do not plan to walk the latter until you have experienced the former.”⁹ True entrepreneurs see owning a business as the real measure of success. Indeed, entrepreneurship often provides the only avenue for success to those who otherwise might have been denied the opportunity.

Who are these entrepreneurs, and what drives them to work so hard with no guarantee of success? What forces lead them to risk so much and to make so many sacrifices in an attempt to achieve an ideal? Why are they willing to give up the security of a steady paycheck working for someone else to become the last person to be paid in their own companies? This chapter will examine the entrepreneur, the driving force behind the American economy.

Source: CartoonStock.



What Is an Entrepreneur?

Adapted from the French verb *entreprendre*, which means “to undertake” or “to attempt,” the word “entrepreneur” was introduced in 1755 in economist Richard Cantillon’s book *Essay on the Nature of Trade in General*. Cantillon defined an entrepreneur as a producer with nonfixed income and uncertain returns.¹⁰ At any given time, an estimated 9 million adults in the United States are engaged in launching a business, traveling down the path of entrepreneurship that Cantillon first wrote about more than 250 years ago.¹¹ An **entrepreneur** is one who creates a new business in the face of risk and uncertainty for the purpose of achieving profit and growth by identifying opportunities and assembling the necessary resources to capitalize on those opportunities. Entrepreneurs usually start with nothing more than an idea—often a simple one—and then find and organize the resources necessary to transform that idea into a sustainable business. Harvard Business School professor Howard Stevenson says that entrepreneurs “see an opportunity and don’t feel constrained from pursuing it because they lack resources. They’re *used* to making do without resources.”¹² In essence, entrepreneurs are *disrupters*, upsetting the traditional way of doing things by creating new ways to do them.

What entrepreneurs have in common is the ability to spot opportunities and the willingness to capitalize on them.



ENTREPRENEURIAL PROFILE: Ted Southern and Nikolay Moiseev: Final Frontier Design

Ted Southern, an artist and designer, and Nikolay Moiseev, a mechanical engineer, launched Final Frontier Design, when they saw the opportunity to create functional, affordable space suits for the burgeoning commercial space flight industry (see the accompanying “Entrepreneurship in Action” feature on page 37). “We recognized a new market in the suborbital space flight industry,” says Southern. Their Brooklyn, New York–based start-up makes space suits that are more flexible than the traditional space suits designed by NASA and include ergonomic designs, clever reinforcements, and innovative joints that allow space travelers (the suits are designed for use inside spacecraft, not for space walks) to move more easily and fluidly. Existing space suits are “expensive, heavy, and not very functional,” says Southern. “We think we can offer real improvements in both performance and cost.” Moiseev designed space suits for the Russian Space Agency for nearly 20 years before moving to the United States, where he and Southern, who was best known for designing wings for the models in Victoria’s Secret runway shows, teamed up to design gloves for astronauts in a competition sponsored by NASA. (They won a \$100,000 prize that they used to launch Final Frontier Design.) After raising more than \$27,000 on crowdfunding site Kickstarter, the entrepreneurs have enough capital to create a prototype of their “3G” spacesuit that they say will sell for as little as \$50,000, far below the \$12 million cost for a traditional space suit.¹³

Although many people dream of owning a business, most of them never actually launch a company. Those who do take the entrepreneurial plunge, however, will experience the thrill of creating something grand from nothing; they will also discover the challenges and the difficulties of building a business “from scratch.” Whatever their reasons for choosing entrepreneurship, many recognize that true satisfaction comes only from running their own businesses the way they choose.

Researchers have invested a great deal of time and effort over the last decade studying these entrepreneurs and trying to paint a clear picture of the entrepreneurial personality. Not surprisingly, the desire for autonomy is the single most important factor motivating entrepreneurs to start businesses (see Table 1.1). Although these studies have produced several characteristics that entrepreneurs tend to exhibit, none of them has isolated a set of traits required for success. We now turn to a brief summary of the entrepreneurial profile.¹⁴

1. Desire and willingness to take initiative. Entrepreneurs feel a personal responsibility for the outcome of ventures they start. They prefer to be in control of their resources and to use those resources to achieve self-determined goals. They are willing to step forward and build businesses based on their creative ideas.

2. Preference for moderate risk. Entrepreneurs are not wild risk takers but are instead *calculating* risk takers. Unlike “high-rolling, riverboat gamblers,” they rarely gamble. Entrepreneurs often have a different perception of the risk involved in a business situation. The goal may appear to be high—even impossible—from others’ perspective, but entrepreneurs typically have thought through the situation and believe that their goals are reasonable and attainable. Entrepreneurship

- Describe the entrepreneurial profile.



Nikolay Moiseev (left) and Ted Southern (right), cofounders of Final Frontier Design.

Source: Final Frontier Design, LLC.

TABLE 1.1 Why Entrepreneurs Start Businesses

Noam Wasserman and Timothy Butler of the Harvard Business School surveyed nearly 2,000 entrepreneurs about their motivations for starting their businesses, analyzed the results by gender and age, and compared them to thousands of nonentrepreneurs. The primary motivator for entrepreneurs is autonomy, but security and a congenial work environment top the list for nonentrepreneurs. Entrepreneurs' source of motivation shifts slightly as they age, more so for women than for men. The following tables summarize the researchers' findings:

Men by Age		
20s	30s	40s+
Autonomy	Autonomy	Autonomy
Power and Influence	Power and Influence	Power and Influence
Managing People	Managing People	Altruism
Financial Gain	Financial Gain	Variety
Women by Age		
20s	30s	40s+
Autonomy	Autonomy	Autonomy
Power and Influence	Power and Influence	Intellectual Challenge
Managing People	Variety	Variety
Altruism	Altruism	Altruism

Source: Adapted from Leigh Buchanan, "The Motivation Matrix," *Inc.*, March 2012, pp. 60–62.

launched many now famous businesses, including Burger King, Microsoft, FedEx, Disney, CNN, MTV, Hewlett Packard, and others, during economic recessions when many people believed their ideas and their timing to be foolhardy.



ENTREPRENEURIAL PROFILE: Nicholas Pelis: Denizen Rum While working for SKYY Vodka, Nicholas Pelis spotted an opportunity to create a new blend of rum, a product that had been "sanitized" by the mass-production mind-set of large modern distilleries. Pelis and his wife sold their house in San Francisco to return to his native New York and used the proceeds of the sale and \$300,000 raised from family and friends to launch Denizen Rum, a company whose distilled spirits blend the mixability of white rum with the bold, smooth flavors of traditional dark rum from Amsterdam, where rum blending has been a tradition since the 1700s. Introduced in 2011, Denizen Rum quickly won critical acclaim, which allowed the Pelis's young company to sign a national distribution contract with one of the largest wine and spirits distributors in the United States. Although some people criticized Pelis for the risk that he took, his industry experience and market research convinced him that his idea was sound and that his company would be successful.¹⁵

This attitude explains why so many successful entrepreneurs failed many times before finally achieving their dreams. For instance, Milton Hershey, founder of one of the world's largest and most successful chocolate makers, started four candy businesses, all of which failed, before he launched the chocolate business that would make him famous. The director of an entrepreneurship center says that entrepreneurs "are not crazy, wild-eyed risk takers. Successful entrepreneurs understand the risks [of starting a business] and figure out how to manage them."¹⁶ Good entrepreneurs become risk *reducers*, and one of the best ways to minimize the risk in any entrepreneurial venture is to conduct a feasibility study and create a sound business plan, which is the topic of Chapter 8.

3. Confidence in their ability to succeed. Entrepreneurs typically have an abundance of confidence in their ability to succeed, and they tend to be optimistic about their chances for business success. Entrepreneurs face many barriers when starting and running their companies, and a healthy dose of optimism can be an important component in their ultimate success. "Entrepreneurs believe they can do anything," says one researcher.¹⁷

4. Self-reliance. Entrepreneurs do not shy away from the responsibility for making their businesses succeed. Perhaps that is why many entrepreneurs persist in building businesses even when others ridicule their ideas as follies. Against the advice of his father, a fifth-generation brewmaster, entrepreneur Jim Koch left his high-paying job as a management consultant to start

Boston Beer Company from his kitchen using his family's beer recipe. Koch recalls thinking, "I'm on this path, and it doesn't lead anywhere I want to go." He made the decision to launch his business to "own my life and make decisions that are not the result of other people's plans or expectations." Today, Boston Beer Company sells 32 types of beer, has 800 employees, and generates sales of \$371 million.¹⁸

5. Perseverance. Even when things don't work out as they planned, entrepreneurs don't give up. They simply keep trying. Real entrepreneurs follow the advice contained in the Japanese proverb, "Fall seven times; stand up eight."



ENTREPRENEURIAL PROFILE: Gail Borden: Borden Inc. Entrepreneur Gail Borden (1801–1874) was a prolific inventor, but most of his inventions, including the terraqueous wagon (a type of prairie schooner that could travel on land or water) and a meat biscuit (a mixture of dehydrated meat and flour that would last for months), never achieved commercial success. After witnessing a small child die from contaminated milk, Borden set out to devise a method for condensing milk to make it safer for human consumption in the days before refrigeration. For two years he tried a variety of methods, but every one of them failed. Finally, Borden developed a successful vacuum condensation process, won a patent for it, and built a company around the product. It failed, but Borden persevered. He launched another condensed milk business, this time with a stronger capital base, and it succeeded, eventually becoming Borden Inc., a multi-billion-dollar conglomerate that still makes condensed milk using the process Borden developed 150 years ago. When he died, Borden was buried beneath a tombstone that reads, "I tried and failed. I tried again and succeeded."¹⁹

6. Desire for immediate feedback. Entrepreneurs like to know how they are doing and are constantly looking for reinforcement. Tricia Fox, founder of Fox Day Schools, Inc., claims, "I like being independent and successful. Nothing gives you feedback like your own business."²⁰

7. High level of energy. Entrepreneurs are more energetic than the average person. That energy may be a critical factor given the incredible effort required to launch a start-up company. Long hours—often 60 to 80 hours a week—and hard work are the rule rather than the exception. Building a successful business requires a great deal of stamina and dedication. "Entrepreneurs have zero sense of balance," says serial entrepreneur Jeff Stibel, CEO of Dun & Bradstreet Credibility Corporation. "We're all in all the time. It doesn't matter if it's day or night, weekday or weekend. Each of us focuses on our vision with a single-minded passion. We'd probably work in our sleep if we could."²¹

8. Competitiveness. Entrepreneurs tend to exhibit competitive behavior, often early in life. They enjoy competitive games and sports and always want to keep score.

9. Future orientation. Entrepreneurs tend to dream big and then formulate plans to transform those dreams into reality. They have a well-defined sense of searching for opportunities. They look ahead and are less concerned with what they accomplished yesterday than what they can do tomorrow. Ever vigilant for new business opportunities, entrepreneurs *observe* the same events other people do, but they *see* something different. "Entrepreneurial brains are full-time pattern recognizers," says Steve Blank, professor of entrepreneurship at Stanford University.²²

Taking this trait to the extreme are **serial entrepreneurs**, those who create multiple companies, often running more than one business simultaneously. These entrepreneurs take multitasking to the extreme. Serial entrepreneurs get a charge from taking an idea, transforming it into a business, and repeating the process.



ENTREPRENEURIAL PROFILE: Paul Hurley: ideeli At age 12, Paul Hurley purchased the equipment to start a lawn care business with the profits he earned investing in small oil company stocks. (He came up with the investment strategy after reading his father's copies of *Forbes*.) Hurley's first hire was a kid who had a driver's license because he was too young to drive the company truck. While attending Yale University, Hurley started a series of companies, learning the fundamentals of developing a workable business model, importing, mastering direct mail, and other business skills. After college, he and his brother started Aveo, a communications software company that attracted investments from venture capital firms before folding. "I was completely wiped out," he recalls. From 2001 to 2006, the serial entrepreneur launched seven businesses in quick succession before devoting his full energy to ideeli, a shopping Web site that runs weekly flash sales that feature thousands of clothing, household, and accessory items from brand-name companies at discounts of up to 50 percent. "See the top 100 store every day," says Hurley. The site, with more than 4.5 million members, has more than 1,000 suppliers and has raised \$70 million in capital from top venture

capital companies. Just three years after its launch, ideeli's annual sales reached nearly \$78 million, but Hurley's vision is much grander. "We're going to build something big and have a meaningful impact," he says.²³

10. Skill at organizing. Building a company "from scratch" is much like piecing together a giant jigsaw puzzle. Entrepreneurs know how to put the right people and resources together to accomplish a task. Effectively combining talent and resources enables entrepreneurs to bring their visions to reality.

11. Value of achievement over money. One of the most common misconceptions about entrepreneurs is that they are driven wholly by the desire to make money. To the contrary, *achievement* seems to be one of the primary motivating forces behind entrepreneurs; money is simply a way of "keeping score" of accomplishments—a *symbol* of achievement. "Money is not the driving motive of most entrepreneurs," says Nick Grouf, founder of a high-tech company. "It's just a very nice by-product of the process."²⁴

Other characteristics entrepreneurs exhibit include the following:

- **High degree of commitment.** Launching a company successfully requires total commitment from the entrepreneur. Business founders often immerse themselves completely in their businesses. "The commitment you have to make is tremendous; entrepreneurs usually put everything on the line," says one expert.²⁵ That commitment helps overcome business-threatening mistakes, obstacles, and pessimism from naysayers, however. Entrepreneurs' commitment to their ideas and the businesses those ideas spawn determine how successful their companies ultimately become.
- **Tolerance for ambiguity.** Entrepreneurs tend to have a high tolerance for ambiguous, ever-changing situations—the environment in which they most often operate. This ability to handle uncertainty is critical because these business builders constantly make decisions using new, sometimes conflicting information gleaned from a variety of unfamiliar sources.
- **Flexibility.** One hallmark of true entrepreneurs is their ability to adapt to the changing demands of their customers and their businesses. In this rapidly changing world economy, rigidity often leads to failure. As society, its people, and their tastes change, entrepreneurs also must be willing to adapt their businesses to meet those changes. Successful entrepreneurs are willing to allow their business models to evolve as market conditions warrant.
- **Tenacity.** Obstacles, obstructions, and defeat typically do not dissuade entrepreneurs from doggedly pursuing their visions. Successful entrepreneurs have the willpower to conquer the barriers that stand in the way of their success. "[Entrepreneurship] is about staying focused on the summit," explains Jim Koch, founder of Boston Beer. "No one climbs a mountain to get to the middle. You don't focus on the difficulties. You take it one step at a time, knowing that you're going to get to the top."²⁶

What conclusion can we draw from the volumes of research conducted on the entrepreneurial personality? Entrepreneurs are not of one mold; no one set of characteristics can predict who will become entrepreneurs and whether they will succeed. Indeed, *diversity* seems to be a central characteristic of entrepreneurs. As you can see from the examples in this chapter, *anyone*—regardless of age, race, gender, color, national origin, or any other characteristic—can become an entrepreneur. There are no limitations on this form of economic expression, and Fabian Ruiz is living proof.



Catherine Rohr, founder of Defy Ventures.

ENTREPRENEURIAL PROFILE: Fabian Ruiz: Infor-Nation After serving a 21-year prison term for killing the man who shot his brother, Ruiz, 37, enrolled in Defy Ventures, a nonprofit organization founded by former Wall Street executive Catherine Rohr that teaches the tools of entrepreneurship to former inmates. "The purpose of Defy is to change the way these men think about themselves and their lives," says Rohr. Participants take a yearlong course of instruction in both business and life skills and work with mentors from colleges, churches, and the business community. They compete in a business plan competition in which the winners share \$100,000 in seed funding and earn a spot in Defy Venture's business incubator. Ruiz is in Defy Venture's first class, and when he graduates, he will start Infor-Nation, a company that will sell printouts of Web pages to inmates in the New York prison system, who are blocked from using the Internet. "This company is helping me fulfill a lot of expectations," says Ruiz. "Things I expected for myself and things my family expected from me."²⁷

Entrepreneurship is not a genetic trait; it is a skill that is learned. The editors of *Inc.* magazine claim, “Entrepreneurship is more mundane than it’s sometimes portrayed. . . . You don’t need to be a person of mythical proportions to be very, very successful in building a company.”²⁸ As you read this book, we hope that you will pay attention to the numerous small business examples and will notice not only the creativity and dedication of the entrepreneurs behind them but also the diversity of those entrepreneurs.



Entrepreneurship in Action

Space: The Next Entrepreneurial Frontier?

Entrepreneur-turned-venture-capitalist Guy Kawasaki says that entrepreneurs are willing to ask the fundamental question, “Wouldn’t it be neat if . . .?” Steve Jobs wondered, “Wouldn’t it be neat if people could take their favorite music with them wherever they go?” and the result was the best-selling iPod. Recently, several serial entrepreneurs asked, “Wouldn’t it be neat if people could ride into space?” and have launched commercial “spaceline” businesses to take customers into the final frontier.

In 2011, the National Aeronautic and Space Administration (NASA) completed its final manned space flight when the space shuttle *Atlantis* touched down, ending the 135th space shuttle flight and marking the end of a program that began in 1981, when the launch of the shuttle *Columbia* began a new era in space travel. The end of NASA’s program has created an opportunity for entrepreneurs who are interested in exploring the business potential of space much like the entrepreneurs who capitalized on the new field of aviation in the 1920s. Although NASA is planning no space flights in the immediate future, the agency is helping private companies develop spacecraft and space flight capability through its Commercial Crew Development program, which so far has invested \$320 million in four companies, three of which are entrepreneurial ventures. “We’re at the dawn of a new era of space exploration, one where there’s a much bigger role for commercial companies,” says Elon Musk, founder of SpaceX. Musk, a serial entrepreneur and cofounder of PayPal, which he sold to eBay for \$1.5 billion in 2002. Musk used \$100 million of the proceeds from the sale to start SpaceX that same year and later invested \$50 million to launch Tesla Motors, a company that makes head-turning, high-performance electric cars. After SpaceX’s first three launches of its Falcon 9 booster rocket ended in failure, the company was on the verge of going out of business. The company’s fourth attempt was successful, however, and its *Dragon* space capsule became the first from a private company to rendezvous 240 miles above the earth with the International Space Station carrying a modest cargo of 162 meal packets, a laptop computer, clothing, and 15 student experiments. The successful flight resulted in a \$1.6 billion contract for SpaceX, which is based in Hawthorne, California, from NASA, under which it will fly 12 cargo missions to the space station. Musk also intends for SpaceX to be one of the companies that NASA selects to take astronauts back to the space station. SpaceX currently launches its flights from NASA’s Cape Canaveral center but plans to build its own launch pad somewhere along the Gulf Coast.

Another serial entrepreneur, Richard Branson, founder of Virgin Atlantic Airways, is a part of Branson’s Virgin Group, a

collection of companies in industries that range from health care and air travel to book publishing and wine, has developed a vehicle, *SpaceShipTwo*, that will carry passengers into suborbital space 70 miles above the earth, where they will experience weightlessness and breathtaking views. After being launched from a mother ship called *LauncherOne*, the two-pilot rocket plane will take six passengers into space but will not orbit the earth. Purchasing a seat on a *SpaceShipTwo* flight costs \$200,000, and already more than 500 space tourists from 40 countries have paid deposits of more than \$60 million to reserve seats on upcoming flights. “We want to enable people all over the world to experience what only about 500 people have seen: Earth from space and the surrounding universe,” says Virgin Galactic CEO George Whitesides.

Another start-up company with several high-profile investors has its eyes on space but with a different twist than SpaceX and Virgin Galactic. The founders of Planetary Resources Inc. are developing a series of low-cost unmanned spacecraft that are designed to prospect and mine valuable minerals on near-Earth asteroids (NEAs). Eric Anderson and Peter Diamandis, the entrepreneurs behind Planetary Resources, say that of the 10,000 known NEAs, more than 1,500 are as easy to reach as the moon. Diamandis says that a typical asteroid that is 265 feet in diameter could contain \$100 billion worth of metals and provide enough energy-generating material to power every space shuttle that has ever traveled into space. The solar system is “full of resources that we could bring back to humanity,” he says. In addition, studying the composition of asteroids could help humans develop methods for preventing them from colliding with earth, an event that could threaten the survival of the human race. Anderson estimates that sending six spacecraft into space to identify the asteroids that offer the greatest potential for mining will cost \$25 million to \$30 million. Hitching a ride on other company’s rockets could lower that cost significantly, which is the reason that the company has entered into a deal with Virgin Galactic to use *LauncherOne* to send Planetary Resources’ *Arkyd* spacecraft into space to explore and eventually mine asteroids.

Investors in Planetary Resources, which currently has more than 30 employees with plans to expand to 100 people who will “devote their lives” to the project, include Google cofounder Larry Page; Ross Perot Jr., chairman of the Perot Group; movie director James Cameron; Chris Lewicki, former Mars mission manager at NASA; and others. “We’re trying to do something so audacious, and we might fail,” acknowledges Anderson. “But we believe that attempting to do this is worth the risk.”

Entrepreneurship in Action *(continued)*

is worth it.” The company says its ultimate goal is to “Planetary Resources’ plan to mine Near-Earth Asteroids for raw materials, ranging from water to precious metals, which will deliver multiple benefits to humanity and grow to be valued at tens of billions of dollars annually.”

1. Assume that you are one of the wealthy potential investors whom the founders of the companies profiled here approached for start-up capital. How would you have responded? What questions would you have asked them?
2. What do you predict for the future of the businesses described here?
3. “If no one is calling you crazy, you’re probably not thinking big enough,” says entrepreneur Linda Rottenberg. What does she mean? Do you agree?

Sources: Based on Emma Haak, “Space, the Private Frontier,” *Fast Company*, February 2012, p. 15; Andrew Shafer, “Up, Up, and Away,” *Inc.*, July/August 2011, pp. 34–35; Andy Pasztor, “Private Space Run Makes History,” *Wall Street Journal*, May 26–27, 2012, pp. A1–A2; George Abbey, “A New Generation of Space Entrepreneurs,” *Chron.com*, June 2012, <http://blog.chron.com/bakerblog/2012/06/a-new-generation-of-space-entrepreneurs>; Christian Cotroneo, “Virgin Galactic Taking Reservations, Calgary Teen Poised to Be Youngest in Space,” *Huffington Post*, August 26, 2011, www.huffingtonpost.ca/2011/06/26/virgin-galactic-reservations-calgary-teen_n_884735.html; Kenneth Chang, “Big Day for a Space Entrepreneur Promising More,” *New York Times*, May 22, 2012, www.nytimes.com/2012/05/23/science/space/spacex-private-cargo-rocket-heads-to-space-station.html; Amir Efrati, “Asteroid Venture Is About Politics, Not Just Mining,” *Wall Street Journal*, April 24, 2012, pp. B1–B2; Amir Efrati, “Asteroid Mining Strategy Is Outlined by a Start-Up,” *Wall Street Journal*, April 25, 2012, p. B3; “Planetary Resources Inc. Announces Agreement with Virgin Galactic for Payload Services,” *Planetary Resources*, July 11, 2012, www.planetaryresources.com/2012/07/planetary-resources-inc-announces-contract-with-virgin-galactic-for-payload-services.

How to Spot Entrepreneurial Opportunities

3.

Explain how entrepreneurs spot business opportunities.

One of the tenets of entrepreneurship is the ability to create new and useful ideas that solve the problems and challenges people face every day. “Entrepreneurs innovate,” said management legend Peter Drucker. “Innovation is the special instrument of entrepreneurship.”²⁹ Entrepreneurs achieve success by creating value in the marketplace when they combine resources in new and different ways to gain a competitive edge over rivals. Entrepreneurs can create value in a number of ways. Indeed, finding new ways of satisfying customers’ needs, inventing new products and services, putting together existing ideas in new and different ways, and creating new twists on existing products and services are hallmarks of the entrepreneur. At first glance, some entrepreneurs’ ideas seem outlandish, but “illogical ideas are how society achieves progress,” observes Steve Blank, professor of entrepreneurship at Stanford.³⁰

What is the entrepreneurial “secret” for creating value in the marketplace? In reality, the “secret” is no secret at all: it is applying creativity and innovation to solve problems and to exploit opportunities that people face every day. **Creativity** is the ability to develop new ideas and to discover new ways of looking at problems and opportunities. **Innovation** is the ability to *apply* creative solutions to those problems and opportunities to enhance or to enrich people’s lives. Harvard’s Ted Levitt says that creativity is *thinking* new things and that innovation is *doing* new things. In short, entrepreneurs succeed by *thinking and doing* new things or old things in new ways. Simply having a great new idea is not enough; turning the idea into a tangible product, service, or business venture is the essential next step.

Entrepreneurs’ ability to build viable businesses around their ideas has transformed the world. From King Gillette’s invention of the safety razor (Gillette) and Mary Kay Ash’s use of a motivated team of consultants to sell her cosmetics (Mary Kay Cosmetics) to Steve Jobs and Steve Wozniak building the first personal computer in a California garage (Apple) and Fred Smith’s concept for delivering packages overnight (FedEx), entrepreneurs have made the world a better place to live. How do entrepreneurs spot opportunities? Although there is no single process, the following techniques will help you discover business opportunities in the same way these successful entrepreneurs did.

Monitor Trends and Exploit Them Early On

Astute entrepreneurs watch both national and local trends that are emerging and then build businesses that align with those trends. Detecting a trend early on and launching a business to capitalize on it enables an entrepreneur to gain a competitive advantage over rivals.



ENTREPRENEURIAL PROFILE: Kian Saneii: Independa Kian Saneii watched his parents, both in their 70s, care for his grandmother, who was in her 90s. Frequent telephone calls to check on her and to remind her to take her medications were part of their daily routine. Saneii realized that his family was facing an issue that was becoming more prevalent in the United States. His

research confirmed that the number of U.S. citizens who are 65 or older will more than double from 40 million to 89 million by 2050. Saneii decided to tap into this trend and invested a year of research before launching Independa, a telecommunications platform that uses telephones, computers, and tablets to deliver reminders to elderly people about taking medications and going to medical appointments. Independa's "aging in place" service also allows people who know nothing about technology to use a television or touch-screen device to video chat or use Facebook, reducing feelings of isolation and depression. It offers games and puzzles for entertainment and mental engagement and a calendar with reminders of family celebrations. Independa also offers a service that uses wireless sensors to monitor a person's vital signs and transmit them via the Internet at regular intervals. Saneii recently acquired \$2.35 million in financing from venture capital firms.³¹

Travel—and Be Inspired

One of the benefits of traveling is the exposure to new ideas. When entrepreneurs travel, they take the time to observe and to be inspired by what they see, always on the lookout for new ideas they can turn into businesses.



ENTREPRENEURIAL PROFILE: Eileen Fisher: Eileen Fisher Legendary fashion designer Eileen Fisher never really thought about becoming a fashion designer even though she learned to sew as a young girl and made her own prom dress. After graduating from college, Fisher worked for a New York City graphic designer, giving her the opportunity to travel to Japan, where she was captivated by the beautiful fabrics and simple styles, such as cropped pants and kimonos. At the time, Fisher recalls, "I hated shopping for clothes because I couldn't find what I wanted." She believed that women's clothes were too complicated and decided to "make simple clothes that would last and that would transcend fashions." In 1984, recalling the simple styles she had seen on her travels in Japan, Fisher designed four garments, found a seamstress to make them, and took them to a boutique fashion show in New York City, where she sold small orders to eight stores. The next year, Fisher expanded her line and took \$40,000 in orders at the same show. Six years later, she opened the first Eileen Fisher store on Madison Avenue in New York City. Today, the entrepreneur, who is still known for her simple mix-and-match collections, has 57 stores in the United States, Canada, and Great Britain and a company that generates more than \$300 million in annual sales.³²

Take a Different Approach to an Existing Market

Another way to spot opportunities is to ask whether there is another way to reach an existing market with a unique product, service, or marketing strategy. Entrepreneurs are famous for finding new, creative approaches to existing markets and turning them into business opportunities.



ENTREPRENEURIAL PROFILE: Joshua Opperman: I Do Now I Don't After Joshua Opperman and his fiancé broke up in 2006, he attempted to get a refund on the diamond ring he had purchased, but the jewelry store would issue only a store credit, and other jewelers and pawn shops offered him just 28 percent of the original \$10,000 purchase price. The painful experience prompted him to start an e-commerce business, cleverly named I Do Now I Don't, that provides a secure Web site on which people can sell slightly used engagement rings. A seller who lists a ring on the site negotiates a price with a buyer, who sends payment to I Do Now I Don't to hold in escrow. The seller sends the ring to I Do Now I Don't, where it is appraised before the company completes the transaction by sending it to the buyer. Opperman's company collects a 15 percent commission for its services. In response to customers' requests, I Do Now I Don't also buys some rings outright from customers and resells them to dealers. Already the company's annual sales are \$3 million and are growing fast.³³

Put a New Twist on an Old Idea

Sometimes entrepreneurs find opportunities by taking an old idea and giving it a unique twist. The result can lead to a profitable business venture.



ENTREPRENEURIAL PROFILE: Jason Brown and David Waxman: Vitaband While jogging one day, Jason Brown was nearly hit by a car, and the near miss gave him the idea for a rubber identification wristband containing a chip that would allow emergency responders to access the wearer's medical history in case of an accident. Brown told his best friend, David Waxman, about his idea, and the two launched Vitaband to bring the product to market. As they built their business, Brown and Waxman introduced an prepaid debit chip to Vitaband so that runners could make purchases simply by waving the band near a wireless payment reader without having to carry a wallet, a credit

card, or cash. Brown and Waxman invested \$50,000 of their own money and raised an additional \$750,000 from family members, friends, and, most recently, angel investors to develop prototypes and market the Vitaband. The next challenge is marketing the Vitaband to other customers, including parents who want a safety device for their children and children who want another layer of security for their aging parents.³⁴

Look for Creative Ways to Use Existing Resources

Another way entrepreneurs uncover business opportunities is to find creative ways to use existing resources. This requires them to cast aside logic and traditional thinking.



ENTREPRENEURIAL PROFILE: Ed Munn: Dig This While using heavy equipment to clear land, build a pond, and dig the foundation for the house he was building for him and his wife in Steamboat Springs, Colorado, contractor Ed Munn thought about how much fun he had operating the equipment and how other people would enjoy the experience as well. Munn used his inventory of equipment to launch Dig This, a business that transforms almost anyone into a heavy equipment operator for a day. Three years later, Munn moved his business to Las Vegas, Nevada, where a real estate collapse had freed up many pieces of heavy equipment and customers would have plenty of room to dig in the dirt like kids but with adult-size toys. For as little as \$250, customers can experience the thrill of moving dirt, digging trenches, and playing “excavator basketball” under the watchful eye of experienced instructors.³⁵

Realize That Others Have the Same Problem You Do

Another way entrepreneurs spot business opportunities is by recognizing the “pain points” they encounter from flaws in existing products or services and asking whether other people face the same problems. Providing a product or service that solves those problems offers the potential for a promising business.



ENTREPRENEURIAL PROFILE: Sanjay Kothari and Vinay Pulim: MileWise Like most frequent fliers, Sanjay Kothari experienced difficulty trying to redeem the miles he accumulated on various airlines. Doing so usually required many hours of searching for available flights, poring over rules and restrictions, and making numerous telephone calls. Kothari discovered that many of the 90 million frequent fliers in the United States never use the airline miles they accumulate because the process of redeeming them is so onerous. Spotting an opportunity, Kothari worked with fellow entrepreneur Vinay Pulim to launch MileWise, a specialized search engine that allows travelers to find flights that they can purchase with airline miles, hotel or credit card points, or cash. The Web site also recommends the best way to pay for a trip based on a user’s reward program and travel preferences. “It usually takes people several hours to figure out whether to pay for travel with cash or rewards,” says Kothari. “We’re trying to help them do that in under 30 seconds.” Kothari and Pulim raised \$1.5 million in start-up financing for MileWise from angel investors and venture capital firms and within one month of the site’s launch had attracted 12,000 users.³⁶

Take Time to Play

Children are so creative because they play and have not yet been subjected to all of the “rules” about how things should work that adults have. When it comes to creativity, entrepreneurs can take a lesson from playful children. Play can be a source of business ideas.



ENTREPRENEURIAL PROFILE: Doug Stienstra: Flash Pals While he was a student at the University of Iowa, Doug Stienstra’s girlfriend wanted a “cute” flash drive. After scouring the Internet and retail stores, Stienstra could not find one, so he decided to make one for her. He bought an animal-shaped finger puppet from a toy store and glued it to a standard flash drive. His girlfriend loved the gift, and “her friends starting asking me to make one for them,” says Stienstra. “I knew I was on to something. I tested the market, and there was clearly a demand, so I kept at it.” Stienstra worked with the Bedell Entrepreneurship Learning Laboratory at the university and launched a business, Flash Pals, that sells the playful flash drives for \$25 to \$30 and donates a portion of each sale to wildlife charities.³⁷

Notice What Is Missing

Sometimes entrepreneurs spot viable business opportunities by noticing what is missing—the “white space” in a market. “Realize that when people say, ‘You’re starting *what?*’ that you’re on

to something,” says one writer.³⁸ The first step is to determine whether a market for the missing product or service actually exists (perhaps the reason it does not exist is that there is no market potential), which is one of the objectives of a feasibility analysis.



ENTREPRENEURIAL PROFILE: Fred Carl: Viking Range Corporation In 1980, while designing the kitchen for their new house, Fred Carl’s wife, Margaret, said that she wanted a heavy-duty gas range like the one her mother had. Carl searched but soon discovered that no company made commercial-grade ovens for home use, so he decided to build one himself. Eventually, he says, “Because no one was doing it, I thought, ‘This is a business.’” Carl contacted every oven manufacturer in the country, and it took two years for him to convince one company to build the oven he had designed. In 1984, he formed a company, Viking Range Corporation, in Greenwood, Mississippi, using his own money, credit cards, and a \$325,000 bank loan, and today the company generates annual sales of more than \$300 million from a full line of quality kitchen appliances.³⁹

No matter which methods they use to detect business opportunities, true entrepreneurs follow up their ideas with action, building companies to capitalize on their ideas.

The Benefits of Owning a Small Business

Surveys show that owners of small businesses believe they work harder, earn more money, and are happier than if they worked for a large company. Entrepreneurs enjoy many benefits of owning a small business, including the following.

4.

Describe the benefits of owning a small business.

Opportunity to Gain Control over Your Own Destiny

Entrepreneurs cite controlling their own destinies as one of the benefits of owning their own businesses. Owning a business provides entrepreneurs the independence and the opportunity to achieve what is important to them. Entrepreneurs want to “call the shots” in their lives, and they use their businesses to bring this desire to life. Numerous studies of entrepreneurs in several countries report that the primary incentive for starting their businesses is “being my own boss.” Entrepreneurs reap the intrinsic rewards of knowing they are the driving forces behind their businesses. “When you’re in the driver’s seat, you are making decisions on how to steer your company into the future,” explains Kasey Gahler, who left his corporate job to start his own financial services company, Gahler Financial.⁴⁰

Opportunity to Make a Difference

Increasingly, entrepreneurs are starting businesses because they see an opportunity to make a difference in a cause that is important to them. Known as **social entrepreneurs**, these business builders seek to find innovative solutions to some of society’s most pressing and most challenging problems. Their businesses often have a triple bottom line that encompasses economic, social, and environmental objectives. These entrepreneurs see their businesses as mechanisms for achieving social goals that are important to them. Whether it is providing sturdy low-cost housing for families in developing countries, promoting the arts in small communities, or creating a company that educates young people about preserving the earth’s limited resources, entrepreneurs are finding ways to combine their concerns for social issues and their desire to earn good livings. Although they see the importance of building viable, sustainable businesses, social entrepreneurs’ primary goal is to use their companies to make a positive impact on the world. Women are slightly more likely than men to start companies for social rather than economic reasons.⁴¹



ENTREPRENEURIAL PROFILE: Gabrielle Palermo, Bill Walters, Susanna Young and Clay Tyler: G3Box When two professors at Arizona State University challenged their engineering students to develop creative ideas for using the hundreds of used shipping containers that are abandoned at ports around the world, Gabrielle Palermo, Bill Walters, Susanna Young, and Clay Tyler came up with the idea of converting the containers into medical clinics that can be deployed anywhere in the world. They created a company, G3Box (the G3 stands for “generating global good”), that transforms the shipping containers into mobile medical clinics and sells them to nonprofit and nongovernmental organizations. The mobile clinics are outfitted with insulation, and the G3Box units are equipped with solar panels, potable water, and other necessities and can be set up as permanent housing for medical care or transported into disaster areas as

temporary clinics. Outfitting a container costs between \$12,000 and \$18,000, depending on the particular setup, but Palermo says that G3Box can modify containers for practically any use, such as classrooms, food distribution units, dental offices, and more. “When I started college, I didn’t really think I was going to be growing a business,” says Palermo, “but doing G3Box as a career or starting other companies that focus on social good is my passion now.”⁴²

Opportunity to Reach Your Full Potential

Too many people find their work boring, unchallenging, and unexciting. But to most entrepreneurs, there is little difference between work and play; the two are synonymous. Roger Levin, founder of Levin Group, the largest dental practice management consulting firm in the world, says, “When I come to work every day, it’s not a job for me. I’m having fun!”⁴³

Entrepreneurs’ businesses become the instrument for self-expression and self-actualization. Owning a business challenges all of an entrepreneur’s skills, abilities, creativity, and determination. The only barriers to success are self-imposed. “It’s more exciting to get a company from zero to \$100 million than to get a billion-dollar company to its next \$100 million,” says Dick Harrington, former CEO of Thomson Reuters and now a principal at Cue Ball, a venture capital firm that invests in promising small companies.⁴⁴ Entrepreneurs’ creativity, determination, and enthusiasm—not limits artificially created by an organization (e.g., the “glass ceiling”)—determine how high they can rise.

Opportunity to Reap Impressive Profits

Although money is *not* the primary force driving most entrepreneurs, the profits their businesses can earn are an important motivating factor in their decisions to launch companies. If accumulating wealth is high on your list of priorities, owning a business is usually the best way to achieve it. Most entrepreneurs never become superrich, but many of them do become quite wealthy. Indeed, nearly 75 percent of those on the *Forbes* list of the 400 richest Americans are first-generation entrepreneurs (and most of the others are part of successful family businesses)!⁴⁵ Self-employed people are four times more likely to become millionaires than those who work for someone else. According to Russ Alan Prince and Lewis Schiff, authors of *The Middle Class Millionaire*, more than 80 percent of middle-class millionaires, those people with a net worth between \$1 million and \$10 million, own their own businesses or are part of professional partnerships. (They also work an average of 70 hours a week.)⁴⁶



ENTREPRENEURIAL PROFILE: Kevin Plank: Under Armour As a special teams captain on the University of Maryland football team, Kevin Plank grew weary of wearing a heavy, sweat-soaked cotton T-shirt under his football pads. He began to research the properties of various fabrics and produced sample shirts made with a polyester-blend base layer that fit as snugly as Spiderman’s suit and were extremely lightweight, durable, and capable of wicking away perspiration so that they stayed dry. He tested early prototypes himself, and, at first, his teammates laughed at him because the fabric resembled lingerie. Before long, however, his teammates were asking for shirts of their own. After graduating, Plank launched a company, Under Armour, from the basement of his grandmother’s townhouse in Washington, D.C., which served as the company’s first office, warehouse, distribution center—and his bedroom. He started Under Armour with \$20,000 of his own money and \$40,000 in credit card debt before landing a \$250,000 loan guaranteed by the U.S. Small Business Administration. Fifteen years later, Plank’s company, which sells a full line of athletic apparel and shoes, generates annual sales of \$1.83 billion. With a personal net worth of \$1.7 billion, Kevin Plank has reaped the financial rewards of entrepreneurship.⁴⁷

Opportunity to Contribute to Society and Be Recognized for Your Efforts

Often, small business owners are among the most respected—and most trusted—members of their communities. A recent survey by the Public Affairs Council reports that 90 percent of Americans have a favorable view of small businesses, far more than those who view large corporations, news media, and the government.⁴⁸ Entrepreneurs enjoy the trust and the recognition they receive from the customers they have served faithfully over the years. A recent Pew Research Center survey reports that small businesses make up the most trusted institution in the United States, ranking ahead of churches and colleges.⁴⁹ Playing a vital role in their local business systems and knowing that the work they do has a significant impact on how smoothly our nation’s economy functions is yet another reward for entrepreneurs.

Opportunity to Do What You Enjoy Doing

A common sentiment among small business owners is that their work *really* isn't work. In fact, a recent survey by Wells Fargo/Gallup Small Business Index reports that 47 percent of business owners say they do not plan to retire from their businesses unless they are forced to because of health reasons!⁵⁰ Most successful entrepreneurs choose to enter their particular business fields because they have an interest in them and enjoy those lines of work. Many of them have made their avocations (hobbies) their vocations (work) and are glad they did! These entrepreneurs are living the advice Harvey McKay offers: "Find a job doing what you love, and you'll never have to work a day in your life."



ENTREPRENEURIAL PROFILE: Jeff Archer and Tom Losee: YOLO Board Jeff Archer was hooked on the sport of stand-up paddling on his first outing when he followed a pod of dolphins and watched them teach a young dolphin how to catch fish. Two weeks later, Archer and business partner Tom Losee, both lifelong aficionados of water sports and fitness, had launched YOLO ("You Only Live Once") Board, a company in Santa Rosa Beach, Florida, that makes a modern version of the stand-up paddle boards invented by the Polynesians centuries ago. YOLO Board manufactures 18 different boards that range in price from \$700 to \$2,000 to accommodate various types of water and paddler preferences. Similar to a surfboard only wider, longer, and more stable, stand-up paddle boards allow users to get exercise, enjoy the beauty of a variety of bodies of water, and experience a sense of calmness. Gliding on the surface of the water, one newcomer to the sport says, "It feels as if we're walking on water." Through YOLO Board, Archer and Losee, whose work wardrobes include board shirts, T-shirts, and flip-flops rather than suits, ties, and wingtips, are able to do what they enjoy and share their passion for the sport with others.⁵¹

The Potential Drawbacks of Entrepreneurship

Although owning a business has many benefits and provides many opportunities, anyone planning to enter the world of entrepreneurship should be aware of its potential drawbacks. "Building a start-up is incredibly hard, stressful, chaotic, and—more often than not—results in failure," says entrepreneur Eric Ries. "So why become an entrepreneur? Three reasons: change the world, make customers' lives better, and create an organization of lasting value. If you want to do only one of these things, there are better options. Only start-ups combine all three."⁵² Let's explore the "dark side" of entrepreneurship.

Uncertainty of Income

Opening and running a business provides no guarantees that an entrepreneur will earn enough money to survive. Even though business owners tend to earn more than wage-and-salary workers, some small businesses barely generate enough revenue to provide the owner-manager with an adequate income. The median income of small business owners (\$72,806) is 82 percent higher than the median income of full-time wage and salary workers (\$40,092), but business owners' income tends to be much more variable.⁵³ In the early days of a start-up, a business often cannot provide an attractive salary for its founder and meet all of its financial obligations, which means that the entrepreneur may have to live on savings for a time. The regularity of income that comes with working for someone else is absent because the owner is always the last one to be paid. A recent survey by Citibank reports that 54 percent of small business owners have gone without a paycheck to help their businesses survive.⁵⁴ The founder of a flavor and fragrances manufacturing operation recalls the time his bank unexpectedly called the company's loans just before Thanksgiving, squeezing both the company's and the family's cash flow. "We had planned a huge Christmas party, but we canceled that," recalls his wife. "And Christmas. And our usual New Year's trip."⁵⁵

Risk of Losing Your Entire Invested Capital

The small business failure rate is relatively high. According to a research by the Bureau of Labor Statistics, 31 percent of new businesses fail within two years, and 51 percent shut down within five years. Within 10 years, 66 percent of new businesses will have folded.⁵⁶ "In the wake of a company failure, the founder knows that he has kicked his family's fortune back to Square One, or past that, to Square Zero, or Minus Three," says Meg Hirshberg, wife of Gary Hirshberg, founder of the organic yogurt producer Stonyfield Farm. "The [failure] of Stonyfield Farm would have meant the loss of our home, our lifestyle, our children's college funds."⁵⁷

5.

Describe the potential drawbacks of owning a small business.

A failed business can be financially and emotionally devastating. Before launching their businesses, entrepreneurs should ask themselves whether they can cope financially and psychologically with the consequences of failure. They should consider the risk-reward tradeoff before putting their financial and mental well-being at risk:

- What is the worst that could happen if I open my business and it fails?
- How likely is the worst to happen?
- What can I do to lower the risk of my business failing?
- If my business were to fail, what is my contingency plan for coping?

Long Hours and Hard Work

The average small business owner works 54 hours per week, compared to the 35 hours per week the typical U.S. employee works.⁵⁸ In many start-ups, 10- to 12-hour days and six- or seven-day workweeks with no paid vacations are the *norm*. A recent survey by Manta Media found that 48 percent of small business owners say that they had no time to take a summer vacation.⁵⁹ “I just took the first vacation in years,” says Greg Selkoe, founder of Karmalooop, a Web site that sells clothing and shoes. “I’ve never taken a vacation in which I don’t work. In one sense, my life is stressful. In another, it’s a vacation because I love what I’m doing. Work is my fun.”⁶⁰

Sleep researcher James Maas of Cornell University estimates that entrepreneurs lose 700 hours of sleep the year in which they launch their companies, which is equivalent to the amount of sleep that a parent loses in the first year of a baby’s life.⁶¹ Dan Croft left a top management job at a large mobile communications company to start Mission Critical Wireless, a small business that helps other businesses select and implement wireless communication systems. Croft’s 25 years of experience in the industry allowed him to make a smooth transition to entrepreneurship, but there were a few surprises. “The highs are much higher, the lows are much lower, and the lack of sleep is much greater,” jokes Croft, referring to the long hours his new role requires.⁶²

Because they often must do everything themselves, owners experience intense, draining workdays. “I’m the owner, manager, secretary, and janitor,” says Cynthia Malcolm, who owns a salon called the Hand Candy Mind and Body Escape in Cheviot, Ohio.⁶³ Many business owners start down the path of entrepreneurship thinking that they will own a business only to discover later that the business owns them!

Lower Quality of Life Until the Business Gets Established

The long hours and hard work needed to launch a company can take their toll on the remainder of an entrepreneur’s life. Business owners often find their roles as husbands and wives or fathers and mothers take a backseat to their roles as company founders. Marriages and friendships are too often casualties of small business ownership. Part of the problem is that entrepreneurs are most likely to launch their businesses between the ages of 25 and 34, just when they start their families.



ENTREPRENEURIAL PROFILE: Peyton Anderson and Affinergy, Inc. Peyton Anderson, owner of Affinergy Inc., a 12-person biotech firm located in Research Triangle Park, North Carolina, struggles to balance the demands of his young company and his family, which includes three children under the age of four. “I do a lot of work from 9 p.m. to midnight,” says Anderson, “and I try to keep Saturday open to do things with the kids.” He also uses flextime during the week to spend more time with his family, but maintaining balance is an ongoing battle, especially when managing a young company. “Even while I’m singing to them in the bathtub, in the back of my mind, I’m grinding on stuff at work,” admits Anderson.⁶⁴

High Levels of Stress

Launching and running a business can be an extremely rewarding experience, but it also can be a highly stressful one. Most entrepreneurs have made significant investments in their companies, left behind the safety and security of a steady paycheck, and mortgaged everything they own to get into business. Failure often means total financial ruin as well as a serious psychological blow, and that creates high levels of stress and anxiety. “Being an entrepreneur takes sheer guts and demands far more than an ‘employee’ mentality,” says Jamie Kreitman, founder of Kreitman Knitworks Ltd., a company specializing in whimsical apparel and accessories.

Complete Responsibility

Owning a business is highly rewarding, but many entrepreneurs find that they must make decisions on issues about which they are not really knowledgeable. When there is no one to ask, pressure can build quickly. The realization that the decisions they make are the cause of success or failure of the business has a devastating effect on some people. Small business owners realize quickly that *they* are the business.

Discouragement

Launching a business requires much dedication, discipline, and tenacity. Along the way to building a successful business, entrepreneurs will run headlong into many obstacles, some of which may appear to be insurmountable. Discouragement and disillusionment can set in, but successful entrepreneurs know that every business encounters rough spots and that perseverance is required to get through them.

Entrepreneurs are not easily dissuaded by the disadvantages of owning a business. In a recent survey by Citibank, 76 percent of small business owners say they would start their businesses again if they knew then what they know now about the challenges they would face.⁶⁶

Why the Boom: The Fuel Feeding the Entrepreneurial Fire

What forces are driving this entrepreneurial trend in our economy? Which factors have led to this age of entrepreneurship? Some of the most significant ones follow.

Entrepreneurs as Heroes

An intangible but very important factor is the attitude that Americans have toward entrepreneurs. Around the world, the most successful entrepreneurs have hero status and serve as role models for aspiring entrepreneurs. Business founders such as Michael Dell (Dell Computers), Oprah Winfrey (Harpo Studios and Oxygen Media), Richard Branson (Virgin), Robert Johnson (Black Entertainment Television), and Mark Zuckerberg (Facebook) are to entrepreneurship what LeBron James and Peyton Manning are to sports. The media reinforce entrepreneurs' hero status with television shows such as *The Apprentice* with Donald Trump and *Shark Tank and Dragons' Den*, both of which features entrepreneurs who pitch their ideas to a panel of tough business experts who have the capital and the connections to make a budding business successful. Nearly 7.5 million people in 123 countries on six continents participate in nearly 34,000 activities during Global Entrepreneurship Week, a celebration of entrepreneurship that is sponsored by the Kauffman Foundation.⁶⁷

Entrepreneurial Education

People with more education are more likely to start businesses than those with less education, and entrepreneurship, in particular, is an extremely popular course of study among students at all levels. A rapidly growing number of college students see owning a business as an attractive career option, and in addition to signing up for entrepreneurship courses, many of them are launching companies while in school. Today, more than two-thirds of the colleges and universities in the United States (more than 2,300) offer courses in entrepreneurship or small business, up from just 16 in 1970. More than 200,000 students are enrolled in entrepreneurship courses, and many colleges and universities have difficulty meeting the demand for courses in entrepreneurship and small business.⁶⁸

Shift to a Service Economy

The service sector accounts for 86 percent of the jobs (up from 70 percent in the 1950s) and 48 percent of the GDP in the United States.⁶⁹ Because of their relatively low start-up costs, service businesses have been very popular with entrepreneurs. The booming service sector has provided entrepreneurs with many business opportunities, from hotels and health care to computer maintenance and Web-based services.

Technology Advancements

With the help of modern business tools—the Internet, cloud computing, personal computers, tablet computers, smart phones, apps, copiers, color printers, instant messaging, and video

6.

Explain the forces that are driving the growth of entrepreneurship.

mail—even one person working at home can look like a big business. At one time, the high cost of such technological wizardry made it impossible for small businesses to compete with larger companies that could afford the hardware. Now the cost of sophisticated technology is low enough that even the smallest companies can use a multitude of devices creatively to gain a competitive edge. One recent survey by AT&T reports that 96 percent of small businesses use wireless technology and that 64 percent of owners say that their companies could not survive without it.⁷⁰ With the help of modern technology, entrepreneurs can run their businesses from almost anywhere very effectively and look like any *Fortune* 500 company to their customers and clients.



ENTREPRENEURIAL PROFILE: Drew Houston and Arash Ferdowsi: Dropbox

Drew Houston, just 24 years old and a student at the Massachusetts Institute of Technology, met fellow MIT student, 21-year-old Arash Ferdowsi, and the two began working on a problem that plagued many people: how to store all of your files in one place so that they are accessible from anywhere. Their solution was to create a virtual storage cabinet in the cloud that enables users to save and access documents, spreadsheets, photographs, music, videos, and anything else from any computer, tablet, or smart phone. (Houston actually began writing the code for the software in a Boston train station.) In 2007, Houston and Ferdowsi launched Dropbox Inc. and moved to San Francisco, where they raised \$7.2 million in equity financing from top-tier venture capital firms. In 2011, the duo attracted another \$250 million in capital to fuel Dropbox's growth. Today, 100 million users save about one billion files on Dropbox each day, generating more than \$500 million in annual revenue for the company.⁷¹

Outsourcing

Entrepreneurs have discovered that they do not have to do everything themselves. Because of advances in technology, entrepreneurs can outsource many of the operations of their companies and retain only those in which they have a competitive advantage. Doing so enhances their flexibility and adaptability to ever-changing market and competitive conditions.



ENTREPRENEURIAL PROFILE: Evan Solida: Cerevellum

Evan Solida left his job as a designer for a kayak manufacturer in Easley, South Carolina, to launch Cerevellum, a company that makes a unique digital rearview mirror for bicyclists. An avid cyclist, Solida came up with the idea a decade earlier as part of a college class project but didn't bring the product to life until he was struck by a car while bicycling. After receiving funding from the Upstate Carolina Angel Network and Michelin Development Corporation, Solida was able to bring to market the Hindsight 35, which attaches a small camera at the rear of the bicycle to a handlebar-mounted screen that also serves as a cyclometer and a "black box" in case of an accident. Solida outsources production of the device to a specialty manufacturer in China, and a company in Texas handles distribution for Cerevellum. Solida's outsourcing strategy allowed him to minimize his start-up costs and enables him to focus on the tasks that he performs best.

Independent Lifestyle

Entrepreneurship fits the way Americans want to live—independent and self-sustaining. Increasingly, entrepreneurs are starting businesses for lifestyle reasons. They want the freedom to choose where they live, the hours they work, and what they do. Although financial security remains an important goal for most entrepreneurs, lifestyle issues such as more time with family and friends, more leisure time, and more control over work-related stress also are important. To these "lifestyle entrepreneurs," launching businesses that give them the flexibility to work the hours they prefer and live where they want to are far more important than money.

E-Commerce, the Internet, and Mobile Computing

The proliferation of the Internet and mobile computing has spawned thousands of entrepreneurial ventures since the beginning in 1993. Currently, more than 167 million customers in the United States alone shop online.⁷² As online shopping becomes easier, more engaging, and more secure for shoppers, e-commerce will continue to grow. eMarketer predicts that online retail sales in the United States will increase from \$224.2 billion in 2012 to \$361.9 billion in 2016.⁷³ Many entrepreneurs see the power of the Internet and mobile computing and are putting them to use, but some small businesses have been slow to adopt the technology. A recent study by Web.com reports that only 60 percent of small businesses have Web sites, and only 26 percent of those Web sites are mobile friendly. (Just 14 percent of small businesses have Web sites specifically designed for mobile devices.)⁷⁴



ENTREPRENEURIAL PROFILE: Boris Saragaglia: Spartoo In Europe, e-commerce sales are growing nearly as fast as in the United States. In 2006, 23-year-old French entrepreneur Boris Saragaglia decided to capitalize on that opportunity and launched Spartoo.com, an e-commerce site that sells shoes. Inspired by the success of online retailer Zappos, Saragaglia made customer service the focal point of Spartoo's strategy, offering customers free delivery and returns on 25,000 shoe styles from 500 brands. His strategy has been successful. With more than a dozen local language versions of its Web site, Spartoo sells more than 1.5 million pairs of shoes annually and generates revenue of \$195 million, mostly from customers across Europe.⁷⁵

International Opportunities

No longer are small businesses limited to pursuing customers within their own borders. The dramatic shift to a global economy has opened the door to tremendous business opportunities for those entrepreneurs willing to reach across the globe. Although the United States is an attractive market for entrepreneurs, approximately 95 percent of the world's population lives outside its borders. With so many opportunities in international markets, even the smallest businesses can sell globally, particularly with the help of the Internet. Jonathan Forgacs, cofounder of Pillow Décor, a Vancouver, Canada-based company that sells more than 1,000 types of decorative pillows online, says that more than 98 percent of sales originate outside of Canada.⁷⁶

Although only 280,000 companies in the United States—less than 1 percent of U.S. small businesses—export, companies with fewer than 20 employees account for 72 percent of all exporters.⁷⁷ Small and medium-size companies generate 33 percent of the nation's export sales.⁷⁸ The barriers to international trade that small business owners encounter most frequently are high shipping costs, language and cultural differences, and difficulty finding potential customers.⁷⁹ Although “going global” can be fraught with many dangers and problems, many entrepreneurs are discovering that selling their products and services in foreign markets is not really as difficult as they originally thought. Patience, diligence, and a management commitment to exporting are essential elements. As business becomes increasingly global in nature, international opportunities for small businesses will continue to grow rapidly.



In the Entrepreneurial Spotlight

Collegiate Entrepreneurs

For growing numbers of students, college is not just a time of learning, partying, and growing into young adulthood; it is fast becoming a place for building a business. Today, more than 2,300 colleges and universities offer courses in entrepreneurship and small business management, and many of them have trouble meeting the demand for these classes. “There's been a change in higher education,” says William Green, dean of the entrepreneurship program at the University of Miami. “Entrepreneurship has become a mainstream activity.” Greater numbers of students are pursuing careers in entrepreneurship and see their college experience as an opportunity to get an early start not only by studying entrepreneurship but also by putting what they learn into practice. In addition to regular classroom courses, colleges increasingly are building an extra dimension in their entrepreneurship programs, including internships with local businesses, mentoring relationships with other entrepreneurs, networking opportunities with potential investors, and participation in business plan competitions. “Entrepreneurial education is a contact sport,” says Allan R. Cohen, dean of the graduate program at Babson College.

As the following examples prove, many college students are not only learning the entrepreneurial skills they are learning in their classes by starting businesses while they are still in college.

ThinkLite

When Dinesh Wadhvani and Enrico Palmerino were students at Babson College in Wellesley, Massachusetts, they saw an ad for a new technology that produces customized energy-efficient lightbulbs but realized that the \$24-per-bulb price tag would dissuade many potential buyers despite the fact that the bulbs produce energy and maintenance savings of up to 90 percent. They approached several large companies that make the bulbs, negotiated discounts for bulk purchases, and started ThinkLite, a Boston-based company that installs the energy efficient bulbs at no up-front cost in exchange for a fixed percentage of the energy savings their customers' realize. The young entrepreneurs have signed on many retail clients, a high-rise apartment building in New York City, and a factory. “College is the best time to have a business venture because all of the money that we make we put back into the business to grow it, and it gives us the liquidity to finance more projects,” says Wadhvani.

After graduating, Wadhvani and Palmerino made their college start-up a full-time venture and have expanded ThinkLite into other cities across the United States and in other countries. Looking back, Wadhvani says that his collegiate entrepreneurial education and experience were “priceless” and credits Babson College with encouraging his entrepreneurial spirit. “Babson has educated me

In the Entrepreneurial Spotlight *(continued)*

on the two different ways one could make a living: conforming to a standard, or being a pioneer of innovation," he says.

Skida

While Corinne Prevot was in high school in East Burke, Vermont, the avid skier found some soft, brightly colored Lycra and fleece fabrics and made ski caps and headbands for herself and the teammates on her cross-country ski team. Soon, other people were asking how they could buy some of the unique hats, and before she knew it, Prevot had started a business making them. To expand her market, she drove to a local sporting goods store in a borrowed car and approached the owner with a boxful of brightly colored caps and headbands. "I have these hats and headbands, and a lot of my friends have been interested in them," she told the owner. "I think your cold weather cyclists would like them, too." The owner purchased the box of caps and headbands, giving Prevot her first big sale.

Now attending Middlebury College, Prevot continues to operate her company, Skida, which currently sells its line of hats, headbands, and scarves—all sporting neon polka dots, bright plaids, and happy geisha flowers—in 47 retail stores across the United States and through the Skida Web site. Prevot, who has a double major in anthropology and geography, says that Skida is profitable and generates annual sales of more than \$100,000.

Bump technologies

In an accounting class in the University of Chicago's MBA program, David Lieb began thinking about an easy way for smart phone users to share contact information with one another. During the first week of classes, "I found myself entering in phone number after phone number and name after name," he recalls. Lieb, a former employee at Texas Instruments, believed that he could create an easy, automated way for smart phone users to share information. He explained his idea to fellow students Andy Huibers and Jake Mintz, and the trio of entrepreneurs began developing a prototype based on Lieb's idea. Two weeks later, they had a rudimentary prototype operating on a laptop, and within five months the entrepreneurs launched Bump Technologies, featuring their mobile app that allows smart phone users to share photos and contact information simply by bumping their phones together. "The first day we got 222 downloads, and soon we were getting thousands," says Lieb. Today, more than 100 million people have downloaded the Bump app. Lieb, Mintz, and Huibers have

raised \$19.9 million in financing, primarily from venture capital firms, and their company now has 26 full-time employees and 11 interns. Looking back, the entrepreneurs say that much of their success originates in two principles that they have relied on since they started their business: (1) creating a strong team of founders whose skill sets complement one another and that is capable of handling the unpredictable tasks of starting a company and (2) regularly testing not only products but also the assumptions on which their business is built.

College can be one of the best places to start a business, but doing so requires discipline, good time management, and a willingness to make mistakes and learn from them. "An entrepreneur's career may include 30 or 40 ventures," says Andrew Bachman, who started Totto Media, a digital advertising company, from his dorm room and sold it a few years later for \$60 million. "Each one should be a stepping stone and a learning experience."

1. "Entrepreneurship can't be taught in a regular classroom any more than surfing can," says one venture capitalist. "To learn it, you have to get your feet wet in the real world." What do you think?
2. In addition to the normal obstacles of starting a business, what other barriers do collegiate entrepreneurs face?
3. What advantages do collegiate entrepreneurs have when launching a business?
4. What advice would you offer a fellow college student about to start a business?
5. Work with a team of your classmates to develop ideas about what your college or university could do to create a culture that supports entrepreneurship on your campus or in your community.

Sources: Based on LeeAnn Maton, "College Entrepreneurs Part 2: Looking for A's in Money Making," *Daily Finance*, June 15, 2012, www.dailyfinance.com/2010/06/15/college-entrepreneurs-part-2-looking-for-as-in-making-money; Lauren Monsen, "Lighting the Way: College Students Help Businesses Go Green," *IIP Digital*, January 26, 2012, <http://iipdigital.usembassy.gov/st/english/article/2012/01/20120126142229nerual0.3576471.html#axzz1pAhYRzqZ>; David Port, "Get Smarter," *Entrepreneur*, April 2009, pp. 51–56; Nichole L. Torres, "Launch Pad to Success," *Entrepreneur*, October 2008, pp. 61–81; Joel Holland, "Breaking Business Models," *Entrepreneur*, March 2009, p. 102; Patricia B. Gray, "Can Entrepreneurship Be Taught?," *FSB*, March 2006, pp. 34–51; Susan Adams, Helen Coster, and Elizabeth Woyke, "All-Star Student Entrepreneurs," *Forbes*, August 22, 2011, pp. 74–79; "About Us," Skida, www.skidasport.com/pages/about-us; Joel Holland, "It's a Hit," *Entrepreneur*, September 2011, p. 98; Andrew Bachman, "3 Golden Rules for College Entrepreneurs," *Young Entrepreneur Council*, April 30, 2012, <http://theyec.org/3-golden-rules-for-college-entrepreneurs>; Victor W. Hwang, "Can Entrepreneurship Be Taught?," *Wall Street Journal*, March 19, 2012, p. R4.

The Cultural Diversity of Entrepreneurship

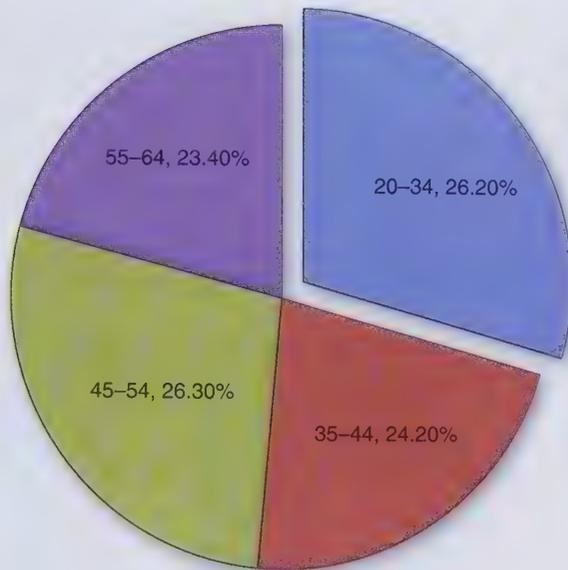
As you have seen, virtually anyone has the potential to become an entrepreneur. The entrepreneurial sector of the United States consists of a rich blend of people of all races, ages, backgrounds, and cultures. It is this cultural diversity that is one of entrepreneurship's greatest strengths. We turn our attention to those who make up this diverse fabric we call entrepreneurship.

Young Entrepreneurs

Young people are setting the pace in entrepreneurship. Disenchanted with their prospects in corporate America and willing to take a chance to control their own destinies, scores of young

7.

Discuss the role of diversity in small business and entrepreneurship.

**FIGURE 1.2****New Entrepreneurs by Age Group**

Source: Based on Robert W. Fairlie, *Kauffman Index of Entrepreneurial Activity, 1996–2012*, April 2013, Kauffman Foundation, p. 12.

people are choosing entrepreneurship as their primary career path. Although people 55 and older have demonstrated the greatest increase in entrepreneurial activity over the last 25 years, Generation Y, made up of people born between 1980 and 2000, is one of the most entrepreneurial generations in history (see Figure 1.2).⁸⁰ Research shows that children whose parents are entrepreneurs are two to three times more likely to pursue entrepreneurship as a career than those whose parents are wage earners.⁸¹

There is no age requirement to be a successful entrepreneur.

ENTREPRENEURIAL PROFILE: Mallory Kievman: Hiccups When 11-year-old Mallory Kievman developed a stubborn case of the hiccups one summer, she tried a variety of home remedies, including swallowing salt water, eating a spoonful of sugar, and sipping pickle juice, but her hiccups persisted. The experience prompted Kievman to develop a cure for hiccups. After two years and testing 100 remedies in her family's kitchen, Kievman developed the Hiccipop, a product that blends the most successful hiccup-fighting remedies she discovered—lollipops, sugar, and apple cider vinegar. She entered her product in the Connecticut Invention Convention, an annual new product competition for kids, and won prizes for innovation and patentability. "Hiccups solves a very simple, basic need," observes Sanny Briere, a serial entrepreneur who is serving as an adviser to Hiccups. Explaining the science behind the Hiccipop, Kievman says, "It triggers a set of nerves in your throat and mouth that are responsible for the hiccup reflex arc. It overstimulates those nerves and cancels out the message to hiccup." Kievman currently is working with a team of MBA students from the University of Connecticut to bring her patented hiccup-fighting lollipops to market.⁸²



Mallory Kievman, founder of Hiccups.

Source: Andrew Douglas Sullivan.

Women Entrepreneurs

Despite years of legislative effort, women still face discrimination in the workforce. However, small business has been a leader in offering women opportunities for economic expression through employment and entrepreneurship. Many women are discovering that the best way to break the "glass ceiling" that prevents them from rising to the top of many organizations is to start their own companies (see Figure 1.3). The freedom that owning their own companies gives them is one reason that entrepreneurship is a popular career choice for women. In fact, women now own almost 30 percent of all businesses in the United States, and many of them are in fields that traditionally have been male dominated.⁸³

ENTREPRENEURIAL PROFILE: Jessica Alba: The Honest Company After film star Jessica Alba became a mother, she "was horrified to find out how many toxic chemicals are in baby products." Inspired by a book about creating a clean home without relying on potentially harmful chemicals that she had read during her first pregnancy, Alba contacted Christopher Gavigan, the book's author, and they decided to create a business that would provide mothers with the products to implement the strategies featured in the book. "You've given me a handbook, but you



Jessica Alba, cofounder of Honest

Company.
Source: © A. Ariani/Corbis.

haven't given me a solution," Alba told Gavigan. "Let's make the solution." Working with serial entrepreneur Brian Lee, Alba and Gavigan launched The Honest Company, a business that sells safe, eco-friendly, affordable products for babies and the home. They started with an eco-friendly disposable diaper because they saw disposable diapers as "the greatest area of opportunity for innovation," says Alba. The Honest Company's diapers, which are 85 percent biodegradable, use a mix of wheat, corn, and wood fluff to achieve 35 percent more absorbency than conventional diapers. The Honest Company has expanded its product line to include detergents, soaps, shampoos, and cleaners; more products are in the planning stage. Sales are growing, but according to Alba, "We're still this scrappy little company where everybody is working long hours and doing everything at once."⁸⁴

Although the businesses women start tend to be smaller than those men start, their impact is anything but small. Women-owned companies in the United States employ 7.7 million workers and generate approximately \$1.3 trillion in revenue.⁸⁵ Women entrepreneurs have even broken through the comic strip barrier. Blondie Bumstead, long a typical suburban housewife married to Dagwood, owns her own catering business with her best friend and neighbor, Tootsie Woodly!

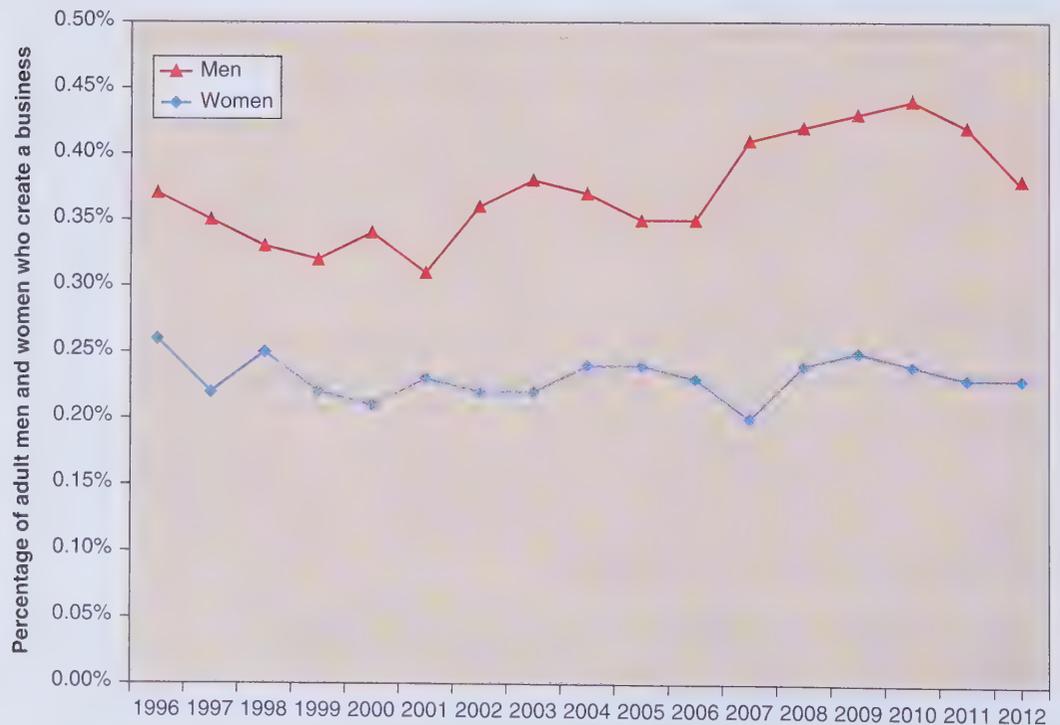
Minority Enterprises

Like women, minorities also are choosing entrepreneurship more often than ever before. Hispanics, African Americans, and Asians are most likely to become entrepreneurs. Hispanics represent the fastest-growing segment of the U.S. population, and Hispanic entrepreneurs represent the largest segment of minority-owned businesses in the United States (see Figure 1.4). More than 2.3 million Hispanic-owned companies employ more than 1.9 million people and generate more than \$345 billion in annual sales.⁸⁶

Minority entrepreneurs see owning their own businesses as an ideal way to battle discrimination, and minority-owned companies have come a long way in the last decade. The most recent Index of Entrepreneurial Activity by the Ewing Marion Kauffman Foundation shows that Hispanics are 38 percent more likely to start a business than whites, and Asians are 7 percent more likely.⁸⁷ Minority entrepreneurs own 22 percent of all businesses in the United States, generate \$1 trillion in annual revenues, and start their businesses for the same reason that most entrepreneurs do: to control their own destinies.⁸⁸ The future is promising for this new generation of minority entrepreneurs who are better educated, have more business experience, have more entrepreneurial role models, and are better prepared for business ownership than their predecessors.

FIGURE 1.3
Entrepreneurial Activity Index by Gender

Source: Based on Robert W. Fairlie, *Kauffman Index of Entrepreneurial Activity, 1996–2012*, Kauffman Foundation, April 2013, p. 5.



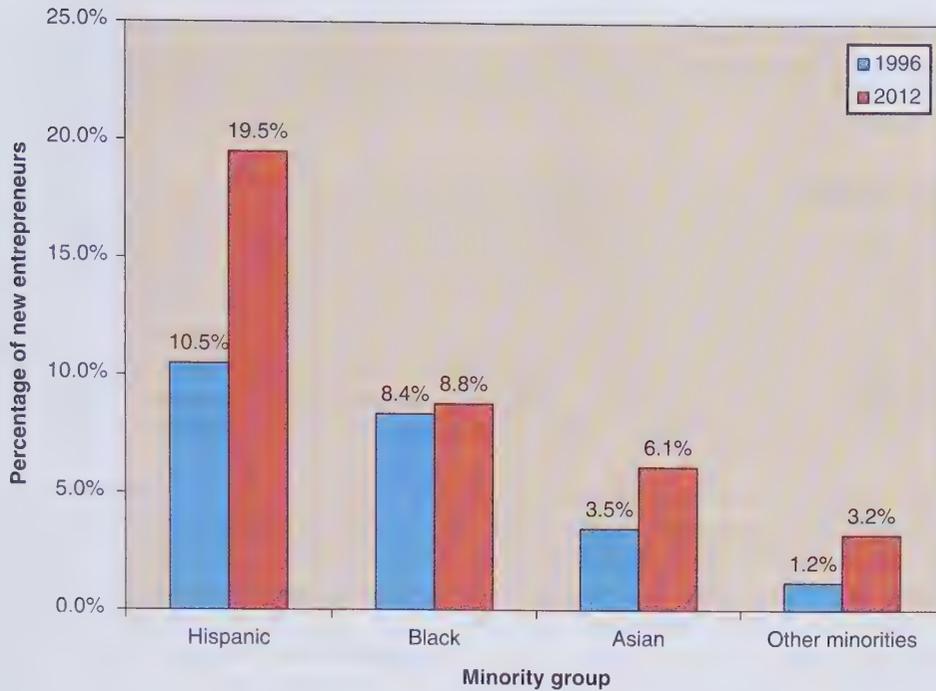


FIGURE 1.4
Percentage of New Entrepreneurs by Minority Group 1996 and 2012

Source: Based on Robert W. Fairlie, *Kauffman Index of Entrepreneurial Activity, 1996–2012*, p. 9.

ENTREPRENEURIAL PROFILE: Venus Williams: V*Star Interiors and Jamba Juice Not only has Venus Williams been a dominant force in the world of professional tennis since she turned pro in 1994, but she also has exercised her entrepreneurial muscles, starting an interior design company, V*Star Interiors, in 2002 and two Jamba Juice franchises in the Washington, D.C., area in 2011 and 2012. V*Star, located in Jupiter, Florida, has done design work for high-profile professional athletes, upscale residential communities, university athletic facilities, and sets for television shows. Williams’s affiliation with Jamba Juice, which offers a wide selection of healthy, vegetarian, and vegan menu items, is “a perfect fit” given her interest in inspiring young people to stay active and make good dietary choices.⁸⁹

Immigrant Entrepreneurs

The United States has always been a “melting pot” of diverse cultures, and many immigrants have been lured to this nation by its economic freedom. Unlike the unskilled “huddled masses” of the past, today’s immigrants arrive with far more education and experience and a strong desire to succeed. They play an especially important role in technology industries. A study by the Kauffman Foundation reports that immigrant entrepreneurs are responsible for 52 percent of Silicon Valley technology start-ups, including Google, PayPal, and YouTube.⁹⁰

Although immigrants make up 13 percent of the U.S. population, immigrant entrepreneurs own 18 percent of businesses in the United States; in 1992, immigrants owned just 9 percent of businesses in the United States. Their companies generate \$776 billion in annual revenues and employ 4.7 million workers.⁹¹ Although many immigrants come to the United States with few assets, their dedication and desire to succeed enable them to achieve their entrepreneurial dreams. “Most immigrants have the risk gene already built in,” explains Al Guerra, who emigrated to the United States from Cuba and now owns Kelvin International, a business that makes cryogenic (ultralow temperature) equipment.⁹²

ENTREPRENEURIAL PROFILE: Delfino Bello: El Faro When Delfino Bello emigrated to the United States from Mexico, he spoke no English but learned quickly working various jobs in the restaurant industry. “I had nothing, nothing when I arrived in this country,” he recalls. Bello worked hard, saved his money, and in 1995 opened a restaurant, El Faro, that specialized in authentic Mexican food in a modest shopping center in Bartlett, Illinois. El Faro flourished, and over the next several years, Bello opened two other locations in Bartlett and Elgin and now has plans to open a



Venus Williams, entrepreneur and tennis star.
 Source: Ezio Petersen/UPI/Newscom.

Part-Time Entrepreneurs

Starting a part-time business is a popular gateway to entrepreneurship. Part-timers have the best of both worlds. They can ease into a business without sacrificing the security of a steady paycheck. The Internet allows many entrepreneurs to run successful part-time businesses.



ENTREPRENEURIAL PROFILE: Sari Crevin: BooginHead By day, Sari Crevin worked as a human resources manager at Microsoft, but in the evenings and on weekends, the part-time entrepreneur operated BooginHead, a company that makes and markets fabric fasteners that parents can attach to pacifiers, sippy cups, and other items that tots like to toss to the ground. “I couldn’t find a product that met my own needs and standards,” says the busy mom. “I was tired of chasing after my one-year-old’s sippy cup that he loved to throw from his high chair and stroller.” Crevin built BooginHead’s annual sales to an impressive \$1.1 million while holding her full-time job before leaving Microsoft to focus her energy on her company. Crevin has a Web site for BooginHead, but most of her sales are at wholesale to large retailers, such as Babies R Us, Baby Depot, and Amazon.⁹⁴

A major advantage of going into business part-time is the lower risk in case the venture flops. Starting a part-time business and maintaining a “regular” job can challenge the endurance of the most determined entrepreneur, but it does provide a safety net in case the business venture fails. Many part-timers are “testing the entrepreneurial waters” to see whether their business ideas will work and whether they enjoy being self-employed. As part-time ventures grow, they absorb more of the entrepreneur’s time until they become full-time businesses. “There comes a point when you cannot get up and go to work because the only thing you want to do is your company,” says Divya Gugnani, who left her job with a venture capital firm to start BehindtheBurner.com, a Web site that features cooking tips and techniques. “The passion is so infectious.”⁹⁵

Home-Based Business Owners

Entrepreneurs in the United States operate 18.3 million home-based businesses, generating \$427 billion a year in sales. Fifty-three percent of all small businesses are home based, but most of them are very small with no employees.⁹⁶ In the past, home-based businesses tended to be rather unexciting cottage industries, such as making crafts or sewing. Today’s home-based businesses are more diverse; modern home-based entrepreneurs are more likely to be running high-tech or service companies with six-figure sales. Eight percent of home-based businesses generate more than \$500,000 in annual revenues.⁹⁷ Their success rate also is higher than companies that have locations outside the home; nearly 70 percent succeed for at least three years.⁹⁸ Less costly and more powerful technology and the Internet, which are transforming ordinary homes into “electronic cottages,” are driving the growth of home-based businesses.

On average, someone starts a home-based business every 11 seconds.⁹⁹ The biggest advantage home-based businesses offer entrepreneurs is the cost savings of not having to lease or buy an external location, something that allows them to generate higher profit margins. Home-based entrepreneurs also enjoy the benefits of flexible work and lifestyles.



ENTREPRENEURIAL PROFILE: Natalie Cox: Natty by Design Natalie Cox, a 28-year-old mother of four children, used her do-it-yourself furniture refurbishing skills to start Natty by Design, a home-based business that gives old pieces of furniture new life by refinishing or repainting them and adding new hardware. She launched the company in the basement of her family’s home in Phoenix, Arizona, to supplement her husband’s salary while he returned to college to earn an MBA degree. Cox describes the style of furniture she sells from a front room of her house that serves as both her office and showroom as “shabby chic.” Most of her company’s sales come from repeat business and referrals from existing customers and from her listings on Craigslist. “[My company] allows me to stay at home with my kids,” says Cox, “and business is thriving.”¹⁰⁰

Table 1.2 offers 20 guidelines home-based entrepreneurs should follow to be successful.

Family Business Owners

A **family-owned business** is one that includes two or more members of a family with financial control of the company. They are an integral part of the global economy. More than 80 percent of all companies in the world are family owned, and their contributions to the global economy are significant. In the United States alone, family businesses create about 60 percent of the nation’s

TABLE 1.2 Rules for a Successful Home-Based Business

- Rule 1. Do your homework.** Much of a home-based business's potential for success depends on how much preparation an entrepreneur makes before ever opening for business. Your local library and the Web are excellent sources of information on customers, industries, competitors, and other important topics.
- Rule 2. Find out what your zoning restrictions are.** In some areas, local zoning laws make running a business from home illegal. Avoid headaches by checking these laws first. You can always request a variance.
- Rule 3. Create distinct zones for your family and business dealings.** Your home-based business should have its own dedicated space. About half of all home-based entrepreneurs operate out of spare bedrooms. The best way to determine the ideal office location is to examine the nature of your business and your clients. Avoid locating your business in your bedroom or your family room.
- Rule 4. Focus your home-based business idea.** Avoid the tendency to be "all things to all people." Most successful home-based businesses focus on a niche, whether it is a particular customer group, a specific product line, or in some other specialty.
- Rule 5. Discuss your business rules with your family.** Running a business from your home means that you can spend more time with your family—and that your family can spend more time with you. Establish the rules for interruptions up front.
- Rule 6. Select an appropriate business name.** Your first marketing decision is your company's name, so make it a good one! Using your own name is convenient, but it's not likely to help you sell your product or service.
- Rule 7. Buy the right equipment.** Modern technology allows a home-based entrepreneur to give the appearance of any *Fortune 500* company, but only if you buy the right equipment. A well-equipped home office should have a separate telephone line, a fast computer, a sturdy printer, a high-speed Internet connection, a copier/scanner, and an answering machine (or voice mail).
- Rule 8. Dress appropriately.** Being an "open-collar worker" is one of the joys of working at home. However, when you need to dress up (to meet a client, make a sale, meet your banker, or close a deal), do it! Avoid the tendency to lounge around in your bathrobe all day.
- Rule 9. Learn to deal with distractions.** The best way to fend off the distractions of working at home is to create a business that truly interests you. Budget your time wisely. Remember: Your productivity determines your company's success.
- Rule 10. Realize that your phone can be your best friend—or your worst enemy.** As a home-based entrepreneur, you'll spend lots of time on the phone. Be sure you use it productively.
- Rule 11. Be firm with friends and neighbors.** Sometimes friends and neighbors get the mistaken impression that because you're at home, you're not working. If someone drops by to chat while you're working, tactfully ask him or her to come back "after work."
- Rule 12. Maximize your productivity.** One advantage of working from home is flexibility. Learn the times during which you tend to work at peak productivity, whether that occurs at 2 P.M. or 2 A.M., and build your schedule around them.
- Rule 13. Create no-work time zones.** Because their businesses are always nearby, the tendency for some home-based entrepreneurs is to work all the time, which is not healthy. Set boundaries that separate work and no work times and stick to them.
- Rule 14. Take advantage of tax breaks.** Although a 1993 Supreme Court decision tightened considerably the standards for business deductions for an office at home, many home-based entrepreneurs still qualify for special tax deductions on everything from computers to cars. Check with your accountant.
- Rule 15. Make sure you have adequate insurance coverage.** Some home-owner's policies provide adequate coverage for business-related equipment, but many home-based entrepreneurs have inadequate coverage on their business assets. Ask your agent about a business owner's policy, which may cost as little as \$300 to \$500 per year.
- Rule 16. Understand the special circumstances under which you can hire outside employees.** Sometimes zoning laws allow in-home businesses, but they prohibit hiring employees. Check local zoning laws carefully.
- Rule 17. Be prepared if your business requires clients to come to your home.** Dress appropriately. (No pajamas!) Make sure your office presents a professional image.
- Rule 18. Get a post office box.** With burglaries and robberies on the rise, you are better off using a P.O. Box address rather than your specific home address. Otherwise, you may be inviting crime.
- Rule 19. Network.** Isolation can be a problem for home-based entrepreneurs, and one of the best ways to combat it is to network. It's also an effective way to market your business.
- Rule 20. Be proud of your home-based business.** Merely a decade ago, there was a stigma attached to working from home. Today, home-based entrepreneurs and their businesses command respect. Be proud of your company!

Sources: Based on Pamela Slim, "5 Keys to Making Your Home Office Work," *Open Forum*, June 24, 2009, www.openforum.com/idea-hub/topics/the-world/article/5-keys-to-making-your-home-office-work-pamela-slim; Lynn Beresford, Janean Chun, Cynthia E. Griffin, Heather Page, and Debra Phillips, "Homeward Bound," *Entrepreneur*, September 1995, pp. 116–118; Jenean Huber, "House Rules," *Entrepreneur*, March 1993, pp. 89–95; Hal Morris, "Home-Based Businesses Need Extra Insurance," *AARP Bulletin*, November 1994, p. 16; Stephanie N. Mehta, "What You Need," *Wall Street Journal*, October 14, 1994, p. R10; Jeffery Zbar, "Home Free," *Business Start-Ups*, June 1999, pp. 31–37.

employ 60 percent of the private sector workforce, and account for 65 percent of all wages paid. Not all family-owned businesses are small, however; 35 percent of *Fortune 500* companies are family businesses.¹⁰¹ Family firms also create 78 percent of the U.S. economy's net new jobs and are responsible for many famous products, including Heinz ketchup, Levi's jeans, and classic toys such as the Slinky and the Wiffle Ball.¹⁰²

"When it works right," says one writer, "nothing succeeds like a family firm. The roots run deep, embedded in family values. The flash of the fast buck is replaced with long-term plans. Tradition counts."¹⁰³



ENTREPRENEURIAL PROFILE: Domino, Julio, and Rene Diaz: Diaz Foods When Fidel Castro's regime seized Domingo Diaz's cattle ranches in Cuba in 1966, he fled to the United States and settled in Atlanta, Georgia, where he found work as a janitor. He eventually saved enough money to purchase a small grocery store that he and his son, Julio, managed. As Diaz Foods grew to four locations, more family members, including Julio's son Rene, began to work there. Today, Rene is head of the family business, which sells Hispanic food products to restaurants and grocery stores in 25 states from a new 250,000-square-foot warehouse on the outskirts of Atlanta. Diaz Foods employs 370 workers and generates annual sales of \$200 million. "I can't count how many family members work here," says Rene. "I always want it to be a privately-held business with family values."¹⁰⁴

Despite their magnitude, family businesses face a major threat—a threat from within: management succession. Only 33 percent of family businesses survive to the second generation, just 12 percent make it to the third generation, and only 3 percent survive to the fourth generation and beyond.¹⁰⁵ Business periodicals are full of stories describing bitter disputes among family members who have crippled or destroyed once-thriving businesses, usually because the founder failed to create a succession plan. To avoid the senseless destruction of valuable assets, founders of family businesses should develop plans for management succession long before retirement looms before them. We will discuss family businesses and management succession in more detail in Chapter 22.

Copreneurs

Copreneurs are entrepreneurial couples who work together as co-owners of their businesses. More than 1.2 million husband-and-wife teams operate businesses in the United States.¹⁰⁶ Unlike the traditional "Mom & Pop" (Pop as "boss" and Mom as "subordinate"), copreneurs divide their business responsibilities on the basis of their skills, experience, and abilities rather than on gender.

Managing a small business with a spouse may appear to be a recipe for divorce, but most copreneurs say not. "There are days when you want to kill each other," says Mary Duty, who has operated Poppa Rollo's Pizza with her husband for 20 years. "But there's nothing better than working side-by-side with the [person] you love."¹⁰⁷ Successful copreneurs learn to build the foundation for a successful working relationship *before* they ever launch their companies. Some of the characteristics they rely on include the following:

- An assessment of how well their personalities will mesh in a business setting.
- Mutual respect for each other and one another's talents.
- Compatible business and life goals—a common "vision."
- A view that they are full and equal partners, not a superior and a subordinate.
- Complementary business skills that each acknowledges in the other and that lead to a unique business identity for each spouse.
- A clear division of roles and authority—ideally based on each partner's skills and abilities—to minimize conflict and power struggles.
- The ability to keep lines of communication open, talking and listening to each other about personal as well as business issues.
- The ability to encourage each other and to lift up a disillusioned partner.
- Separate work spaces that allow them to escape when the need arises.
- Boundaries between their business life and their personal life so that one doesn't consume the other.
- A sense of humor.
- An understanding that not every couple can work together.

Although copreneuring isn't for every couple, it works extremely well for many couples and often leads to successful businesses.



ENTREPRENEURIAL PROFILE: Karine and Aaron Hirschhorn: DogVacay When Karine and Aaron Hirschhorn traveled, they dreaded boarding their beloved dogs, Rocky and Rambo, in a kennel but had little choice. Poor kennel experiences prompted the Hirschhorns to launch DogVacay, an online marketplace that allows dog owners to browse hundreds of online profiles of people nearby who are willing to provide temporary homes for dogs for fees that range between \$15 and \$70 per night. DogVacay subjects all host families to a vetting process using background checks and interviews. The average price for dog-sitting is \$25 per night (host families set their own rates), and DogVacay, which is based in Santa Monica, California, collects 3 to 10 percent of each transaction. DogVacay has more than 4,000 host families in major cities across the United States, and the 12-employee company is growing fast. The potential market for DogVacay is huge; pet owners in the United States spend \$10 billion annually on pet boarding, and the Hirschhorns are making plans to expand DogVacay across the nation. The copreneurs have landed a total of \$22 million in financing from several venture capital firms to fuel their company's growth.¹⁰⁸

Corporate Castoffs

Concentrating on trying to operate more efficiently, corporations have been downsizing, shedding their excess bulk, and slashing employment at all levels in the organization. These downsizing victims or “corporate castoffs” have become an important source of entrepreneurial activity. Skittish about downsizing at other large companies they might join, many of these castoffs are choosing instead to create their own job security by launching their own businesses or buying franchises. They have decided that the best defense against future job insecurity is an entrepreneurial offense. Armed with years of experience, tidy severance packages, a working knowledge of their industries, and a network of connections, these former managers are starting companies of their own.



ENTREPRENEURIAL PROFILE: Forrest Graves: JumpinGoat Forrest Graves spent many years selling equipment to the printing industry for one of the largest corporations in the United States only to become a victim of the Great Recession. After he was laid off, Graves considered finding another corporate job but knew “that I would be better off to do my own thing,” he recalls. He created a business plan for a coffee roasting company, JumpinGoat, that purchases green coffee that comes from the 10 major coffee regions around the world, roasts it, and sells packages of premium coffee through a retail outlet in tiny Helen, Georgia, to other retail coffee shops and online through its Web site. JumpinGoat has been successful, and within six months of launching the company, Graves was earning more than he did in his corporate job. However, the income is not what matters most to Graves. “My passion and income are now fueled with the truth that I’m actually building something sustainable,” he says. “I am now the benefactor of a better ‘work life balance,’ freedom to make my own mistakes and failures, and the notion that there is no cap on my financial well-being.”¹⁰⁹

Corporate “Dropouts”

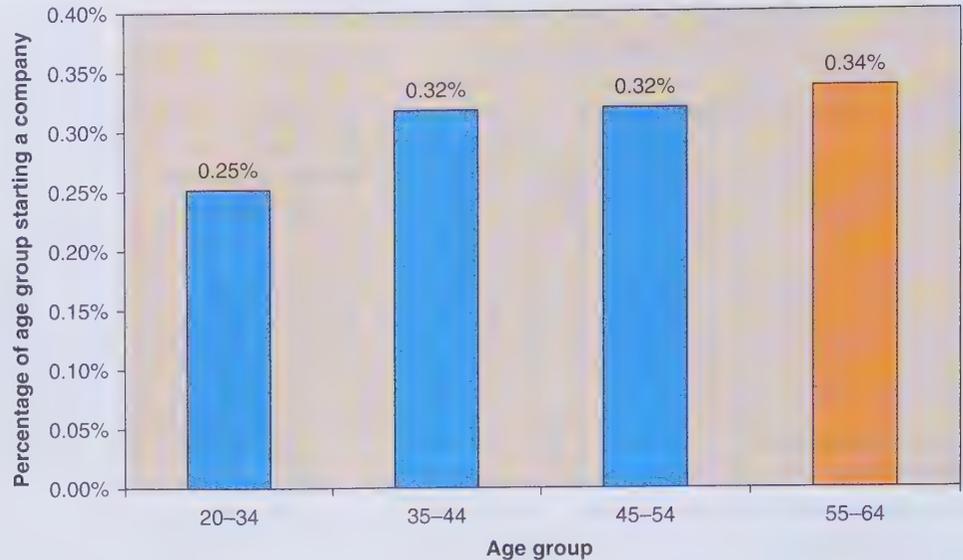
The dramatic downsizing in corporate America has created another effect among the employees left after restructuring: a trust gap. The result of this trust gap is a growing number of “dropouts” from the corporate structure who then become entrepreneurs. Although their workdays may grow longer and their incomes may shrink, those who strike out on their own often find their work more rewarding and more satisfying because they are doing what they enjoy and they are in control.

Because they often have college degrees, a working knowledge of business, and years of management experience, both corporate castoffs and dropouts will likely increase the small business survival rate. Better-trained, more experienced entrepreneurs are less likely to fail in business. Many corporate castoffs and dropouts choose franchising as the vehicle to business ownership because it offers the structure and support with which these former corporate executives are most comfortable. *Entrepreneur* magazine surveyed the companies on its *Franchise 500* list recently and discovered that 77 percent of franchisors report that “second-career ex-

ecutive dropouts and castoffs) were among the primary purchasers of their franchises.¹¹⁰

FIGURE 1.5
Entrepreneurial Activity
by Age Group 1996–2012

Source: Based on Robert W. Fairlie, *Kauffman Index of Entrepreneurial Activity, 1996–2012*, Kauffman Foundation, April 2013, p. 12.



Retired Baby Boomers

Members of the Baby Boom Generation (1946–1964) are retiring, but many of them are not idle; instead, they are launching businesses of their own. A survey by Robert Half reports that 54 percent of Baby Boomers plan to work beyond the traditional retirement age, and many of those who do will choose entrepreneurship as their second career.¹¹¹ A study by the Kauffman Foundation shows that the average level of entrepreneurial activity over the last 15 years among people age 55 to 64 actually is higher than that among people of any other age-group (see Figure 1.5). One advantage that older entrepreneurs have is wisdom that has been forged by experience. Because people are living longer and healthier than ever before, many entrepreneurs start their entrepreneurial ventures late in life. At age 65, Colonel Harland Sanders, for example, began franchising the fried chicken business that he had started three years earlier, a company that became Kentucky Fried Chicken (now known as KFC).

To finance their businesses, retirees often use some of their invested “nest eggs,” or they can rely on the same sources of funds as younger entrepreneurs, such as banks, private investors, and others.



ENTREPRENEURIAL PROFILE: Michael Brown: MJB Organics At age 66, Michael Brown, a retired human resources manager at a large security firm, launched MJB Organics, a company in New Addington, England, that sells a line of organic shaving soaps manufactured by another local small business, John Perry Soaps. A longtime user of the soaps, Brown says, “As I was shaving one morning, I came up with the idea of setting up my own business selling the line of soaps. I may have retired, but I didn’t want to put my feet up.” The retired grandfather started selling the soaps at indoor markets near his home, but sales have grown so rapidly that Brown now sells to other retailers and has plans to move into upscale shops in Brighton and London. “I think organic products are the future,” says the eager entrepreneur.¹¹²

The Contributions of Small Businesses

Since 1997, the number of small businesses in the United States has grown more than 30 percent.¹¹³ Of the 27.2 million businesses in the United States today, approximately 27.1 million, or 99.7 percent, can be considered “small.” Although there is no universal definition of a small business, a common delineation of a **small business** is one that employs fewer than 100 people. They thrive in virtually every industry, although the majority of small companies are concentrated in the service industry (see Figure 1.6). Their contributions to the economy are as numerous as the businesses themselves. For example, small companies employ 49.2 percent of the nation’s private sector workforce and pay 43 percent of the total private payroll in the United States. Although 79 percent of small companies have no employees other than the founder, the 21 percent that do have employees actually create more

8.

Describe the contributions small businesses make to the U.S. economy.

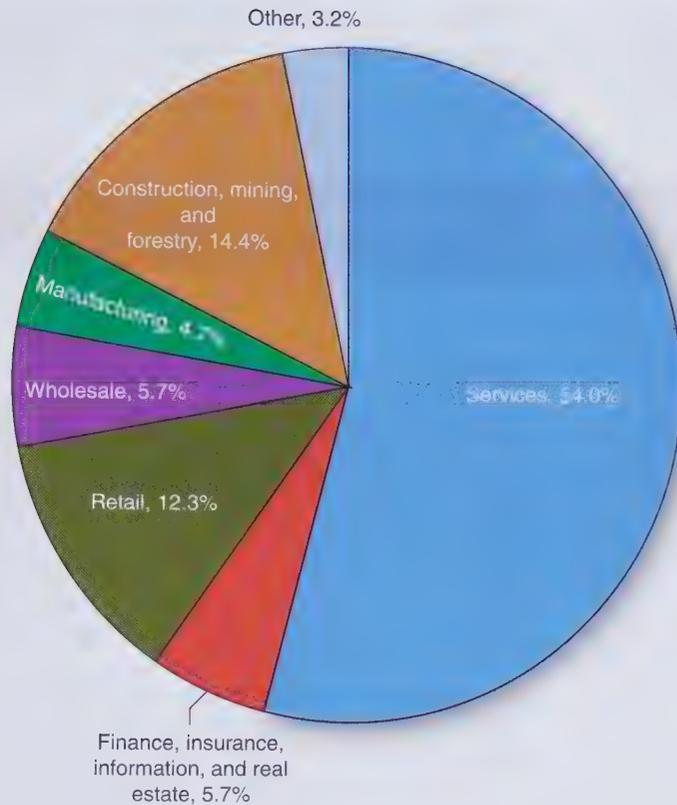


FIGURE 1.6
Small Businesses
by Industry

Source: Based on Small Business Administration, 2012.

jobs than do big businesses. Small businesses have created 65 percent of the net new jobs in the United States between 1993 and 2009.¹¹⁴

David Birch, president of the research firm Arc Analytics, says that the ability to create jobs is not distributed evenly across the small business sector, however. His research shows that just 6 percent of these small companies create 70 percent of the net new jobs, and they do so across all industry sectors—not just in “hot” industries. Birch calls these job-creating small companies “gazelles,” those growing at 20 percent or more per year with at least \$100,000 in annual sales. His research also identified “mice,” small companies that never grow much and don’t create many jobs. The majority of small companies are “mice.” Birch tabbed the country’s largest businesses “elephants,” which have continued to shed jobs for several years.¹¹⁵ In an updated study, researchers found that small companies with fewer than 20 employees accounted for 93.8 percent of all “high-impact firms,” those that have both fast revenue and employment growth. These high-impact companies make up less than 3 percent of all businesses but account for almost all of the employment and revenue growth in the U.S. economy.¹¹⁶

Not only do small companies lead the way in creating jobs, but they also bear the brunt of training workers for them. Small businesses provide 67 percent of workers with their first jobs and basic job training. Small companies offer more general skills instruction and training than large ones, and their employees receive more benefits from the training than do those in larger firms. Although their training programs tend to be informal, in-house, and on-the-job, small companies teach employees valuable skills—from written communication to computer literacy.¹¹⁷

Small businesses also produce 46 percent of the country’s private GDP and account for 47 percent of business sales.¹¹⁸ In fact, the U.S. small business sector is the world’s third-largest “economy,” trailing only the economies of the United States and China. Small businesses also play an integral role in creating new products, services, and processes. Small companies produce 16.5 times more patents per employee than do large firms, and many of those patents are among the most significant inventions in their fields. A study by the SBA reports that the smallest businesses, those with fewer than 25 employees, produce the greatest number of patents per employee.¹¹⁹ Many important inventions trace their roots to an entrepreneur; for example, the zipper, the personal computer, FM radio, air conditioning, the escalator, the lightbulb, the

helicopter, and the automatic transmission all originated in small businesses. Entrepreneurs continue to create innovations designed to improve people's lives in areas that range from energy and communications to clothing and toys.



Lessons from the Street-Smart Entrepreneur

Bulletproofing Your Start-Up

It happens thousands of times every day: Someone comes up with a great idea for a new business, certain that the idea is going to be “the next big thing.” Technology advances, the Internet, increased global interconnectivity, and computer-aided-design tools that allow inventors to go from the idea stage to creating a prototype faster than ever have made transforming a great idea into reality much easier than at any point in the past. In addition, entrepreneurial training, improved access to information, and greater awareness of entrepreneurship as a career choice have made it easier than ever to launch a business. However, *succeeding in business today is as challenging as it ever was.*

What steps can a potential entrepreneur with a great idea take to build a “bulletproof” start-up? Take these tips from the Street-Smart Entrepreneur:

Step 1. Test to see whether your idea really is a good one

The reality is that transforming an idea into a successful business concept is much like the television show *American Idol*. For every person who really is a great singer, there are 99 people who can't stay on key but who *think* they are great singers. This step involves getting a reality check from other people—and not just friends and relatives who may not tell you what they really think about your idea because they don't want to hurt your feelings. The goal is to determine whether your business idea really has market potential. One key is to get your product or service into potential customers' hands and see how they respond. In 2009, Terry Danielson started Simmer Down Teas in Eagan, Minnesota, as a part-time business after spending time with the owner of a teahouse on a business trip to Taiwan and learning the intricacies of blending teas. Danielson began by testing his business idea at Eagan's Market Fest, a weekly farmer's market that runs from June to September and draws more than 34,000 visitors annually, a practice that he continues to use. “It's fertile ground, and it's very inexpensive to test products,” he says. Customer feedback has helped Danielson identify the most popular tea blends and has helped him to validate his business idea. He is planning to make Simmer Down Teas a full-time venture. “I put my big toe in the water, and now I'm ready to dive in,” he says.

Entrepreneur Hugh Crean suggests another technique that involves strangers called the “\$20 Starbucks Test” and is designed to judge the validity of new product, service, or start-up ideas: Take \$20 to a nearby Starbucks and offer to buy someone a cup of coffee in exchange for his or her opinion about a business idea that your “brother” has. Explain that your “brother” is about to get a second mortgage on his house, raid his retirement plan, and quit his job to pursue his start-up idea. (Making the idea your

“brother's” means that people are more likely to tell you the truth about your idea than if you tell them it's your idea.) His wife and your parents are afraid that he will lose everything and have come to you for help to try to talk him out of starting the business. Then give the person your best two- to three-minute elevator pitch, ask him or her for reasons why the idea won't work, and listen to his or her comments. Resist the temptation to argue with his or her reasoning. Finally, thank the person and repeat the experiment with someone else until your \$20 runs out.

“The most likely outcome is that you will hear the same obvious rejections of your idea that you already have and believe are surmountable,” says Crean. “Your \$20 didn't generate any great new insight but was an inexpensive check that you aren't blind to an obvious shortcoming. A good outcome is that you hear sound new objections that you never thought of before. This should give you real pause about your idea. A not-so-likely outcome is that your strangers will find themselves agreeing with you and your ‘brother’ that it is a great idea. If this happens, you probably have a real hit on your hands. Run with it!”

Sometimes entrepreneurs discover that step 1 is as far as they should go; otherwise, they would be wasting time, talent, and resources. Other entrepreneurs receive confirmation that they really are on to something at this step and move forward.

Step 2. Conduct a feasibility analysis

The purpose of a feasibility analysis is to subject a business idea to what one entrepreneur calls a “quick scrub,” judging its merits in four areas: the attractiveness of the industry and market segment, the ability to provide the proposed product or service at a reasonable cost, the ability of the entrepreneurial team to implement the idea successfully, and the capacity to generate a reasonable profit and return on investment. If an idea passes the feasibility test, entrepreneurs can begin building their new venture team and creating a business plan.

Step 3. Start building your entrepreneurial team

Nearly half of all new business ventures are started by teams of people. As one business writer observes, “Launching a company isn't just a full-time job; in many cases, it's three full-time jobs.” Perhaps that is why a study of 2,000 businesses by researchers at Marquette University found that companies started by teams of entrepreneurs are nearly 16 times more likely to become high-growth ventures than those started by solo entrepreneurs. Indeed, launching a company is a demanding task that requires a diverse blend of skills, abilities, and experience that not every individual possesses. If that is the case, the best alternative is to launch your company with others whose skills, abilities, and

experience *complement* rather than *mirror* yours. Picking the right entrepreneurial players is as essential to business success as picking the best kids to be on your kickball team was in grammar school! However many people it may require, ideally a start-up team includes a “big-picture” strategic thinker, a top-notch networker with marketing and sales know-how, and a hands-on technical person who understands the business opportunity at the “nuts-and-bolts” level.

Step 4. Do your research and create a business plan

Smart entrepreneurs know that creating a business plan is an important step in building a successful company even if they are not seeking capital from external sources. Starting a company without a business plan is like trying to build a house without a set of blueprints. Even though a business plan is a valuable document that entrepreneurs use in many ways, the real value in creating a plan lies in the *process*. Developing a plan requires entrepreneurs to address an array of important issues, ranging from which form of ownership is best and how much capital is required to researching their target customers and preparing financial and cash flow forecasts.

David Langer and Andy Young met at an entrepreneurial club while they were students at Oxford University. Both young men were officers in campus organizations and began talking about how the processes for contacting members, keeping track

of dues payments, and maintaining membership records were scattered, inefficient, and time consuming and required the use of multiple tools. To solve their problem, they decided to create a platform that would handle all of the administrative activities for clubs and organizations conveniently and in one place. They soon realized that other people would be interested in their solution and created a company, GroupSpaces, to market it. “The key is in bringing everything together in one place,” says Langer. The duo created a business plan and within three months used it to secure \$244,000 in seed capital from an Oxford, England–based angel capital network. GroupSpace provides its basic service for free to small groups but charges a subscription for large groups and groups that want additional functionality. It also collects a small percentage of each payment it processes. GroupSpaces’s software now helps manage more than 1 million groups in more than 30 countries and has raised a total of \$2.1 million in capital from angel capital networks.

Sources: Based on David Henke, “Eagan’s Market Fest a Hotbed of Entrepreneurial Spirit,” *EaganPatch*, June 21, 2012, http://eagan_patch.com/articles/eagan-s-market-fest-a-hotbed-of-entrepreneurial-spirit; Jennifer Hill, “Start-Up Execs Schooled from Oxbridge,” *Venture Capital Journal*, April 6, 2011, pp. 47–50; Peter Day, “Top Tips for Starting Your Own Business,” *BBC News*, January 18, 2012, www.bbc.co.uk/news/business-16595152; Sara Wilson, “Laid Off in 2008? Start a Business in 2009,” *Entrepreneur*, February 2009, pp. 73–77; Michael V. Copeland and Om Malik, “How to Build a Bulletproof Start-up,” *Business 2.0*, June 2006, pp. 76–92; Michael V. Copeland and Andrew Tilin, “The New Instant Companies,” *Business 2.0*, June 2005, pp. 82–94; Daniel Roth, “The Amazing Rise of the Do-It-Yourself Economy,” *Fortune*, May 30, 2005, pp. 45–46; Sean Johnson, “The \$20 Start-Up Test,” *Monkey Opus*, December 2010, <http://blog.snootymonkey.com/post/2432103782/the-20-starbucks-test>.

Putting Failure into Perspective

Because of their limited resources, inexperienced management, and lack of financial stability, small businesses suffer relatively high mortality rates (see Figure 1.7). Research shows that 52 percent of new businesses will have failed within five years. Why are entrepreneurs willing to endure these odds? Because they are building businesses in an environment filled with uncertainty and shaped by rapid change, entrepreneurs recognize that failure is likely to be a part of their lives, yet they are not paralyzed by that fear. “The excitement of building a new business from scratch is far greater than the fear of failure,” says one entrepreneur who failed in business several times before finally succeeding.¹²⁰ Instead, they use their failures as a rallying point and as a means of defining their companies’ reason for being more clearly. They see failure for what it really is: an opportunity to learn what doesn’t work! Successful entrepreneurs are what one author calls “rebounders,” people who suffer great setbacks, often repeatedly, but who demonstrate the persistence and tenacity necessary to rise above the challenges and succeed.¹²¹ They understand that failures are simply stepping-stones along the path to success. Author J. K. Rowling was a penniless, unemployed, single parent when she penned a book about a boy wizard and his adventures. She submitted her manuscript to 12 publishers, all of whom rejected it. Rowling persisted, however, and a small London publisher, Bloomsbury, finally decided to take a chance on *Harry Potter and the Philosopher’s Stone* after a glowing review from the CEO’s young daughter. The seven-book Harry Potter series went on to sell more than 450 million copies worldwide, making Rowling the first billionaire author.¹²²

Failure is a natural part of the creative process. The only people who never fail are those who never do anything or never attempt anything new. Baseball fans know that Babe Ruth held the record for career home runs (714) for many years, but how many know that he also held the record for strikeouts (1,330)? Successful entrepreneurs realize that hitting an entrepreneurial home run requires a few strikeouts along the way, and they are willing to accept that. In an address at Harvard University’s graduation, author J. K. Rowling told students, “You might never

- Put business failure into the proper perspective.

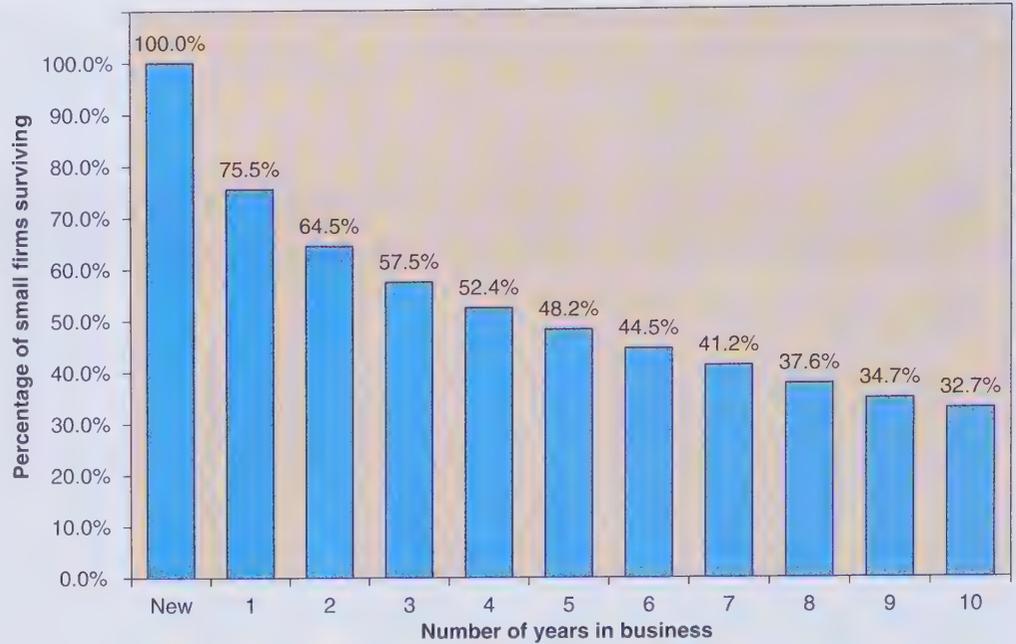


J. K. Rowling.

Source: © jeremy sutton-hibbert/Alamy.

FIGURE 1.7**Small Business Survival Rate**

Source: Based on “Table 7: Survival of Private Sector Establishments by Opening Year,” Business Employment Dynamics, Bureau of Labor Statistics, www.bls.gov/bdm/bdmage.htm#TOTAL.



fail on the scale I did, but some failure in life is inevitable. It is impossible to live without failing at something, unless you live so cautiously that you might as well not have lived at all—in which case, you fail by default.”¹²³ Although entrepreneurs don’t always succeed, they are not willing to fail by default.

One hallmark of successful entrepreneurs is the ability to fail *intelligently*, learning why they failed so that they can avoid making the same mistake again. They know that business success does not depend on their ability to avoid making mistakes but to be open to the lessons each mistake brings. They *learn* from their failures and use them as fuel to push themselves closer to their ultimate target. Many entrepreneurs became successful by becoming adept at failing quickly and cheaply, learning from their failures, and moving on to the next business idea. Entrepreneurs are less worried about what they might lose if they try something and fail than about what they miss if they fail to try.

Entrepreneurial success requires both persistence and resilience, the ability to bounce back from failures. Inventor James Dyson, founder of the company that sells vacuum cleaners, fans, heaters, and hand dryers and that bears his name, discovered 5,127 ways not to build a bagless vacuum cleaner before he developed a design that worked—and revolutionized the world of vacuum cleaners.¹²⁴ R. H. Macy failed in business seven times before his department store in New York City became a success. Entrepreneur Bryn Kaufman explains this “don’t-quit” attitude: “If you are truly an entrepreneur, giving up is not an option.”¹²⁵

How to Avoid the Pitfalls

10.

Explain how small business owners can avoid the major pitfalls of running a business.

As valuable as failure can be to the entrepreneurial process, no one sets out to fail. We now examine the ways to avoid becoming another failure statistic and gain insight into what makes a start-up successful. Entrepreneurial success requires much more than just a good idea for a product or service. It also takes a solid plan of execution, adequate resources (including capital and the right people), the ability to assemble and manage those resources, and perseverance. The following suggestions for success follow naturally from the causes of business failures.

Know Your Business in Depth

We have already emphasized the need for the right type of experience in the business. Get the best education in your business area you possibly can *before* you set out on your own. Read everything you can—trade journals, business periodicals, books, and Web pages—relating to your

industry. Personal contact with suppliers, customers, trade associations, and others in the same industry is another excellent way to get important knowledge.



ENTREPRENEURIAL PROFILE: Jessica Gold Newman and Catherine Doyle: Dobbin Clothing

Jessica Gold Newman and Catherine Doyle grew up working as sales associates in retail stores near Boston and met while working at Liz Lange Maternity, where Gold Newman led the company's marketing department, and Doyle was responsible for fashion design. Gold Newman left to work as a retail consultant, and Doyle began developing store concepts for another major retail chain. In 2011, building on their knowledge of and experience in the retail clothing industry, the business partners launched Dobbin (from the British nickname for a workhorse), a clothing line aimed at working women over the age of 35. Dobbin offers customers a mix of classic and vintage-inspired designs made of washable European fabrics in flattering fits made for "real women" that sell at reasonable prices.¹²⁶

Like Jessica Gold Newman and Catherine Doyle, successful entrepreneurs are like sponges, soaking up as much knowledge as they can from many sources, and they continue to learn about their businesses, markets, and customers as long as they are in business.

Prepare a Business Plan

To wise entrepreneurs, a well-written business plan that defines the company's business model and defines the market opportunity is a crucial ingredient in business success. Without a sound business plan, a company merely drifts along without any real direction and often stalls out when it faces its first challenge. Yet entrepreneurs, who tend to be people of action, often jump right into a business venture without taking time to prepare a written plan outlining the essence of the business. "Most entrepreneurs don't have a solid business plan," says one business owner. "But a thorough business plan and timely financial information are critical. They help you make the important decisions about your business; you constantly have to monitor what you're doing against your plan."¹²⁷ We will discuss the process of developing a business plan in Chapter 8.

Manage Financial Resources

The best defense against financial problems is developing a practical financial information system and then using this information to make business decisions. No entrepreneur can maintain control over a business unless he or she is able to judge its financial health.

The first step in managing financial resources effectively is to have adequate start-up capital. Too many entrepreneurs begin their businesses with too little capital. One experienced business owner advises, "Estimate how much capital you need to get the business going and then double that figure." In other words, launching a business almost always costs more than *any* entrepreneur expects. Establishing a relationship early on with at least one reliable lender or investor who understands your business is a good way to gain access to financing when a company needs capital for growth or expansion.

The most valuable financial resource to any small business is *cash*; successful entrepreneurs learn early on to manage it carefully. Although earning a profit is essential to its long-term survival, a business must have an adequate supply of cash to pay its bills. Some entrepreneurs count on growing sales to supply their company's cash needs, but it almost never happens. Growing companies usually consume more cash than they generate; and the faster they grow, the more cash they gobble up! We will discuss cash management techniques in Chapter 15.

Understand Financial Statements

Every business owner must depend on records and financial statements to know the condition of his or her business. All too often, these records are used only for tax purposes rather than as vital control devices. To truly understand what is going on in the business, an owner must have at least a basic understanding of accounting and finance.

When analyzed and interpreted properly, financial statements are reliable indicators of a small company's health. They can be quite helpful in signaling potential problems. For example, declining sales or profits, rising debt, and deteriorating working capital are all symptoms of trouble that require immediate attention. We will discuss financial statement analysis in Chapter 14.

Learn to Manage People Effectively

No matter what kind of business you launch, you must learn to manage people. Every business depends on a foundation of well-trained, motivated employees. No entrepreneur can do everything alone. The people an entrepreneur hires ultimately determine the heights to which the company can climb—or the depths to which it can plunge. Attracting and retaining a corps of quality employees is no easy task, however; it remains a challenge for every small business owner. One entrepreneur alienated employees with a memo chastising them for skipping lines on interoffice envelopes (the cost of a skipped line was two-thirds of a penny) while he continued to use a chauffeur-driven luxury car and to stay at exclusive luxury hotels while traveling on business.¹²⁸ Entrepreneurs quickly learn that treating their employees with respect and compassion usually translates into their employees treating customers in the same fashion. Successful entrepreneurs value their employees and constantly find ways to show it. We will discuss the techniques of managing and motivating people effectively in Chapter 21.

Set Your Business Apart from the Competition

The formula for almost certain business failure involves becoming a “me-too business”—merely copying whatever the competition is doing. Successful entrepreneurs find a way to convince their customers that their companies are superior to their competitors even if they sell similar products or services. We will discuss the strategies for creating a unique footprint in the marketplace in Chapter 4 and Chapter 9.

Maintain a Positive Attitude

Achieving business success requires an entrepreneur to maintain a positive mental attitude toward business and the discipline to stick with it. Successful entrepreneurs recognize that their most valuable resource is their time, and they learn to manage it effectively to make themselves and their companies more productive. None of this, of course, is possible without passion—passion for their businesses, their products or services, their customers, and their communities. Passion is what enables a failed business owner to get back up, try again, and make it to the top! One business writer says that growing a successful business requires entrepreneurs to have great faith in themselves and their ideas, great doubt concerning the challenges and inevitable obstacles they will face as they build their businesses, and great effort—lots of hard work—to make their dreams become reality.¹²⁹

Conclusion—and a Look Ahead

As you can see, entrepreneurship lies at the heart of this nation’s free enterprise system; small companies truly are the backbone of our economy. Their contributions are as many and as diverse as the businesses themselves. Indeed, diversity is one of the strengths of the U.S. small business sector. Although there are no secrets to becoming a successful entrepreneur, there are steps that entrepreneurs can take to enhance the probability of their success. The remainder of this book will explore those steps and how to apply them to the process of launching a successful business with an emphasis on building a sound business plan.

- Section 2, *Launching a Venture: Entry Strategies* (Chapters 5–8), discusses the classic start-up questions every entrepreneur faces, particularly developing a strategy, choosing a form of ownership, alternative methods for becoming a business owner (franchising and buying an existing business), and building a business plan.
- Section 3, *Building a Marketing Plan*: (Chapters 9–13), focuses on creating an effective marketing plan for a small company. These chapters address developing advertising and promotional campaigns, establishing pricing and credit strategies, penetrating global markets, and creating an effective e-commerce strategy.
- Section 4, *Building a Business Plan: Financial Issues* (Chapters 14–17), explains how to develop the financial component of a business plan, including creating projected financial statements and forecasting cash flow. These chapters also offer existing business owners practical financial management tools and explain how entrepreneurs can find the financing, both debt (borrowed capital) and equity (invested capital) they need to launch their businesses.

- Section 5, Building an Operating Plan (Chapters 18–21), describes how entrepreneurs should select a location for their businesses and how to create a layout that enhances sales and employee productivity. This section also explains the practical aspects of supply chain management and inventory control. It concludes with a chapter on assembling a strong new venture team and leading its members to success.
- Section 6, Legal Aspects of Business Ownership: Succession and Government Regulation (Chapters 22 and 23), discusses the important topics of management succession and risk management and avoiding legal and regulatory pitfalls.

As you can see, the journey down the road of entrepreneurship will be an interesting and exciting one. Let's get started!

Chapter Review

1. Define the role of the entrepreneur in business.
 - Record numbers of people have launched companies over the past decade. The boom in entrepreneurship is not limited solely to the United States; many nations across the globe are seeing similar growth in the small business sector. A variety of competitive, economic, and demographic shifts have created a world in which "small is beautiful."
 - Society depends on entrepreneurs to provide the drive and risk taking necessary for the business system to supply people with the goods and services they need.
2. Describe the entrepreneurial profile.
 - Entrepreneurs have some common characteristics, including a desire for responsibility, a preference for moderate risk, confidence in their ability to succeed, desire for immediate feedback, a high energy level, a future orientation, skill at organizing, and a value of achievement over money. In a phrase, they are high achievers.
3. Describe the benefits of owning a small business.
 - Driven by these personal characteristics, entrepreneurs establish and manage small businesses to gain control over their lives, become self-fulfilled, reap unlimited profits, contribute to society, and do what they enjoy doing.
4. Describe the potential drawbacks of owning a small business.
 - Small business ownership has some potential drawbacks. There are no guarantees that the business will make a profit or even survive. The time and energy required to manage a new business may have dire effects on the owner and family members.
5. Explain the forces that are driving the growth in entrepreneurship.
 - Several factors are driving the boom in entrepreneurship, including entrepreneurs portrayed as heroes, better entrepreneurial education, economic and demographic factors, a shift to a service economy, technological advancements, more independent lifestyles, and increased international opportunities.
6. Discuss the role of diversity in small business and entrepreneurship.
 - Several groups are leading the nation's drive toward entrepreneurship—women, minorities, immigrants, "part-timers," home-based business owners, family business owners, copreneurs, corporate castoffs, corporate dropouts, and retired Baby Boomers.
7. Describe the contributions small businesses make to the U.S. economy.
 - The small business sector's contributions are many. They make up 99.7 percent of all businesses, employ 49.2 percent of the private sector workforce, create 65 percent of the new jobs in the economy, produce 46 percent of the country's private GDP, and account for 47 percent of business sales. Small companies also create 16.5 times more innovations per employee than large companies.
8. Explain the reasons small businesses fail.
 - The failure rate for small businesses is higher than for big businesses, and profits fluctuate with general economic conditions. SBA statistics show that 52 percent of new businesses will have failed within five years.
9. Put business failure into the proper perspective.
 - Because they are building businesses in an environment filled with uncertainty and shaped by rapid change, entrepreneurs recognize that failure is likely to be a part of their lives, yet they are not paralyzed by that fear. Successful entrepreneurs have the attitude that failures are simply stepping stones along the path to success.
10. Explain how small business owners can avoid the major pitfalls of running a business.
 - There are several general tactics the small business owner can employ to avoid failure. The entrepreneur should know the business in depth, develop a solid business plan, manage financial resources effectively, understand financial statements, learn to manage people effectively, set the business apart from the competition, and maintain a positive attitude.

Discussion Questions

- 1-1. What forces have led to the boom in entrepreneurship in the United States?
- 1-2. What is an entrepreneur? Give a brief description of the entrepreneurial profile.
- 1-3. *Inc.* magazine claims, "Entrepreneurship is more mundane than it's sometimes portrayed . . . you don't need to be a person of mythical proportions to be very, very successful in building a company." Do you agree? Explain.
- 1-4. What are the limitations of owning a small business enterprise?
- 1-5. What are the advantages of owning a small business enterprise?
- 1-6. Briefly describe the role of the following groups in entrepreneurship: women, minorities, immigrants, "part-timers," home-based business owners, family business owners, copreneurs, corporate castoffs, and corporate dropouts.
- 1-7. Discuss with examples the growth of small business enterprises in *Fortune 500* companies.
- 1-8. Explain how entrepreneurs spot business opportunities.
- 1-9. How can the small business owner avoid the common pitfalls that often lead to business failures?
- 1-10. What are the main reasons for the failure of small business enterprises?
- 1-11. Explain the typical entrepreneur's attitude toward failure.
- 1-12. One entrepreneur says that too many people "don't see that by spending their lives afraid of failure, they *become* failures. But when you go out there and risk as I have, you'll have failures along the way, but eventually the result is great success if you are willing to keep risking. . . . For every big 'yes' in life, there will be 199 'nos.'" Do you agree? Explain.
- 1-13. What advice would you offer an entrepreneurial friend who has just suffered a business failure?
- 1-14. Noting the growing trend among collegiate entrepreneurs launching businesses while still in school, one educator says, "A student whose main activity on campus is running a business is missing the basic reason for being here, which is to get an education." Do you agree? Explain.

CHAPTER 2

Ethics and Social Responsibility: Doing the Right Thing



Learning Objectives

On completion of this chapter, you will be able to:

1. Define business ethics and describe three levels of ethical standards.
2. Determine who is responsible for ethical behavior and why ethical lapses occur.
3. Explain how to establish and maintain high ethical standards.
4. Explain the difference between social entrepreneurs and traditional entrepreneurs.
5. Define social responsibility.
6. Understand the nature of business's responsibility to the environment.
7. Describe business's responsibility to employees.
8. Explain business's responsibility to customers.
9. Discuss business's responsibility to investors.
10. Discuss business's responsibility to the community.

A man does what he must . . . in spite of personal consequences, in spite of obstacles and dangers, and pressures . . . and that is the basis of all human morality.

—John F. Kennedy

If ethics are poor at the top, that behavior is copied down through the organization

—Robert Noyce,
Inventor of the Silicon Chip

Business ethics involves the moral values and behavioral standards that businesspeople draw on as they make decisions and solve problems. It originates in a commitment to do what is right. Ethical behavior—doing what is “right” as opposed to what is “wrong”—starts with the entrepreneur. The entrepreneur’s personal values shape the business from day one. Entrepreneurs’ personal values and beliefs influence the way they lead their companies and are apparent in every decision they make, every policy they write, and every action they take. The entrepreneurs’ values set the tone for the culture that will guide the ethical actions of every employee they bring into their businesses. Entrepreneurs who succeed in the long term have a solid base of personal values and beliefs that they articulate to their employees, put into practice in ways that others can observe, and are carried out through the culture of the organization. Values-based leaders do more than merely follow rules and regulations; their consciences dictate that they do what is right.

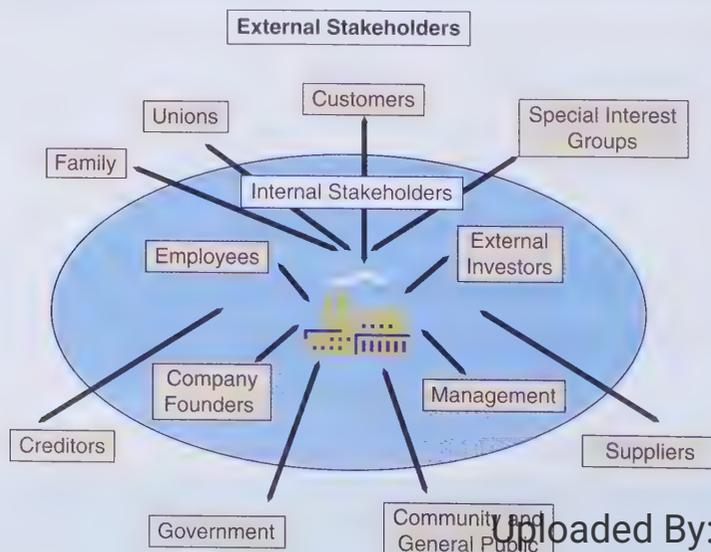
For many entrepreneurs, the ability to determine the values and ethics that shape how business will be conducted is a major motivation to launching a venture. For example, when Bob Wahlstedt and his partners left successful corporate careers to found Reell Precision Manufacturing (RPM), a major driving force in their decision was to be able to found a company that values workers and customers over short-term profits and allows employees to put their families ahead of their jobs. “If there’s a conflict between the job and the family, *we expect the employee to resolve the matter in favor of the family*, says Wahlstedt.”¹ To bring these values to life, RPM does not require employees to travel on weekends to ensure that they can be home with their families and has implemented a generous sick leave policy that allows the use of sick time for any purpose, even attending a child’s ball game!

The values and morals that entrepreneurs draw on to guide their ethical behaviors can come from a variety of sources, including their family upbringing, their faith traditions, mentors who have shaped their lives, and the communities they grew up in. Bringing their personal values into their decision making and actions in their businesses ensures that entrepreneurs will act with integrity. Acting with integrity means that entrepreneurs do what is right no matter what the circumstances.

In some cases, ethical dilemmas are apparent. Entrepreneurs must be keenly aware of the ethical entrapments awaiting them and know that society will hold them accountable for their actions. More often, however, ethical issues are less obvious, cloaked in the garb of mundane decisions and everyday routine. Because they can easily catch entrepreneurs off guard and unprepared, these ethical “sleepers” are most likely to ensnare business owners, soiling their reputations and those of their companies. To make proper ethical choices, entrepreneurs must first be aware that a situation with ethical implications exists.

Complicating the issue even more is that, in some ethical dilemmas, no clear-cut, right or wrong answers exist. There is no direct conflict between good and evil, right and wrong, or truth and falsehood. Instead, there is only the issue of conflicting interests among a company’s **stakeholders**, the various groups and individuals who affect and are affected by a business. These conflicts force entrepreneurs to identify their stakeholders and to consider the ways in which entrepreneurs will deal with them (see Figure 2.1). For instance, when the founders of a local

FIGURE 2.1
Key Stakeholders



coffee shop make business decisions, they must consider the impact of those decisions on many stakeholders, including the team of employees who work there, the farmers and companies that supply the business with raw materials, the union that represents employees in collective bargaining, the government agencies that regulate a multitude of activities, the banks that provide the business with financing, the founding partners and other external investors who helped fund the start-up, the general public the business serves, the community in which the company operates, the customers who buy the company's products, and their families. When making decisions, entrepreneurs often must balance the needs and demands of a company's stakeholders, knowing that whatever the final decision is, not all groups will be satisfied.

Ethical leaders approach their organizational responsibilities with added dimensions of thought and action. They link ethical behaviors to organizational outcomes and incorporate social responsibility into daily decisions. They establish ethical behavior and concern for the environment as an integral part of organizational training and eventually as part of company culture. What does this mean from a practical standpoint? How does a commitment to “doing the right thing” apply to employees, customers, and other stakeholders, and how does it affect an entrepreneur's daily decision making? For example, Facebook has been facing an ethical dilemma as it has attempted to find a way to gain access to the Chinese market. Facebook and other social networking services such as Twitter have been banned by China's Ministry of Industry and Information Technology. Facebook has been pursuing a partnership with Baidu, which is the leading Chinese-language search engine. To enter the Chinese market, Facebook would have to comply with the restrictive Internet censorship protocol strictly enforced by the Chinese government. The Chinese government also uses the Internet as a surveillance tool to monitor its citizens for political dissent. If Facebook enters into this partnership, it faces the high cost associated with complying with the Chinese Internet restrictions and controls, and it faces an even greater risk of damaging its reputation with its current users and the general public by agreeing to comply with restrictions that allow for censorship and violations of the privacy of its users. On the other hand, from a shareholder perspective, entering the Chinese market is an attractive business opportunity that would potentially add hundreds of millions of new users to Facebook.² Balancing the demands of various stakeholders to make ethical decisions is no easy task.

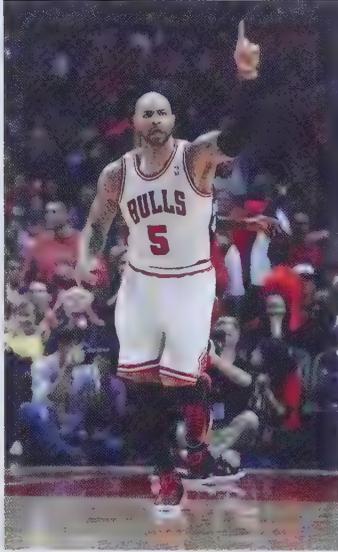
Business operates as an institution in our often complex and ever-evolving society. As such, every entrepreneur is expected to behave in ways that are compatible with the values system of society. It is society that imposes the rules of conduct for all business owners in the form of ethical standards of behavior and responsibilities to act in ways that benefit the long-term interest of all. Society expects business owners to strive to earn a profit on their investment. Ethics and social responsibility simply set behavioral boundaries for decision makers. **Ethics** is a branch of philosophy that studies and creates theories about the basic nature of right and wrong, duty, obligation, and virtue. **Social responsibility** involves how an organization responds to the needs of the many elements in society, including shareholders, lenders, employees, consumers, governmental agencies, and the environment. Because business is allowed to operate in society, it has an obligation to behave in ways that benefit all of society.

An Ethical Perspective

Business ethics consist of the fundamental moral values and behavioral standards that form the foundation for the people of an organization as they make decisions and interact with stakeholders. Business ethics is a sensitive and highly complex issue, but it is not a new one. In 560 BC, the Greek philosopher Chilon claimed that a merchant does better to take a loss than to make a dishonest profit.³ Maintaining an ethical perspective is essential to creating and protecting a company's reputation, but it is no easy task. Ethical dilemmas lurk in the decisions—even the most mundane ones—that entrepreneurs make every day. Succumbing to unethical temptations ultimately can destroy a company's reputation, one of the most precious and most fragile possessions of any business.

Building a reputation for ethical behavior typically takes a long time; unfortunately, destroying that reputation requires practically no time at all, and the effects linger for some time. One top manager compares a bad reputation to a hangover. “It takes a while to get rid of, and it makes

1. Define business ethics and describe three levels of ethical standards.



Carlos Boozer.

Source: © epa european pressphoto agency b.v./Alamy.



ENTREPRENEURIAL PROFILE: Claudio Osorio: InnoVida Holdings Claudio Osorio had been a well-respected entrepreneur, once being designated as “Entrepreneur of the Year” by the tax and consulting firm Ernst & Young. Osorio was the president and owner of the Miami-based company InnoVida Holdings, which manufactured fiber composite panels that could be used to build homes and other buildings without cement, steel, or wood. The company had many prominent people on its board, including former Florida governor Jeb Bush and General Wesley Clark. One of his investors was Chicago Bulls basketball star Carlos Boozer. In an indictment by the U.S. Attorney’s Office, prosecutors said that Osorio defrauded investors from 2007 to 2010, exaggerating the company’s finances and pocketing millions of dollars to fund a lavish lifestyle that included a Miami Beach mansion, a Maserati car, and a Colorado mountain retreat home.⁵

Three Levels of Ethical Standards

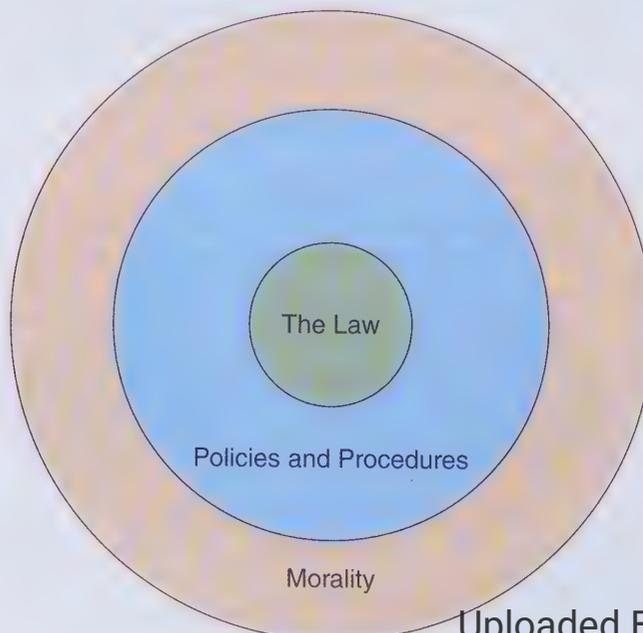
As displayed in Figure 2.2, there are three levels of ethical standards:

1. *The law*, which defines for society as a whole those actions that are permissible and those that are not. The law is the narrowest level of ethical standards. The law merely establishes the minimum standard of behavior. Actions that are legal, however, may not be ethical. Simply obeying the law is insufficient as a guide for ethical behavior; ethical behavior requires more. Few ethical issues are so simple and one dimensional that the law can serve as the acid test for making a decision.
2. *Organizational policies and procedures*, which serve as specific guidelines for people as they make daily decisions. Policies and procedures include a broader definition of ethical standards that go beyond what is defined by the law. Many colleges and universities have created honor codes, and companies rely on policies covering everything from sexual harassment and gift giving to hiring and whistle-blowing.
3. *The moral stance* that employees take when they encounter a situation that is not governed by levels 1 and 2. It is the broadest and most fundamental definition of ethical standards. The values people learn early in life at home, from their religious upbringing, in the communities they were raised in, in school, and at work are key ingredients at this level. Morality is what shapes a person’s character. A strong determinant of moral behavior is *training*. As Aristotle said thousands of years ago, you get a good adult by teaching a child to do the right thing. A company’s culture can serve either to support or undermine its employees’ concept of what constitutes ethical behavior.

Ethics is something that every business person faces daily; most decisions involve some degree of ethical judgment. Over the course of a career, entrepreneurs can be confident that they will face some tough ethical choices. But that is not necessarily bad! Situations such as these give

FIGURE 2.2

Levels of Ethical Standards



entrepreneurs the opportunity to flex their ethical muscles and do what is right. Entrepreneurs set the ethical tone for their companies. The ethical stance employees take when faced with difficult decisions often reflects the values that entrepreneurs have used to intentionally shape the culture within their businesses.

Immoral, Amoral, and Moral Management

Although companies may set ethical standards and offer guidelines for employees, the ultimate decision on whether to abide by ethical principles rests with the *individual*. In other words, companies really are not ethical or unethical; individuals are. Managers, however, can greatly influence individual behavior within the company. That influence must start at the *top* of the organization. The entrepreneur who practices ethical behavior establishes the moral tone for the entire organization. Table 2.1 summarizes the characteristics of the three ethical styles of management: immoral, amoral, and moral management.

IMMORAL MANAGEMENT Immoral managers are motivated by selfish reasons such as their own gains or those of the company. The driving force behind immoral management is *greed*: achieving personal or organizational success at any cost. Immoral management is the polar opposite of ethical management; immoral managers do what they can to circumvent laws and moral standards and are not concerned about the impact that their actions have on others.

AMORAL MANAGEMENT The principal goal of amoral managers is to earn a profit, but their actions differ from those of immoral managers in one key way: They do not purposely violate laws or ethical standards. Instead, amoral managers neglect to consider the impact their decisions have on others; they use free-rein decision making without reference to ethical standards. Amoral management is not an option for socially responsible businesses.

MORAL MANAGEMENT Moral managers also strive for success but only within the boundaries of legal and ethical standards. Moral managers are not willing to sacrifice their values and violate ethical standards just to make a profit. Managers who operate with this philosophy see the law as a minimum standard for ethical behavior.

TABLE 2.1 Approaches to Business Ethics

Organizational Characteristics	Immoral Management	Amoral Management	Moral Management
Ethical norms	Management decisions, actions, and behavior imply a positive and active opposition to what is moral (ethical). Decisions are discordant with accepted ethical principles. An active negation of what is moral is implicit.	Management is neither moral nor immoral; decisions are not based on moral judgments. Management activity is not related to any moral code. A lack of ethical perception and moral awareness may be implicit.	Management activity conforms to a standard of ethical, or right, behavior. Management activity conforms to accepted professional standards of conduct. Ethical leadership is commonplace.
Motives	Selfish. Management cares only about its or its company's gains.	Well-intentioned but selfish in the sense that impact on others is not considered.	Good. Management wants to succeed but only within the confines of sound ethical precepts such as fairness, justice, and due process.
Goals	Profitability and organizational success at any price.	Profitability. Other goals are not considered.	Profitability within the confines of legal obedience and ethical standards.
Orientation toward law	Legal standards are barriers that management must overcome to accomplish what it wants.	Law is the ethical guide, preferably the letter of the law. The central question is, what can we do legally?	Obedience toward letter and spirit of the law. Law is a minimal ethical behavior. Prefer to operate well above what law mandates.
Strategy	Exploit opportunities for corporate gain. Cut corners when it appears useful.	Give managers free rein. Personal ethics may apply but only if managers choose. Respond to legal mandates if caught and required to do so.	Live by sound ethical standards. Assume leadership position when ethical dilemmas arise. Enlightened self-interest.

The Benefits of Moral Management

One of the most common misconceptions about business is that there is a contradiction between earning a profit and maintaining high ethical standards. In reality, companies have learned that these two goals are consistent with one another. Tom Chappell, founder of Tom's of Maine and Rambler's Way Farm, companies known almost as well for their ethical and socially responsible behavior as for their natural personal care products and environmentally friendly clothing, says, "You can make money and do good at the same time. They are not separate acts."⁶ Many entrepreneurs launch businesses with the idea of making a difference in society. They quickly learn that to "do good," their companies must first "do well." Bridget Hilton, founder of Jack's Soap, a for-profit company that addresses the problem of child mortality due to hygiene by donating one bar of soap to a child in need for every bar of soap sold, says, "Cynics believe there's no way to do good while reaping financial rewards. We beg to differ."⁷

According to a survey by the public relations firm Edelman, 83 percent of U.S. consumers say that transparent and honest practices and operating as a business that one can trust are the most important factors in a company's reputation.⁸ The Edelman survey also reports that people in the United States (and globally) trust small businesses more than big businesses.⁹



Tal Dehtiar, founder of Oliberté.

Source: Keith Beaty/Newscom.



ENTREPRENEURIAL PROFILE: Tal Dehtiar: Oliberté Tal Dehtiar, founder of the for-profit company Oliberté, is helping to develop a middle class in Africa by creating fair-wage, sustainable jobs in Ethiopia, Liberia, and Kenya. The company hires women to manufacture shoes made of eco-friendly materials using ethical business practices to help build the local economy and strengthen the skills of its workforce. Due to the success of his business model, Dehtiar has plans to expand Oliberté manufacturing to Cameroon, Congo, Uganda, and Zambia. "At the end of the day, when you strip everything away, we're a shoe company," says Dehtiar. "We make shoes, and we want people to buy them. The more they buy, the more money we make. That being said, though, we do it fairly and properly. . . . In my opinion, that shouldn't be a social business. It should be every business."¹⁰

Although behaving ethically has value in itself, there are many other benefits to companies that adhere to high ethical standards. First, companies avoid the damaging fallout from unethical behavior on their reputations. Unethical businesses usually gain only short-term advantages; over the long run, unethical decisions don't pay. It's simply not good business.

Second, a solid ethical framework guides managers as they cope with an increasingly complex network of influence from external stakeholders. Dealing with stakeholders is much easier if a company has a solid ethical foundation on which to build.

Third, businesses with solid reputations as ethical companies find it easier to attract and retain quality workers. Explaining why she came to work for shoemaker Timberland, Helen Kellogg, a senior manager, says, "I was looking for a company that had a conscience." Timberland gives every employee 40 hours of paid leave every year to work on volunteer projects. Bonnie Monahan, a Timberland vice president who organized a bike-a-thon that raised \$50,000 for a local charity, says that she has turned down "several lucrative job offers" from larger companies to stay with Timberland, where "you don't have to leave your values at the door." Every year, Timberland sponsors Serv-a-palooza, a one-day blitz of community service that involves 170 projects in 27 countries.¹¹

Fourth, ethical behavior has a positive impact on a company's bottom line. Research by Dov Seidman, a management consultant, shows that companies that outperform their competitors ethically also outperform them financially.¹² However, financial rewards should never become the motivating force behind acting ethically. Entrepreneurs must strive to do the right thing simply because it is the right thing to do!

Finally, a company's ethical philosophy has an impact on its ability to provide value for its customers. The "ethics factor" is difficult to quantify, yet it is something that customers consider when deciding where to shop and which company's products to buy. "Do I want people buying Timberland boots as a result of the firm's volunteer efforts?" asks CEO Jeffrey Swartz. "You bet."¹³ Timberland's commitment to "doing good" in addition to "doing well" is expressed in its slogan, "Boots, Brand, Belief." Like other social entrepreneurs, Swartz's goal is to manage the company successfully so that he can use its resources to combat social problems.

Entrepreneurs must recognize that ethical behavior is an investment in the company's future rather than merely a cost of doing business. Table 2.2 shows the results of a comprehensive study

TABLE 2.2 Reasons to Run a Business Ethically and the Factors that Drive Business Ethics**Top Five Reasons to Run a Business Ethically**

1. Protect brand and company reputation
2. It is the right thing to do
3. Maintain customers' trust and loyalty
4. Maintain investors' confidence
5. Earn public acceptance and recognition

Top Five Factors that Drive Business Ethics

1. Corporate scandals
2. Marketplace competition
3. Demands by investors
4. Pressure from customers
5. Globalization

Source: Adapted from *The Ethical Enterprise: A Global Study of Business Ethics 2005–2015* (American Management Association/Human Resource Institute, New York City: 2006), p. 2.

that was conducted by the American Management Association of global human resources directors who were asked about the reasons for their companies' engaging in ethical behavior and the factors that drive business ethics today.

Establishing an Ethical Framework

To cope successfully with the many ethical decisions they face, entrepreneurs must develop a workable ethical framework to guide themselves and the organization. Although many frameworks exist, the following five-step process works quite well:

Step 1. Identify the personal moral and ethical principles that shape all business

decisions. Entrepreneurs build the foundation for making ethical decisions by understanding how their personal values come to life in business situations. This starts with an inventory of the important principles that define one's personal values. The entrepreneur then determines how each of these principles affects each of the major stakeholders of the business. Many entrepreneurs integrate this proactive approach to ethical decision making into their business plans to ensure the integrity of their business actions as they launch and grow their business ventures.

Step 2. Recognize the ethical dimensions involved in the dilemma or decision.

Before entrepreneurs can make informed ethical decisions, they must recognize that an ethical situation exists. Only then is it possible to define the specific ethical issues involved. Too often, business owners fail to take into account the ethical impact of a particular course of action until it is too late. To avoid ethical quagmires, entrepreneurs must consider the ethical forces at work in a situation—honesty, fairness, respect for the community, concern for the environment, trust, and others—to have a complete view of the decision.

Step 3. Identify the key stakeholders involved and determine how the decision will affect

them. Every business influences and is influenced by a multitude of stakeholders. Frequently, the demands of these stakeholders conflict with one another, putting a business in the position of having to choose which groups to satisfy and which to alienate. Before making a decision, managers must sort out the conflicting interests of the various stakeholders by determining which ones have important stakes in the situation. Although this analysis may not resolve the conflict, it will prevent the company from inadvertently causing harm to people it may have failed to consider. More companies are measuring their performance using a **triple bottom line (or 3BL)** that, in addition to the traditional measure of profitability, includes the commitment to ethics and social responsibility and the impact on the environment (“profit, people, and planet”).



ENTREPRENEURIAL PROFILE: Corbin Clay: Azure Furniture Corbin Clay founded Azure Furniture in Denver, Colorado, in 2009 to address two problems. The first problem was a dramatic decline in American-manufactured furniture over the past decades. The second problem was the loss of 4 million acres of pine trees in the Rocky Mountains to bark beetle infestation. Although the bark beetles kill the trees they infest, they do not harm the wood logs from these trees. Azure Furniture works with local sawmills, the Department of Forestry at Colorado State University, and the U.S. Department of Forestry to harvest this wood and use it to make hand-crafted, solid wood furniture. The process is both an efficient use of materials and an environmentally sound way to address the problem created by the bark beetle.¹⁴

- Step 4. Generate alternative choices and distinguish between ethical and unethical responses.** When entrepreneurs are generating alternative courses of action and evaluating the consequences of each one, they must consider the stakeholders who will be affected and what society considers to be “right” to ensure that everyone involved is aware of the ethical dimensions of the issue.
- Step 5. Choose the “best” ethical response and implement it.** At this point, there likely will be several ethical choices from which managers can pick. Comparing these choices with the “ideal” ethical outcome may help managers make the final decision. The final choice must be consistent with the company’s goals, culture, and value system as well as those of the individual decision makers.

Why Ethical Lapses Occur

Although most small business owners run their companies ethically, business scandals involving Enron, WorldCom, Tyco, and other high-profile companies have sullied the reputations of businesses of all sizes. The best way for business owners to combat these negative public perceptions is to run their business ethically. When faced with an ethical dilemma, however, not every entrepreneur or employee will make the right decision. According to KPMG’s Integrity Survey, 73 percent of workers say that they have observed ethical lapses in their companies within the last year. (Fifty-six percent of employees say that misconduct they observed would cause “a significant loss of public trust if discovered.”¹⁵) Many unethical acts are committed by normally decent people who believe in moral values. Figure 2.3 shows the results of an integrity survey that identifies the primary causes of misconduct in businesses.

Let’s explore some of these causes of ethical lapses in more detail.

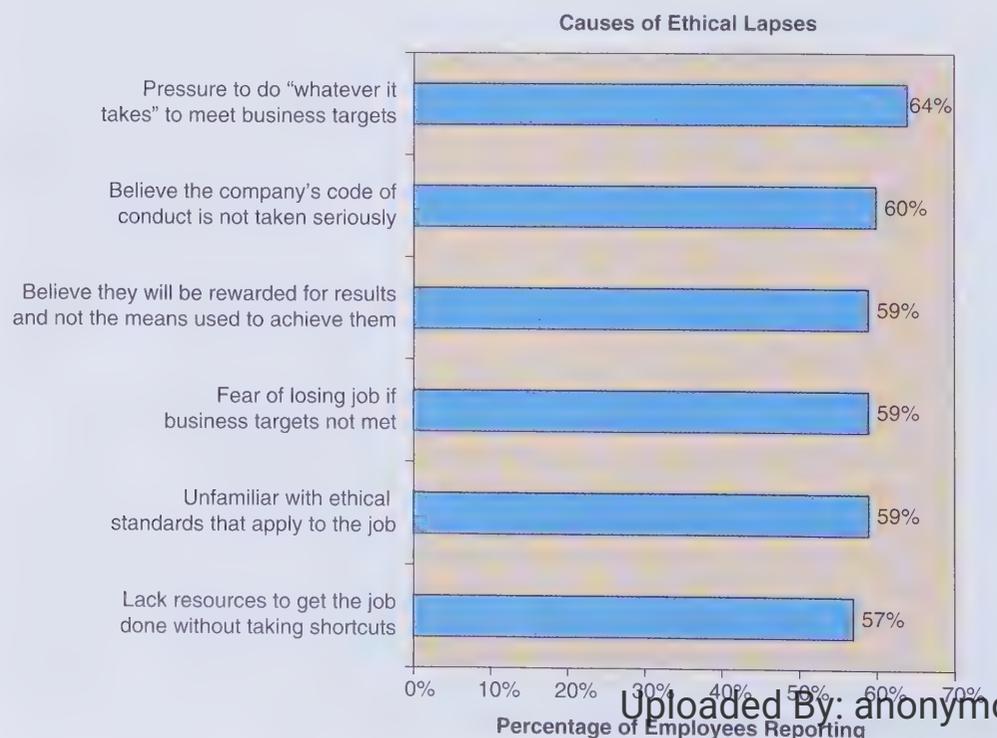
2.

Determine who is responsible for ethical behavior and why ethical lapses occur.

FIGURE 2.3

Causes of Ethical Lapses

Source: Based on 2013 KPMG Integrity Survey, KPMG LLC, p. 12.



An Unethical Employee

Ethical decisions are individual decisions, and some people are corrupt. Try as they might to avoid them, small businesses occasionally find that they have hired a “bad apple.” Eliminating unethical behavior requires eliminating these bad apples.

An Unethical Organizational Culture

In some cases, a company’s culture has been poisoned with an unethical overtone; in other words, the problem is not the “bad apple” but the “bad barrel.” Pressure to prosper produces an environment that creates conditions that reward unethical behavior, and employees act accordingly. Studies show that companies with strong ethical cultures experience fewer ethical violations than those with weak ethical cultures.¹⁶ In fact, an ethical culture positively influences the behaviors of employees *independently* of the degree to which there is a match between employee and organizational values.¹⁷

Moral Blindness

Sometimes, fundamentally ethical people commit unethical blunders because they are blind to the implications of their conduct. Moral blindness may be the result of failing to realize that an ethical dilemma exists, or it may arise from a variety of mental defense mechanisms. One of the most common mechanisms is rationalization:

“Everybody does it.”

“If they were in my place, they’d do it too.”

“Being ethical is a luxury I cannot afford right now.”

“The impact of my decision/action on (whomever or whatever) is not my concern.”

“I don’t get paid to be ethical; I get paid to produce results.”

Conducting ethics training and creating a culture that encourages employees to consider the ethical impact of their decisions reduces the likelihood of moral blindness. Instilling a sense of individual responsibility and encouraging people at all levels of an organization to speak up when they see questionable actions create a company-wide ethical conscience. However, employees are not the only ones who need guidance when facing ethical decisions. Entrepreneurs themselves should also seek advice and counsel when it comes to ethics. One reason entrepreneurs should establish advisory boards is to serve as a sounding board to help ensure that they understand the moral and ethical dimensions of major decisions.

Competitive Pressures

If competition is so intense that a company’s survival is threatened, managers may begin to view what were once unacceptable options as acceptable. Managers and employees are under such pressure to produce that they may sacrifice their ethical standards to reduce the fear of failure or the fear of losing their jobs. Without a positive organizational culture that stresses ethical behavior regardless of the consequences, employees respond to feelings of pressure and compromise their personal ethical standards to ensure that the job gets done.

Opportunity Pressures

When the opportunity to “get ahead” by taking some unethical action presents itself, some people cannot resist the temptation. The greater the reward or the smaller the penalty for unethical acts, the greater is the probability that such behavior will occur. If managers, for example, condone or even encourage unethical behavior, they can be sure it will occur. Those who succumb to opportunity pressures often make one of two mistakes: They overestimate the cost of doing the right thing, or they underestimate the cost of doing the wrong thing. Either error can lead to disaster.

Globalization of Business

The globalization of business has intertwined what once were distinct cultures. This cultural cross-pollination has brought about many positive aspects, but it has created problems as well. Copyright 2015 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-203 However, what there is no single standard of ethical behavior applying to all business decisions in the international arena. Practices that are illegal in one country may be

TABLE 2.3 Ethics Research Reveals Features of Ethical Cultures

1. Leaders support and model ethical behavior.
2. Consistent communications come from all company leaders.
3. Ethics is integrated into the organization's goals, business processes, and strategies.
4. Ethics is part of the performance management system.
5. Ethics is part of the company's selection criteria and its selection process.

Source: Adapted from *The Ethical Enterprise: A Global Study of Business Ethics 2005–2015* (American Management Association/Human Resource Institute, New York City: 2006), pp. 5, 6, 10.

perfectly acceptable, even expected, in another. Actions that would send a businessperson to jail in Western nations are common ways of working around the system in others.

Table 2.3 provides a summary of important ethics research concerning the characteristics that are most important to establishing an ethical culture.

Establishing and Maintaining Ethical Standards

Establishing Ethical Standards

A study by the Southern Institute for Business and Professional Ethics found that small companies are less likely than large ones to have ethics programs.¹⁸ Although they may not have formal ethics programs, entrepreneurs can encourage employees to become familiar with the following ethical tests for judging behavior:

- The utilitarian principle. Choose the option that offers the greatest good for the greatest number of people.
- Kant's categorical imperative. Act in such a way that the action taken under the circumstances could be a universal law or rule of behavior.
- The professional ethic. Take only those actions that a disinterested panel of professional colleagues would view as proper.
- The Golden Rule. Treat other people the way you would like them to treat you.
- The television test. Would you and your colleagues feel comfortable explaining your actions to a national television audience?
- The family test. Would you be comfortable explaining to your children, your spouse, and your parents why you took this action?¹⁹

Although these tests do not offer universal solutions to ethical dilemmas, they do help employees identify the moral implications of the decisions they face. People must be able to understand the ethical impact of their actions before they can make responsible decisions. Table 2.4 describes ten ethical principles that differentiate between right and wrong, thereby offering a guideline for ethical behavior.

Maintaining Ethical Standards

Establishing ethical standards is only the first step in an ethics-enhancing program; implementing and maintaining those standards is the real challenge facing management. What can entrepreneurs do to integrate ethical principles into their companies? To create an environment that encourages ethical behavior, entrepreneurs must make building an intentional culture that is based on a strong ethical foundation a core responsibility as leaders of their businesses.

SET THE TONE “The character of the leader casts a long shadow over the organization and can determine the character of the organization itself,” says one business executive.²⁰ Entrepreneurs must remember that ethics starts at the top and set an impeccable ethical example at all times. If entrepreneurs and their managers talk about the importance of ethics and then act in an unethical manner, they send mixed signals to employees. Workers believe the *actions* of those in charge more than their words. What you do, how you do it, and what you say set the tone for your employees. The values you profess must be aligned with the behaviors you demonstrate.

3.

Explain how to establish and maintain high ethical standards.

TABLE 2.4 Ten Ethical Principles to Guide Behavior

The study of history, philosophy, and religion reveals a strong consensus about certain universal and timeless values that are central to leading an ethical life.

1. **Honesty.** Be truthful, sincere, forthright, straightforward, frank, and candid; do not cheat, lie, steal, deceive, or act deviously.
2. **Integrity.** Be principled, honorable, upright, and courageous and act on convictions; do not be two-faced or unscrupulous or adopt an ends-justifies-the-means philosophy that ignores principle.
3. **Promise-keeping.** Be worthy of trust, keep promises, fulfill commitments, and abide by the spirit as well as the letter of an agreement; do not interpret agreements in a technical or legalistic manner to rationalize noncompliance or to create excuses for breaking commitments.
4. **Fidelity.** Be faithful and loyal to family, friends, employers, and country; do not use or disclose information earned in confidence; in a professional context, safeguard the ability to make independent professional judgments by scrupulously avoiding undue influences and conflicts of interest.
5. **Fairness.** Be fair and open-minded, be willing to admit error, and, when appropriate, change positions and beliefs and demonstrate a commitment to justice, the equal treatment of individuals, and tolerance for diversity; do not overreach or take undue advantage of another's mistakes or adversities.
6. **Caring for others.** Be caring, kind, and compassionate; share, be giving, and serve others; help those in need and avoid harming others.
7. **Respect for others.** Demonstrate respect for human dignity, privacy, and the right to self-determination for all people; be courteous, prompt, and decent; provide others with the information they need to make informed decisions about their own lives; do not patronize, embarrass, or demean.
8. **Responsible citizenship.** Obey just laws [if a law is unjust, openly protest it]; exercise all democratic rights and privileges responsibly by participation [voting and expressing informed views], social consciousness, and public service; when in a position of leadership or authority, openly respect and honor democratic processes of decision making, avoid secrecy or concealment of information, and ensure others have the information needed to make intelligent choices and exercise their rights.
9. **Pursuit of excellence.** Pursue excellence in all matters; in meeting personal and professional responsibilities, be diligent, reliable, industrious, and committed; perform all tasks to the best of your ability, develop and maintain a high degree of competence, and be well informed and well prepared; do not be content with mediocrity, but do not seek to win "at any cost."
10. **Accountability.** Be accountable; accept responsibility for decisions, for the foreseeable consequences of actions and inactions, and for setting an example for others. Parents, teachers, employers, many professionals, and public officials have a special obligation to lead by example and to safeguard and advance the integrity and reputation of their families, companies, professions, and the government; avoid even the appearance of impropriety and take whatever actions are necessary to correct or prevent inappropriate conduct by others.

Source: Michael Josephson, "Teaching Ethical Decision Making and Principled Reasoning," *Ethics: Easier Said Than Done*, Winter 1988, pp. 28–29, www.JosephsonInstitute.org.

CREATE A COMPANY CREDO A **company credo** defines the values underlying the entire company and its ethical responsibilities to its stakeholders. It offers general guidance in ethical issues. The most effective credos capture the elusive essence of a company—what it stands for and why it's important—and they can be a key ingredient in a company's competitive edge. A company credo is especially important for a small company, where the entrepreneur's values become the values driving the business. A credo is an excellent way to transform those values into guidelines for employees' ethical behavior.

ESTABLISH HIGH STANDARDS OF BEHAVIOR It is essential to emphasize to *everyone* in the organization the importance of ethics. All employees must understand that ethics is *not* negotiable. The role that an entrepreneur plays in establishing high ethical standards is critical; no one has more influence over the ethical character of a company than its founder. One experienced entrepreneur offers this advice to business owners: "Stick to your principles. Hire people who want to live by them, teach them thoroughly, and insist on total commitment."²¹

INVOLVE EMPLOYEES IN ESTABLISHING ETHICAL STANDARDS Encourage employees to offer feedback on how to establish standards. Involving employees improves the quality of a company's ethical standards and increases the likelihood of employee compliance.

CREATE A CULTURE THAT EMPHASIZES TWO-WAY COMMUNICATION A thriving ethical environment requires two-way communication. Employees must have the opportunity to report any ethical violations they observe. A reliable, confidential reporting system is essential to a whistle-blowing program, in which employees anonymously report breaches of ethical behavior through proper channels. Eliminate “undiscussables.” One of the most important things entrepreneurs can do to promote ethical behavior is to instill the belief that it is acceptable for employees to question what happens above them. Doing away with undiscussables makes issues transparent and promotes trust both inside and outside the company.²²

DEVELOP A CODE OF ETHICS A code of ethics is a written statement of the standards of behavior and ethical principles a company expects from its employees. A code of ethics spells out what kind of behavior is expected (and what kind will not be tolerated) and offers everyone in the company concrete guidelines for dealing with ethics every day on the job. Although creating a code of ethics does not guarantee 100 percent compliance with ethical standards, it does tend to foster an ethical atmosphere in a company. Workers who will be directly affected by the code should have a hand in developing it.

ENFORCE THE CODE OF ETHICS THROUGH POLICIES Set appropriate policies for your organization. Communicate them on a regular basis and adhere to them yourself so that others can see. Show zero tolerance for ethical violations and realize that the adage “Don’t do as I do; do as I say” does *not* work. Without a demonstration of real consequences and personal accountability from the CEO, organizational policies are meaningless. Managers must take action whenever they discover ethical violations. If employees learn that ethical breaches go unpunished, the code of ethics becomes meaningless. Enforcement of the code of ethics demonstrates to everyone that you believe that ethical behavior is mandatory.

RECRUIT AND PROMOTE ETHICAL EMPLOYEES Ultimately, the decision in any ethical situation belongs to the individual. Hiring people with strong moral principles and values is the best insurance against ethical violations. To make ethical decisions, people must have (1) *ethical commitment*—the personal resolve to act ethically and do the right thing; (2) *ethical consciousness*—the ability to perceive the ethical implications of a situation; and (3) *ethical competency*—the ability to engage in sound moral reasoning and develop practical problem-solving strategies.²³ Find colleges and universities that incorporate business ethics into courses and make them prime recruiting sources. Tina Byles Williams, owner of FIS Group, an investment advising and management firm, understands how important it is to hire honest employees with a strong sense of ethics. Although Williams knows that there is no foolproof hiring method, she has redesigned her company’s selection process with an emphasis on screening for integrity.²⁴

CONDUCT ETHICS TRAINING Instilling ethics in an organization’s culture requires more than creating a code of ethics and enforcing it. Managers must show employees that the organization truly is committed to practicing ethical behavior. One of the most effective ways to display that commitment is through ethical training designed to raise employees’ consciousness of potential ethical dilemmas. Ethics training programs not only raise employees’ awareness of ethical issues but also communicate to employees the core of the company’s value system. Rob Kaplan, professor of management practice at Harvard University, recommends that employees be trained to follow a simple yet powerful three-step process when facing an ethical situation:

1. Slow down.
2. Seek advice and elevate the issue.
3. Don’t get bullied into making a quick decision that you might later regret.²⁵

REWARD ETHICAL CONDUCT The reward system is a large window into the values of an organization. If you reward a behavior, people have a tendency to repeat the behavior.

SEPARATE RELATED JOB DUTIES This is a basic organizational concept. Not allowing the employee who writes checks to reconcile the company bank statement is one example.

PERFORM PERIODIC ETHICAL AUDITS One of the best ways to evaluate the effectiveness of an ethics system is to perform periodic audits. These reviews send a signal to employees that ethics is not just a passing fad.



Entrepreneurship in Action

Don't Just Do It, Do It Right.

Nike, Inc. is an American multinational corporation and the world's leading innovator in athletic footwear, apparel, equipment, and accessories as well as sports-inspired casual products. It is the owner of seven brands—Nike, Cole Haan, Converse, Hurley International LLC, Umbro, Nike Golf and Jordan—each very famous and popular. The annual revenue of the corporation is \$20.9 billion. Its logo “Swoosh” is a symbol for its “Just Do It” spirit, and represents the wings of the eponymous ancient Greek deity, also known as the Winged Goddess of Victory.

But not too long ago, Nike was in the eye of a storm and was being shamed in public for its allegedly unethical labor practices. This gave a bad reputation to the corporation and started having a negative impact on its sales.

Nike has never made shoes in the U.S. Its operating strategy has been outsourcing all manufacturing to contractors in low-wage countries and pouring the company's resources into high-profile marketing, which includes involving sporting celebrities for their campaigns. Over the years, Nike has enlisted superstars like Michael Jordan and Tiger Woods to endorse its products.

Nike started operations in 1964. It contracted manufacturers in Japan, when wages there were low. When the wages rose in Japan, Nike transferred its operations to South Korea and Taiwan. After rise in wages and labor unrest in these two countries started affecting the business, the operations were moved to South Asian nations.

Its business is characterized by making its goods in developing countries, having very cheap labor, authoritarian governments, and a lack of human rights appeal or union movements. As a result, Nike has enjoyed greater margins on operation costs. So its success story is attached to tears of exploited workers and child labor.

As a strategy, Nike does not launch its production in a developing country. Instead, it subcontracts it to a local firm. This firm has to abide by Nike's international rules and regulations when producing its goods. It is the duty of Nike to monitor the practices of its subcontracted firm. But this did not happen as Nike and its subcontractors often used illegal and unethical practices to minimize costs.

In the early 1990s, journalist Jeff Ballinger published a number of exposés on Nike's dubious labor practices.

Worldwide protests erupted over the alleged “sweatshop conditions” in Nike factories across South Asia. Nike defended itself by claiming that it merely bought products from independent companies in these countries. It argued that the workers were not employees of Nike, and the wages they were getting were above the legal minimum and the prevailing market rates. The company claimed that it had given jobs to thousands of people who would not be working otherwise.

In 1996, Nike established a department to look into how to improve the lives of the workers, and the following year, the corporation commissioned diplomat and activist Andrew Young to examine its labor practices. But the demand for its goods continued to fall till then-CEO Phil Knight acknowledged in a speech in May 1998, “The Nike product has become synonymous with slave wages, forced overtime, and arbitrary abuse. I truly believe the American consumer doesn't want to buy products made under abusive conditions.” He also announced that Nike would raise the minimum age of the workers, increase monitoring, and adapt U.S. OSHA rules.

The following year, Nike created the Fair Labor Association—a non-profit group—to fix the problem. In 2005, it became the first company to publish a complete list of factories it contracts with, and it continues to do so as part of its corporate social responsibility reports.

Now, even human rights activists acknowledge that though some of the issues still persist, the increased monitoring has dealt with the worst problems of labor abuse. The proactive attitude of the corporation has also helped improve its reputation in the market.

1. Why did worldwide protests break out over alleged “sweatshops conditions” in Nike factories across South Asia? Were the business practices ethical?
2. Was Nike a helper or exploiter of the Third World?
3. Comment on the statement, “Don't Just Do It, Do It Right.”

Sources: Douglas Kellner, *Media Spectacle*, New York: Routledge, 2003; Max Nisen, “How Nike Solved Its Sweatshop Problem”, May 9, 2013, *Business Insider*, www.businessinsider.com/how-nike-solved-its-sweatshop-problem-2013-5; www.nikeresponsibility.com/report/content/chapter/labor.

Social Entrepreneurship

Whereas traditional entrepreneurs seek opportunities to create market value, there is a growing trend to use entrepreneurship to pursue opportunities to create social value. These **social entrepreneurs**, people who start businesses so that they can create innovative solutions to society's most vexing problems, see themselves as change agents for society. Social entrepreneurs are finding the resources to tackle challenging problems confronting the global economy, including pollution, habitat destruction, human rights, AIDS, hunger, poverty, and others. Social entrepreneurship can be characterized by the following:

1. Social entrepreneurs seek solutions for social problems that neither the market nor

4.

Explain the difference between social entrepreneurs and traditional entrepreneurs.

2. Social entrepreneurs are motivated primarily by creating social benefit rather than commercial success.
3. Social entrepreneurs tackle social problems by taking full advantage of natural market forces.²⁶

Social entrepreneurs use their creativity to develop solutions to social problems that range from cleaning up the environment to improving working conditions for workers around the world; their goal is to use their businesses to make money *and* to make the world a better place to live.

A recent Global Entrepreneurship Monitor survey of entrepreneurial activity in 54 countries reports that 36 percent of entrepreneurs launch for-profit companies that also include a social responsibility focus.²⁷ Bill Drayton, founder of Ashoka, an organization that promotes social entrepreneurship, says, “Social entrepreneurs are not content just to give a fish or teach [someone] how to fish. They will not rest until they have revolutionized the fishing industry.”²⁸



Ugandan woman/Krochet Kids.
Source: Krochet Kids International.



ENTREPRENEURIAL PROFILE: Kohl Crecelius: Krochet Kids International Kohl Crecelius, CEO and cofounder of Krochet Kids International, learned how to crochet hats from his older brother. He passed on this skill to two of his friends who shared his passion for snow sports. The novelty of their hats caught on, and they soon began to sell their headwear to classmates as a means of supporting their wintertime recreation. A few years later, the three friends, who had all gone their separate ways in college, were trying to find a way to help those suffering the effects of two decades of civil war in Uganda. They decided to teach the Ugandan women who were refugees living in government camps how to crochet as a way for them to create a living wage and rise up out of poverty. Soon they had trained more than 150 people in Uganda who were then able to earn their own living, receive an education, and have hope for a brighter future all thanks to their hats. They also have expanded their operations into Peru. “This may sound weird,” said Kohl, “but there was never really a doubt that this would help or that we would be able to accomplish our mission.”²⁹



In the Entrepreneurial Spotlight

Making a Profit and Making a Difference

There is a significant growth in young entrepreneurs pursuing social ventures. The business models these social entrepreneurs are developing are often based on the notion of a **triple bottom line**—profits, people and planet. “I believe capitalism is in the midst of an evolution,” said Jim Schorr, a professor at Vanderbilt University’s Owen School of Management. He goes on to state that social enterprise “represents a 21st-century version of capitalism that’s more conscious of social and environmental responsibilities.”

In his short career as a social entrepreneur, Kyle McCollum has already launched two social enterprises—the first that addresses the problem of inmate recidivism at a local level and the second that seeks to address the global issue of dehydration.

Triple Thread

As an undergraduate student at Vanderbilt University, Kyle McCollum served as a volunteer at Dismas House, which is a halfway house for former offenders who recently had been released from jail. Kyle did not just drop in as a volunteer—he actually moved into the halfway house. The idea for Triple Thread came from dinner conversations at Dismas House where Kyle and other students heard the residents talk about their desire to start a business, rather than continue to face constant rejection in their

efforts to find jobs due to their felony records. However, these ex-felons lacked the financial resources and business knowledge to launch businesses on their own.

William Williams is one of these residents. The convicted felon just got out of jail after serving years for a robbery charge. Williams had tried for a long time to find a job, but his criminal record kept him from finding work.

Then one day Kyle found inspiration for a business opportunity to help Williams and the other residents. He noticed how many students wore custom shirts on campus. He also recognized the demand for employment for former offenders. Like many entrepreneurs, Kyle made the connection between these two observations and came up with a business idea.

They convinced the administrators at Dismas House and some university professors to help create this business for residents to launch and operate. In 2010 they were able to use a \$30,000 grant to help the ex-felons of Dismas House realize their dream of starting a business. During its first year of operation, Triple Thread provided more than 20 former offenders with job training and work and brought in revenue of more than \$120,000.

Triple Thread is beginning to see returns on its triple bottom line. Many of the former offenders are now leading productive lives.

Everly

By the time Kyle had graduated from Vanderbilt in spring of 2011, Triple Thread had become self-sufficient. The residents and former residents of Dismas House were able to run the operations of the tee shirt business with only occasional business advising from Kyle.

In the fall of 2011 Kyle McCollum launched a second social venture, this time with Vanderbilt classmate Chris Cole as his partner. The idea for this venture came from separate experiences each of the partners had while in school.

Kyle got the idea for a new drink mix to add to water while on a week-long canoe trek in the Boundary Waters of Minnesota. He had been sipping on drink mixes in his water bottle, but tired of their artificial taste and ingredients. He saw an opportunity to make a natural drink mix that could meet the needs of active, adventurous consumers.

Chris had spent a summer working in Bangladesh, where he learned of the horrors of waterborne disease. Chris learned about the needs for life-saving medicines called Oral Rehydration Salts (ORS) to save children sick with waterborne disease from death by dehydration.

The two friends realized that these two experiences could be linked together to create a venture with a triple bottom line. They could earn **profits** through the development and sale of the all-natural drink mix. They could help **people** by committing to send ORS packets to those in impoverished countries for each packet of drink mix they sold. They could help the **planet** by reducing the number of plastic bottles being thrown away by encouraging people to mix their own drinks in reusable water bottles.

Kyle McCollum was named a #Inspire 100 as a “World Changer” by Dell for his work in launching Everly.

“I’d like to spend my life being a social entrepreneur,” Kyle says, “starting businesses like this that have an impact in addition to having a profit so that we can continue to give back.”

1. Do you agree with the path Kyle McCollum is taking to use for-profit business to help support social causes? Explain.
2. What benefits does Everly realize by committing to donate Oral Rehydration Salts for every sale they make of their drink packets?
3. Select a local social issue and work with a team of your classmates to brainstorm ideas for a social venture that could help create a sustainable cash flow to help address this social cause. What advice can you offer social entrepreneurs on how to build ventures with a Triple Bottom Line?

Sources: Nevin Batiwalla, “Nashville’s social entrepreneurs mix business, charity,” *Nashville Business Journal*, September 14, 2012, <http://www.bizjournals.com/nashville/print-edition/2012/09/14/nashvilles-social-entrepreneurs-mix.html>; “Vanderbilt students create company to hire ex-offenders,” *News 2 WKRN-TV*, September 10, 2010, <http://www.wkrn.com/story/13135456/vanderbilt-students-create-company-to-hire-ex-offenders?redirected=true>; Linda Bryant, “Money with a Mission,” *Nashville Post*, July 5, 2011, http://nashvillepost.com/news/2011/7/5/money_with_a_mission; Amanda Hara, “Vanderbilt Student Finds Success for Felons,” *NewsChannel5.com*, January 19, 2011, <http://www.newschannel5.com/story/13872304/vanderbilt-student-finds-success-for-felons>; “Vanderbilt students design Triple Thread Apparel to train ex-offenders,” *jailstojobs.org*, March 1, 2012, <http://jailstojobs.org/wordpress/successstories/vanderbilt-students-design-triple-thread-apparel-to-train-ex-offenders/>; <http://triplethreadapparel.com/about/story/>; <http://www.goeverly.com/about/>; Kicking off Inspired Gifting This Holiday Season, Dell Announces the #Inspire 100, *DailyFinance*, November 20, 2012, <http://www.dailyfinance.com/2012/11/20/kicking-off-inspired-gifting-this-holiday-season-d/>.

Social Responsibility

The concept of social responsibility has evolved from that of a nebulous “do-gooder” to one of “social steward” with the expectation that businesses will produce benefits not only for themselves but also for society as a whole. Society is constantly redefining its expectations of business and now holds companies of all sizes to high standards of ethics and social responsibility. Companies must go beyond “doing well”—simply earning a profit—to “doing good”—living up to their social responsibility. They also must recognize the interdependence of business and society. Each influences the other, and both must remain healthy to sustain each other over time. A growing recognition of social responsibility is true not only for large public corporations but also for small businesses. Two surveys by SurePayroll shed light onto the scope of small business owner’s engagement in social responsibility. One survey reports that 55 percent of small business’s mission statements include a reference to achieving some type of social goal, and a second report finds that 90 percent of small business owners give to charity and that 70 percent donate both money *and time* to local causes.³⁰

Companies that are most successful in meeting their social responsibility select causes that are consistent with their core values and their employees’ interests and skill sets. In fact, some entrepreneurs allow employees to provide input into the decision concerning which causes to support. A common strategy is to allow employees to provide pro bono work for the charitable organizations they support.



ENTREPRENEURIAL PROFILE: Emma, Inc. Emma, Inc., an e-mail marketing company with about 100 employees that is based out of Nashville, Tennessee, is an example of a small company that has an active giving program. Emma has five programs tied to giving back. First, for every new customer the company wins, Emma donates \$5 to a program that supports the needs of teachers and their students. So far, Emma has helped 16,000 students in 37 states. The second program is also tied to new accounts. The employees of Emma plant five trees for every new customer. So far, they have planted more than 53,000 trees! Third, Emma gives away 25 free

5.

Define social responsibility.

Source: Scott Adams/Universal Uclick.



lifetime accounts to nonprofits each year. Fourth, a team of Emma employees manages the company's microloan program through Kiva, which gives microloans to entrepreneurs around the globe to help alleviate poverty. Finally, Emma has a program that allows employees to request funding and volunteer support for charities that they personally care about.³¹

In a free enterprise system, companies that fail to respond to their customers' needs and demands soon go out of business. Today, customers are increasingly demanding the companies they buy goods and services from to be socially responsible. When customers shop for "value," they no longer consider only the price–performance relationship of the product or service; they also consider the company's stance on social responsibility. Whether a company supports a social or an environmental cause has a significant effect on shoppers' behavior. A study by Penn Schoen Berland, in conjunction with Burson-Marsteller and Landor, reports that more than 75 percent of consumers say that social responsibility is important in their purchasing decisions. The survey finds that 55 percent are more likely to choose a product that supports a certain cause when choosing between otherwise similar products and that 38 percent of consumers are willing to pay more for products with added social benefits.³² Other studies conclude that when price, service, and quality are equal among competitors, customers buy from the company that has the best reputation for social responsibility.

Other studies show a connection between social responsibility and profitability. One team of researchers evaluated 52 studies on corporate social responsibility that were conducted over 30 years and concluded that a positive correlation existed between a company's profitability and its reputation for ethical, socially responsible behavior. The relationship also was self-reinforcing. "It's a virtuous cycle," says Sara Rynes, one of the researchers. "As a company becomes more socially responsible, its reputation and financial performance go up, which causes them to become even more socially responsible."³³ The message is clear: Companies that incorporate social responsibility into their competitive strategies outperform those that fail to do so. Today's socially wired, transparent economy makes ethical and socially responsible behavior highly visible and, conversely, improper behavior more difficult to hide.

One problem businesses face is defining just what socially responsible behavior is. Is it manufacturing environmentally friendly products? Is it donating a portion of profits to charitable organizations? Is it creating jobs in inner cities plagued by high unemployment levels? The nature of a company's social responsibility efforts depends on how its owners, employees, and other stakeholders define what it means to be socially responsible. Typically, businesses have responsibilities to several key stakeholders, including the environment, employees, customers, investors, and the community.

Business's Responsibility to the Environment

Due to a strong personal belief in environmental protection, many entrepreneurs seek to start ventures that have a positive impact on the environment or take steps to operate their businesses in ways that help protect the environment. Also driven by a commitment of their customers' interest in protecting the environment, small businesses have become more sensitive to the impact their products, processes, and packaging have on the planet. Environmentalism has become—and will continue to be—one of the dominant issues for companies worldwide because consumers have added another item to their list of buying criteria: environmental

6. Understand the nature of business's responsibility to the environment.

friendliness and safety. Companies have discovered that sound environmental practices make for good business. In addition to lowering their operating costs, environmentally safe products attract environmentally conscious customers and can give a company a competitive edge in the marketplace. Socially responsible business owners focus on the three Rs: reduce, reuse, and recycle:

- *Reduce* the amount of energy and materials used in your company, from the factory floor to the copier room.
- *Reuse* whatever you can.
- *Recycle* the materials that you must dispose of.



ENTREPRENEURIAL PROFILE: Kyle Parsons: Indosole On a trip to Indonesia, Kyle Parsons heard about landfills spontaneously combusting due to the number of tires thrown in every year. To address this environmental problem, Parsons founded Indosole, which creates sandals and shoes made from repurposed Indonesian motorcycle tires. Indosole creates two pairs of shoes from every tire it salvages from the landfill. The production process involves no melting down, off-gassing, or re-forming of materials salvaged. In addition, all the shoes are made by hand rather than by machine. Indosole strives to create sustainable local jobs with a clean, fair, and healthy working environment. The profits from Indosole are used to help send the workers' kids to school.³⁴

Many progressive small companies are taking their environmental policies a step further, creating redesigned, “clean” manufacturing systems that focus on *avoiding* waste and pollution and using resources efficiently. That requires a different manufacturing philosophy. These companies design their products, packaging, and processes from the start with the environment in mind, working to eliminate hazardous materials and by-products and looking for ways to turn what had been scrap into salable products. This approach requires an ecological evaluation of every part of the process, from the raw materials that go into a product to the disposal or reuse of the packaging that contains it.



ENTREPRENEURIAL PROFILE: Joshua Onysko: Pangea Organics Joshua Onysko, founder of Pangea Organics, incorporates these principles into his business, which uses organic, all-natural ingredients, such as beeswax, almond oil, and sweet basil, to produce its line of soaps and body lotions. Pangea's packaging is made from 100 percent recycled paper using a “zero waste” process. The packages even include the seeds of herbs such as basil and amaranth. Once customers remove the product, they simply soak the package in water for one minute, plant it, and wait for the seeds to sprout! Pangea's 10,000-square-foot factory in Denver, Colorado, is powered completely by wind, and a 2,500-square-foot garden provides lunch for the company's 22 employees seven months out of the year. Onysko says that Pangea is gearing up for an audit of its environmental impact so that the company can be even more environmentally sensitive.³⁵



Indonesian worker for Indosole.

Source: Indosole LLC.

Business's Responsibility to Employees

Few other stakeholders are as important to a business as its employees. It is common for managers to *say* that their employees are their most valuable resource, but the truly excellent ones actually *treat* them that way. Employees are at the heart of increases in productivity, and they add the personal touch that puts passion in customer service. In short, employees produce the winning competitive advantage for an entrepreneur. Entrepreneurs who understand the value of their employees follow a few simple procedures by doing the following:

- Listening to employees and respecting their opinions.
- Asking for their input; involving them in the decision-making process.
- Providing regular feedback—positive and negative—to employees.
- Telling them the truth—always.
- Letting them know exactly what's expected of them.
- Rewarding employees for performing their jobs well.

• Treating them, creating an environment of respect and teamwork.

7.

Describe business's responsibility to employees.



ENTREPRENEURIAL PROFILE: Lee Company Leon Lee started Lee Company in Franklin, Tennessee, in 1944 to provide service for refrigeration and heating equipment. His goal from the beginning was to focus on people—hiring the best people and treating them well. Now in its third generation of family ownership, Lee Company continues this focus as it has grown to hundreds of employees doing work with customers nationwide. Lee Company was recently named one of the top 10 companies to work for in the state of Tennessee. The mission statement of Lee Company begins with the following: “To create a workplace where our employees can thrive.” Lee Company established an employee emergency assistance fund that allows employees to contribute both money and days off to a pool used to help coworkers facing an emergency or crisis. Because so many of their workers are young blue-collar workers, these employees can be particularly vulnerable to a financial crisis. “If they have a health insurance claim that’s not covered or they have an unexpected death and they have funeral expenses, it is a real crisis for them,” explains Bill Lee, current CEO of Lee Company. “So we set something up that would keep our folks from being financially devastated and also something to let the employees be involved in helping one another. Employees put the money into our Lee Employee Assistance Fund for their co-workers. It is not just the company doing something for them, but it is the workers doing something for one another.” Lee Company also established a single benefit plan that applies to every employee in the company, no matter what level. “In our company we have had a long standing tradition of not having a different set of benefits for our field employees than we do for our office employees,” said Bill Lee. “A lot of companies have dual benefits. Office workers get this, field workers get that. And there are certainly things inherent in their jobs that are different for field and office workers. One of the things that we have tried to do is keep the barriers broken down so that people feel like the \$9 an hour entry-level, low-skilled worker is just as valuable to this company as the CFO. The entry level employee’s benefit package is the same as the CFO’s. He is treated as fairly and justly as anyone else in the company.” Lee Company has experienced very low turnover among employees due in large part to the quality of the work environment and culture.³⁶

Several important issues face entrepreneurs who are trying to meet their social responsibility to employees, including cultural diversity, drug testing, AIDs, sexual harassment and privacy.

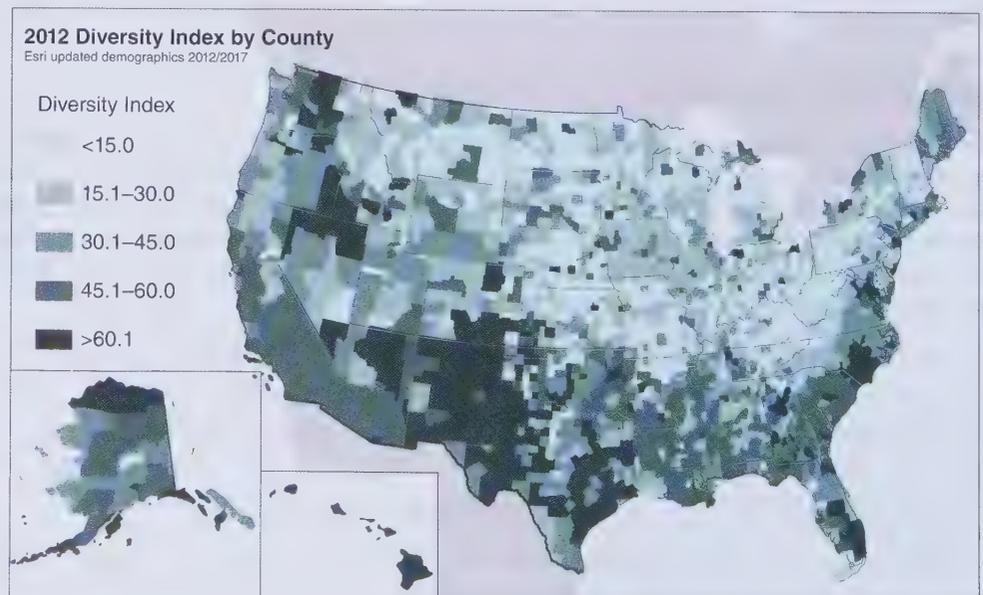
Cultural Diversity in the Workplace

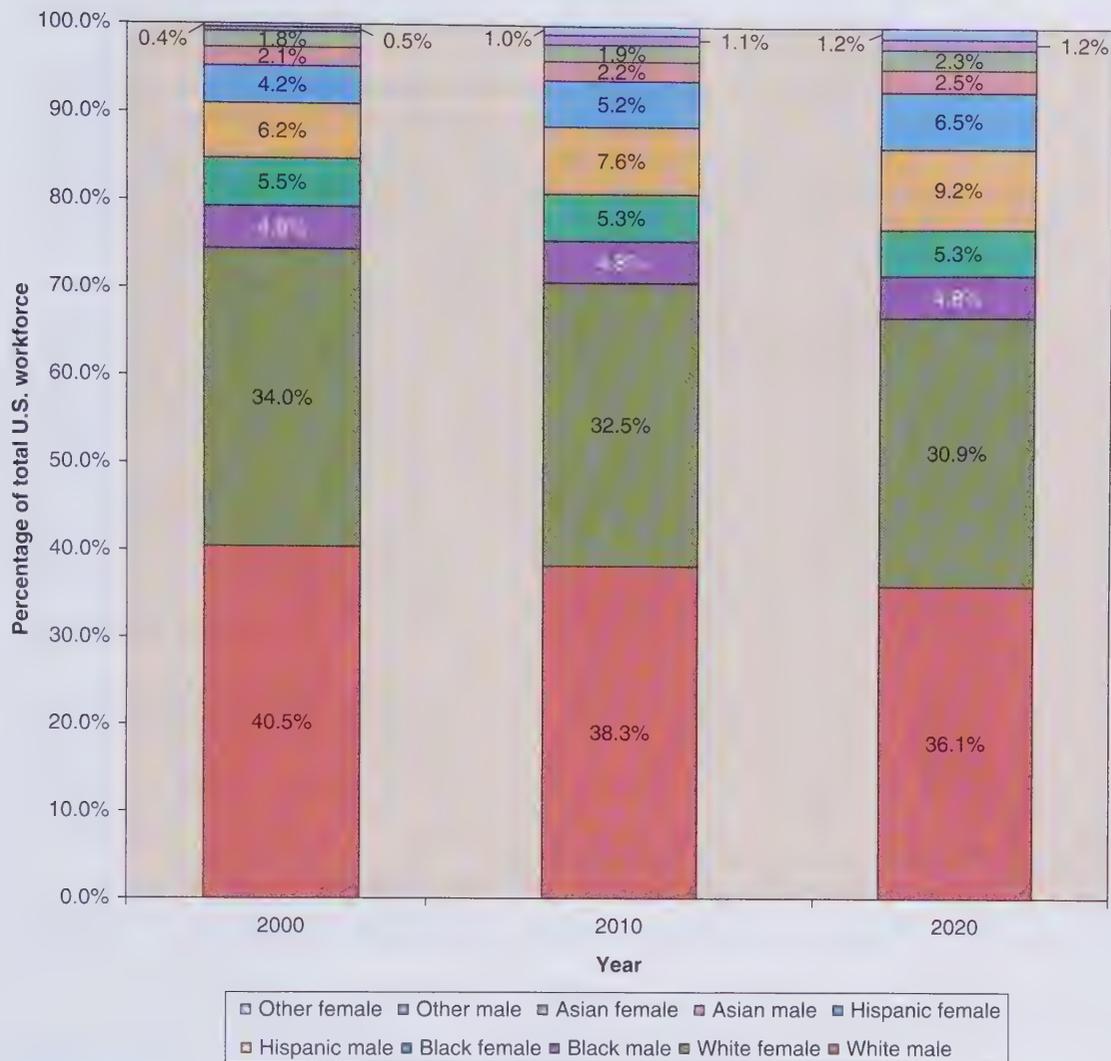
The United States has always been a nation of astonishing cultural diversity (see Figure 2.4), a trait that has imbued it with an incredible richness of ideas and creativity. Indeed, this diversity is one of the driving forces behind the greatest entrepreneurial effort in the world, and it continues to grow. The United States, in short, is moving toward a “minority majority,” and significant demographic shifts will affect virtually every aspect of business. Nowhere will this be more visible than in the makeup of the nation’s workforce (see Figure 2.5). In 2020, members of five different generations will be working side by side in the United States.³⁷ By 2039, the *majority* of the workforce in the United States will be members of a minority.³⁸ The Hispanic population is

FIGURE 2.4
Diversity Index
by County

The diversity Index measures the probability that two people chosen at random from the same area belong to two different race or ethnic groups. The Diversity Index ranges from 0 (no diversity) to 100 (complete diversity). The diversity index for the entire United States is 62.1, an increase from 54 in 2000.

Source: Diversity Index Statement 2012. Ersi, p. 3.



**FIGURE 2.5****Composition of U.S. Workforce by Race and Gender 2000, 2010, and 2020**

Source: Based on Mitra Toossi, "Labor Force Projections to 2020: A More Slowly Growing Workforce," *Monthly Labor Review*, January 2012, pp. 43–64.

the fastest-growing sector in the United States, and Hispanics now make up the largest minority population in the nation.

This rich mix of generations, cultures, and backgrounds within the workforce presents both opportunities and challenges to employers. One of the chief benefits of a diverse workforce is the rich blend of perspectives, skills, talents, and ideas that employees have to offer. In addition, the changing composition of the nation's population will change business's customer base. What better way is there for an entrepreneur to deal with culturally diverse customers than to have a culturally diverse workforce? "No matter who you are, you're going to have to work with people who are different from you," says Ted Childs, vice president of global workforce diversity for IBM. "You're going to have to sell to people who are different from you, buy from people who are different from you, and manage people who are different from you."³⁹ Diversity is more than just checking boxes to ensure that a broad spectrum of people work in a business, however. Shirley Engelmeier, CEO of InclusionINC, recommends that entrepreneurs view diversity "through the lens of what are the diverse competencies you need to build your business, and those diverse competencies are going to show up in different people. Don't just do it to get numbers. Don't just do it to make your team look different. That's part of corporate diversity

linking it to what the bottom line business rationale is for that, and the bottom line business rationale is about skills.”⁴⁰

Managing a culturally diverse workforce presents a real challenge for employers, however. Molding workers with highly varied beliefs, backgrounds, and biases into a unified team takes time and commitment. Stereotypes, biases, and prejudices present barriers that workers and managers must constantly overcome. Communication may require more effort because of language differences. In many cases, dealing with diversity causes a degree of discomfort for entrepreneurs because of the natural tendency to associate with people who are similar to ourselves. These reasons and others cause some entrepreneurs to resist the move to a more diverse workforce, a move that threatens their ability to create a competitive edge.

How can entrepreneurs achieve unity through diversity? The only way is by *managing* diversity in the workforce. In its *Best Practices of Private Sector Employers*, an Equal Employment Opportunity Commission task force suggests following a “SPLENDID” approach to diversity:

- **Study.** Business owners cannot solve problems they don’t know exist. Entrepreneurs must familiarize themselves with issues related to diversity, including relevant laws.
- **Plan.** Recognizing the makeup of the local population, entrepreneurs must set targets for diversity hiring and develop a plan for achieving them.
- **Lead.** A diversity effort starts at the top of the organization with managers communicating their vision and goals to everyone in the company.
- **Encourage.** Company leaders must encourage employees at levels of an organization to embrace the diversity plan.
- **Notice.** Entrepreneurs must monitor their companies’ progress toward achieving diversity goals.
- **Discussion.** Managers must keep diversity on the company’s radar screen by communicating the message that diversity is vital to business success.
- **Inclusion.** Involving employees in the push to achieve diversity helps break down barriers that arise.
- **Dedication.** Achieving diversity in a business does not happen overnight, but entrepreneurs must be persistent in implementing their plans.⁴¹

The goal of diversity efforts is to create an environment in which all types of workers—men, women, Hispanic, African American, white, disabled, homosexual, elderly, and others—can flourish and can give top performances to their companies. In fact, researchers at Harvard University report that companies that embrace diversity are more productive than those that shun diversity. A distinguishing factor the companies supporting diversity share is the willingness of people to learn from their coworkers’ different backgrounds and life experiences.⁴²

Managing a culturally diverse workforce requires a different way of thinking, and that requires training. In essence, diversity training helps make everyone aware of the dangers of bias, prejudice, and discrimination, however subtle or unintentional they may be. Managing a culturally diverse workforce successfully requires a business owner to do the following:

Assess your company’s diversity needs. The starting point for an effective diversity management program is assessing a company’s needs. Surveys, interviews, and informal conversations with employees can be valuable tools. Several organizations offer more formal assessment tools—cultural audits, questionnaires, and diagnostic forms—that also are useful.

Learn to recognize and correct your own biases and stereotypes. One of the best ways to identify your own cultural biases is to get exposure to people who are not like you. By spending time with those who are different from you, you will learn quickly that stereotypes simply don’t hold up. Giving employees the opportunity to spend time with one another is an excellent way to eliminate stereotypes. The owner of one small company with a culturally diverse staff provides lunch for his workers every month with a seating arrangement that encourages employees to mix with one another.

Avoid making invalid assumptions. Decisions that are based on faulty assumptions are bound to be flawed. False assumptions built on inaccurate perceptions or personal bias have kept many qualified minority workers from getting jobs and promotions. Make sure that it does not happen in your company.

Push for diversity in your management team. To get maximum benefit from a culturally diverse workforce, a company must promote nontraditional workers into top management. A culturally diverse top management team that can serve as mentors and role models provides visible evidence that nontraditional workers can succeed.

Concentrate on communication. Any organization, especially a culturally diverse one, will stumble if lines of communication break down. Frequent training sessions and regular opportunities for employees to talk with one another in a nonthreatening environment can be extremely helpful.

Make diversity a core value in the organization. For a cultural diversity program to work, top managers must “champion” the program and take active steps to integrate diversity throughout the entire organization.

Continue to adjust your company to your workers. Rather than pressure workers to conform to the company, entrepreneurs with the most successful cultural diversity programs are constantly looking for ways to adjust their businesses to their workers. Flexibility is the key.

As business leaders look to the future, an increasingly diverse workforce stares back. People with varying cultural, racial, gender and lifestyle perspectives seek opportunity and acceptance from coworkers, managers, and business owners. Currently, women make up 46 percent of the U.S. workforce, and minority workers make up more than 33 percent of the labor force.⁴³ Businesses that value the diversity of their workers and the perspectives they bring to work enjoy the benefits of higher employee satisfaction, commitment, retention, creativity, and productivity more than those companies that ignore the cultural diversity of their workers. In addition, they deepen the loyalty of their existing customers and expand their market share by attracting new customers. In short, diversity is a winning proposition from every angle!

Drug Testing

One of the realities of our society is substance abuse. Another reality, which entrepreneurs now must face head on, is that substance abuse has infiltrated the workplace. In addition to the lives it ruins, substance abuse takes a heavy toll on business and society. Drug and alcohol abuse by employees results in reduced productivity (an estimated \$262.8 billion per year), increased medical costs, higher accident rates, and higher levels of absenteeism. Alarmingly, 66 percent of all drug abusers and 77 percent of alcohol abusers are employed.⁴⁴ Small companies bear a disproportionate share of the burden because they are less likely to have drug-testing programs than large companies and are more likely to hire people with substance abuse problems. Abusers who know that they cannot pass a drug test simply apply for work at companies that do not use drug tests. In addition, because the practice of drug testing remains a controversial issue, its random use can lead to a variety of legal woes for employers, including invasion of privacy, discrimination, slander, or defamation of character.

An effective, proactive drug program should include the following five elements:

1. **A written substance abuse policy.** The first step is to create a written policy that spells out the company’s position on drugs. The policy should state its purpose, prohibit the use of drugs on the job (or off the job if it affects job performance), specify the consequences of violating the policy, explain the drug-testing procedures the company will use, and describe the resources available to help troubled employees.
2. **Training for supervisors to detect substance-abusing workers.** Supervisors are in the best position to identify employees with alcohol or drug problems and to encourage them to get help. The supervisor’s job, however, is not to play “cop” or “therapist.” The supervisor should identify problem employees early and encourage them to seek help. The focal point of the supervisor’s role is to track employees’ performances against their objectives.

to identify the employees with performance problems. Vigilant managers look for the following signs:

- Frequent tardiness or absences accompanied by questionable excuses
 - Long lunch, coffee, or bathroom breaks
 - Frequently missed deadlines
 - Withdrawal from or frequent arguments with fellow employees
 - Overly sensitive to criticism
 - Declining or inconsistent productivity
 - Inability to concentrate on work
 - Disregard for personal safety or the safety of others
 - Deterioration of personal appearance
3. **An employee education program.** Business owners should take time to explain the company's substance abuse policy, the reasons behind it, and the help that is available to employees who have substance abuse problems. Every employee should participate in training sessions, and managers should remind employees periodically of the policy, the magnitude of the problem, and the help that is available. Some companies have used inserts in pay envelopes, home mailings, lunch speakers, and short seminars as part of their ongoing educational efforts.
 4. **A drug-testing program, when necessary.** Experts recommend that business owners seek the advice of an experienced attorney before establishing a drug-testing program. Preemployment testing of job applicants generally is a safe strategy to follow as long as it is followed consistently. Testing current employees is a more complex issue, but, again, consistency is the key.
 5. **An employee assistance program.** No drug-battling program is complete without a way to help addicted employees. An **employee assistance program (EAP)** is a company-provided benefit designed to help reduce workplace problems such as alcoholism, drug addiction, a gambling habit, and other conflicts and to deal with them when they arise. Although some troubled employees may balk at enrolling in an EAP, the company controls the most powerful weapon in motivating them to seek and accept help: *their jobs*. The greatest fear that substance-abusing employees have is losing their jobs, and the company can use that fear to help workers recover. EAPs, which cost between \$18 and \$30 per employee each year to operate, are an effective weapon in the battle against workplace substance abuse. Research shows that EAPs can pay for themselves quickly by reducing absenteeism and tardiness by 25 percent and increasing productivity by 25 percent.⁴⁵ Unfortunately, only 21 percent of small companies (compared to 76 percent of large companies) offer EAPs.⁴⁶



ENTREPRENEURIAL PROFILE: Eastern Industries Eastern Industries, a Pennsylvania-based company that produces building supplies, concrete, asphalt, and stone, operates in an industry that traditionally has been plagued by substance abuse problems. (A recent study shows that 15.1 percent of workers in the construction industry had substance abuse problems, second only to the food service industry.) Initially, Eastern's substance abuse policy was simple: We test for drugs, and if you fail the test, you are fired. The all-or-nothing policy affected the company's ability to keep and retain skilled workers, and company managers decided to change it to a policy that includes prevention, testing, and rehabilitation. Eastern includes educational sessions on substance abuse in its employee orientation program and ongoing programs for all workers. If an employee fails a drug test, he or she can enroll in an employee assistance program that includes rehabilitation that, once successfully completed, allows the worker to return to his or her job. Managers at Eastern say the program has been a tremendous success, allowing them to keep good workers they would have lost under the old policy and giving employees the opportunity to correct bad decisions and keep their jobs.⁴⁷

HIV/AIDS

One of the most serious health problems to strike the world is HIV/AIDS (acquired immune deficiency syndrome). Health care experts estimate that more than 1.1 million people in the

United States have HIV/AIDS, and 50,000 new cases are diagnosed each year. HIV/AIDS claims the lives of about 15,500 people annually.⁴⁸ This deadly disease, for which no cure yet exists, poses an array of ethical dilemmas for business, ranging from privacy to discrimination. AIDS has had an impact on our economy in the form of billions of dollars in lost productivity and increased health care costs. For most business owners, the issue is not one of *whether* one of their employees will contract AIDS but *when*.

Coping with AIDS in the workplace is not like managing normal health care issues because of the fear and misunderstanding the disease creates among coworkers. When confronted by the disease, many employers and employees operate on the basis of misconceptions and fear, resulting in “knee-jerk” reactions that are illegal, including firing the worker and telling other employees. Too many entrepreneurs know very little about their legal obligation to employees with AIDS. In fact, AIDS is considered a disability and is covered by the Americans with Disabilities Act. This legislation prohibits discrimination against any person with a disability, including AIDS, in hiring, promoting, discharging, or compensation. In addition, employers are required to make “reasonable accommodations” that will allow an AIDS-stricken employee to continue working. Some examples of these accommodations include job sharing, flexible work schedules, job reassignment, sick leave, and part-time work.

Coping with AIDS in a socially responsible manner requires a written policy and an educational program, ideally implemented *before* the need arises. When dealing with AIDS, entrepreneurs must base their decisions on facts rather than on emotions, so they must be well informed. As with drug testing, it is important to ensure that a company’s AIDS policies are legal. In general, a company’s AIDS policy should include the following:

Employment. Companies must allow employees with AIDS to continue working as long as they can perform the job.

Discrimination. Because AIDS is a disability, employers cannot discriminate against qualified people with the disease who can meet job requirements.

Employee benefits. Employees with AIDS have the right to the same benefits as those with any other life-threatening illness.

Confidentiality. Employers must keep employees’ medical records strictly confidential.

Education. An AIDS education program should be a part of every company’s AIDS policy. The time to create and implement one is before the problem arises. As part of its AIDS program, one small company conducted informational seminars, distributed brochures and booklets, established a print and video library, and even set up individual counseling for employees.

Reasonable accommodations. Under the Americans with Disabilities Act, employers must make “reasonable accommodations” for employees with AIDS. These may include extended leaves of absence, flexible work schedules, restructuring a job to require less strenuous duties, purchasing special equipment to assist affected workers, and other modifications.

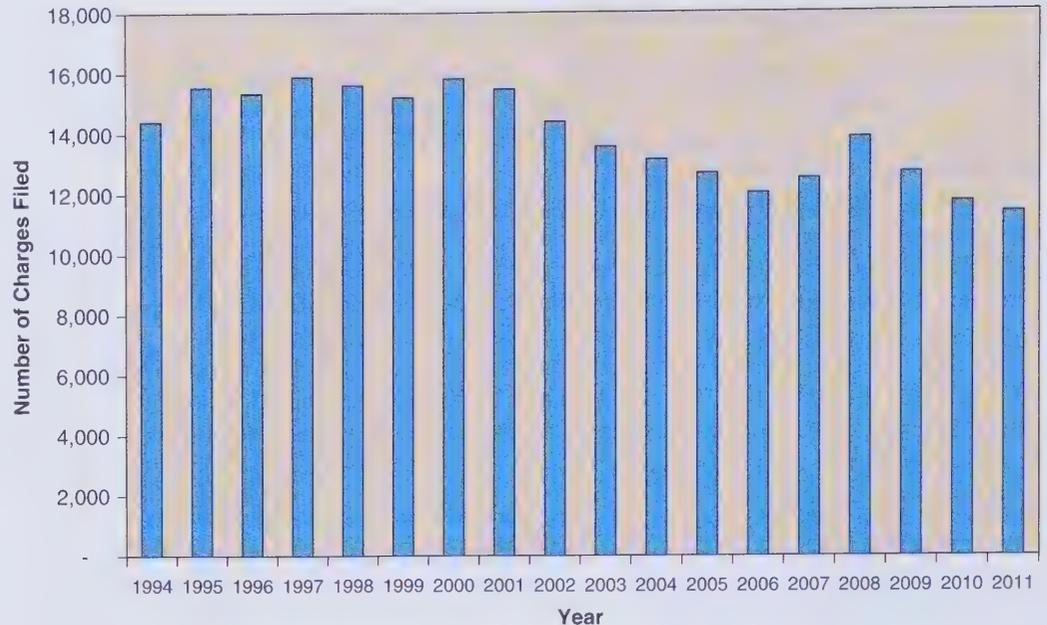
Sexual Harassment

Sexual harassment is a problem in the workplace, and thousands of workers file sexual harassment charges with the Equal Employment Opportunity Commission against their employers every year (see Figure 2.6). A survey by Reuters-Ipsos reports that 10 percent of workers in 24 countries say that they have been physically or sexually harassed. Employees in India were most likely to report sexual harassment (26 percent), and those in France and Sweden were least likely (3 percent). The incidence of sexual harassment in the United States is slightly below the global average at 9 percent.⁴⁹ Sexual harassment is a violation of Title VII of the Civil Rights Act of 1964 and is considered to be a form of sex discrimination. Studies show that sexual harassment occurs in businesses of all sizes, but small businesses are especially vulnerable because they typically lack the policies, procedures, and training to prevent it.

Sexual harassment is any unwelcome sexual advance, request for sexual favors, and other verbal or physical sexual conduct made explicitly or implicitly as a condition of employment. Women bring about 84 percent of all sexual harassment charges.⁵⁰ Jury verdicts reaching into the hundreds of thousands are common. In 2011, there were 11,364 sexual harassment claims that yielded a total of \$52.3 million in settlements to the victims.⁵¹ Retaliation, such as demotions and

FIGURE 2.6**Sexual Harassment Charges Filed**

Source: Based on "Sexual Harassment Charges EEOC & FEPAs Combined: FY 1997–GY 2011," US Equal Employment Opportunity Commission.



assignments to less attractive work against employees who file complaints of sexual harassment, occurs too often, but the most common form of employer retaliation is termination. Types of behavior that may result in sexual harassment charges include the following.

QUID PRO QUO HARASSMENT The most blatant and most potentially damaging form of sexual harassment is *quid pro quo* ("this for that"), in which a superior conditions the granting of a benefit (promotion, raise, and so on) on the receipt of sexual favors from a subordinate. Only managers and supervisors, not coworkers, can engage in quid pro quo harassment.

HOSTILE ENVIRONMENT Behavior that creates an abusive, intimidating, offensive, or hostile work environment also constitutes sexual harassment. A hostile environment usually requires a *pattern* of offensive sexual behavior rather than a single, isolated remark or display. When judging whether a hostile environment exists, courts base their decisions on how a "reasonable woman" would perceive the situation. (The previous standard was that of a "reasonable person.") Examples of what creates a hostile work environment might include the following:

- Displaying sexually suggestive pictures or posters.
- Engaging in sexually related humor within hearing of someone who takes offense.
- Talking about sexual matters where others can hear (as in colorfully relating one's "conquests").
- Making sexual comments to other employees.
- Dispensing assignments based on sexual orientation.
- Repeatedly asking a coworker for a date after having been refused multiple times.⁵²

Although not easily defined, a hostile work environment is one in which continuing unwelcome sexual conduct in the workplace interferes with an employee's work performance. Most sexual harassment charges arise from claims of a hostile environment.

HARASSMENT BY NONEMPLOYEES An employer can be held liable for third parties (customers, sales representatives, and others) who engage in sexual harassment if the employer has the ability to stop the improper behavior. For example, one company required a female employee to wear an extremely skimpy, revealing uniform. She complained to her boss that the uniform encouraged members of the public to direct offensive comments and physical contact toward her. The manager ignored her complaints, and later she refused to wear the uniform, which resulted in her dismissal. When she filed a sexual harassment claim, the court held the company accountable for the employee's sexual harassment by nonemployees because it required her to wear the uniform after she complained of the harassment.⁵³

No business wants to incur the cost of defending itself against charges of sexual harassment, but those costs can be devastating for a small business. Multi-million-dollar jury awards in harassment cases are becoming increasingly common because the Civil Rights Act of 1991 allows victims to collect punitive damages and emotional distress awards. A jury awarded Shannen De La Cruz \$2.16 million in damages after she won a lawsuit in which she claimed that her supervisor at the casino where she worked as a card dealer made inappropriate comments and sexual innuendo toward her. After De La Cruz reported the behavior to the company's human resources manager, a woman who also had filed (and settled) a sexual harassment suit against the company, the supervisor began disciplining her for minor and fabricated violations. Managers at the company did nothing to stop the actions of the supervisor, who fired De La Cruz after he discovered that she was exploring legal action against the company over the harassment. On appeal, a judge affirmed the lower court's ruling but reduced the award to \$1.26 million.⁵⁴

The U.S. Supreme Court has expanded the nature of an employer's liability for sexual harassment, rejecting the previous standard that the employer had to be negligent to be liable for a supervisor's improper behavior toward employees. In *Burlington Industries v. Ellerth*, the court ruled that an employer can be held liable *automatically* if a supervisor takes a "tangible employment action," such as failing to promote or firing an employee whom he has been sexually harassing. The employer is liable even if he was not aware of the supervisor's conduct. If a supervisor takes no tangible employment action against an employee but engages in sexually harassing behavior, such as offensive remarks, inappropriate touching, or sexual advances, the employer is not *automatically* liable for the supervisor's conduct. However, an employer would be liable for such conduct if, for example, he knew (or should have known) about the supervisor's behavior and failed to stop it.⁵⁵

A company's best weapons against sexual harassment are education, policy, and procedures.

EDUCATION Preventing sexual harassment is the best solution, and the key to prevention is educating employees about what constitutes sexual harassment. Training programs are designed to raise employees' awareness of what might be offensive to other workers and how to avoid sexual harassment altogether.

POLICY Another essential ingredient is a meaningful policy against sexual harassment that management can enforce. The policy should do the following:

- Clearly define what behaviors constitute sexual harassment.
- State in clear language that harassment will not be tolerated in the workplace.
- Identify the responsibilities of supervisors and employees in preventing harassment.
- Define the sanctions and penalties for engaging in harassment.
- Spell out the steps to take in reporting an incident of sexual harassment.

In another case, the Supreme Court ruled that an employer was liable for a supervisor's sexually harassing behavior even though the employee never reported it. The company's liability stemmed from its failure to communicate its sexual harassment policy throughout the organization. This ruling makes employers' policies and procedures on sexual harassment the focal point of their defense.

PROCEDURES Socially responsible companies provide a channel for all employees to express their complaints. Choosing a person inside the company (perhaps someone in the human resources area) and one outside the company (a close adviser or attorney) is a good strategy because it gives employees a choice about how to file a complaint. At least one of these people should be a woman. When a complaint arises, managers should do the following:

- Listen to the complaint carefully without judging. Taking notes is a good idea. Tell the complainant what the process involves. Never treat the complaint as a joke.
- Investigate the complaint *promptly*, preferably within 24 hours. Failure to act quickly is irresponsible and illegal. Table 2.5 offers suggestions for conducting a sexual harassment investigation.

TABLE 2.5 What to Do When an Employee Files a Sexual Harassment Complaint

When an employee files a sexual harassment complaint, the Equal Employment Opportunity Commission (EEOC) recommends that employers (1) question both parties in detail and (2) probe for corroborative evidence. Here is a checklist to help when following these EEOC recommendations:

- Analyze the victim’s story for sufficient detail, internal consistency, and believability.
- Do not attach much significance to a general denial by the accused harasser.
- Search completely and thoroughly for evidence that corroborates either person’s story.
- You can do this by:
 - interviewing coworkers, supervisors, and managers;
 - obtaining testimony from individuals who observed the accuser’s demeanor immediately after the alleged incident of harassment; and
 - talking to people with whom the alleged victim discussed the incident (e.g., coworkers, a doctor, or a counselor).
- Ask other employees whether they noticed changes in the accusing individual’s behavior at work or in the alleged harasser’s treatment of him or her.
- Look for evidence of other complaints, either by the victim or other employees.
- Follow up on evidence that other employees were sexually harassed by the same person.

To make a fair and legal decision on a sexual harassment complaint, you must find out as much information as you can, not only on the incident itself but also on the victim’s and accuser’s personalities, surroundings, and relationships. To accomplish this task, you should ask many questions not only of the victim and the accuser but also of any witnesses to the incident.

Source: Adapted from “Questions for Investigations,” Women’s Studies Database at the University of Maryland, www.mith2.umd.edu/WomensStudies/GenderIssues/SexualHarassment/questions-for-investigations.

- Keep findings confidential.
- Decide what action to take, relying on company policy as a guideline.
- Inform both the complaining person and the alleged harasser of the action taken.
- Document the entire investigation.⁵⁶

The accompanying “Lessons from the Street-Smart Entrepreneur” feature includes a quiz on sexual harassment for both employees and managers.



Lessons from the Street-Smart Entrepreneur

How to Avoid Sexual Harassment Charges

The Equal Employment Opportunity Commission handles about 12,000 charges of sexual harassment each year from both women and men. Not surprisingly, women file 84 percent of the charges. Experts say that many other employees are sexually harassed but never file charges because of the stigma associated with doing so. What can you do to ensure you provide your employees a safe work environment that is free of sexual harassment? Consider the following case and then take the quizzes below on sexual harassment.

Theresa Waldo was the only woman working in the Transmission Lines Department, a traditionally male-dominated job in which workers maintain and repair high-voltage power lines, sometimes at heights up to 250 feet, for Consumers Energy (CE).

Her supervisor told her that the company did not “have women in this department” and had never had them there and that “they are not strong enough” to do the job. Despite resistance from her supervisor and her coworkers, Waldo, who started her career with CE as a meter reader, was participating in a four-year Line Apprentice Training Program that would entitle her to a higher-paying job. On several occasions, Waldo’s supervisor told her that he would “wash her out” of the apprenticeship program.

During her time in the apprenticeship program, Waldo alleges that she faced an “abusive and dysfunctional environment” in which she was constantly “bombarded with sexually abusive and derogatory language and conduct.” Male coworkers subjected her to magazines, calendars, playing cards, and other

items that contained photographs of nude women. They also referred to Waldo using derogatory, sexually offensive names and on one 90-degree day intentionally locked her in a port-a-potty for 20 minutes. On another occasion, her supervisor ordered her to clean up the tobacco spit of the male workers; when she refused, her coworkers locked her in a trailer. Waldo complained to the company's management about the sexual harassment on several occasions, but managers failed to take any meaningful action to stop the behavior.

After Waldo had successfully completed three years of the apprenticeship program, CE removed her from it and transferred her to the Sub Metro Department, where her pay was \$4 less per hour. She filed a sexual harassment charge, alleging that the company had created a hostile work environment, committed sexual harassment, and engaged in gender discrimination and retaliation.

Does Waldo have a legitimate sexual harassment complaint? Explain.

[Yes. Although the jury in the trial ruled in favor of the employer on all claims, the judge granted Waldo's motion for a new trial, acknowledging that the jury's verdict on the hostile work environment and sexual harassment should be set aside because of the "clear evidence presented" in the case. The court ruled that the evidence "demonstrated egregious actions and sexually offensive and demeaning language" directed at Waldo. The court concluded that the harassment created "an intimidating, hostile, and offensive work environment" and that EC "knew of the harassment and failed to implement proper and appropriate corrective action." At the second trial, a jury ruled in Waldo's favor and granted her \$400,000 in compensatory damages and \$7.5 million in punitive damages.]

One of the primary causes of sexual harassment in the workplace is the lack of education concerning what constitutes harassment. The following quizzes ask you to assume the roles of an employee and of a manager when answering the questions. Learning from these quizzes can help your company avoid problems with sexual harassment.

A test for employees

Answer the following true/false questions:

1. If I just ignore unwanted sexual attention, it will usually stop.
2. If I don't mean to sexually harass another employee, he or she cannot perceive my behavior as sexually harassing.
3. Some employees don't complain about unwanted sexual attention from another worker because they don't want to get that person in trouble.
4. If I make sexual comments to someone and that person doesn't ask me to stop, I can assume that my behavior is welcome.
5. To avoid sexually harassing a woman who comes to work in a traditionally male workplace, men simply should not haze her.
6. A sexual harasser may be told by a court to pay part of a judgment to the employee he or she harassed.

A sexually harassed man does not have the same legal rights as a woman who is sexually harassed.

8. About 84 percent of all sexual harassment in today's workplace is done by males to females.
9. Sexually suggestive pictures or objects in a workplace don't create a liability unless someone complains.
10. Displaying nude pictures can constitute a hostile work environment even though most employees in the workplace think they are harmless.
11. Telling someone to stop his or her unwanted sexual behavior usually doesn't do any good.

Answers (1) False, (2) False, (3) True, (4) True, (5) False, (6) True, (7) False, (8) True, (9) False, (10) True, (11) False.

A test for managers

Answer the following true/false questions:

1. Men in male-dominated workplaces usually have to change their behavior when a woman begins working there.
2. Employers are not liable for the sexual harassment of one of their employees unless that employee loses specific job benefits or is fired.
3. Supervisors can be liable for sexual harassment committed by one of their employees against another.
4. Employers can be liable for the sexually harassing behavior of management personnel even if they are unaware of that behavior and have a policy forbidding it.
5. It is appropriate for a supervisor, when initially receiving a sexual harassment complaint, to determine whether the alleged recipient overreacted or misunderstood the alleged harasser.
6. When a supervisor is to tell an employee that an allegation of sexual harassment has been made against the employee, it is best to ease into the allegation instead of being direct.
7. Sexually suggestive visuals or objects in a workplace don't create a liability unless an employee complains about them and management allows them to remain.
8. The lack of sexual harassment complaints is a good indication that sexual harassment is not occurring.
9. It is appropriate for supervisors to tell an employee to handle unwelcome sexual behavior if they think that the employee is misunderstanding the behavior.
10. The *intent* behind employee A's sexual behavior is more important than the *impact* of that behavior on employee B when determining if sexual harassment has occurred.
11. If a sexual harassment problem is common knowledge in a workplace, courts assume that the employer has knowledge of it.

Answers (1) False, (2) False, (3) True, (4) True, (5) False, (6) False, (7) False, (8) False, (9) False, (10) False, (11) True.

Sources: Reprinted with permission from *Industry Week*, November 18, 1991, p. 40. Copyright Penton Publishing, Cleveland, Ohio; Sexual Harassment Manual for Managers and Supervisors (Chicago: Commerce Clearing House), 1992, p. 22; Andrea P. Brandon and David R. Eyster, *Working Together* (New York: McGraw-Hill), 1994; *Theresa Waldo v. Consumers Energy Company*, 2010 U.S. District Lexis 55068; 109 Fair Employment Practices Case (BNA) 11348, June 4, 2010; John Agar, "Consumers Energy Ordered to Pay \$8 Million in Sexual Harassment Lawsuit Verdict," *Mlive.com*, http://www.mlive.com/story/2010/10/consumers_energy_ordered_to_pay.html.

Privacy

Modern technology has given business owners the ability to monitor workers' performances as they never could before, but where is the line between monitoring productivity and invasion of privacy? With a few mouse clicks, it is possible for managers to view e-mail messages employees send to one another, listen to voice-mail or telephone conversations, and actually see what is on their monitors while they are sitting at their computer terminals. Some employers have begun to demand Facebook usernames and passwords from job applicants. Employers have established policies that prohibit employees from stating negative information—or in some cases *any* information—about the company in any social media (including Facebook, Twitter, blogs, and so forth). Employers can monitor all activities, including Web usage and text messages that employees send on their employer-issued smart phones. Managers use electronic monitoring to track customer service representatives, word-processing clerks, data entry technicians, and other workers for speed, accuracy, and productivity. Even truck drivers, the lone rangers of the road, are not immune to electronic tracking. Most major trucking companies outfit their trucks with GPS devices that they use to monitor drivers' exact locations at all times, regulate their speed, make sure they stop only at approved fueling points, and ensure that they take the legally required hours of rest. Although many drivers support the use of these devices, others worry about their tendency to create George Orwell's "Big Brother" syndrome.

E-mail also poses an ethical problem for employers. Internet users have more than 4.1 billion e-mail accounts worldwide (974 million of which are business e-mail accounts), and people send more than 100 billion business e-mails per day.⁵⁷ Although most e-mails are unwanted spam, e-mail messages are a common way for employees to communicate with one another. Most workers do not realize that, in most states, employers legally can monitor their e-mail and voice-mail messages without notification. Only two states (Connecticut and Delaware) require companies to notify employees that they are monitoring e-mail. According to the Electronic Monitoring and Surveillance Survey, 43 percent of businesses monitor employees' e-mail, and 26 percent have fired employees for misusing e-mail.⁵⁸ To avoid ethical (and legal) problems, business owners should follow these guidelines:

- **Establish a clear policy for monitoring employees' communications.** Employees should know that the company is monitoring their e-mails and other forms of communication, and the best way to make sure they do is to create an unambiguous policy. Once you create a policy, be sure to follow it. Some managers ask employees to sign a consent form acknowledging that they have read and understand the company's monitoring policy.
- **Create guidelines for the proper use of the company's communication technology and communicate them to everyone.** A company's policies and guidelines should be reasonable and should reflect employees' reasonable expectations of privacy.
- **Monitor in moderation.** Employees resent monitoring that is unnecessarily invasive. In addition, excessively draconian monitoring may land a company in a legal battle.



Entrepreneurship in Action

Think Before You Hit "Post" on Facebook

There has been increasing attention given to employee posts on social media sites such as Facebook and Twitter. The National Labor Relations Board (NLRB) and several judges have begun to define what is protected, private speech when it is posted on a personal Facebook or Twitter account. Several cases have helped

Employee rant

Dawnmarie Souza was a paramedic working for American Medical Response of Connecticut Inc. Souza was fired after calling her supervisor a "scumbag" on Facebook from her home computer. She was angry about her supervisor's actions after a written complaint. She also posted a comment, "love how the company

allows a 17 to become a supervisor." "17" is the company's terminology for a psychiatric patient. Her comments led to several supportive responses from her coworkers and more negative comments about the supervisor.

The NLRB filed a complaint on behalf of Souza, which was the first case they had ever filed involving social media. "You're allowed to talk about your supervisor with your coworkers," said Jonathan Kreisberg of the NLRB. "You're allowed to communicate the concerns and criticisms you have. The only difference in this case is she did it on Facebook and did it on her own time and her own computer."

The case was settled before it was ruled on by the judge.

Employee threat?

A warehouse employee, Roy Rhone Jr., made comments on Facebook that indicated a threat of violence toward his employer. Frito-Lay fired Rhone after he posted on Facebook that he was "a hair away from setting it off in that b—." He had been told he would lose attendance points if he left work early because he felt ill. A human resources manager later told Rhone that the Facebook post sounded like a threat to shoot everyone in the warehouse.

Rhone told the manager that "setting it off" meant swearing at someone or walking out on the job. The NLRB said the comments weren't protected.

When sarcasm goes too far

Robert Becker, a car salesperson, was fired by a Chicago-area car dealership Knauz BMW. Becker posted comments and pictures on Facebook of a sales event in which the dealership served hot dogs and bottled water to customers with the comment, "I was happy to see that Knauz went 'All Out' for the most important launch of a new BMW in years." That same day, he also posted on Facebook pictures of a Land Rover at a nearby dealership also owned by the Knauz group that the 13-year-old son of a customer who was allowed to sit in the driver's seat of the vehicle

had driven into a pond. Becker's comments on this post were, "This is your car. This is your car on drugs." Becker deleted the posts after his supervisor asked him to. He was still fired later that same day.

The NLRB said that Becker's Facebook posts were protected speech and that the dealership could not fire him. The posts about the food were just an extension of conversations that Becker and the other sales staff had about concerns that the food served might hurt their ability to sell cars and earn commission. The NLRB argued that the dealership could not fire Becker for making these comments on Facebook.

Although the judge ruled that Becker's online posts about the sales event were protected by federal law, he did not rule in favor of Becker regarding his comments and pictures about the Land Rover accident. They were not considered protected speech for an employee because they had nothing to do with his conditions of employment.

1. If you were the judge in the Becker case, how would you rule? Explain your reasoning.
2. If you were the judge and the Souza case had not been settled, how would you rule? Explain your reasoning.
3. What policies would you put in place as a business owner about employee comments on social media sites like Facebook and Twitter? Explain your policies based on the cases discussed above.

Sources: Ameet Sachdevhttp, "Judge Backs Car Dealer That Fired Employee over Facebook Post," *Chicago Tribune*, October 1, 2011, http://articles.chicagotribune.com/2011-10-01/business/ct-biz-1001-nlr-20111001_1_facebook-post-karl-knauz-bmw-dealership; Julianne Pepitone, "Facebook Firing Test Case Settled Out of Court," *CNN Money*, February 1, 2011, http://money.cnn.com/2011/02/08/technology/facebook_firing_settlement/index.htm; Steven Greenhouse, "Company Accused of Firing over Facebook Post," *New York Times*, November 8, 2010, www.nytimes.com/2010/11/09/business/09facebook.html?_r=0; Melanie Trotman, "For Angry Employees, Legal Cover for Rants," *Wall Street Journal*, December 2, 2011, <http://online.wsj.com/article/SB10001424052970203710704577049822809710332.html>.

Business's Responsibility to Customers

One of the most important groups of stakeholders that a business must satisfy is its *customers*. Building and maintaining a base of loyal customers is no easy task because it requires more than just selling a product or a service. The key is to build relationships with customers. Socially responsible companies recognize their duty to abide by the Consumer Bill of Rights, first put forth by President John Kennedy. This document gives consumers the following rights.

Right to Safety

The right to safety is the most basic consumer right. Companies have the responsibility to provide their customers with safe, quality products and services. The greatest breach of trust occurs when businesses produce products that, when properly used, injure customers.

ENTREPRENEURIAL PROFILE: New England Compounding Center In 2012, a deadly outbreak of fungal meningitis affected more than 500 people, killing more than 30. Patients contracted the deadly fungal meningitis after being injected with a contaminated preservative-free steroid used to treat pain and inflammation that was manufactured at the New England Compounding Center, a small compounding pharmacy in Framingham, Massachusetts. Preliminary investigations indicated that there were unsanitary, dangerous conditions at the company. Federal authorities launched a criminal investigation into the practices at New England Compounding Center, and the U.S. Dept. of Health and Human Services pharmacy has voted to revoke permanently the company's license to operate in Massachusetts.

8. Explain business's responsibility to customers.



Source: CJ GUNTHER/Newscom.

Product liability cases can be controversial, such as the McDonald's coffee lawsuit, in which a jury found that the fast-food giant's coffee was too hot when served and caused a serious injury when a customer at a drive-through window spilled coffee in her lap. In other situations, the evidence is clear that a product suffers from fundamental flaws in either design or construction and caused an injury to its user when used properly.

Many companies have responded by placing detailed warning labels on their products that sometimes insult customers' intelligence. Consider the following actual examples from product warning labels:

- “Do not eat toner” on a toner cartridge for a laser printer.
- “Never operate your speakerphone while driving,” a warning attached to a “Drive ‘N’ Talk” speakerphone for use with cell phones.
- “Do not use orally” on a toilet bowl cleaning brush.
- “Do not try to dry your phone in a microwave oven” in the instructions for a cellular phone.
- “Caution: Remove infant before folding for storage” on a baby stroller.⁵⁹

Right to Know

Consumers have the right to honest communication about the products and services they buy and the companies that sell them. In a free market economy, information is one of the most valuable commodities available. Customers often depend on companies for the information they need to make decisions about price, quality, features, and other factors. As a result, companies have a responsibility to customers to be truthful in their advertising.

Unfortunately, not every business recognizes its social responsibility to be truthful in advertising. The Federal Trade Commission reached a settlement requiring Oreck Corporation to stop making allegedly false and unproven claims that two of its vacuum cleaners can reduce the risk of flu and other illnesses and eliminate virtually all common germs and allergens. The company also has agreed to pay \$750,000 in fines.⁶⁰ Businesses that rely on unscrupulous tactics may profit in the short term, but they will not last in the long run.

Right to Be Heard

The right to be heard suggests that the channels of communication between companies and their customers run in both directions. Socially responsible businesses provide customers with a mechanism for resolving complaints about products and services. Some companies have established a consumer ombudsman to address customer questions and complaints. Others have created customer hot lines, toll-free numbers designed to serve customers more effectively. Today, many businesses actively monitor social media, watching for customer complaints or negative comments that customers make about the company or its products and services and then addressing them promptly.

Another effective technique for encouraging two-way communication between customers and companies is the customer report card. The Granite Rock Company, a business that supplies a variety of building materials to construction companies, relies on an annual report card from its customers to learn how to serve them better. Although the knowledge an entrepreneur gets from customer feedback is immeasurable for making improvements, only 1 in 12 small companies regularly schedules customer satisfaction surveys such as Granite Rock's. It is a tool that can boost a company's profitability significantly.

Right to Education

Socially responsible companies give customers access to educational material about their products and services and how to use them properly. The goal is to give customers enough information to make informed purchase decisions. A product that is the wrong solution to the customer's needs results in a disappointed customer who is likely to blame the manufacturer or retailer for the mistake. Consumer education is an inexpensive investment in customer satisfaction (especially when done online) and the increased probability that a satisfied customer is a repeat buyer.

Right to Choice

Inherent in the free enterprise system is the consumer's right to choose among competing products and services. Socially responsible companies do not restrict competition, and they abide by U.S. antitrust policy, which promotes free trade and competition in the market. The foundation of this policy is the Sherman Antitrust Act of 1890, which forbids agreements among sellers that restrain trade or commerce and outlaws any attempts to monopolize markets (see Chapter 23).

Business's Responsibility to Investors

Companies have the responsibility to provide investors with an attractive return on their investments. Although earning a profit may be a company's *first* responsibility, it is not its *only* responsibility; meeting its ethical and social responsibility goals is also a key to success. Investors today want to know that entrepreneurs are making ethical decisions and acting in a socially responsible manner. Those who invest in entrepreneurial ventures are a small community (see Chapter 16). Reputation can mean everything for an entrepreneur because most investors invest more on the basis of the entrepreneur's track record than on the entrepreneur's idea. Maintaining high standards of ethics and social responsibility translates into a business culture that sets the stage for future equity investments and in more profitable business operations.

Companies also have the responsibility to report their financial performances in an accurate and timely fashion to their investors. Businesses that misrepresent or falsify their financial and operating records are guilty of violating the fiduciary relationship with their investors.



ENTREPRENEURIAL PROFILE: Richard Priddy and Charles Sample: TVI Corporation

Richard Priddy, CEO of TVI Corporation, and Charles Sample, the company's CFO, were sentenced to prison time and ordered to pay \$595,000 in restitution for defrauding the company of more than \$1.4 million. Priddy and Sample learned that they could purchase from a company in Seattle at significantly lower prices the same parts that TVI had been buying. Rather than allow TVI to switch to the lower-cost supplier, they formed a separate company, Containment & Transfer Systems, LLC (CATS), to purchase the parts from the Seattle company and resell them to TVI. Over the next five years, Priddy and Sample hid the fact that they owned CATS from the TVI board and investors and defrauded TVI of more than \$1.4 million before board members discovered the executives' illicit actions.⁶¹

Business's Responsibility to the Community

As corporate citizens, businesses have a responsibility to the communities in which they operate. In addition to providing jobs and creating wealth, companies contribute to the local community in many different ways. Socially responsible businesses are aware of their duty to put back into the community some of what they take out as they generate profits; their goal is to become a neighbor of choice.

Experts estimate that 80 percent of companies worldwide engage in some type of socially responsible activity.⁶² The following are just a few examples of ways small businesses have found to give back to their communities:

- Act as volunteers for community groups such as the American Red Cross, United Way, literacy programs, and a community food bank.
- Participate in projects that aid the elderly or economically disadvantaged.
- Adopt a highway near the business to promote a clean community.
- Volunteer in school programs, such as Junior Achievement.

In a recent survey, 75 percent of consumers say that companies living up to their social responsibility is important even during economic recessions.⁶³ Even small companies that may be short on funding can support causes by choosing them strategically and discovering creative ways to help them. The key to choosing the "right" cause is finding one that makes an impact and whose purpose resonates with customers, employees, and owners. Small companies can commit

9.

Discuss business's responsibility to investors.

10.

Discuss business's responsibility to the community.

their employees' talent and know-how, not just dollars, to carefully chosen social causes and then tell the world about their cause and their dedication to serving it. By forging meaningful partnerships, both the businesses and the causes benefit in unique ways. Over the years, companies have helped social causes enjoy financial rewards and unprecedented support. In addition to doing good, companies have been able to enhance their reputations, deepen employee loyalty, strengthen ties with business partners, and sell more products or services.



ENTREPRENEURIAL PROFILE: Ray Booska: Glacier Tek Ray Booska, founder of Glacier Tek, a West Melbourne, Florida–based company that makes body-cooling vests for a variety of applications, learned about the challenges that the intense heat in the Middle East creates for bomb-sniffing dogs stationed there on military duty and decided that his company could help. Booska and his team of designers tested several prototypes on Booska's retired police dog, Fritz, before finding one that worked to their satisfaction. The vest is made of a nontoxic coolant that works like gel ice packs and can be recharged in just 15 minutes. Glacier Tek added the canine vest to its product line but has donated more than 500 of them to dogs in military zones in the Middle East. "These dogs save the lives of our sons and daughters," says Booska, "and we're going to do everything we can to help them."⁶⁴

Entrepreneurs such as Booska who demonstrate their sense of social responsibility not only make their communities better places to live and work but also stand out from their competitors. Their efforts to operate ethical, socially responsible businesses create a strong sense of loyalty among their customers and their employees.

Conclusion

Businesses must do more than merely earn profits; they must act ethically and in a socially responsible manner. Establishing and maintaining high ethical and socially responsible standards must be a top concern of every business owner. Managing in an ethical and socially responsible manner presents a tremendous challenge, however. There is no universal definition of ethical behavior, and what is considered ethical may change over time and may be different in other cultures.

Finally, business owners and managers must recognize the key role they play in influencing their employees' ethical and socially responsible behavior. What owners and managers *say* is important, but what they *do* is even more important! Employees in a small company look to the owner and managers as models; therefore, owners and managers must commit themselves to following the highest ethical standards if they expect their employees to do so.

Chapter Review

1. Define business ethics and describe the three levels of ethical standards.
 - Business ethics involves the fundamental moral values and behavioral standards that form the foundation for the people of an organization as they make decisions and interact with organizational stakeholders. Small business managers must consider the ethical and social as well as the economic implications of their decisions.
 - The three levels of ethical standards are (1) the law, (2) the policies and procedures of the company, and (3) the moral stance of the individual.
2. Determine who is responsible for ethical behavior and why ethical lapses occur.
 - Managers set the moral tone of the organization. There are three ethical styles of management: immoral, amoral, and moral. Although moral management has value in itself, companies that operate with this philosophy discover other benefits, including a positive reputation among customers and employees.
 - Ethical lapses occur for a variety of reasons:
 - Some people are corrupt ("the bad apple").
 - The company culture has been poisoned ("the bad barrel").

Competitive pressures push managers to compromise.

Managers are tempted by an opportunity to “get ahead.”

Managers in different cultures have different views of what is ethical.

3. Explain how to establish and maintain high ethical standards.
 - Philosophers throughout history have developed various tests of ethical behavior: the utilitarian principle, Kant’s categorical imperative, the professional ethic, the Golden Rule, the television test, and the family test.
 - A small business manager can maintain high ethical standards in the following ways:
 - Create a company credo.
 - Develop a code of ethics.
 - Enforce the code fairly and consistently.
 - Hire the right people.
 - Conduct ethical training.
 - Perform periodic ethical audits.
 - Establish high standards of behavior, not just rules.
 - Set an impeccable ethical example at all times.
 - Create a culture emphasizing two-way communication.
 - Involve employees in establishing ethical standards.
4. Explain the difference between social entrepreneurs and traditional entrepreneurs.
 - Traditional entrepreneurs seek opportunities to create market value and profit.
 - Social entrepreneurs use entrepreneurship to pursue opportunities to create social value by creating innovative solutions to society’s most vexing problems.
5. Define social responsibility.
 - Social responsibility is the awareness of a company’s managers of the social, environmental, political, human, and financial consequences of their actions.
6. Understand the nature of business’s responsibility to the environment.
 - Environmentally responsible business owners focus on the three Rs: reduce, reuse, recycle: *reduce* the amount of materials used in the company from the factory floor to the copier room, *reuse* whatever you can, and *recycle* the materials that you must dispose of.
7. Describe business’s responsibility to employees.
 - Companies have a duty to act responsibly toward one of their most important stakeholders: their employees. Businesses must recognize and manage the cultural diversity that exists in the workplace, establish a responsible strategy for combating substance abuse in the workplace (including drug testing) and dealing with AIDS, prevent sexual harassment, and respect employees’ right to privacy.
8. Explain business’s responsibility to customers.
 - Every company’s customers have a right to safe products and services; to honest, accurate information; to be heard; to education about products and services; and to choices in the marketplace.
9. Discuss business’s responsibility to investors.
 - Companies have the responsibility to provide investors with an attractive return on their investments and to report their financial performances in an accurate and timely fashion to their investors.
10. Describe business’s responsibility to the community.
 - Increasingly, companies are seeing a need to go beyond “doing well” to “doing good”—being socially responsible community citizens. In addition to providing jobs and creating wealth, companies contribute to the local community in many different ways.

Discussion Questions

- 2-1. What is ethics? Discuss the three levels of ethical standards.
- 2-2. List the core personal values that you intend to bring to your business (e.g., treating people fairly, giving something back to the community, and so on). Where does each of these core values come from (religious faith, family, and so on)? Why is each of these important to you?
- 2-3. In any organization, who determines ethical behavior? Briefly describe the three ethical styles of management. What are the benefits of moral management?
- 2-4. What are the reasons to run a business ethically?
- 2-5. What are the factors that drive business ethics in an organization?
- 2-6. Mention ten ethical principles that guide business behavior.
- 2-7. What is social entrepreneurship?
- 2-8. Explain with examples how social entrepreneurs make the world a better place to live in.
- 2-9. What is social responsibility?
- 2-10. Describe business’s social responsibility to each of the following areas:
 - The environment
 - Employees
 - Customers
 - Investors
 - The community

- 2-11. What can businesses do to improve the quality of our environment?
- 2-12. Should companies be allowed to test employees for drugs? Explain. How should a socially responsible drug-testing program operate?
- 2-13. Many owners of trucking companies use electronic communications equipment to monitor their drivers on the road. They say that the devices allow them to remain competitive and to serve their customers better by delivering shipments of vital materials exactly when their customers need them. They also point out

that the equipment can improve road safety by ensuring that drivers get the hours of rest the law requires. Opponents argue that the surveillance devices work against safety. "The drivers know they're being watched," says one trucker. "There's an obvious temptation to push?" What do you think? What ethical issues does the use of such equipment create? How should a small trucking company considering the use of such equipment handle these issues?

- 2-14. What rights do customers have under the Consumer Bill of Rights? How can businesses ensure those rights?

CHAPTER 3

Creativity and Innovation: Keys to Entrepreneurial Success



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain the differences among creativity, innovation, and entrepreneurship.
2. Describe why creativity and innovation are such integral parts of entrepreneurship.
3. Understand how the two hemispheres of the human brain function and what role they play in creativity.
4. Explain the 10 “mental locks” that limit individual creativity.
5. Understand how entrepreneurs can enhance the creativity of their employees as well as their own creativity.
6. Describe the steps in the creative process.

The chief enemy of creativity is “good” sense.

—Pablo Picasso

Genius is born from a thousand failures.

—Greg Linden

One of the tenets of entrepreneurship is the ability to create new and useful ideas that solve the problems and challenges people face every day. Entrepreneurs achieve success by creating value in the marketplace when they combine resources in new and different ways to gain a competitive edge over rivals. From Alexander Fleming’s pioneering work that resulted in a cure for infections (penicillin) and the founders of the Rocket Chemical Company’s fortieth try to create an industrial lubricant (WD-40) to Jeff Bezos’s innovative use of the Internet in retailing (*Amazon.com*) and Ted Turner’s around-the-clock approach to the availability of television news (CNN), entrepreneurs’ ideas have transformed the world.

As you learned in Chapter 1, entrepreneurs can create value in a number of ways—inventing new products and services, developing new technology, creating new business models, discovering new knowledge, improving existing products or services, finding different ways of providing more goods and services with fewer resources, and many others. Indeed, finding new ways of satisfying customers’ needs, inventing new products and services, putting together existing ideas in new and different ways, and creating new twists on existing products and services are hallmarks of the entrepreneur! “At the heart of any successful business is a great idea,” says one business writer. “Some seem so simple we wonder why nobody thought of them before. Others are so revolutionary that we wonder how anybody could have thought of them at all.”¹



John Friedman and Brad McNamara, cofounders of Freight Farms.

Source: Freight Farms.



ENTREPRENEURIAL PROFILE: Jon Friedman and Brad McNamara: Freight Farms

Friedman and Brad McNamara came up with the idea of transforming used shipping containers, thousands of which sit abandoned in ports across the United States, into highly productive gardens that produce year-round and can be located almost anywhere, even in metropolitan areas. The entrepreneurs launched Freight Farms in 2010 to market their Leafy Green Machines, converted 320-square-foot modular, stackable shipping containers that can produce up to 900 heads of leafy green vegetables each week, the equivalent yield of a one-acre farm. The containers cost \$60,000 and come fully “outfitted with advanced climate technology that creates the optimal growing conditions needed to maximize any harvest,” seeds, and nutrients. LED lights simulate night and day, and a climate-control system ensures optimal growing conditions no matter what the weather is like outside. Every Leafy Green Machine comes with a tablet PC that allows a customer to monitor and control growing conditions remotely. Friedman and McNamara are targeting restaurants, food wholesalers, cooperatives, and nonprofit organizations that help with disaster relief and claim that their Leafy Green Machines deliver high-quality produce at low cost and use a fraction of the energy compared to traditional and greenhouse production. Currently, they are developing containers designed to grow vine crops and mushrooms.²

Like many innovators, Friedman and McNamara created a successful business by taking common items—shipping containers—that have existed for many years, looked at them in a different way, and put them to use in a creative fashion.

Creativity, Innovation, and Entrepreneurship

According to the Battelle and *R&D Magazine*, U.S. companies, government agencies, and universities invest \$501 billion annually in research and development (R&D), about one-third of \$1.5 billion global expenditure on R&D.³ Small companies are an important part of the total R&D picture. One study by the Small Business Administration reports that small companies that receive patents produce 16 times more patents per employee than their larger rivals that receive patents.⁴ “Small businesses have an inherent innovative advantage over large businesses,” says one writer. “They are less likely to have an interest in maintaining the status quo, and they are more responsive and quicker to change. As a result, they have a disproportionate impact on ‘disruptive’ innovation—change that creates an entirely new market—as opposed to large firms, which tend to engage in incremental innovation.”⁵

What is the entrepreneurial “secret” for creating value in the marketplace? In reality, the “secret” is no secret at all: It is applying creativity and innovation to solve problems and to exploit opportunities that people face every day. **Creativity** is the ability to develop new ideas and to discover new ways of looking at problems and opportunities. **Innovation** is the ability to *apply* creative solutions to those problems and opportunities to enhance or to enrich people’s lives. Harvard’s Ted Levitt says that creativity is *thinking* new things and that innovation is *doing* new things. In short, entrepreneurs succeed by *thinking and doing* new things or old things in new ways. Simply having a great new idea is not enough; transforming the idea into a tangible

1.

Explain the differences among creativity, innovation, and entrepreneurship.

product, service, or business venture is the essential next step. As management legend Peter Drucker said, “Innovation is the specific instrument of entrepreneurs, the act that endows resources with a new capacity to create wealth.”⁶

Software maker Intuit published a study about how small businesses would compete in 2020 and identified six “enablers” of small business innovation:⁷

1. **Passion.** Entrepreneurs typically start businesses using ideas about which they are passionate. Their passion and enthusiasm makes them willing to test new business models and invent new products and services.
2. **Customer connection.** Because entrepreneurs are close to their customers, they listen to their customers, understand their needs and problems, and develop creative solutions for meeting and solving them.
3. **Agility and adaptation.** One hallmark of successful entrepreneurs is their ability to adapt and adjust, making the necessary “pivots” when their business models do not work the way they anticipated.
4. **Experimentation and improvisation.** Successful entrepreneurs understand that creativity and innovation produce big payoffs but also carry a high probability of failure. They accept that failure is merely a stepping-stone on the pathway to success.
5. **Resource limitations.** Because small companies usually operate with limited resources, they are accustomed to doing more with less. Entrepreneurs’ resource limitations often require them to be highly innovative.
6. **Information sharing and collaboration.** Entrepreneurs rely on a strong network of people—customers, friends, family members, and social networks—from whom they get useful feedback on their ideas, giving them the ability to discard quickly ideas that do not work and improve those that do.

Successful entrepreneurs introduce new ideas, products, services, and business models that solve a problem or fill a need. In a world that is changing faster than most of us ever could have imagined, creativity and innovation are vital to a company’s success—and ultimate survival. That’s true for businesses in every industry—from automakers to tea growers—and for companies of all sizes. GE’s Global Innovation Barometer reports that 84 percent of 3,100 global business executives believe that innovation can originate from companies of any size. The executives in the survey also say that incremental improvements of existing products and services has been and continues to be the most important factor in their companies’ innovation engines but that creating new business models will play a much more important role in innovation in the future.⁸ In an earlier version of the survey, executives say that their companies will have to innovate in ways that are “totally different than ever before.” As Doreen Lorenzo, president of global innovation consulting firm, says, “Doing business as usual means that you could be out of business sooner than you think.”⁹ In other words, to be successful, business leaders must develop innovations in their business models as well as in their product and service lines. Table 3.1 summarizes the results of a study by Hal Gregersen, professor of innovation and leadership at Insead, that explains the components of discovery-driven leadership.

Although big businesses develop many new ideas, creativity and innovation are the signatures of small, entrepreneurial businesses. Creative thinking has become a core business skill, and entrepreneurs lead the way in developing and applying that skill. In fact, creativity and innovation often lie at the heart of small companies’ ability to compete successfully with their larger rivals. Even though they cannot outspend their larger rivals, small companies can create powerful, effective competitive advantages over big companies by “out-creating” and “out-innovating” them! If they fail to do so, entrepreneurs don’t stay in business very long. Leadership expert Warren Bennis says, “Today’s successful companies live and die according to the quality of their ideas.”¹⁰

Some small businesses create innovations *reactively* in response to customer feedback or changing market conditions, and others create innovations *proactively*, spotting opportunities on which to capitalize. Sometimes innovation is *revolutionary*, creating market-changing, disruptive breakthroughs that are the result of generating something from nothing. More often, innovation is *evolutionary*, developing market-sustaining ideas that elaborate on existing products, processes, and services that result from putting old things together in new ways or from taking something away to create something simpler or better. Apple did not invent the digital music

TABLE 3.1 The Five Dimensions of Discovery-Driven Leadership

Hal Gregersen's research suggests the leaders engage in two types of leadership: delivery driven and discovery driven. Delivery-driven leadership includes the traditional management roles of analyzing, controlling, planning, and directing that often leads to only incremental innovations. Recognizing that many consumers misused Nyquil cold medicine to induce sleep even when they did not have colds, consumer products giant Procter & Gamble introduced an incremental "innovation" with Zzzquil, which is nothing more than its NyQuil cold relief medicine without the cold medication. "The reality is when you look at companies that produce long-term, organic profit growth, a huge amount of what they do is incremental innovation," says one innovation expert. Incremental innovations may produce profitable products, but can companies that become content with incremental innovation succeed in the long run, or will they be eclipsed by companies that create disruptive innovations?

Discovery-driven leadership, which innovative entrepreneurs exhibit, produces disruptive innovations and includes the following five dimensions:

1. *Associating* involves drawing connections among ideas, questions, processes, or problems from diverse and unrelated fields.
2. *Questioning* poses questions that challenge conventional thinking and common wisdom. Entrepreneurs recognize that well-established processes may not be the best way to accomplish a task.
3. *Networking* involves entrepreneurs engaging people from different backgrounds who have different ideas and perspectives from their own. Their goal is to learn from people who are different from themselves.
4. *Observing* the behavior of customers, suppliers, and competitors gives entrepreneurs insight into how they can develop new products, services, processes, and business models.
5. *Experimenting* involves constructing interactive experiences (often with customers or potential customers) to see whether their ideas are successful, to gauge customers' reactions, and to gather meaningful insights.

The following table shows the percentile rankings on the five dimensions of discovery-driven leadership for different types of leaders:

Percentile Rankings for Various Types of Leaders on the Five Dimensions

Type of Leader	Dimension				
	Associating	Questioning	Observing	Networking	Experimenting
Non-innovators	48%	49%	48%	47%	39%
Process innovators	70%	65%	68%	61%	68%
Product innovators	78%	77%	79%	72%	74%
Corporate entrepreneurs	76%	67%	75%	77%	69%
Start-up entrepreneurs	78%	72%	75%	74%	73%

Doron Shafir and Sayre Swartztrauber, who cofounded Quadlogic Controls Corporation in New York City in 1984, demonstrated discovery-driven leadership in their company, which provides products that track energy usage for tenants living in the same building. Their business had just posted its best year ever with \$15 million in annual sales when the housing market collapsed and Quadlogic's sales plummeted. A few years before, a conversation with a business associate about how energy theft was a major problem in many developing countries had led Shafir and Swartztrauber to begin tinkering with a new product designed to prevent utility metering systems from being breached by energy thieves. However, the product was incomplete, and the entrepreneurs had not yet identified any potential customers.

They decided that the best strategy for their company was to introduce the new anti-theft product and launch it with a big marketing blast. "We saw our survival threatened and that gave us the incentive to make it happen," says Swartztrauber. Their risk-taking strategy paid off; within five months, Quadlogic had signed a multi-million-dollar deal with a utility company in Jamaica. Since then, hundreds of customers in Mexico, Ecuador, Costa Rica, and other countries have purchased the anti-theft device, and Quadlogic recently achieved a new sales record, generating \$20 million in annual sales. Shafir and Swartztrauber's discovery-driven leadership style, their ability to spot new business opportunities, and their willingness to take risks probably saved their company. "You have to place your bets," says Swartztrauber philosophically.

Sources: Based on Hal Gregersen, "The Entrepreneur's DNA," *Wall Street Journal*, February 26, 2013, p. B13; John Bussey, "The Innovator's Enigma," *Wall Street Journal*, October 4, 2012, <http://online.wsj.com/article/SB10000872396390443493304578036753351798378.html>; Sarah Needleman, Vanessa O'Connell, Emily Maltby, and Angus Loten, "And the Most Innovative Entrepreneurs," *Wall Street Journal*, November 14, 2011, pp. R1, R4.

player, but Steve Jobs's company created a player that was easier to use and offered a "cool" factor that existing MP3 players did not have. One experimenter's research to improve the adhesive on tape resulted in a glue that hardly stuck at all. Although most researchers might have considered the experiment a total failure and scrapped it, this researcher asked a simple, creative question: What can you do with a glue when you take away most of its stickiness? The answer led to the invention of one of the most popular office products of all time: the Post-It Note, a product that now includes more than 4,000 variations. Although both types of innovation produce useful results, revolutionary innovation that produces disruptive changes is momentous—and often highly profitable.

Some entrepreneurs stumble onto their ideas by accident but are clever enough to spot the business opportunities they offer.

 **ENTREPRENEURIAL PROFILE: Michael Maness and Bill Silva: CamCaddy Pro** Michael Maness, a professional golfer and PGA caddy, was hitting golf balls on a driving range one day and wanted to capture a video of his swing to share with his instructor. "I had my phone propped up on my golf bag," he recalls, which did not work very well. Maness mentioned the event to his friend Bill Silva, who also was at the range that day. Over lunch, the two friends began brainstorming ideas and making sketches of a simple device to which golfers could attach their phones and record their swings from the same perspective. That led them to create the CamCaddy Pro, an adjustable smart phone holder that snaps onto a standard alignment stick, a common tool that golfers use. "People have been using their phones to do this, but they haven't had a consistent way to get the same perspective," says Silva. In just six months, Maness and Silva sold 10,000 CamCaddy Pros and have since signed distribution agreements with Dick's Sporting Goods and several other major sporting goods retailers. They expect sales of the CamCaddy Pro, which won the award for best new product at a recent PGA Merchandise Show, to reach \$1.2 million in the company's first full year of operation. Maness and Silva already are at work on a version of CamCaddy Pro that holds tablets and on variations that people can use anywhere they want to shoot hands-free videos, such as baseball fields, tennis courts, or the beach.¹¹

More often, creative ideas arise when entrepreneurs look at something old and think something new or different. Legendary Notre Dame football coach Knute Rockne, whose teams dominated college football in the 1920s, got the idea for his constantly shifting backfields while watching a burlesque chorus routine! Rockne's innovations in the backfield (which included the legendary "Four Horsemen") and his emphasis on the forward pass (a legal but largely unused tactic in this era) so befuddled opposing defenses that his teams compiled an impressive 105–12–5 record.¹²

 **ENTREPRENEURIAL PROFILE: SportsArt Fitness** Employees at SportsArt Fitness, a manufacturer of exercise machines based in Woodinville, Washington, developed a way to capture the energy that health club members generate while exercising on elliptical trainers and treadmills and use it to produce electricity. The company's Green System line of exercise equipment captures up to 72 percent of the power that exercisers create during a workout and directs it back into the local electrical system. Anita Miller, the company's senior product manager, says that 10 people using 10 elliptical trainers for an average of eight hours a day can cut a gym's electrical bill by \$60 per month.¹³

Entrepreneurship is the result of a disciplined, systematic process of applying creativity and innovation to needs and opportunities in the marketplace. It involves applying focused strategies to new ideas and new insights to create a product or a service that satisfies customers' needs or solves their problems. It is much more than random, disjointed tinkering with a new gadget. Millions of people come up with creative ideas for new or different products and services; most of them, however, never do anything with them. Entrepreneurs are people who connect their creative ideas with the purposeful action and structure of a business. "Great ideas are abundant," says Samer Kurdi, head of Entrepreneurs' Organization, "but it is what we decide to do with them that counts."¹⁴ Successful entrepreneurship is a constant process that relies on creativity, innovation, and application in the marketplace.

Innovation must be a constant process because most ideas don't work and most innovations fail. One writer explains, "Trial—and lots of error—is embedded in entrepreneurship."¹⁵

For every 5,000 to 10,000 new drug discoveries, only about 250 get to preclinical trials, and only five of those make it to clinical trials. Just one or two drugs emerge from clinical trials for review by the U.S. Food and Drug Administration, and only one typically gets to the market

in a process that typically takes 10 to 15 years.¹⁶ New products are crucial to companies' success, however. According to Robert Cooper, a researcher who has analyzed thousands of new product launches, new products (those launched within the previous three years) account for an impressive 38 percent of sales at top-performing companies.¹⁷ Still, successful entrepreneurs recognize that many failures will accompany innovations, and they are willing to accept their share of failures because they know that failure is merely part of the creative process. Rather than quit when they fail, entrepreneurs simply keep trying. While working as a textbook editor, James Michener had an idea for a book based on his experiences in the Solomon Islands during World War II. He sent the manuscript to a publisher and received the following note: "You are a good editor. Don't throw it all away trying to be a writer. I read your book. Frankly, it's not really that good." Michener persisted and went on to publish *South Pacific*, for which he won a Pulitzer Prize and which became the basis for one of Broadway's most successful musicals of all time.¹⁸

Entrepreneurship requires business owners to be bold enough to try their new ideas, flexible enough to throw aside those that do not work, and wise enough to learn about what will work based on their observations of what did not. We now turn our attention to creativity, the creative process, and methods for enhancing creativity.

Creativity—Essential to Survival

2.

Describe why creativity and innovation are such integral parts of entrepreneurship.

In this fiercely competitive, fast-paced, global economy, creativity is not only an important source for building a competitive advantage but also a necessity for survival. When developing creative solutions to modern problems, entrepreneurs must go beyond merely relying on what has worked in the past. "A company that's doing all the things that used to guarantee success—providing quality products backed by great service, marketing with flair, holding down costs, and managing cash flow—is at risk of being flattened if it fails to become an engine of innovation," says one business writer.¹⁹ Transforming their organizations into engines of innovation requires entrepreneurs to cast off limiting assumptions, beliefs, and behaviors and develop new insights into the relationship among resources, needs, and value. In other words, they must change their perspectives, looking at the world in new and different ways.

Entrepreneurs must always be on guard against traditional assumptions and perspectives about how things out to be because they are certain killers of creativity. These self-imposed mental constraints that people tend to build over time push creativity right out the door. These ideas become so deeply rooted in our minds that they become immovable blocks to creative thinking—even though they may be outdated, obsolete, and no longer relevant. In short, they act as logjams to creativity. That's why children are so creative and curious about new possibilities; society has not yet brainwashed them into an attitude of conformity, nor have they learned to accept *traditional* solutions as the *only* solutions. By retaining their creative "inner child," entrepreneurs are able to throw off the shackles on creativity and see opportunities for creating viable businesses where most people see what they've always seen (or, worse yet, see nothing). Creative exercises such as the one in Figure 3.1 can help adults reconnect with the creativity they exhibited so readily as children.

Many years ago, during an international chess competition, Frank Marshall made what has become known as one of the most beautiful—and one of the most creative—moves ever made on a chess board. In a crucial game in which he was evenly matched with a Russian master player, Marshall found his queen under serious attack. Marshall had several avenues of escape for his queen available. Knowing that the queen is one of the most important offensive players on the chessboard, spectators assumed that Marshall would make a conventional move and push his queen to safety.

Using all of the time available to him to consider his options, Marshall picked up his queen—and paused—and put it down on the most *illogical* square of all—a square from which the queen could easily be captured by any one of three hostile pieces. Marshall had done the unthinkable! He had sacrificed his queen, a move typically made only under the most desperate of circumstances. All of the spectators—even Marshall's opponent—groaned in dismay. Then the Russian—and finally the crowd—realized that Marshall's move was, in reality, a brilliant one. No matter how the Russian opponent took the queen, he would eventually be in a losing position. Seeing the

inevitable outcome, the Russian conceded the game. Marshall had won the match in a rare and daring fashion: He had won by sacrificing his queen!²⁰

What lesson does this story hold for entrepreneurs? By suspending conventional thinking long enough to even consider the possibility of such a move, Marshall was able to throw off the usual assumptions constraining most chess players. He had looked beyond the traditional and orthodox strategies of the game and was willing to take the risk of trying an unusual tactic to win. The result: He won. Although not every creative business opportunity that entrepreneurs take will be successful, many who, like Frank Marshall, are willing to go beyond conventional wisdom will be rewarded for their efforts. Successful entrepreneurs, those who are constantly pushing technological and economic boundaries forward, constantly ask, “Is it time to sacrifice the queen?”

Merely generating one successful creative solution to address a problem or a need usually is not good enough to keep an entrepreneurial enterprise successful in the long run, however. Success—even survival—in the modern world of business requires entrepreneurs to tap their

<u>Order</u>	Stranger + Stranger Strangers	Tailgate	<u>PUT IT RENRUB</u>
DISH PIZZA	<u>1,3,5,7,9,11</u> WHELMING	P.O.L.K.A.	
ARUPMS	EDGE TECHNOLOGY	B STUDY C K L E	NO LAND 
SCtheOOP	Get 2 .	<u>LOST</u>	DNUORG 
CO ⁰ FFEE	ClaimsCOURT	K C I YOUR SLEEVE T	URGENCCY
Rival Rival	<u>COVER</u> BOSS	CROLOSTWD	OF THE MONTH <u>DUE</u>
DEDNAH COMPLIMENT	INCREDIBLE MAN	INVASIVE SURGERY	COST 
EVER EVER 24 Hours EVER EVER	2 nd 2 nd GNIIOG 2 nd 2 nd	HEAD ACHE	GRACE.

FIGURE 3.1
“How Creative Are You?”

creativity (and that of their employees) constantly. Entrepreneurs can be sure that if they have developed a unique, creative solution to solve a problem or to fill a need, a competitor (perhaps one six times zones away) is hard at work developing an even more creative solution to render theirs obsolete. This rapid and accelerating rate of change has created an environment in which staying in a leadership position requires constant creativity, innovation, and entrepreneurship. A company that has achieved a leadership position in an industry but then stands still creatively is soon toppled from its number one perch. The entrepreneur's job is to keep the company focused on the future. Jay Walker, founder of *Priceline.com*, suggests that entrepreneurs constantly ask, "What might my customers want tomorrow? What might my customers want in six months, a year, two years, that they don't want today?"²¹ As valuable as customer feedback is, merely soliciting it is not likely to produce disruptive innovation; that usually requires a company whose culture and employees are focused on developing new products, services, and business models.

Can Creativity Be Taught?

Because creativity appears to be almost magical, conventional wisdom held that a person was either creative—imaginative, free-spirited, entrepreneurial—or not—logical, narrow-minded, rigid. Today, we know better. "Creativity is not magic, and there's no such thing as a 'creative type,'" says creativity expert Jonah Lehrer. "Creativity is not a trait that we inherit or a blessing bestowed by the angels. It is a skill. Anyone can learn to be creative and to get better at it."²² The problem is that in most organizations, employees have never been expected to be creative. In addition, many businesses fail to foster an environment that encourages creativity among employees. Restricted by their traditional thinking patterns, most people never tap into their pools of innate creativity, and the company becomes stagnant. "The direct benefit of employee innovation is a competitive advantage," says creativity expert David Silverstein, "but the secondary benefits are greater employee empowerment and satisfaction."

Not only can entrepreneurs and the people who work for them learn to think creatively, but they must for their companies' sake! "Innovation and creativity are not just for artists," says Joyce Wycoff, author of several books on creativity. "These are skills with a direct, bottom-line payoff."²³ Before entrepreneurs can draw on their own creative capacity or stimulate creativity in their own organizations, they must understand creative thinking.

Creative Thinking

Research into the operation of the human brain shows that each hemisphere of the brain processes information differently and that one side of the brain tends to be dominant over the other. The human brain develops asymmetrically, and each hemisphere tends to specialize in certain functions. The left brain is guided by linear, vertical thinking (from one logical conclusion to the next), whereas the right brain relies on kaleidoscopic, lateral thinking (considering a problem from all sides and jumping into it at different points). The left brain handles language, logic, and symbols; the right brain takes care of the body's emotional, intuitive, and spatial functions. The left brain processes information in a step-by-step fashion, but the right brain processes it intuitively—all at once, relying heavily on images.

Left-brain vertical thinking is narrowly focused and systematic, proceeding in a highly logical fashion from one point to the next. Right-brain lateral thinking, on the other hand, is somewhat unconventional, unsystematic, and unstructured, much like the image of a kaleidoscope, whirling around to form one pattern after another. It is this right-brain-driven, lateral thinking that lies at the heart of the creative process. Those who have learned to develop their right-brain thinking skills tend to do the following:

- Always ask the question, "Is there a better way?"
- Challenge custom, routine, and tradition.
- Be reflective, often staring out windows, deep in thought. (How many traditional managers would stifle creativity by snapping these people out of their "daydreams," chastise them for "loafing," and admonish them to "get back to work?") Great ideas need time to percolate, and smart entrepreneurs give employees (and themselves) some down time during the day to think and reflect.
- Be prolific thinkers. They know that generating lots of ideas leads to a few highly creative ideas. Nobel laureate Paul Berg, recalling his friend

3.

Understand how the two hemispheres of the human brain function and what role they play in creativity.

Francis Crick, who also won a Nobel Prize as codiscoverer of the structure of DNA, says, “He had 10 ideas for every one that was truly brilliant.”²⁴

- Play mental games, trying to see an issue from different perspectives.
- Realize that there may be more than one “right answer.”
- See mistakes as mere “pit stops” on the way to success.
- See problems as springboards for new ideas. While Cristy Clarke was on her way to a holiday party, she began to think of questions to serve as starters for meaningful, interesting conversations because she did not want to endure yet another dull evening of meaningless small talk. Her experiment was a success, and the next morning Clarke began developing the questions that would become part of the successful party game TableTopics, which Clarke markets along with 29 other products through her company, Ruby Mine Inc.²⁵
- Understand that failure is a natural part of the creative process. James Dyson spent 15 years and nearly his entire savings before he succeeded in developing the bagless vacuum cleaner that made him rich and famous. “If you want to discover something that other people haven’t,” he says, “you need to do things the wrong way. You don’t learn from success.”²⁶
- Have “helicopter skills,” the ability to rise above the daily routine to see an issue from a broader perspective and then swoop back down to focus on an area in need of change.
- Relate seemingly unrelated ideas to a problem to generate innovative solutions.

ENTREPRENEURIAL PROFILE Glen Jakins: Humless and Green Energy Innovation

Glen Jakins, originally from South Africa, has built several surprising new businesses again and again. In March 2008, Jakins was camping with his family in the redwood forests of North America. Early one evening, a nearby camper started up a diesel generator and let it run most of the night, ruining the peace in the forest. Jakins, then 41, became increasingly irritated by the experience and decided to invent a portable silent generator. Thus, a Utah-based company called Humless was conceived from a frustrating camping trip. Jakins became an energy innovator and invented a perfect battery technology—a combination of lightweight and long charging. The batteries used for the Humless generator, which Jakins’s team assembles in Provo, Utah, are one-third the mass of lead-acid batteries of comparable storage found in the United States. Humless also offers accessories like speakers and headphones. Besides this, Jakins has poured his energy into numerous creative business ventures, vigorously probing markets with products of his own design. He owns several businesses, including The Original Scrapbox. These rake in millions of dollars in revenue. His products range from stuffed toys to artful handbags, computer cases, iPad covers, a steam generator, and a modern material for transferring graphic images permanently onto any object. A notable success is an armoire-style organizer for scrapbookers. His holding company, Ensign Group International, released a desktop version with a glass-like top that allows viewing and selection of a potpourri of goods for hobbyists. Jakins is a free spirit who insists he won’t rely on the government to help him in his entrepreneurial journey. He keeps on trying new things to change people’s energy expectations one project at a time. That’s precisely how the innovative entrepreneurs of the world also generate innovative businesses.²⁷



In the Entrepreneurial Spotlight

The Ingredients of Creativity

According to creativity expert Tina Seelig, a person must have three factors to be creative:

1. Imagination, the ability to allow your mind to come up with innovative ideas.
2. A knowledge base that allows you to understand a problem or situation and that serves as a base from which you can generate unique solutions. Seelig calls knowledge the

“toolbox for your imagination.”

3. The motivation and drive to solve the problem “because getting beyond the obvious answers requires a tremendous amount of energy.”

Sometimes creative solutions arise as a result of solving a simple problem. Christoph Rochna’s girlfriend wanted to shop a local flea market for mismatched chairs to go with the new dining room table and decorations that she had purchased from Ikea. Knowing that finding just the right chairs could take months,

In the Entrepreneurial Spotlight *(continued)*

Rochna took the corrugated cardboard packaging from their purchases and fashioned temporary chairs, which his girlfriend loved. “The chairs lasted for six months,” says Rochna, “which got me thinking, ‘If this crudely constructed furniture could last this long, it’s something we should pursue.’” Rochna invited two friends, Mario Bauer and Benjamin Kwitek, to form a business to produce biodegradable furniture made from a patented composite of paper, viscose fabric, and biopolymer. With \$200,000 in seed capital, the three entrepreneurs launched Papernomad and achieved immediate success selling their biodegradable furniture to companies for use at outdoor festivals and to consumers who wanted inexpensive outdoor furniture.

A year later, Rochna came up with a new product idea: protective sleeves and covers for electronic devices, such as tablet computers and smart phones. He realized that existing sleeves and covers were made of plastic and neoprene, materials that will outlast the devices they protect and will most likely end up in a landfill for several thousands of years. “It seemed sensible to create sleeves that lasted just as long as the device that lives in them,” says Rochna. Papernomad’s protective sleeves were a hit with consumers and won the prestigious red dot award for product design. Their success led Rochna and his team to drop their line of biodegradable furniture and focus solely on manufacturing protective sleeves and covers for electronic devices. Customers appreciate the environmentally friendly products, which sell for between €26 and €58, and the fact that they can customize their sleeves and covers simply by drawing any design they want on them.

Serendipity, stumbling onto a creative solution by chance, also plays a role in creativity. Steve Cox was the owner of Green Foam Blanks, a company that manufactured surfboard blanks, the core of every surfboard that is made from recycled polyurethane foam. Cutting the blanks and shaping surfboards from them creates mountains of “shaper dust,” which many surfboard makers reluctantly dumped in landfills. “We’d been trying to figure out ways to get rid of this stuff without putting it in the landfill,” says Jerry O’Keefe, owner of Soul Stix Surfboards, in San Clemente, California.

One day, after a machine in Cox’s factory leaked two quarts of hydraulic fluid, Cox grabbed a handful of shaper dust and threw it on the spill. To his amazement, the dust soaked up the spill in seconds. Cox realized that he was on to something and decided to conduct another test. “I got some old oil from a mechanic’s shop and went to a stagnant pond I knew and put in a quart,” he recalls. “I threw the [shaper dust] on it, and it bonded immediately. I was able to scoop it out, and it left the water perfectly clear.” The material’s secret, Cox learned, lies in its cell structure, which resembles a honeycomb. The cells attract liquids

but do not allow them to penetrate, characteristics that allow the dust to soak up spills, including those on water but without sinking as other absorbent materials do.

Cox abandoned his surfboard blank-making business and teamed up with Tom and T. J. Rossi and Daniel Fitzgerald to start a company, Monarch Green, to refine the shaper dust into a commercial product, Spillinex, a process that took the better part of a year. Monarch Green changed Spillinex’s name to Incredisorb, which it sells for \$1.99 per pound to companies for cleaning up oil and chemical spills, a \$1-billion-per-year industry (compared to just \$160 million in surfboard manufacturing). Studies show that Incredisorb can absorb 638 percent of its own weight in motor oil. Cox and his team also have developed Oilinator, mats covered with an absorbent shell and filled with Incredisorb. With 10 million to 25 million gallons of oil spilled in the United States annually, Monarch Green has a bright future.

Entrepreneurs can encourage creativity in their organizations by providing certain external factors, such as a culture that supports creativity, a work space that encourages creativity, the resources necessary for creativity, an attitude that expects and tolerates failure, and many others. To send a clear signal that creative ideas sometimes fail, every quarter Tor Myhren, a top manager at Grey New York, an advertising agency, gives one employee the “Heroic Failure” award, a garish two-foot-tall trophy that recognizes bold, brilliant ideas that do not always pan out. “How companies deal with failure is a very big part of innovation,” observes Judy Estrin, a serial entrepreneur and innovation expert. The Heroic Failure award lets employees know that Grey New York values creativity and that they will not be punished for trying creative solutions that fail. “The most successful people tend to be those with the most failures,” says Keith Simonton, an expert on creativity.

1. The three factors that Tina Seelig identifies as essential to creativity are internal factors that an individual must possess. List and describe five external factors that businesses can provide to encourage their employees’ creativity.
2. Use a search engine to find an example of an entrepreneur who, like Christoph Rochna and Steve Cox, used their creative ability to develop a business idea. Write a brief summary of the entrepreneur’s process.

Sources: Based on Suzanne Todd Woody, “Wipe Up,” *Forbes*, October 24, 2011, pp. 70–72; Jodi Helmer, “Looks Good on Paper,” *Entrepreneur*, October 2012, p. 96; Sue Shellenbarger, “Better Ideas Through Failure,” *Wall Street Journal*, September 27, 2011, pp. D1, D4; Drake Baer, “A Crash Course in Creative Breakthroughs,” *Fast Company*, April 18, 2012, www.fastcompany.com/1834454/crash-course-creative-breakthroughs.

Although each hemisphere of the brain tends to dominate in its particular functions, the two halves normally cooperate, with each part contributing its special abilities to accomplish those tasks best suited to its mode of information processing. Sometimes, however, the two hemispheres may even compete with each other, or one half may choose not to participate. Some researchers have suggested that each half of the brain has the capacity to keep information from the other! The result, literally, is that “the left hand doesn’t know what the right hand is doing.” Perhaps the most important characteristic of this split-brain phenomenon is that an individual can learn to control which side of the brain is dominant in a given situation. In other words, a person can learn to “turn down” the dominant left hemisphere (Upload By: anonymous)

and “turn up” the right hemisphere (focusing on intuition and unstructured thinking) when a situation requiring creativity arises.²⁸ With practice, a person can learn to control this mental shift, tapping the pool of creativity that lies hidden within the right side of the brain. This ability has tremendous power to unleash the creative capacity of entrepreneurs. The need to develop this creative ability means that exploring inner space (the space within our brains)—not outer space—becomes the challenge of the century.

Successful entrepreneurship requires both left- and right-brain thinking. Right-brain thinking draws on the power of divergent reasoning, which is the ability to create a multitude of original, diverse ideas. Left-brain thinking counts on convergent reasoning, the ability to evaluate multiple ideas and choose the best solution to a given problem. Entrepreneurs need to rely on right-brain thinking to generate innovative product, service, or business ideas. Then they must use left-brain thinking to judge the market potential of the ideas they generate. Successful entrepreneurs have learned to coordinate the complementary functions of each hemisphere of the brain, using their brains’ full creative power to produce pragmatic innovation. Otherwise, entrepreneurs, who rarely can be accused of being “halfhearted” about their business ideas, run the risk of becoming “half-headed.”

How can entrepreneurs learn to tap their innate creativity more readily? The first step is to break down the barriers to creativity that most of us have erected over the years. We now turn our attention to these barriers and some suggested techniques for tearing them down.

Barriers to Creativity

The number of potential barriers to creativity is virtually limitless—time pressures, unsupportive management, pessimistic coworkers, overly rigid company policies, and countless others. Perhaps the most difficult hurdles to overcome, however, are those that individuals impose on themselves. In his book *A Whack on the Side of the Head*, Roger von Oech identifies 10 “mental locks” that limit individual creativity:²⁹

1. Searching for the one “right” answer. Recent research by Kyung Hee Kim, a professor at the College of William and Mary, shows that creativity (as measured by the Torrance Test of Creative Thinking) among both children and adults in the United States has declined markedly since 1990. The decline, which Kim says is “very significant,” is particularly acute among the youngest segment of the population, children from kindergarten to sixth grade.³⁰ “Children have become less emotionally expressive, less energetic, less talkative and verbally expressive, less humorous, less imaginative, less unconventional, less lively and passionate, less perceptive, less apt to connect seemingly irrelevant things, less synthesizing, and less likely to see things from a different angle,” she says.³¹ Part of the problem is that deeply ingrained in most educational systems is the assumption that there is one “right” answer to a problem. In reality, however, most problems are ambiguous. The average student who has completed four years of college has taken more than 2,600 tests; therefore, it is not unusual for this one-correct-answer syndrome to become an inherent part of our thinking. “Schools are educating creativity and innovation out of children,” says Matt Goldman, a cofounder of the Blue Man Group, which recently started Blue School, a pre-K and elementary school that focuses on developing creativity in its students. Depending on the questions one asks, there may be (and usually are) several “right” answers.

4.

Explain the 10 “mental locks” that limit individual creativity.

ENTREPRENEURIAL PROFILE: Ben Vigoda and David Reynolds: Lyric Semiconductor

From their earliest days, computers have processed information using the binary code, a system that uses only zeroes and ones. However, Ben Vigoda and David Reynolds, the cofounders of Lyric Semiconductor, a small company based in Cambridge, Massachusetts, realized that there might be other ways for computers to process information. They have developed a semiconductor chip (the “brain” of any computer) that also uses values between zero and one, an advancement that has the potential to revolutionize computing. Lyric’s probability processing technology not only dramatically increases the speed with which a computer works, ranging from faster Google searches to speedier analysis of the human genome, but also reduces the size of computers because fewer chips are needed to process a given amount of data. “We are changing something that’s been true for 50 or 60 years,” says Vigoda. Lyric’s creative technology holds so much potential that venture capital firms and the U.S. Department of Defense have invested \$20 million in the company, which recently was named one of the world’s most innovative companies by *Technology Review* magazine.³²

2. Focusing on “being logical.” Logic is a valuable part of the creative process, especially when evaluating ideas and implementing them. However, in the early imaginative phases of the process, logical thinking can restrict creativity. Focusing too much effort on being logical also discourages the use of one of the mind’s most powerful creations: intuition. Von Oech advises us to “think something different” and to use nonlogical thinking freely, especially in the imaginative phase of the creative process. Intuition, which is based on the accumulated knowledge and experiences a person encounters over the course of a lifetime and resides in the subconscious, can be unlocked. It is a crucial part of the creative process because using it often requires one to tear down long-standing assumptions that limit creativity and innovation.



ENTREPRENEURIAL PROFILE: Jae Lee: Georgia Chopsticks When Jae Lee learned that China cannot harvest enough domestic wood to produce the billions of pairs of disposable chopsticks used there each year, the Americus, Georgia, resident launched Georgia Chopsticks, the only chopsticks manufacturer in the United States. His company uses the ample supply of local poplar to produce and export to China 80 million pairs of chopsticks annually—at a price that is 20 percent lower than Chinese-manufactured chopsticks. Lee recently expanded Georgia Chopsticks’s product line to include toothpicks and tongue depressors, both of which he makes from the wood scraps that are left over from chopstick production.³³

3. Blindly following the rules. We learn at a very early age not to “color outside the lines,” and we spend the rest of our lives blindly obeying such rules. Sometimes, creativity depends on our ability to break the existing rules so that we can see new ways of doing things. Consider, for example, the top row of letters on a standard keyboard:

Q W E R T Y U I O P

In the 1870s, Sholes & Company, a leading manufacturer of typewriters, began receiving numerous customer complaints about its typewriter keys sticking together when typists’ fingers were practiced enough to go really fast. Company engineers came up with an incredibly creative solution to eliminate the problem of sticking keys. They designed a *less* efficient keyboard configuration, placing the letters O and I (the fourth and fifth most commonly used letters of the alphabet) so that the weaker middle and ring fingers would strike them. By slowing down typists with this inefficient keyboard, the engineers solved the sticking keys problem. Today, despite the fact that computer technology has eliminated all danger of sticking keys, this same inefficient keyboard configuration remains the industry standard!

4. Constantly being practical. Imagining impractical answers to “what if” questions can be powerful stepping-stones to creative ideas. Suspending practicality for a while frees the mind to consider creative solutions that otherwise might never arise. Whenever Thomas Edison hired an assistant to work in his creative laboratory, he would tell the new employee, “Walk through town and list 20 things that interest you.” When the worker returned, Edison would ask him to split the list into two columns. Then he would say, “Randomly combine objects from column A and column B and come up with as many inventions as you can.” Edison’s methods for stimulating creativity in his lab proved to be successful; he holds the distinction of being the only person to have earned a patent every year for 65 consecutive years!³⁴

Periodically setting aside practicality allows entrepreneurs to consider taking a product or a concept from one area and placing it in a totally different application.



ENTREPRENEURIAL PROFILE: Michelle Marciniak and Susan Walvius: Sheex Former collegiate basketball coaches Michelle Marciniak and Susan Walvius enjoyed the moisture-wicking properties of the high-performance athletic clothing that they and their athletes wore. After a workout one day, Walvius said, “I’d love to have bed sheets made out of this stuff,” and a business idea was born. That year, the entrepreneurs worked with students at the University of South Carolina’s Moore School of Business to conduct a feasibility study and to create a business plan. “We learned that the big issue most people have that disrupts their sleep is being too warm,” says Walvius. Within a year, the budding entrepreneurs gave up their coaching jobs to focus on launching Sheex. Sheex, which are made from microfiber polyester and spandex, are designed to transfer body heat twice as effectively as traditional sheets, breathe 50 percent better than cotton, and wick away moisture to keep sleepers dry. Marciniak and Walvius sell Sheex through several national retail chains, including

Bed, Bath, & Beyond, Brookstone, and Sleep Number, and their company now generates \$240 million in annual sales.³⁵

5. Viewing laughter and play as frivolous. A playful attitude is fundamental to creative thinking. There is a close relationship between the “haha” of humor and the “aha” of discovery. Laughter tends to help people relax, which in turn allows them to be more creative. Researchers have discovered that exposing people to short video clips of stand-up comedy or humorous comedy scenes increases their creativity.³⁶

Play gives us the opportunity to reinvent reality and to rethink established ways of doing things. Play also stimulates the left side of the brain, which is responsible for creativity. Play at work causes people to remove idea filters that can be barriers to creativity and sends a signal to employees that they “work in a permissive and playful environment,” says Tim Brown, CEO of global design company IDEO. “We need to be able to trust to play and be creative.”³⁷ Children learn when they play, and so can entrepreneurs. Watch children playing, and you will see them invent new games, create new ways of looking at old things, and learn what works (and what doesn’t) in their games. Entrepreneurs can benefit from playing in the same way that children do. They, too, can learn to try new approaches and discover what works and what doesn’t. Creativity results when entrepreneurs take what they have learned at play, evaluate it, corroborate it with other knowledge, and put it into practice. Encourage employees to have fun when solving problems; they are more likely to push the boundaries and come up with a genuinely creative solution if they do. What kind of invention would Wile E. Coyote, who seems to have an inexhaustible supply of ideas for catching Roadrunner in those cartoons, create in this situation? How might the Three Stooges approach this problem? What would Seinfeld’s Kramer suggest? What would a six-year-old do? The idea is to look at a problem or situation from different perspectives.



ENTREPRENEURIAL PROFILE: Kim Vandenbroucke: Brainy Chick For Kim Vandenbroucke, owner of Brainy Chick and a game inventor with a track record of hits such as Cranium Party Playoff, Barbie Mini Kingdom, and Scattergories Categories (part of which she came up with on her honeymoon), playing is an important part of the creative process. Vandenbroucke, who says she grew up in a household of game players, says she still plays at least one game a day, often drawing on the experience for inspiration. Although she keeps many sources of creative inspiration near her desk, one of her favorites is a copy of *Meet Mr. Product*, a book that features classic characters from the world of advertising. It’s “a great place to get ideas,” she says. “I love old advertising characters—the styles, the names, the nostalgia.” Vandenbroucke also carries a small notebook in which she writes down game ideas, “seeds,” she calls them, as they come to her.³⁸

6. Becoming overly specialized. A common killer of creativity is **myopic thinking**, which is narrowly focused and limited by the status quo. Because experts are so immersed in what they know, they often are victims of myopic thinking. That’s why creative companies include *nonexperts* in creative problem solving or idea generation sessions; they are free to ask questions and offer ideas that challenge the status quo and traditional solutions that experts “know” cannot work but often do. “The real disruptors will be those individuals who are not steeped in one industry of choice but individuals who approach challenges with a clean lens, bringing together diverse experiences, knowledge, and opportunities,” says serial entrepreneur and philanthropist Naveen Jain.³⁹

Creative thinkers tend to be “explorers,” searching for ideas outside of their areas of specialty. The idea for the roll-on deodorant stick came from the ballpoint pen. The famous Mr. Potato Head toy was invented by a father sitting with his family at the dinner table who noted how much fun his children had playing with their food. Velcro was invented by a man who, while hiking one day to take a break from work, had to stop to peel sticky cockleburs from his clothing. As he picked them off, he noticed how their hooked spines caught on and held tightly to the cloth. When he resumed his hike, he began to think about the possibilities of using a similar design to fasten objects together. Thus was born Velcro!



ENTREPRENEURIAL PROFILE: Jessica Smith: Casttoo When Jessica Smith tried to jump a curb on her bicycle, she ended up with a broken wrist. The 21-year-old art student painted a beautiful floral design on her cast, and when she returned to the doctor to have it removed, “he said that if someone would produce art like that for casts, he’d buy them,” she recalls. The comment inspired Smith to turn her artwork into the first generation of Casttoos, a special adhesive

film with brightly colored designs that, when applied to a cast and heated for 10 seconds with a hair dryer, melts into the plaster cast. Smith's simple idea led her to launch the Casttoo Web site, where she has sold tens of thousands of her brightly colored decals. "At any given time, 10 percent of the population is healing from a broken bone," she says. Casttoo recently partnered with global giant 3M and is negotiating the rights to sports and cartoon characters. Designs range from zebra stripes and Egyptian motifs to soccer balls and floral patterns, all of which are consistent with Smith's "Happy Healing" philosophy.⁴⁰

7. Avoiding ambiguity. Ambiguity can be a powerful creative stimulus; it encourages us to "think something different." Being excessively detailed in an imaginative situation tends to stifle creativity. Ambiguity, however, requires us to consider at least two different, often contradictory notions at the same time, which is a direct channel to creativity. Ambiguous situations force us to stretch our minds beyond their normal boundaries and to consider creative options we might otherwise ignore. Although ambiguity is not a desired element when entrepreneurs are evaluating and implementing ideas, it is a valuable tool when they are searching for creative ideas and solutions. Entrepreneurs are famous for asking a question and then going beyond the first answer to explore other possible answers. The result is that they often find business opportunities by creating ambiguous situations.

8. Fearing looking foolish. Creative thinking is no place for conformity! New ideas rarely are born in a conforming environment. People tend toward conformity because they don't want to look foolish. The fool's job is to whack at the habits and rules that keep us thinking in the same old ways. In that sense, entrepreneurs are top-notch "fools." They are constantly questioning and challenging accepted ways of doing things and the assumptions that go with them. The noted entrepreneurship theorist Joseph Schumpeter wrote that entrepreneurs perform a vital function—"creative destruction"—in which they rethink conventional assumptions and discard those that are no longer useful. According to Schumpeter, "The function of entrepreneurs is to reform or revolutionize the pattern of production by exploiting an invention or, more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way, by opening up a new source or supply of materials or a new outlet for products, by reorganizing an industry or so on."⁴¹ In short, entrepreneurs look at old ways of doing things and ask, "Is there a better way?" By destroying the old, they create the new.



ENTREPRENEURIAL PROFILE: Rich Able and Christoph Mack: X2 Impact

After Rich Able's son sustained a concussion during a high school football game, Able and his business partner Christoph Mack took a new look at an old technology: athletic mouth guards. Able and Mack designed a new mouth guard, the BTX2 Impact Intelligence System, which uses accelerometers and gyroscopes to measure the force and the direction of the blows that an athlete receives. A radio system inside the mouth guard transmits the information to an app that runs on a smart phone or tablet on the sidelines. The app also contains numerous tests to help trainers and medical professionals assess the severity of an athlete's injuries as a result of a blow. After their high-tech mouth guard passed live tests with several sports teams, Able and Mack's company, X2 Impact, is selling the BTX2 Impact Intelligence System to teams across the United States for about \$100 each.⁴²

9. Fearing mistakes and failure. Creative people realize that trying something new often leads to failure; however, they do not see failure as an end. It represents a learning experience on the way to success. As you learned in Chapter 1, failure is an important part of the creative process; it signals entrepreneurs when to change their course of action. Entrepreneurship is all about the opportunity to fail! Many entrepreneurs failed numerous times before finally succeeding. Despite their initial setbacks, they were able to set aside the fear of failure and keep trying. Arianna Huffington, author of a dozen books and founder of the news and blog Web site Huffington Post, says, "I love talking about my failures more than my successes. Think of failure as a stepping stone to success. I was rejected by 35 publishers before getting to yes." The highly successful *Huffington Post*, which Huffington launched in 2005, attracts more than 35 million unique visitors per month, more than the Web sites of any major newspaper in the United States.⁴³

The key is to see failure for what it really is: a chance to learn how to succeed. Entrepreneurs who willingly risk failure and learn from it when it occurs have the best chance of succeeding. Charles F. Kettering, a famous inventor (he invented the lighting and ignition systems in automobiles, among other things), explains, "You fail because your ideas aren't right, but you should learn to fail

intelligently. When you fail, find out *why* you failed and each time it will bring you nearer to the goal.”⁴⁴ Successful entrepreneurs equate failure with innovation rather than with defeat.

Thanks to technology, the cost of failed attempts at innovation has never been lower. Entrepreneurs and companies can test new ideas at speeds and costs that were unimaginable only a few years ago. Building prototypes, getting them into potential customers’ hands, and getting useful feedback on them has never been easier and less expensive. Entrepreneurs use the Internet and social media to determine whether customers are interested in purchasing their product and service innovations and to generate ideas for improving them.

10. Believing that “I’m not creative.” Some people limit themselves because they believe creativity belongs only to the Einsteins, Beethovens, and da Vincis of the world. Unfortunately, this belief often becomes a self-fulfilling prophecy. A person who believes he is not creative will, in all likelihood, behave that way and will make that belief come true. Some people who are considered geniuses, visionaries, and inventors actually are no smarter and have no more innate creative ability than the average person; however, they have learned how to think creatively and are persistent enough to keep trying until they succeed.

Successful entrepreneurs recognize that “I’m not creative” is merely an excuse for inaction. *Everyone* has within him or her the potential to be creative; not everyone will tap that potential, however. Innovation expert Hal Gregersen says that his research suggests that “one-third of our creative capacity is in our DNA. The other two-thirds [originates in] the world we grow up and work in.”⁴⁵ Successful entrepreneurs find a way to unleash their creative powers on problems and opportunities.

By avoiding these 10 mental locks, entrepreneurs can unleash their own creativity and the creativity of those around them as well. Successful entrepreneurs are willing to take some risks, explore new ideas, play a little, ask “What if?,” and learn to appreciate ambiguity. By doing so, they develop the skills, attitudes, and motivation that make them much more creative—one of the keys to entrepreneurial success. The accompanying “Lessons from the Street-Smart Entrepreneur” feature includes questions designed to spur the imagination.



Lessons from the Street-Smart Entrepreneur

Questions to Spur the Imagination

We learn at an early age to pursue answers to questions. Creative people, however, understand that *good questions* are extremely valuable in the quest for creativity. Some of the greatest breakthroughs in history came as a result of creative people asking thought-provoking questions. Bill Bowerman, contemplating a design for the soles of running shoes over a breakfast of waffles, asked, “What would happen if I poured rubber into my waffle iron?” He did, and that’s how Nike shoes came to be. (Bowerman’s rubber-coated waffle iron is on display in the Nike Town superstore and museum in Chicago.) Albert Einstein, creator of the theory of relativity, asked, “What would a light wave look like to someone keeping pace with it?”

To jump-start creativity, Steve Gillman suggests writing a short list of adjectives, such as *light, cheap, fast, big, short, small, fun*, and others, and use them to ask “what if” questions. What if this product could be lighter? What if this process could be faster? What if this service could be cheaper? Don Wetzel, vice president of product planning at Docutel, a company that developed automated baggage-handling equipment, was standing in a long teller line at a bank in Dallas, Texas, in 1968, when he asked, “What if banks could offer banking services *without* a big,

expensive building and bank tellers?” Wetzel pitched his idea to the management of Docutel, and by 1969, the company had a working prototype of an automated teller machine (ATM). Later that year, Chemical Bank in New York City became the first bank to install an ATM and promoted its convenience with an ad campaign that said, “On September 3, 1969, our branch will open its doors at 9:00 A.M. and we’ll never close again!” The banking industry would never be the same.

The Street-Smart Entrepreneur suggests asking the following questions to help spur your imagination:

1. Is there a new way to do it?
2. Can you borrow or adapt it?
3. Can you give it a new twist?
4. Do you merely need more of the same?
5. Less of the same?
6. Is there a substitute?
7. Can you rearrange the parts?
8. What if you do just the opposite?

Lessons from the Street-Smart Entrepreneur (continued)

9. Can you combine ideas?
10. Are customers using your product or service in ways you never expected or intended?
11. Which customers are you not serving? What changes to your product or service are necessary to reach them?
12. Can you put it to other uses?
13. What else could we make from this?
14. Are there other markets for it?
15. Can you reverse it?
16. Can you rearrange it?
17. Can you put it to another use?
18. What idea seems impossible but, if executed would revolutionize your business?

When Chester Carlson was a boy, he was fascinated by chemistry and graphic arts, two distinct disciplines that he would later combine to create a popular invention. After graduating from the California Institute of Technology with a degree in physics, Carlson earned a law degree from New York Law School and became the head of the patent department for P.R. Mallory and Company, an electronics company in New York City. While studying law and working at Mallory, Carlson was frustrated by having to make handwritten copies of the information he needed from law books and patent applications and decided to create a machine that could make copies of documents. Rather than utilize the well-researched field of traditional photography as the foundation for his work, Carlson decided to use an emerging technology

called photoconductivity as the basis for his device. His research led him to conduct rudimentary experiments in the kitchen of his apartment in Jackson Heights, Queens, and in September 1938, Carlson filed his first patent for xerography, a process that used electrophotography and chemistry, to create images of documents. From 1939 to 1944, Carlson pitched his invention to more than 20 companies, but every one of them rejected it. Finally, the Battelle Memorial Institute signed a royalty-sharing agreement with Carlson and by 1947 had entered into a contract with a small company called Haloid (which would later change its name to Xerox) to develop the machine. It wasn't until 1959 that Xerox unveiled the first convenient office copier that could produce copies on plain paper with the touch of a single button. Carlson's invention, the photocopier, became the foundation of a huge global industry—all because he asked, "Can you combine ideas?"

Sources: Based on "How to Come Up with a Great Idea," *Wall Street Journal*, April 29, 2013, p. R1; "Chester F. Carlson," *The Great Idea Finder*, www.ideafinder.com/history/inventors/carlson.htm; "Timeline: The ATM's History," International Merchant Services, www.atm24.com/newssection/industry%20news/timeline%20-%20the%20atm%20history.aspx; Mary Bellis, "The ATM Machine of Don Wetzel," *About*, http://inventors.about.com/od/astartinventions/a/atm_3.htm; Chuck Frey, "How to Develop a Powerful Arsenal of Creative Questions," *Innovation Tools*, March 1, 2011, www.innovationtools.com/weblog/innovationblog-detail.asp?ArticleID=1570; David Lidsky, "Brain Calisthenics," *Fast Company*, December 2004, p. 95; Thea Singer, Christopher Caggiano, Ilan Mochari, and Tahl Raz, "If You Come, They Will Build It," *Inc.*, August 2002, p. 70; Creativity Web, "Question Summary," www.ozemail.com.au/~caveman/Creative/Techniques/osb_quest.html; *Bits & Pieces*, February 1990, p. 20; *Bits & Pieces*, April 29, 1993, "Creativity Quiz," *In Business*, November/December 1991, p. 18; Doug Hall, *Jump Start Your Brain*, (New York: Warner Books, 1995), pp. 86–87; Christine Canabou, "Imagine That," *Fast Company*, January 2001, p. 56; Steve Gillman, "Step Out of Business Mode to Solve Problems," *Regan's Manager's eBulletin*, May 22, 2008, p. 1; Tim McKeough, "The Shape-Shifting Car," *Fast Company*, November 2008, p. 84.

How to Enhance Creativity

Enhancing Organizational Creativity

Creativity doesn't just happen in organizations; entrepreneurs must establish an environment in which creativity can flourish—for themselves and for their workers. "Everyone has a creative spark, but many factors can inhibit its ignition," says one writer. "Part of an [entrepreneur's] role is to see the spark in his or her people, encourage its ignition, and champion its success."⁴⁶ New ideas are fragile creations, but the right company culture can encourage people to develop and cultivate them. Ensuring that workers have the freedom and the incentive to be creative is one of the best ways to achieve innovation. Entrepreneurs can stimulate their own creativity and encourage it among workers by following the suggestions outlined in the following section; these suggestions are designed to create a culture of innovation.

INCLUDE CREATIVITY AS A CORE COMPANY VALUE AND MAKE IT AN INTEGRAL PART OF THE COMPANY'S CULTURE Innovative companies do not take a passive approach to creativity; they are proactive in their search for new ideas. One of the best ways to set a creative tone throughout an organization begins with the company's mission statement. Entrepreneurs should incorporate creativity and innovation into their companies' mission statements and affirm their commitment to them in internal communications. Innovation allows a company to shape, transform, and direct its future, and the natural place to define that future is in the mission statement. If creativity and innovation are vital to a company's success (and they are!), they also should be a natural part of its culture. "Innovation occurs only if it's an attitude that runs through a company's culture," says one expert on innovation.⁴⁷ Integrating an attitude of innovation into a company's culture is much easier in small companies than in large ones.

Innovation can be a particularly powerful competitive weapon in industries that are resistant to change and are populated by companies that cling to the same old ways of doing business.

5.

Understand how entrepreneurs can enhance the creativity of their employees as well as their own creativity.

Even small companies that are willing to innovate can have a significant impact on entire industries by shaking up the status quo with their creative approaches. The result often is growing market share and impressive profits for the innovator.

HIRE FOR CREATIVITY Research published in the *Sloan Management Review* concludes that the most effective way for companies to achieve continuous innovation over the long term is by hiring and cultivating talented people.⁴⁸ Often the most creative people also tend to be somewhat different, even eccentric. Two researchers call these employees “the odd clever people every organization needs” because they use their creativity to create disproportionate amounts of value for their companies.⁴⁹

EMBRACE DIVERSITY One of the best ways to cultivate a culture of creativity is to hire a diverse workforce. When people solve problems or come up with ideas, they do so within the framework of their own experience. Hiring people from different backgrounds with different cultural experiences, hobbies, and interests provides a company with a crucial raw material needed for creativity. Smart entrepreneurs hire capable people of diverse backgrounds, different personalities, and varied work experience, confident that this eclectic mix of people will produce creative results for their businesses.

Focusing the talent and creativity of a diverse group of employees on a problem or challenge is one of the best ways to generate creative solutions. Research by Harvard Business School professor Karim Lakhani concludes that the experiences, viewpoints, and thought processes of diverse groups of people are powerful tools for solving problems creatively. “It’s very counterintuitive,” says Lakhani, “but not only did the odds of a [problem] solver’s success actually increase in fields outside his expertise, but also the further a challenge was from his specialty, the greater was the likelihood of success.”⁵⁰ The lesson for entrepreneurs: To increase the odds of a successful creative solution to a problem, involve in the process people whose background and experience lies *outside* of the particular problem area. One manager says, “They create a little grit to stimulate the oyster to produce a pearl.”⁵¹

ESTABLISH AN ORGANIZATIONAL STRUCTURE THAT NOURISHES CREATIVITY John Kao, an economist whose nickname is “Mr. Creativity,” says that innovative companies are structured like spaghetti rather than a traditional pyramid. In a spaghetti-style organization, employees are encouraged to mix and mingle constantly so that creative ideas flow freely throughout the company.⁵² At innovative companies, managers create organizational structures and cultures that emphasize the importance of creativity. Managers at Dunkin’ Donuts, with 9,235 coffee and donut outlets worldwide, recognize that innovation is the key to the 60-year-old company’s success. A few years ago, they created the Dunkin’ Brands Innovation Team, a group of 18 bakery specialists, and assigned them the task of developing new products for the company’s menu. Although many product ideas never make it out of the test kitchen, the Innovation Team launches about 20 new product ideas each year. One of its most successful additions was the bagel twist, which took the team 10 months to perfect and comes in a variety of flavors.⁵³

EXPECT CREATIVITY Employees tend to rise—or fall—to the level of expectations entrepreneurs have of them. One of the best ways to communicate the expectation of creativity is to encourage them to be creative.



ENTREPRENEURIAL PROFILE: West Paw Design West Paw Design, a company based in Bozeman, Montana, that produces eco-friendly pet toys, sponsors a creativity contest in which its 36 employees, from president to seamstresses, form small teams to develop prototypes of new product ideas. The winning team receives the coveted Golden Hairball Award, a statue reminiscent of the Oscar but with one of the company’s cat toys perched atop its head. Employees develop ideas and sketches, scrounge through bins of discarded materials, and assemble prototypes in less than two hours. The entire staff votes on a winner by secret ballot, and in addition to the Golden Hairball Award, the winning team members receive \$100 gift cards. The winning team in a recent contest was comprised of a sales representative, a seamstress, and a shipping department worker. Their idea: the Eco Bed, a stuffed dog bed made completely from recycled materials. West Paw included the bed in its product line, and it became an instant hit among customers.⁵⁴

EXPECT FAILURE AND LEARN FROM IT Creative ideas produce failures as well as successes. Failure is not a sign of being creative. Creativity requires taking chances, and managers must remove employees’ fear of failure. The surest way to quash creativity throughout an

organization is to punish employees who try something new and fail. Failure is a natural part of the creative process; therefore, entrepreneurs must give employees the freedom to fail early and often by encouraging them to test their new ideas against the lens of reality. The key is not to attempt to avoid failures (which are inevitable) but to learn from them. Inspired by Google's well-known 20 percent policy in which employees spend 20 percent of their time working on "pet projects" that they find interesting and believe have potential, National Public Radio (NPR) gives employees two or three days off once a quarter during the company's "Serendipity Days" to team up with people from other departments with whom they normally do not work to come up with creative ideas and projects. One purpose of the sessions is to "work with groups you wouldn't ordinarily work with through the course of your week," says Lars Schmidt, NPR's director of talent acquisition and innovation, whose team recently developed a new social media training program for the NPR staff. The goal is to "tap the creative ideas of the team and create a vehicle for getting small, cool projects and research explored," says one NPR employee. "There are some failures," he admits, which led managers to introduce a special award for these pioneers: the Penguin Award, named to honor the first bird in the flock bold enough to jump off the ice floe, knowing that he risks being eaten by a leopard seal. NPR employees have incorporated several of the ideas spawned at Serendipity Days into the company.⁵⁵

INCORPORATE FUN INTO THE WORK ENVIRONMENT Smart entrepreneurs know that work should be fun, and although they expect employees to work hard, they create a company culture that allows employees to have fun. "If you want creative workers, give them enough time to play," says actor John Cleese. At Radio Flyer, the Chicago-based company that makes the classic little red wagon for children, employees routinely participate in fun activities at work that include karaoke, tricycle races, pumpkin-carving contests, a Hollywood Squares game, and others. CEO Robert Pasin intentionally has made fun events a part of the company's culture. "There's method to the madness," says the company's "chief wagon officer," pointing out that the company's success depends on creative employees who are motivated and engaged in their work.⁵⁶

ENCOURAGE CURIOSITY Entrepreneurs and their employees constantly should ask "what if" questions and to take a "maybe we could" attitude. Challenging standing assumptions about how something should be done ("We've always done it that way.") is an excellent springboard for creativity. Doing so allows people to break out of assumptions that limit creativity. Supporting employees' extracurricular activities also can spur creativity on the job. For instance, Clay Carley, owner of a real estate development company in Boise, Idaho, recently hired a local dance troupe, Trey McIntyre Project, to help him and his employees brainstorm ideas for creating a new mixed-use project in Old Boise, a historic downtown district. "They've helped us to imagine the space in non-traditional ways," says Carley. Watching the dancers perform and learning about their creative process "pulls our staff out of the same way we do things so that we can design better solutions and solve problems."⁵⁷

Encouraging employees to "think big" also helps. "Incremental innovation is not a winner's game," says creativity expert John Kao. "The opportunity these days is to become a disruptive inventor," striving for major changes that can revolutionize an entire industry and give the company creating it a significant competitive advantage.⁵⁸



ENTREPRENEURIAL PROFILE: Joshua Silver In the 1980s, Joshua Silver, an atomic physicist at Oxford University and a lifelong tinkerer, began working to develop adjustable eyeglasses whose focusing power users could change themselves. Over time, Silver created a system of two flexible, transparent membranes with a clear silicone fluid between them. Changing the volume of fluid changes the curvature and the power of the lenses. "I did it because I was curious," says Silver of his invention. The adjustable glasses are ideal for people in developed nations, where only 5 percent of people wear eyeglasses, primarily because they live in rural areas and have no access to eye care professionals or lack the money to afford glasses. Silver's glasses come with plastic syringes filled with silicone fluid; users add or remove fluid by turning a dial that controls a small pump until the focus is right. Then they remove the syringes, and the adjustable glasses are ready to use. "All users have to do is look at a reading chart and adjust the glasses until they can see the letters clearly," says Silver, who hopes to eventually distribute a billion pairs of the glasses. "It's as simple as that."⁵⁹

DESIGN A WORKSPACE THAT ENCOURAGES CREATIVITY The physical environment in which people work has an impact on their level of creativity. The cubicles made so famous in the "Dilbert" cartoon strip can suck the creativity right out of a workspace. Transforming a typical

office space—even one with cubicles—into a haven of creativity does not have to be difficult or expensive. Covering bland walls with funny posters, photographs, murals, or other artwork; adding splashes of color; and incorporating live plants enliven a work space and enhance creativity. Designs that foster employee interaction, especially informal interaction, enhance an organization’s creative power. A study by the Massachusetts Institute of Technology reports that 80 percent of breakthrough innovations in products and services at companies came as a result of informal (sometimes chance) encounters among people. Many leading companies, including Google, Salesforce, and Zappos, have intentionally designed office layouts that encourage interaction among employees—informal employee “collisions.” At Google, these informal encounters led to collaborations among employees that resulted in both Gmail and Street View. “We want Googlers to bump into each other and collaborate,” says a company spokesperson. At Pixar, Steve Jobs insisted on placing bathrooms in the center of the building so that people working in different parts of the company would encounter one another. Salesforce has installed “lunch button” kiosks that employees can use to find other employees in the company with similar interests with whom to have lunch. Employees also can converse over meals with colleagues in other locations around the world using a “conversation portal,” a videoconferencing system set up in the dining area.⁶⁰



ENTREPRENEURIAL PROFILE: Mark Pincus: Zynga Mark Pincus, founder of Zynga, a maker of social media games, used Willie Wonka’s chocolate factory as the inspiration for the design of the company’s headquarters. Zynga offers employees a full-service gym and a health spa that provides free massages and acupuncture, and arcade games are scattered about the building. The office design is light and open, encouraging employees to interact with one another. Meeting rooms are filled with mismatched, retro furniture that lets employees know how important “being different” is to the company’s culture. Employees also are free to bring their dogs to work. (After all, Pincus named the company after his beloved American bulldog.)⁶¹



Zynga’s headquarters.

Source: Karsten Lemm/Newscom.

Although setting up arcade games may not be not practical for every business, entrepreneurs can still stimulate creativity by starting meetings with some type of short, fun exercise designed to encourage participants to think creatively.

VIEW PROBLEMS AS OPPORTUNITIES Every problem offers the opportunity for innovation. One of the best ways to channel a company’s innovative energy productively is to address questions that focus employees’ attention on customers’ problems and how to solve them.



ENTREPRENEURIAL PROFILE: Lihang Nong: PicoSpray Lihang Nong, a student at the University of Michigan, participated in a competition that challenged participants make a small engine more fuel efficient and less polluting. Nong learned that small engines, those that power lawn mowers, mopeds, motorcycles, generators, and other products, outnumber automotive engines and that they produce more greenhouse gases than automotive engines, mainly because they rely on older, cheaper carburetors rather than the more efficient electronic fuel injection systems that modern cars and trucks use. Unfortunately, traditional fuel-injected engines cost five times more than engines equipped with carburetors. As a student pursuing a master’s degree in mechanical engineering, Nong developed a simple, super-efficient fuel injection system designed that costs one-half to one-third as much as a standard fuel injection system because it eliminates the need for two of the three components traditionally used in fuel-injected engines. Nong’s fuel injection system not only produces the same gains in fuel efficiency as traditional systems but also generates far lower levels of greenhouse gases. Nong has filed a patent application for his novel small engine fuel injection system and launched a company, PicoSpray, to produce and market it.⁶²

PROVIDE CREATIVITY TRAINING Almost everyone has the capacity to be creative, but developing that capacity requires training. One writer claims, “What separates the average person from Edison, Picasso, or even Shakespeare isn’t creative capacity—it’s the ability to tap that capacity by encouraging creative impulses and then acting upon them.”⁶³ Training accomplished through books, seminars, workshops, and professional meetings can help everyone learn to tap their creative capacity. Research shows that even a single creativity training session can enhance employees’ creative ability.⁶⁴

STUDENTS HUB.com Entrepreneurs must give employees the tools and the resources they need to be creative. Entrepreneurs should remember that creativity often requires nonwork phases, and

Uploaded By: anonymous

giving employees time to “daydream” is an important part of the creative process. The creativity that employees display when they know that managers value innovation can be amazing—and profitable. These **intrapreneurs**, entrepreneurs who operate within the framework of an existing business, sometimes can transform a company’s future or advance its competitive edge. Jim Lynch, an electrical engineer at iRobot, a leading maker of robotic devices including the Roomba vacuum cleaner, was cleaning the gutters on his house one day and thought, “This is the perfect job for a robot because it fits our company’s three criteria: dumb, dirty, and dangerous.” Lynch began tinkering and built a gutter-cleaning robot using a spaghetti ladle and an electric screwdriver. At the company’s “Idea Bake-Off,” an event at which employees have 10 minutes to pitch a new product idea, Lynch’s idea received solid support and became an official project. Fellow employees volunteered to work on Lynch’s team, and within one year, iRobot introduced the Looj, the world’s first gutter-cleaning robot!⁶⁵

DEVELOP A PROCEDURE FOR CAPTURING IDEAS Small companies that are outstanding innovators do not earn that mantle by accident; they have a process in place to solicit and then collect new ideas. When workers come up with creative ideas, however, not every organization is prepared to capture them. The unfortunate result is that ideas that might have vaulted a company ahead of its competition or made people’s lives better simply evaporate. Without a structured approach for collecting employees’ creative concepts, a business leaves its future to chance. Clever entrepreneurs establish processes within their companies that are designed to harvest the results of employees’ creativity. At Lark Technologies, a Mountain View, California–based consumer electronics company that makes wearable wellness monitors and a vibrating silent alarm clock, most of the walls are made of whiteboards on which employees write out and draw sketches of new product ideas and post problems that they have not been able to solve. Company founder and CEO Julia Hu says that employees constantly add to each other’s ideas on the walls, creating an ongoing brainstorming session that has helped the young company expand its product line beyond its original vibrating silent alarm clock that links to an iPhone or iPod and that awakens only the person wearing it to include a diet, exercise, and sleep monitoring and feedback system. *Fast Company* magazine recently named Lark Technologies one of the 10 most innovative consumer electronics companies in the United States.⁶⁶

TALK WITH CUSTOMERS—OR, BETTER YET, INTERACT WITH THEM Innovative companies take the time to get feedback about how customers use the companies’ products or services, listening for new ideas. The voice of the customer can be an important source of creative ideas, and the Internet allows entrepreneurs to hear their customers’ voices quickly and inexpensively. Some companies engage their customers in social media conversations (or at least read what customers are writing about their products in social media); others observe their customers actually using their products or services to glean ideas that may lead to improvements and new features. Some companies go farther, forging alliances with customers to come up with creative ideas and develop new products based on them.



ENTREPRENEURIAL PROFILE: Jack Groetzinger and Russ D’Souza: SeatGeek Inc.

Jack Groetzinger and Russ D’Souza launched SeatGeek Inc. in 2009 in New York City as a service that predicted concert ticket prices, which can fluctuate wildly between the time promoters put them on sale and when the concert actually takes place. As customers signed up for the service, Groetzinger and D’Souza asked users permission to send them periodic e-mail surveys so that the company could get fresh ideas for improved or additional services. In its first questionnaire, which SeatGeek sent to 5,000 customers, the cofounders learned that customers wanted to see prices of available tickets listed in real time. “It really changed the way we thought about what we should do,” says Groetzinger. Today, SeatGeek has morphed into the largest event ticket search engine in the world and helps customers find the best deals on tickets for thousands of concerts and sporting events across the United States.⁶⁷

MONITOR EMERGING TRENDS AND IDENTIFY WAYS YOUR COMPANY CAN CAPITALIZE ON THEM Taco Bell, the quick-service chain of Mexican restaurants, invests resources in monitoring demographic and social trends that influence customers’ dining habits. Two trends that the company recently identified are the demand for healthier menus and customers’ focus on value-priced meals. To capitalize on these trends, Taco Bell introduced a fresher, lighter, and healthier Fresco product line and is developing a “home replacement menu” that offers food in large

containers that customers take home to share with their families. The company normally creates about 200 new product ideas each year before winnowing them down to about 20 products to introduce into test markets. Those that succeed in the test markets are rolled out nationwide. “Fail to innovate at your own risk,” says Taco Bell’s chief marketing officer, David Ovens.⁶⁸

LOOK FOR USES FOR YOUR COMPANY’S PRODUCTS OR SERVICES IN OTHER MARKETS Focusing on the “traditional” uses of a product or service limits creativity—and a company’s sales. Entrepreneurs can boost sales by finding new applications, often in unexpected places, for their products and services.

 **ENTREPRENEURIAL PROFILE: Neil Wadhawan and Raj Raheja: Heartwood Studios** In 2002, Neil Wadhawan and Raj Raheja launched Heartwood Studios, a company that produced 3-D renderings and animations of buildings and products for architects and designers. Their business was successful, but a brainstorming session helped the entrepreneurs to realize that their company’s 3-D renderings had applications in other industries as well. Today, Heartwood Studios has clients in the defense and aerospace industries as well as in the fields of entertainment and sports. In fact, the company creates animations for use on the giant screens in sports arenas for the Dallas Cowboys and the New Jersey Nets.⁶⁹

REWARD CREATIVITY Entrepreneurs can encourage creativity by rewarding it when it occurs. Financial rewards can be effective motivators of creative behavior, but nonmonetary rewards, such as praise, recognition, and celebration, usually offer more powerful incentives for creativity.

 **ENTREPRENEURIAL PROFILE: Mike Tattersfield: Caribou Coffee** At Caribou Coffee, a chain of coffee shops with nearly 500 locations in the United States and abroad, CEO Mike Tattersfield, whose desk doubles as a foosball table, celebrates employees’ creative contributions to the company at an awards banquet, where winners receive watermelons as prizes. “You get it for using your melon,” explains Tattersfield. The company also awards winners with a pair of custom Converse Chuck Taylor tennis shoes that they themselves design and that Tattersfield inscribes with a personal note of thanks. “All I ask is that they send me a photo of them wearing the sneakers,” he says.⁷⁰

MODEL CREATIVE BEHAVIOR Creativity is “caught” as much as it is “taught.” Companies that excel at innovation find that the passion for creativity starts at the top. Entrepreneurs who set examples of creative behavior, taking chances, and challenging the status quo will soon find their employees doing the same. “Innovative companies are led by innovative chief executives,” says creativity expert Hal Gregersen. “They spend their time asking provocative questions, observing the world, and networking with people who don’t think, act, or talk like them. They are willing to experiment and try new things. It’s the CEO who sets the stage for innovation.”

 **ENTREPRENEURIAL PROFILE: Jason Fried: 37signals** Jason Fried, cofounder of 37signals, a software company based in Chicago, understands the importance of innovation in the fast-moving software business. Fried worked with his staff recently to create an “end of the road” list of products that they will retire. One of the products marked for elimination, Sortfolio, generates more than \$200,000 in annual revenue and significant profits. “What entrepreneur voluntarily parts with a profitable service? Are we crazy?” he asks. Fried decided to retire Sortfolio to free up his staff to work on improving the company’s other software products and to give them the time and energy to come up with ideas for new products. Fried also used the same reasoning when he decided that the best way to improve Basecamp, the company’s eight-year-old best-selling product, was to rebuild it from scratch. “We have ideas that are more revolutionary than incremental that will dramatically enhance Basecamp’s speed, power, and flexibility,” he says.⁷¹

Enhancing Individual Creativity

Just as entrepreneurs can cultivate an environment of creativity in their organizations by using the techniques described above, they can enhance their own creativity by using the techniques discussed in the following section.

ALLOW YOURSELF TO BE CREATIVE As we have seen, one of the biggest obstacles to creativity is the self-imposed belief that he or she is not creative. Giving yourself the permission to be creative is the first step toward establishing a pattern of creative thinking. Refuse to give in

to the temptation to ignore ideas simply because you fear that someone else may consider them “stupid.” When it comes to creativity, there are no stupid ideas!

FORGET THE “RULES” Creative individuals take a cue from Captain Jack Sparrow in the *Pirates of the Caribbean* series of movies. When faced with a difficult (sometimes impossible) situation, Sparrow (played by Johnny Depp) usually operates outside the rules and, as a result, comes up with innovative solutions. “[Sparrow] creates new degrees of freedom that enable him to act in ways that someone encumbered by the rules cannot,” says one writer. “In that space outside the rules are some pretty interesting solutions.”⁷²

GIVE YOUR MIND FRESH INPUT EVERY DAY To be creative, your mind needs stimulation. Imagination is the fuel that drives creativity. Do something different each day—listen to a new radio station, take a walk through a park or a shopping center, or pick up a magazine you never read—to stimulate your imagination. “You’re not going to get innovation if you don’t have imagination,” says Jay Walker, founder of *Priceline.com*.⁷³



ENTREPRENEURIAL PROFILE: Doris Raymond: The Way We Wore The Way We Wore, a huge vintage clothing store in Los Angeles started by Doris Raymond in 2004 that stocks garments from the Victorian era to the 1980s, has become a destination for designers from many fashion houses and retailers, ranging from Marc Jacobs to Forever 21, who are looking for inspiration for their clothing collections. Recognizing that meeting customers’ demand for fresh designs gives their clothing lines a competitive advantage, many designers are looking to the past for creative ideas, taking note not only of fabrics and patterns but also of the smallest details, such as buttons and the type of stitching used on pockets. These fashion experts have discovered that exposing their minds to “new” designs is a great way to stimulate their own creativity.⁷⁴

TRAVEL—AND OBSERVE Visiting other countries (even other states) is a creativity stimulant. Travelers see new concepts and engage in new experiences that can spark creative ideas.



ENTREPRENEURIAL PROFILE: Johanna Uurasjarvi: Leifsdottir Johanna Uurasjarvi, creator and designer of the fashion brand Leifsdottir, draws the inspiration for her clothing from her Scandinavian heritage and from her passion for travel. Celebrities including Taylor Swift, Sarah Jessica Parker, and Melissa George often sport Uurasjarvi’s fashions, which feature impeccable craftsmanship and unique patterns and sumptuous textures inspired by Uurasjarvi’s travels to places as far-flung as Turkey and Brazil. “I wanted to combine the Scandinavian element with my global experience of traveling,” she says. “You collect [ideas] until you have so much, you have to do something with it.”⁷⁵

COLLABORATE WITH OTHER PEOPLE Working with other people, particularly people from different backgrounds, is an excellent way to stimulate creativity. When he invented the lightbulb, Thomas Edison’s team included chemists, mathematicians, and glassblowers.⁷⁶ “You need a group composed of individuals who bring different perspectives to the table, who respect different working styles, and who resolve conflicts along the way,” says Tina Seelig, an expert in creativity. “Great teams also have a healthy dose of playfulness,” she adds.⁷⁷

OBSERVE THE PRODUCTS AND SERVICES OF OTHER COMPANIES, ESPECIALLY THOSE IN COMPLETELY DIFFERENT MARKETS Creative entrepreneurs often borrow ideas from companies that are in businesses totally unrelated to their own. Using pattern thinking, entrepreneurs look for underlying patterns in businesses that are totally different from their own and then apply those patterns to their own companies and industries. “Look outside your industry to see how others are solving problems,” says Angela Benton, founder of NewME Accelerator. “Approaches that they think are routine might be out of the ordinary for you—and inspire great ideas.”⁷⁸



ENTREPRENEURIAL PROFILE: Jerry Barber: Barber Wind Turbines In 1971, Jerry Barber started Venture Ride Manufacturing, a company that produced amusement rides in Greenville, South Carolina. Over the course of the next 18 years, his small business grew to employ 70 people and earned many patents for its amusement ride designs. He sold the company in 1989 and became interested in wind turbines after having a conversation with an old friend who was delivering the gearbox assembly for a wind turbine. “I was shocked that the thing was the size of an SUV,” he says. Drawing from his years of designing amusement rides, Barber came up with a design for a

wind turbine that does not require a gearbox, which costs \$250,000 and lasts for only 20 years. Barber's turbines have five blades (rather than the traditional three blades) inside a ring, and wheels on the edge of the ring, which are similar to those on a Ferris wheel, turn the generator to produce electricity. "This is a potential game-changer in the wind industry," says one industry expert.⁷⁹

RECOGNIZE THE CREATIVE POWER OF MISTAKES AND ACCIDENTS Innovations sometimes are the result of serendipity, finding something while looking for something else, and sometimes they arise as a result of mistakes or accidents. Creative people recognize that even their errors may lead to new ideas, products, and services. "I would love to get to a place in my life where I can laugh at my failures," says one successful song writer, "because for every failed creative attempt, I'm closer to a successful one."⁸⁰ Louis Daguerre, a scene painter for the Paris Opera, was fascinated with lighting and in 1822 began conducting experiments with the effect of light on translucent screens. In 1829, Daguerre formed a partnership with Joseph Nicépe, who had invented a primitive version of photography called the heliograph in 1829. (The exposure time for Nicépe's first photograph was a mere eight hours!) The two men worked for years trying to capture photographic images on metal plates treated with silver iodide, but they made little progress before Nicépe died in 1833. One evening in 1835, Daguerre placed one of his treated plates in his chemical cupboard, intending to recoat it for other experiments. When he removed it later, he was surprised to see a photographic image with brilliant highlights. Excited but puzzled by the outcome, Daguerre finally discovered that mercury vapors from a broken thermometer in the cupboard had caused the photographic image to appear on the treated metal plate. Daguerre refined the process, naming it *Daguerreotype* after himself, and the world of modern photography was born—and an accident played a significant role.⁸¹

BE POSITIVE A negative outlook drains creative capacity and undermines the brain's ability to generate creative solutions. Research shows that positive emotions increase creativity and high-performance behavior. "Positive emotions expand awareness and attention," explains Barbara Fredrickson, a pioneer in this area of research. The good news: Entrepreneurs tend to be optimistic and resilient.

NOTICE WHAT IS MISSING Sometimes entrepreneurs spot viable business opportunities by noticing something, often very practical and simple, that is *missing*. The first step is to determine whether a market for the missing product or service actually exists (perhaps the reason it does not exist is that there is not market potential), which is one of the objectives of building a business plan.

 **ENTREPRENEURIAL PROFILE: Shawn Boyer: Snagajob** Shawn Boyer was trying to help a friend who was finishing her doctorate in an obscure liberal arts field land an internship and noticed that existing job search sites focused on salaried jobs but offered no listings for people seeking internships or hourly jobs. As entrepreneurs are wont to do, Boyer decided to capitalize on the opportunity he spotted and launched Snagajob, a Web site that lists available full-time and part-time hourly jobs. He quit his job, cashed out his retirement account, and borrowed a significant chunk of money from his parents to start his business. Today, Snagajob has more than 40 million registered job seekers and 45,000 registered employers of all sizes and helps nearly 1 million people find hourly jobs each year.⁸²

PERIODICALLY ASK YOURSELF, "AM I ASKING THE RIGHT QUESTIONS?" Sometimes creative flashes come when we change our perspective and ask questions that frame a problem or situation in a different light.

 **ENTREPRENEURIAL PROFILE: Yuri Malina: SwipeSense** While Yuri Malina was a student at Northwestern University, he cofounded Design for America, an organization that helps students create solutions for various social problems, with two fellow students and a faculty member. Malina discovered that hospital acquired infections, most of which originate because of improper hand washing among health care professionals, cause more than 100,000 deaths each year in the United States. Although hospitals provide plenty of hand-sanitizing stations, health care professionals do not always use them. To solve the vexing problem, Malina and his team observed doctors and nurses at a local hospital and realized that physicians and nurses were so busy helping patients that they were constantly on the move. Malina realized that hospitals were asking the wrong question: "How can we get health care professionals to comply with hand-washing requirements?" Malina and his team posed a different question: "How can we provide a nonintrusive solution to

hand sanitizing that meshes with health care professionals' work habits and busy schedules?" That led Malina's team to develop SwipeSense, a smart phone-sized hand-sanitizing device that attaches to a health care professional's belt or waistband and allows busy doctors and nurses to clean their hands as they move from one patient to the next. Malina and his team acquired a patent for their device and raised \$50,000 in seed capital and landed a spot in a health care-focused business incubator.⁸³

KEEP A JOURNAL HANDY TO RECORD YOUR THOUGHTS AND IDEAS Creative ideas are too valuable to waste, so always keep a journal nearby to record them as soon as you get them. Leonardo da Vinci was famous for writing down ideas as they struck him. Patrick McNaughton invented the neon blackboards that restaurants use to advertise their specials. In addition to the neon blackboard, McNaughton has invented more than 30 new products, many of which are sold through the company that he and his sister, Jamie, own. McNaughton credits much of his creative success to the fact that he writes down every idea he gets and keeps it in a special folder. "There's no such thing as a crazy idea," he insists.⁸⁴

LISTEN TO OTHER PEOPLE No rule of creativity says that an idea has to be your own! Sometimes the best business ideas come from someone else, but entrepreneurs are the ones to act on them.



ENTREPRENEURIAL PROFILE: Cameron Roelofson: Splash Mobile Car Wash Cameron Roelofson, owner of Splash Mobile Car Wash in Concord, Ontario, washes 2,500 tractor-trailer trucks per week during warm months but sales in his highly seasonal business fall to nothing during the frigid winters. On one cold winter day, Roelofson was talking with an acquaintance who asked if he would use his mobile truck wash equipment to put water into an outdoor skating rink. He agreed and quickly realized the potential for a business that would offset seasonality in the sales of his truck-washing business. Roelofson began advertising, and sales took off. For \$1,000 to \$2,000, Splash builds a frame with a reusable liner and then fills it with water. Three days later, frozen solid in Ontario's winter weather, the rink is ready for skating or hockey. In the spring, Splash returns to disassemble the rink and store it until the next winter.⁸⁵

GET ADEQUATE SLEEP Sleep restores both our bodies and our brains. A study by the Mental Health Foundation shows a correlation between sound sleep and a person's ability to produce creative ideas and new insights.⁸⁶

WATCH A MOVIE Great business ideas come from the strangest places, even the movies. As a child, Stanley Yang was fascinated by sci-fi movies such as *Star Wars*. That fascination led him to become an engineer so that he could transform his ideas into reality. Yang's company, NeuroSky, has developed headsets that allow people to control video games with their minds using biosensor technology, a concept used by an advanced alien race in the movie *Battle Los Angeles*. "Movies may spark an idea," says Yang, who still dreams of building a functional light saber.

TALK TO A CHILD As we grow older, we learn to conform to society's expectations about many things, including creative solutions to problems. Children place very few limitations on their thinking; as a result, their creativity is practically boundless. (Remember all of the games you and your friends invented when you were young?)



ENTREPRENEURIAL PROFILE: Maxine Clark: Build-a-Bear Workshop Maxine Clark was president of Payless ShoeSource when she took her best friend's young daughter, Katie Burkhardt, shopping. After a fruitless search for a Beany Baby she didn't already have, Katie picked up a Beany Baby and said to Clark, "We could make one." "She meant we could go home and make the small bears, but I heard something different," recalls Clark. "Her words gave me the idea to create a company that would allow people to create their own customized stuffed animals. I did some research and began putting together a plan. Build-a-Bear Workshop would be a theme park factory in a mall." Clark's plan proved to be successful. Today, the company she launched, Build-a-Bear Workshop, has 425 stores worldwide and generates annual sales of nearly \$400 million.⁸⁷

DO SOMETHING ORDINARY IN AN UNUSUAL WAY Experts say that simply doing something out of the ordinary can stimulate creativity. To stimulate his own creativity, Scott Jones, an

entrepreneur who is known as “the guy who invented voice mail” (and many other items as well), often engages in what other people might consider bizarre behavior—eating without utensils, watching television sitting one foot away from the screen, or taking a shower with his eyes closed. “Anything I normally do, I’ll do differently just to see what happens,” says Jones.⁸⁸

KEEP A TOY BOX IN YOUR OFFICE Your box might include silly objects such as wax lips, a yo-yo, a Slinky, fortune cookie sayings, feathers, a top, a compass, or a host of other items. When you are stumped, pick an item at random from the toy box and think about how it relates to your problem.

TAKE NOTE OF YOUR “PAIN POINTS”: DO OTHER PEOPLE EXPERIENCE THEM AS WELL? Entrepreneurs often create innovations to solve problems they themselves face. Observing “pain points” that result from missing products or services or flaws in existing products or services can be an excellent source of business ideas.



ENTREPRENEURIAL PROFILE: Payal Kadakia: Classtivity While working at Warner Music Group in New York City, Payal Kadakia, who started dancing as a child, wanted to take a ballet class but could not find one at a convenient time that fit into her schedule. “I thought, ‘This is ridiculous. This needs to be solved. There are so many classes being offered at this very moment, and I can’t find one of them.’” Kadakia realized that this was a common problem and left her job to start Classtivity, a Web site that provides a searchable listing of classes, ranging from ballet and beer brewing to cooking and yoga, and their scheduled times and locations. Classtivity provides for classes much like OpenTable does for restaurants, offering users the convenience of easily finding the classes they seek and booking slots in them online, and charging the businesses that offer the classes a percentage (that ranges between 10 and 15 percent) of the class fee. Kadakia has included a social media component to the Classtivity Web site, expanded to San Francisco and Los Angeles, and has plans to take her successful concept to other cities as well.⁸⁹



Payal Kadakia, founder of Classtivity.

Source: Stephanie Haller.

DO NOT THROW AWAY SEEMINGLY “BAD” IDEAS Some creative ideas prove to be impractical, too costly, or too silly to work. Creative entrepreneurs, however, do not discard these seemingly bad ideas. Instead, they ask, “What part of this idea can I build on?” and “What could I change about this idea to make it work?” They realize that seemingly bad ideas can be the nucleus of a really good idea. Spencer Williams, president of West Paw Design, the company that encourages creativity with its creativity contest featuring the Golden Hairball Award, says that many of the great ideas for new products come from ideas that don’t win the contest. The company’s R&D team meets after each contest to review *all* of the ideas that employees submit. “We look for one piece of a new idea,” he says.⁹⁰

READ BOOKS ON STIMULATING CREATIVITY OR TAKE A CLASS ON CREATIVITY Creative thinking is a technique that anyone can learn. Understanding and applying the principles of creativity can improve dramatically the ability to develop new and innovative ideas.

TAKE SOME TIME OFF Relaxation is vital to the creative process. Getting away from a problem gives the mind time to reflect on it. It is often during this time, while the subconscious works on a problem, that the mind generates many creative solutions. One study reports that 35 percent of entrepreneurs say that they come up with their best ideas during down time, when they are away from work.⁹¹ Research suggests that simply taking a walk outside, particularly in a garden or wooded area, can increase one’s creativity.⁹² One creativity expert claims that fishing is the ideal activity for stimulating creativity. “Your brain is on high alert in case a fish is around,” he says, “but your brain is completely relaxed. This combination is the time when you have the ‘Aha!’ moment.”⁹³

BE PERSISTENT Entrepreneurs know that one secret to success is persistence and a “don’t quit” attitude. Twelve publishers rejected J. K. Rowling’s manuscript about the adventures of a boy wizard and his friends, which she started writing at age 25 when she was a single mother trying to raise her children on welfare, before Bloomsbury, a small London publishing house, agreed to publish 1,000 copies of *Harry Potter and the Philosopher’s Stone*. Rowling’s seven-part Harry Potter book series went on to sell more than 450 million copies worldwide, making Rowling the



How to Create a Culture of Creativity and Innovation

Creativity and innovation are important drivers of the global economy, allowing companies that use them well to prosper and providing consumers with products and services that make their lives better. A recent study by marketing communications firm MDC Partners reports that 98 percent of top executives say that creativity is critical to economic success; in addition, 76 percent of the managers believe that the world has entered an “imagination economy,” in which companies’ ability to harness the power of creativity determines their success. How can a company create a culture that promotes creativity among its employees and allows it to use innovation to gain a competitive advantage over its rivals? The following seven tips can help.

Ignite passion

The philosopher Denis Diderot said, “Only passions, great passions, can elevate the soul to great things.” So it is with creativity. The most basic ingredient for building a creative company culture is a passion to discover something new, to contribute to the betterment of society, and to make a difference. That passion starts at the top of an organization with the entrepreneur. Steve Jobs, cofounder of Apple Inc., often said that he wanted “to put a ding in the universe,” an attitude that led his company to introduce many innovative products. When Jobs died in 2011, many observers noted how in his brief career he truly had changed the world. Your job as leader is to make sure that your passion for creativity spreads to everyone in your company.

Celebrate creative ideas

In some companies, people who come up with new ideas learn quickly that the organization does not value creativity and risk taking and shies away from ideas that might fail. Smart entrepreneurs, however, recognize that the only way to move their companies forward is to take measured risks by implementing creative ideas that have potential. In fact, these entrepreneurs reward employees (and not just financially, although that helps) who develop creative ideas and innovative solutions to problems even if they fail. They understand that even though one idea fails, the next idea might be “the big one.” Celebrating creative ideas with praise (both public and private), promotions, and cash send a clear signal to employees that a company values creativity.

Foster autonomy

“The act of creativity is one of self-expression,” says serial entrepreneur Josh Linkner. To be creative, employees must have the freedom to make decisions and call their own shots. Micromanaging saps creativity out of any organization. Smart entrepreneurs know that their job is to focus employees’ efforts on the problems to solve and then to get out of their way and let them do it. “We challenge our employees to be their own CEOs,” says Dan Satterwaithe, director of human resources at DreamWorks Animation, the animated filmmaker. Delegating authority and responsibility requires an atmosphere of trust, which increases the likelihood that employees are engaged in their work and buy into the company’s mission. They key is letting employees know that

Encourage courage

Some companies actually discourage creativity and innovation by punishing those who dare to take chances and fail. Businesses that succeed over time have cultures that encourage employees to be bold enough to take creative chances without fear of repercussions. At DreamWorks Animation, managers regularly solicit ideas from every employee—and not just those in the creative side of the business. Accountants, administrative assistants, lawyers—anyone—can (and do) submit ideas for everything from story lines for new movies to improving a business system.

Fail forward

The most creative companies have built cultures that encourage people to try new ideas and recognize that many (perhaps most) of them will fail. Companies that punish failure end up with a cadre of employees who simply keep their heads down, never step out of line, and produce only mediocre results. “Failing forward means taking risks and increasing the rate of experimentation,” says Josh Linkner. The key is to fail quickly, learn from the failure, make necessary adjustments, and try again.

Ensure interaction

Creative managers know that one of the best ways to stimulate creativity is to ensure that employees interact with one another. At DreamWorks Animation, employees use cloud-computing technology to collaborate on projects, but managers also insist on face-to-face interactions, both formal and informal, because they know that’s where many creative ideas originate. Many companies that cultivate creativity establish work spaces that encourage employees to interact with one another and talk about new ideas.

Maximize diversity

Companies have discovered that hiring workers from different cultures, with varied backgrounds, and with diverse work experience enhances creativity. The 120 employees at Ziba, an innovation consulting firm in Portland, Oregon, come from 18 different countries and speak 26 different languages. “Genetic diversity breeds creativity, much like it does with biology,” says Sohrab Vossoughi, the company’s founder and CEO. To encourage creativity, Ziba implemented an “Ambassador Program,” in which employees spend three months working in other areas of the company, which are known as tribes. “This helps create an understanding of another world,” says Vossoughi.

1. Do you agree with the top managers in the MDC Partners survey who say that we have entered an “imagination economy”? Explain.
2. List and describe two additional steps that a company can take to create a culture of creativity and innovation.

Sources: Based on Josh Linkner, “7 Steps to a Culture of Innovation,” *Inc.*, June 16, 2011, www.inc.com/articles/201106/josh-linkner-7-steps-to-a-culture-of-innovation.html; Anita Bruzzese, “DreamWorks Is Believer in Every Employee’s Creativity,” *USA Today*, <http://usatoday30.usatoday.com/money/jobcenter/workplace/bruzzese/story/2012-07-22/dreamworks-values-innovation-in-all-workers/56376470/1>; “MDC Partners and Allison and Partners Study Reveals Leading CEOs and CMOs View Creativity as a Critical Driver of the Global Economy,” *Business Wire*, October 4, 2011, www.businesswire.com/news/home/20111004005439/en/MDC-Partners-Allison-Partners-Study-Reveals-Leading

The Creative Process

Although creative ideas may appear to strike as suddenly as a bolt of lightning, they are actually the result of the creative process, which involves seven steps:

- Step 1. Preparation
- Step 2. Investigation
- Step 3. Transformation
- Step 4. Incubation
- Step 5. Illumination
- Step 6. Verification
- Step 7. Implementation

6.

Describe the steps in the creative process.

Step 1. Preparation

This step involves getting the mind ready for creative thinking. Preparation might include a formal education, on-the-job training, work experience, and taking advantage of other learning opportunities. This training provides a foundation on which to build creativity and innovation. As one writer explains, “Creativity favors the prepared mind.”⁹⁵ For example, Dr. Hamel Navia, a scientist at tiny Vertex Pharmaceuticals, was working on a promising new drug to fight the AIDS virus. His preparation included earning an advanced degree in the field of medicine and learning to use computers to create 3-D images of the protein molecules he was studying.⁹⁶ How can you prepare your mind for creative thinking?

- Adopt the attitude of a lifelong student. Realize that educating yourself is a never-ending process. Look at every situation you encounter as an opportunity to learn.



ENTREPRENEURIAL PROFILE Scientific Anglers: Sharkskin Fly Line To develop a new fly line that reduces drag and allows anglers to cast flies more easily, researchers at Scientific Anglers studied how some insects can walk on the surface of the water, the leaves of the lotus plant can clean themselves, and geckoes can easily cling to almost any surface. Their research led them to develop a process that embosses the fly line, which they named Sharkskin, with a repeating geometric micropattern that mimics those found in nature and minimizes the line's contact with the rod's guides, greatly reducing friction and allowing a fisherman to cast more easily and to make longer casts. The line, which has a texture like sharkskin, is a radical departure from the traditional smooth-surface fly line that fly fishermen have used for decades.⁹⁷

- Read—a lot—and not just in your field of expertise. Many innovations come from blending ideas and concepts from different fields in science, engineering, business, and the arts. Reading books, magazines, and papers covering a variety of subject matter is a great way to stimulate your creativity.
- Clip articles of interest to you and create a file for them. Over time, you will build a customized encyclopedia of information from which to draw ideas and inspiration.
- Take time to discuss your ideas with other people, including those who know little about it as well as experts in the field. Sometimes, the apparently simple questions an “unknowledgeable” person asks lead to new discoveries and to new approaches to an old problem. At Fahrenheit 212, an innovation consulting firm based in New York City, founder Mark Payne encourages employees to interact with one another to come up with new ideas and solutions to clients' problems. Almost every wall in the creative offices is made of glass, and markers are placed everywhere, allowing employees to sketch ideas as they discover them and to talk about them with coworkers. The work space follows an open design that encourages “wandering around” that leads to a “spontaneous combustion” of ideas, says Payne.⁹⁸
- Join professional or trade associations and attend their meetings. There you have the chance to interact with others who have similar interests. Learning how other people have solved a particular problem may give you fresh insight into solving it.

- Develop listening skills. It's amazing what you can learn if you take the time to listen to other people—especially those who are older and have more experience. Try to learn something from everyone you meet.
- Eliminate creative distractions. Interruptions from telephone calls, e-mails, social media, and visitors can crush creativity. Allowing employees to escape to a quiet, interruption-free environment enhances their ability to be creative.

Step 2. Investigation

This step requires one to develop a solid understanding of the problem, situation, or decision at hand. To create new ideas and concepts in a particular field, an individual first must study the problem and understand its basic components. Creative thinking comes about when people make careful observations of the world around them and then investigate the way things work (or fail to work). For example, Dr. Navia and another scientist at Vertex had spent several years conducting research on viruses and on a protein that blocks a virus enzyme called protease. His exploration of the various ways to block this enzyme paved the way for his discovery.



ENTREPRENEURIAL PROFILE: Christopher Leamon: Endocyte After earning his PhD in chemistry, Christopher Leamon began researching targeted anticancer therapy using molecules that tumors absorb as “Trojan horses” to deliver drugs that are lethal to them. Initially, Leamon had focused on the vitamin biotin, but after nine months of research and hard work, “it was a total failure,” he says. One morning while sitting at the breakfast table with his wife, Leamon, a longtime cereal lover, was reading the ingredients on the nutrition panel of his box of Kellogg’s Frosted Flakes. One of the items, folic acid, caught his attention. Leamon dashed off to the library and found a research paper on how folic acid enters a human cell. “I knew this was it,” he recalls. Before long, Leamon had developed a technique for attaching cancer drugs to folic acid so that they would be absorbed and enable the cells to fight the disease in much the same way they battle infections. Leamon has licensed the promising therapy to a company called Endocyte, which plans to have drugs on the market within a few years. “There are lots of ‘Eureka’ moments in the lab,” says Leamon. “None as great as the one with the folic acid though. That breakfast redefined my career and my life.”⁹⁹

Step 3. Transformation

Transformation involves viewing the similarities and the differences among the information collected. This phase requires two types of thinking: convergent and divergent. **Convergent thinking** is the ability to see the *similarities* and the connections among various and often diverse data and events. “So much of innovation comes from connecting things where other people don’t make connections,” says Mark Rice, professor of technology entrepreneurship at Olin College.¹⁰⁰ Johannes Gutenberg made a connection between a common device of his day, the wine press, and a machine he invented that relied on the same principle to print books cheaply and efficiently using movable blocks of letters and graphics. His printing press is often cited as one of the most important inventions in the history of the world.



ENTREPRENEURIAL PROFILE: Kate Szilagyi: Tempaper Kate Szilagyi, a former set decorator in the film industry and window designer for Saks Fifth Avenue, knew all too well how difficult replacing traditional wallpaper is. Working with her nieces, Jennifer and Julia Biancella, Szilagyi combined the concepts of traditional wallpaper and Post-It Notes to develop wallpaper that uses a temporary adhesive (similar to the one used on Post-It Notes). The resulting wallpaper, which they call Tempaper, acts like a giant sticker and is easily removable and restickable. Installation involves peeling off a backing and sticking it on the wall. The entrepreneurs sell Tempaper through their New York City-based company, Lollipop, for \$75 to \$85 for a 33-foot roll.¹⁰¹

Divergent thinking is the ability to see the *differences* among various data and events. While developing his AIDS-fighting drug, Dr. Navia studied the work of other scientists whose attempts at developing an enzyme-blocking drug had failed. He was able to see the similarities



Source: Michael Crawford/The New Yorker Collection/www.cartoonbank.com.

and the differences in his research and theirs and to build on their successes while avoiding their failures.

How can you increase your ability to transform the information collected into a purposeful idea?

- Evaluate the parts of the situation several times, trying to grasp the big picture. Getting bogged down in the details of a situation too early in the creative process can diminish creativity. Look for patterns that emerge and for connections among things that on the surface do not appear to be connected, a process known as global processing.
- Rearrange the elements of the situation. By looking at the components of an issue in a different order or from a different perspective, you may be able to see the similarities and the differences among them more readily. Rearranging them also may help uncover a familiar pattern that had been masked by an unfamiliar structure. Engineers at Windtronics, a company in Muskegon, Michigan, rearranged the elements of a traditional power-generating wind turbine, moving them from the center to the outside of the blades. As a result, the blades of Windtronics turbines turn faster, operate more quietly and efficiently, and can generate electricity at wind speeds as low as two miles per hour, compared to six to eight miles per hour for traditional turbines. At just six feet in diameter, Windtronics turbines are suitable for industrial, commercial, and residential use. “We’ve turned traditional wind turbines inside out,” says CEO Reg Adams.¹⁰²
- Try using synectics (a term derived from the Greek words for “to bring together” and “diversity”), taking two seemingly nonsensical ideas and combining them. For instance, why not launch a bookstore with no physical storefront and no books—an accurate description of what Jeff Bezos did when he came up with the idea for Amazon.com.¹⁰³
- Before locking into one particular approach to a situation, remember that several approaches might be successful. If one approach produces a dead end, don’t hesitate to jump quickly to another. Considering several approaches to a problem or opportunity simultaneously would be like rolling a bowling ball down each of several lanes in quick succession. The more balls you roll down the lanes, the greater is the probability of hitting at least one strike. Resist the temptation to make snap judgments on how to tackle a problem or opportunity. The first approach may not be the best one.

Step 4. Incubation

Often, ideas require a gestation period. The subconscious needs time to reflect on the information collected. To an observer, this phase of the creative process would be quite boring; it looks

as though nothing is happening! In fact, during this phase, it may appear that the creative person is *loafing*. Incubation occurs while the individual is away from the problem, often engaging in some totally unrelated activity. Research shows that walking away from a problem to engage in routine tasks sparks creativity.¹⁰⁴ Dr. Navia's creative powers were working at a subconscious level even when he was away from his work, not even thinking about his research on AIDS-fighting drugs.

How can you enhance the incubation phase of the creative process, letting ideas marinate in your mind?

- Walk away from the situation. Time away from a problem is vital to enhancing creativity. A study by Wilson Brill, an expert on creativity, of how 350 great ideas became successful products shows that two-thirds of the ideas came to people while they were *away* from work—in the shower, in their cars, in bed, on a walk, and other nonwork situations.¹⁰⁵ Doing something totally unrelated to the problem gives your subconscious mind the chance to work on the problem or opportunity.



ENTREPRENEURIAL PROFILE: Amy Baxter: Buzzy For years, Amy Baxter, a physician and pain researcher, had been searching for a way to use cold to relieve the pain of children's vaccinations. While driving home from an all-night shift in the emergency room, she noticed that the steering wheel on her car was vibrating (her tires were badly misaligned). When she got out of her car, her hands were numb from the vibration. That's when the idea hit her: Combining vibration and cold temperatures could desensitize a vaccination site. To test her idea, she applied a frozen bag of peas and a vibrating massager to her son's arm and then rolled a small metal wheel used by neurologists over the area, and he could feel nothing. Baxter went on to invent Buzzy, a bee-shaped cold pack outfitted with a vibrating device that more than 500 hospitals and doctors' offices now use before administering vaccinations.¹⁰⁶

- Take the time to daydream. Creative people build time into their schedules to allow their minds to wander. Although it may *look* as if you're doing nothing, daydreaming is an important part of the creative process. That's when your mind is most free from self-imposed restrictions on creativity. Research shows a connection between daydreaming and creativity; people who daydream are better at generating new ideas.¹⁰⁷ Feel free to let your mind wander, and it may just stumble onto a creative solution.



ENTREPRENEURIAL PROFILE: John Stapleton: 22squared John Stapleton, an ad executive at 22squared in Atlanta, Georgia, had worked without success for weeks to come up with a campaign to encourage people to visit Costa Rica. Only when he left his office, traveled to Costa Rica, and began to relax on the patio at a resort in the midst of a rain forest did he come up with a creative idea. As a rainstorm approached, "all the howler monkeys started woofing like dogs, and the rain forest came to life," says Stapleton. He created a successful ad based only on sound and built it around an app that allows people to create their own music, syncing the jungle sounds of rain, howler monkeys, frogs, and flowing streams—all designed to pique people's interest in Costa Rica's lush and beautiful biodiversity. "A key factor was to get away from juggling accounts and being constantly distracted, jumping from one task to the next," says Stapleton.¹⁰⁸

- Relax—and play—regularly. Perhaps the worst thing you can do for creativity is to work on a problem or opportunity constantly. Soon enough, fatigue walks in, and creativity walks out! Great ideas often are incubated on the golf course, on the basketball court, on a hiking trail, or in the hammock.



ENTREPRENEURIAL PROFILE: Aaron Lemieux: Tremont Electric Aaron Lemieux was carrying a backpack while hiking the 1,500-mile Appalachian Trail when the idea for his business struck. Lemieux, trained as a mechanical and biomedical engineer, grew tired of purchasing disposable batteries along the way to power his portable devices and began to think about ways to capture the wasted kinetic energy generated by the movement of his backpack. Lemieux's hiking experience led him to launch Tremont Electric, a company that produces the nPower Personal Energy Generator, a small, lightweight electrical generator that produces enough energy to power



Source: bikeriderlondon/Shutterstock.

personal electronic devices by simply harvesting kinetic energy from normal human movement, such as walking.¹⁰⁹

- Dream about the problem or opportunity. “Dreams have been responsible for two Nobel prizes, the invention of a couple of major drugs, other scientific discoveries, several important political events, and innumerable novels, films, and works of visual art,” says Harvard Medical School psychologists Dierdre Barrett.¹¹⁰ Although you may not be able to dream on command, thinking about an issue just before you drift off to sleep can be an effective way to encourage your mind to work on it while you sleep, a process called lucid dreaming. Barrett’s research suggests that about 50 percent of people can focus their dreams by contemplating a particular problem before they go to sleep, in essence “seeding” the subconscious to influence their dreams.¹¹¹ Arianna Huffington, founder of the *Huffington Post*, says that when she needs a creative solution, she goes to sleep. “There are many great ideas locked inside us,” she says. “We just need to close our eyes to see them.” To encourage creativity among her staff, Huffington has set up three “nap rooms” in the company’s offices.¹¹²
- Work on the problem or opportunity in a different environment—somewhere other than the office. Take your work outside on a beautiful fall day or sit on a bench in a mall. The change of scenery will likely stimulate your creativity.

Step 5. Illumination

This phase of the creative process occurs at some point during the incubation stage when a spontaneous breakthrough causes “the lightbulb to go on.” It may take place after five minutes—or five years. Ben Baldwin, cofounder of ClearFit, a company that helps small companies find the best job candidates and predict their success, says that the idea for the company’s business model “hatched in the back of my mind while I was driving 80 miles an hour, not thinking about work at all.” Baldwin had been working on similar ideas for seven years before ClearFit’s business model crystallized in his mind. “ClearFit wasn’t the first company to help [companies] find employees, nor the first to predict job fit, nor the first company to make software that’s easy for small businesses to use. However, it’s the first to combine these in a way that’s easy for anyone to find employees who fit.”¹¹³

In the illumination stage, all of the previous stages come together to produce the “Eureka factor”—the creation of the innovative idea. In one study of 200 scientists, 80 percent said that at least once a solution to a problem had “just popped into their heads”—usually when they were away from the problem.¹¹⁴ For Dr. Navia, the illumination stage occurred one day while he was reading a scientific journal. As he read, Dr. Navia says he was struck with a “hallucination” of a novel way to block protease.

Although the creative process itself may last for months or even years, the suddenness with which the illumination step occurs can be deceiving, making the process appear to occur much faster than it actually does. One night, Kent Murphy, an electrical engineer, began dreaming about what it would be like to be a photon of light. “I was riding a ray of light moving through the fiber,” he recalls about his dream. Murphy, who holds 30 patents, used the insight from his dream to invent a fiber-optic gauge that monitors on a real-time basis the structural wear in airplanes.¹¹⁵

Step 6. Verification

For entrepreneurs, validating an idea as realistic and useful may include conducting experiments, running simulations, test marketing a product or service, establishing small-scale pilot programs, building prototypes, and many other activities designed to verify that the new idea will work and is practical to implement. The goal is to subject the innovative idea to the test of cold, hard reality. At this phase, appropriate questions to ask include the following:

- Is it *really* a better solution to a particular problem or opportunity? Sometimes an idea that appears to have a bright future in the lab or on paper dims considerably when put to the test of reality.
- Will it work?

- Is there a need for it?
- If so, what is the best application of this idea in the marketplace?
- Does this product or service idea fit into our core competencies?
- How much will it cost to produce or to provide?
- Can we sell it at a reasonable price that will produce adequate sales, profit, and return on investment for our business?

Ramtron International Corporation, a maker of memory chips, uses a “product justification form” to collect information from the idea generator as well as from other departments in the company so that it can verify the potential of each idea.¹¹⁶ To test the value of his new drug formulation, Dr. Navia used powerful computers at Vertex Pharmaceuticals to build 3-D Tinkertoy-like models of the HIV virus and then simulated his new drug’s ability to block the protease enzyme. Subsequent testing of the drug verified its safety. “I was convinced that I had an insight that no one else had,” he recalls.¹¹⁷

Step 7. Implementation

The focus of this step is to transform the idea into reality. Plenty of people come up with creative ideas for promising new products or services, but most never take them beyond the idea stage. What sets entrepreneurs apart is that they *act* on their ideas. An entrepreneur’s philosophy is “Ready, aim, fire,” not “Ready, aim, aim, aim, aim.” Innowattech, a company based in Ra’anana, Israel, has developed a variety of piezoelectric (PE) crystals that possess the ability to transform vibrations, motion, and temperature changes into clean energy. Like minigenerators, the pressure-sensitive ceramic crystals give off small electrical charges when “squeezed, squashed, bent, or slapped,” says Markys Cain, a materials scientist. In a recent test, Innowattech placed PE generators two inches beneath a small section of Israel’s busy Highway 4, where passing cars compressed the road, activated the tiny generators, and produced energy. The company estimates that placing the PE crystals under a half-mile stretch of highway would generate enough energy to supply 250 homes. Innowattech also has developed crystals for collecting clean energy from railways, airport runways, and pedestrian walkways. Pavegen Systems, a London-based company, has developed a similar technology for pedestrian walkways that captures the kinetic energy from passersby. Installed on a busy thoroughfare, the company’s energy-absorbing pads (which are made from recycled material) can generate enough energy to power the area’s lighting and signs.¹¹⁸ The key to both companies’ success is their ability to take a creative idea for a useful new product and turn it into a reality. As one creativity expert explains, “Becoming more creative is really just a matter of paying attention to that endless flow of ideas you generate, and learning to capture and act upon the new that’s within you.”¹¹⁹

For Dr. Navia and Vertex Pharmaceuticals, the implementation phase required testing the drug’s ability to fight the deadly virus in humans. If it proved to be effective, Vertex would complete the process by bringing the drug to market. In this final phase of testing, Navia was so certain that he was on the verge of a major breakthrough in fighting AIDS that he couldn’t sleep at night. Unfortunately, the final critical series of tests proved that Dr. Navia’s flash of creativity was, as he now says, “completely, totally, and absolutely incorrect.” Although his intuition proved to be wrong this time, Dr. Navia’s research into fighting AIDS continues. Much of the current work at Vertex is based on Dr. Navia’s original idea. Although it proved to be incorrect, his idea has served a valuable purpose: generating new ideas. “We are now applying a powerful technology in HIV research that wasn’t used before, one inspired by a hunch,” he says.¹²⁰

Conclusion

As you have seen, creativity and innovation are vital components to entrepreneurial success. “Innovation for a start-up is imperative,” says Lisa Bodell, founder of futurethink, a global training company. “Small companies are often founded on a single, unorthodox idea.” Successful entrepreneurs constantly push themselves and the people in their businesses to think bold new thoughts, come up with fresh new ideas, and question the status quo. The results of their efforts are innovative new products, services, and business models that benefit all of us and improve the quality of our lives.

Chapter Review

1. Explain the differences among creativity, innovation, and entrepreneurship.
 - The entrepreneur's "secret" for creating value in the marketplace is applying creativity and innovation to solve problems and to exploit opportunities that people face every day. Creativity is the ability to develop new ideas and to discover new ways of looking at problems and opportunities. Innovation is the ability to apply creative solutions to those problems and opportunities to enhance or to enrich people's lives. Entrepreneurship is the result of a disciplined, systematic process of applying creativity and innovation to needs and opportunities in the marketplace.
2. Describe why creativity and innovation are such integral parts of entrepreneurship.
 - Entrepreneurs must always be on guard against paradigms—preconceived ideas of what the world is, what it should be like, and how it should operate—because they are logjams to creativity. Successful entrepreneurs often go beyond conventional wisdom as they ask "Why not?"
 - Success—even survival—in this fiercely competitive, global environment requires entrepreneurs to tap their creativity (and that of their employees) constantly.
3. Understand how the two hemispheres of the human brain function and what role they play in creativity.
 - For years, people assumed that creativity was an inherent trait. Today, however, we know better. Research shows that almost anyone can learn to be creative. The left hemisphere of the brain controls language, logic, and symbols, processing information in a step-by-step fashion. The right hemisphere handles emotional, intuitive, and spatial functions, processing information intuitively. The right side of the brain is the source of creativity and innovation. People can learn to control which side of the brain is dominant in a given situation.
4. Explain the 10 "mental locks" that limit individual creativity.
 - The number of potential barriers to creativity is limitless, but entrepreneurs commonly face 10 "mental locks" on creativity: searching for the one "right" answer, focusing on "being logical," blindly following the rules, constantly being practical, viewing play as frivolous, becoming overly specialized, avoiding ambiguity, fearing looking foolish, fearing mistakes and failure, and believing that "I'm not creative."
5. Understand how entrepreneurs can enhance the creativity of their employees as well as their own creativity.
 - Entrepreneurs can stimulate creativity in their companies by expecting creativity, expecting and tolerating failure, encouraging curiosity, viewing problems as challenges, providing creativity training, providing support, rewarding creativity, and modeling creativity.
 - Entrepreneurs can enhance their own creativity by using the following techniques: allowing themselves to be creative, giving their minds fresh input every day, keeping a journal handy to record their thoughts and ideas, reading books on stimulating creativity or taking a class on creativity, and taking some time off to relax.
6. Describe the steps in the creative process.
 - The creative process consists of seven steps. Step 1, preparation, involves getting the mind ready for creative thinking. Step 2, investigation, requires the individual to develop a solid understanding of the problem or decision. Step 3, transformation, involves viewing the similarities and the differences among the information collected. Step 4, incubation, allows the subconscious mind to reflect on the information collected. Step 5, illumination, occurs at some point during the incubation stage when a spontaneous breakthrough causes "the lightbulb to go on." Step 6, verification, involves validating the idea as accurate and useful. Step 7, implementation, involves transforming the idea into a business reality.

Discussion Questions

- 3-1. Explain the differences among creativity, innovation, and entrepreneurship.
- 3-2. Identify six enablers of small business innovation.
- 3-3. Comment on the statement, "Innovation is the specific instrument of entrepreneurs, the act that endows resources with a new capacity to create wealth."
- 3-4. What are the ingredients of creativity?
- 3-5. Explain how to enhance organizational creativity.
- 3-6. How does the human brain function? What operations does each hemisphere specialize in? Which hemisphere is the "seat" of creativity?
- 3-7. Briefly outline the 10 "mental locks" that can limit individual creativity. Give an example of a situation in which you subjected yourself to one of these mental locks.

- 3-8. What can entrepreneurs do to stimulate their own creativity and to encourage it among workers?
- 3-9. Explain the steps of the creative process. What can an entrepreneur do to enhance each step?
- 3-10. Interview at least two entrepreneurs about their experiences as business owners. Where did their business ideas originate? How important are creativity and innovation to their success? How do they encourage an environment of creativity in their businesses?
- 3-11. Your dinner guests are to arrive in five minutes, and you've just discovered that you forgot to chill the wine!

Wanting to maintain your reputation as the perfect host/hostess, you must tackle this problem with maximum creativity. What could you do? Generate as many solutions as you can in five minutes working alone. Then work with two or three students in a small group to brainstorm the problem.

- 3-12. Work with a group of your classmates to think of as many alternative uses for the commercial lubricant, WD-40, as you can. Remember to think *fluidly* (generating a quantity of ideas) and *flexibly* (generating unconventional ideas).

CHAPTER 4

Strategic Management and the Entrepreneur



Learning Objectives

On completion of this chapter, you will be able to:

1. Understand the importance of strategic management to a small business.
2. Explain why and how a small business must create a competitive advantage in the market.
3. Develop a strategic plan for a business using the nine steps in the strategic planning process.
4. Discuss the characteristics of three basic strategies: low cost, differentiation, and focus.
5. Understand the importance of controls such as the balanced scorecard in the planning process.

There is no competitive advantage in being just like everyone else.

—Daniel Burrus

Having a strategy in the first place is hard. Maintaining a strategy is even harder.

—Michael Porter

1.

Understand the importance of strategic management to a small business.

Few activities in the life of a small business are as vital—or as overlooked—as that of developing a strategy for success. Too often, entrepreneurs brimming with optimism and enthusiasm launch businesses destined for failure because their founders never stop to define a workable strategy that sets them apart from their competition. Because entrepreneurs tend to be people of action, they often find the process of developing a strategy dull and unnecessary. Their tendency is to start a business, try several approaches, and see what works. Without a cohesive plan of action, however, these entrepreneurs have as much chance of building a successful business as a defense contractor attempting to build a jet fighter without blueprints. Companies lacking clear strategies may achieve success in the short run, but as soon as competitive conditions stiffen or an unanticipated threat arises, they usually “hit the wall” and fold. Without a strategy for differentiating itself from a pack of similar competitors, the best a company can hope for is mediocrity in the marketplace. “The worst [management] mistake—and the most common one—is not having a strategy at all,” says strategy guru Michael Porter.¹

In today’s global, competitive environment, any business, large or small, that is not thinking and acting strategically is extremely vulnerable. Every business is exposed to the forces of a rapidly changing competitive environment, and in the future small business executives can expect even greater change and uncertainty. “The pace of disruption is roaring ahead,” says one business writer. “Uncertainty has taken hold; chaotic disruption is rampant.”² In 2007, three companies—Nokia, Research in Motion, and Motorola—accounted for 64 percent of the market for smart phones. Just five years later, smart phones from two different companies—Samsung and Apple—made up 60 percent of sales, reflecting the unprecedented level of turbulence in a major technology market.³

From more intense global competition and newly emerging international markets to sweeping political changes around the planet and rapid technological advances, the business environment has become more turbulent and challenging for entrepreneurs. Although this market turbulence creates many challenges for small businesses, it also creates opportunities for those companies that have in place strategies to capitalize on them. Small companies now have access to technology, tools, and techniques that once were available only to large companies, enabling them to achieve significant, sometimes momentous, results. To achieve those results, however, requires a business strategy that is stout enough to guide a company through normal turbulence but fluid enough to adapt to the sweeping changes wrought by the often chaotic uncertainty of the business environment.

Historically important, entrepreneurs’ willingness to create change, experiment with new business models, and break traditional rules have become more important than ever. Rather than merely respond to the chaos in the environment, small companies that are prepared actually can *create* the disruptions that revolutionize their industries and gain a competitive edge. Just as sales of music CDs were at their peak, Steve Jobs’s Apple Inc. revolutionized the music industry with the introduction of the iPod. Apple still commands more than 70 percent market share in the market for MP3 players more than a decade after introducing the iPod, and its iTunes Music Store became the world’s leading music retailer within five years of its launch, having now sold more than 25 *billion* song downloads. In addition, Apple does not wait for rivals to render its products obsolete with better, more powerful versions; instead, the company disrupts its own products! Apple introduced the iPod Touch just 24 months after it released the highly successful iPod Nano and continues that pattern today with both the iPod and the iPhone.⁴

Perhaps the biggest change entrepreneurs face is still unfolding: the shift in the world’s economy from a base of *financial to intellectual* capital. Intellectual capital is the knowledge and information a company acquires and uses to create a competitive edge in its market segment. “Knowledge is no longer just a factor of production,” says futurist Alvin Toffler. “It is the *critical* factor of production.”⁵ Most small companies have significant stockpiles of valuable knowledge that can help them gain an edge in the marketplace *if* they put it to good use. Norm Brodsky, a serial entrepreneur who founded eight successful businesses, discovered the importance of intellectual capital early on in his business career, and it is a competitive advantage that he continues to rely on today. “I found that I could close a significantly higher percentage of sales than my competitors simply by knowing more than they did about the customer, its representatives, and every other aspect of the deal.”⁶ The same is true today.

Brodsky explains what happens at his records storage business before a potential customer comes on site:

We prepare thoroughly. Before the customer's people arrive, I go online and find out as much as I can about the organization's structure, mission, and history. My salespeople give me a full briefing on the visitors I'm about to meet—what they're like as individuals, whom else they're considering, how the decision will be made, and so on. I tailor my presentation accordingly.

The result of Brodsky's use of the knowledge in his company is a closing rate that exceeds 95 percent for all prospective customers who visit his company's facility.⁶

Unfortunately, much of the knowledge that resides in many small companies sits idle or is shared only by happenstance on an informal basis. This scenario is the equivalent of having a bank account without a checkbook or a debit card to access it! The key is learning how to utilize the knowledge a company accumulates over time as a strategic resource and as a competitive weapon. **Knowledge management** is the practice of gathering, organizing, and disseminating the collective wisdom and experience of a company's employees for the purpose of strengthening its competitive position. Because of their size and simplicity, small businesses have an advantage over large companies when it comes to managing knowledge. Knowledge management requires a small company to identify what its workers know, incorporate that knowledge into the business, distribute it where it is needed, and leverage it into more useful knowledge.

Today, a company's intellectual capital is likely to be the source of its competitive advantage in the marketplace. **Intellectual capital** is comprised of three components:⁷

1. *Human capital* includes the creativity, talents, skills, and abilities of a company's workforce and shows up in the innovative strategies, plans, and processes that the people in an organization develop and then passionately pursue.
2. *Structural capital* is the accumulated knowledge and experience in the industry and in business in general that a company possesses. It can take many forms including processes, software, patents, copyrights, and, perhaps most importantly, the knowledge and experience of the people in a company. "Don't let knowledge leave the premises when workers exit the building," advises one expert. "Some of it never returns."⁸
3. *Customer capital* is the established customer base, positive reputation, ongoing relationships, and goodwill a company builds up over time with its customers.

Increasingly, entrepreneurs are recognizing that the capital stored in these three areas forms the foundation of their ability to compete effectively and that they must manage this intangible capital base carefully. Every business uses all three components in its strategy, but the emphasis they place on each component varies.



ENTREPRENEURIAL PROFILE: Joe Coulombe: Trader Joe's Trader Joe's, founded by Joe Coulombe in 1967, is a highly successful grocery store chain with 372 stores in 33 states that relies on structural capital to create a significant competitive advantage. In an industry in which most companies treat their employees like interchangeable parts, Trader Joe's has built valuable structural capital by investing more in training, developing, compensating, and motivating its employees than its competitors. The company empowers every employee to do whatever it takes to make sure that customers have a "wow!" experience when they shop. The strategy works: Annual sales at Trader Joe's are nearly \$10 billion and are growing at an impressive 12 percent a year. Zeynep Ton, a professor who has studied the retail industry and Trader Joe's, says that "highly successful retail chains not only invest heavily in store employees but also have the lowest prices in their industries, solid financial performance, and better customer service than their competitors."⁹

The rules of the competitive game of business are undergoing dramatic change. Entrepreneurs must recognize that the business forecast calls for continued chaos and disruption with the certainty of new opportunities and a slight chance of disaster. To be successful in this environment, entrepreneurs can no longer do things in the way they've always done them. They must learn to be initiators and agents of change. The late management guru Peter Drucker said that the key challenge for managers in the twenty-first century is leading change and that doing so successfully requires leaders "to abandon yesterday," leaving behind the products, services, management styles, marketing techniques, and other ideas that no longer work.¹⁰

Fortunately, successful entrepreneurs have at their disposal a powerful weapon to cope with a chaotic environment filled with disarray and constant disruptions: the process of strategic management. **Strategic management** is a process that involves developing a game plan to guide the company as it strives to accomplish its vision, mission, goals, and objectives and to keep it from straying off its desired course. The idea is to give the owner a blueprint for matching the company's strengths and weaknesses to the opportunities and threats in the environment.

Building a Competitive Advantage

The goal of developing a strategic plan is to create for a small company a **competitive advantage**—the aggregation of factors that differentiates a small business from its competitors and gives it a unique and superior position in the market. From a strategic perspective, the key to business success is to develop a unique competitive advantage, one that creates value for customers, is sustainable, and is difficult for competitors to duplicate. No business can be everything to everyone. In fact, one of the biggest pitfalls many entrepreneurs stumble into is failing to differentiate their companies from the crowd of competitors. Entrepreneurs faced with the challenge of setting their companies apart from their larger, more powerful competitors (who can easily outspend them) use the creativity, speed, flexibility, and special abilities of their businesses as differentiators. Entrepreneurs should examine five aspects of their businesses to define their companies' competitive advantages:

1. Products they sell. What is unique about the products the company sells? Do they save customers time or money? Are they more reliable and more dependable than those that competitors sell? Do they save energy, protect the environment, or provide more convenience for customers? By identifying the unique customer benefits of their companies' products, entrepreneurs can differentiate their businesses.

ENTREPRENEURIAL PROFILE: Mark Highland: Organic Mechanics Soil Company Mark Highland, who has a master's degree in public horticulture, transformed his specialized knowledge of compost into a successful business, Organic Mechanics Soil Company. Highland uses fertile compost rather than the peat moss mixture that other companies rely on to create an environmentally friendly potting soil that requires less watering and produces bigger flower blooms, fruit, and vegetable crops. Founded in 2006, Organic Mechanics Soil Company has expanded its product line to include nine items, which together generate more than \$1 million in annual revenue. Despite competing in an industry dominated by several giant companies, Organic Mechanics Soil Company's unique line of products is profitable and growing fast.¹¹

2. Service they provide. Many entrepreneurs find that the service they provide their customers is an excellent way to differentiate their companies. Because they are small, friendly, and close to their customers, small businesses are able to provide customer service that is superior to that which their larger competitors can provide. What services does the company provide (or which ones can it provide) to deliver added value and a superior shopping experience for customers?

3. Pricing they offer. As we will see later in this chapter, some small businesses differentiate themselves using price. Low prices can be a powerful point of differentiation but only if a business has the low-cost structure to drive them. However, offering the lowest prices is not always the best way to create a unique image. Small companies that do not offer the lowest prices must emphasize the value that their products offer.

4. Way they sell. Customers today want convenience when they shop, and companies that provide it (perhaps via the Internet) have a foundation for an important competitive advantage. Companies also can add value to customers' buying experience by creating fun, engaging places to shop that offer more than just products and services.

ENTREPRENEURIAL PROFILE: Richard Howorth: Square Books At Square Books, an independent bookstore started in 1979 in Oxford, Mississippi, owner Richard Howorth wants to create in his customers' eyes the image that his business is more than a bookstore by hosting a unique, live radio show, Thacker Mountain Radio, every week and sponsoring frequent author appearances. Howorth records the authors' readings and offers them as podcasts on the store's Web site. Square Books also offers a Signed Firsts Club that sells limited-edition, signed copies of books.

2.

Explain why and how a small business must create a competitive advantage in the market.



Mark Highland, founder of Organic Mechanics Soil Company.

Source: Natalie Brasington.

Howorth maximizes customers' convenience and sets his company apart from its competition by providing a free delivery service to any customer who lives within one mile of the city limits. "Amazon brags about how fast they can get books to you, but we can get ours out faster," he says.¹²

5. Values to which they are committed. The most successful companies exist for reasons that involve far more than merely making money. The entrepreneurs behind these companies understand that one way to connect with customers and establish a competitive edge is to manage their companies from a values-based perspective and operate them in an ethical and socially responsible fashion. In other words, they recognize that there is no inherent conflict between earning a profit and creating good for society and the environment.

Building a competitive advantage alone is not enough; the key to success over time is building a *sustainable* competitive advantage. In the long run, a company gains a sustainable competitive advantage through its ability to develop a set of core competencies that enable it to create value for its selected target customers better than its rivals. **Core competencies** are a unique set of capabilities that a company develops in key areas, such as superior quality, customer service, innovation, team building, flexibility, responsiveness, and others that allow it to vault past competitors. As the phrase suggests, they are central to a company's ability to compete successfully and are usually the result of important knowledge, skills, and lessons a business has learned over time (see Figure 4.1).

Typically, a company is likely to build core competencies in no more than three to five (sometimes fewer) areas. These core competencies form the nucleus of a company's competitive advantage and are usually quite enduring over time. Markets, customers, and competitors may change, but a company's core competencies are more durable, forming the building blocks for *everything* a company does. In fact, to be effective, these competencies must be sustainable over time. They also should be difficult for competitors to duplicate and must provide customers with a valuable perceived benefit. Small companies' core competencies often have to do with the advantages of their size—agility, speed, closeness to their customers, superior service, or ability to innovate. In short, they use their "smallness" to their advantage, doing things that their larger rivals cannot. The key to success is to build core competencies (or to identify the ones a company already has) and concentrate them on providing superior service and value for a company's target customers. Developing core competencies does *not* necessarily require a company to spend a great deal of money. It does, however, require an entrepreneur to use creativity, imagination, experience, and vision to identify or develop those things that the business does best and that are most important to its target customers.

Entrepreneurs should use their companies' core competencies to define a compelling **value proposition**, the value that the combination of goods and services that a business delivers to customers to create a sustainable competitive edge. Gaining a competitive advantage is not solely about outpacing one's rivals; it involves creating a meaningful value proposition for customers. Creating a meaningful value proposition necessitates identifying a company's target customers and understanding customers' needs, wants, behaviors, and buying motives. To be effective, a value proposition must be authentic, which means that a company should be able to identify tangible points of difference that are important to customers. A genuine value proposition should increase convenience, lower costs, or improve performance for customers. Ideally, a company can prove the validity of its value proposition with facts and back it up with customer testimonials.

Companies have three choices for defining their value propositions with an almost infinite number of variations on each one: product or service leadership, customer intimacy, and

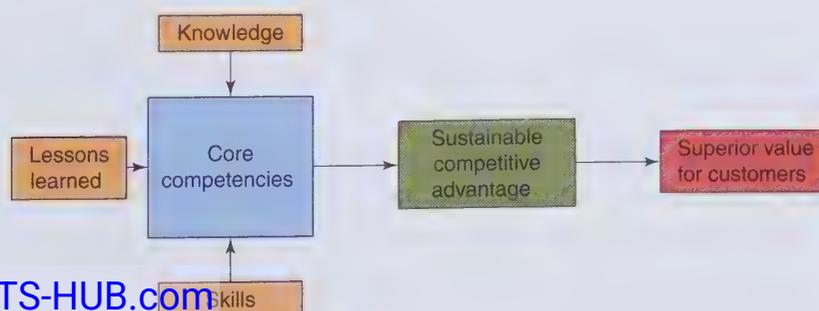


FIGURE 4.1

Building a Sustainable Competitive Advantage

operational excellence.¹³ Successful businesses usually excel at one option and maintain acceptable levels of the other two. Companies that choose a product or service leadership value proposition tout their unique products or services as innovative solutions to customers' needs.



ENTREPRENEURIAL PROFILE: Ren Ng: Lytro Inc. Entrepreneur Ren Ng plans to build his company, Lytro, on a product leadership value proposition. Ng spent years studying light fields and optics and developed the Lytro, an easy-to-use camera that instantaneously captures not only the color and intensity of light rays in an image but also their direction. The result is a camera that needs no focusing and creates “living pictures.” Photographers simply capture an image and then create an almost infinite number of variations of it by changing the focus and the perspective of any element in the photograph later.¹⁴

Businesses that use customer intimacy as the foundation of their value propositions develop close relationships with customers and set themselves apart by providing superior customer service and total solutions to customers' problems. Companies that differentiate themselves using operational efficiency excel at speed, selection, quality, availability, price, or some other important product or service characteristic. They set themselves apart by being the best at meeting customers' needs quickly and efficiently. For instance, Southwest Airlines has attracted a loyal following of customers with its low fares; simple check-in process; fast, efficient boarding; and enviable on-time record.

When it comes to developing a strategy for establishing a competitive advantage, small companies have a variety of natural advantages over their larger competitors. The typical small business has fewer product lines, a more clearly defined customer base, and a limited geographic market area. Entrepreneurs usually are in close contact with their customers, giving them valuable knowledge on how to best serve their customers' needs and wants. Because of the simplicity of their organization structures, small business owners are in touch with employees daily, often working side by side with them, allowing them to communicate strategic moves firsthand. Consequently, small businesses find that strategic management comes more naturally to them than to larger companies with their layers of bureaucracy and far-flung operations.

Strategic management can increase a small company's effectiveness, but entrepreneurs first must have a process designed to meet their needs and their business's special characteristics. The strategic management procedure for a small business should include the following features:

- Use a relatively short planning horizon—two years or less for most small companies.
- Be informal and not overly structured; a “shirt-sleeve” approach is ideal.
- Encourage the participation of employees and outside parties to improve the reliability and creativity of the resulting plan.
- Do not begin with setting objectives because extensive objective setting early on may interfere with the creative process of strategic management.
- Maintain flexibility; competitive conditions change too rapidly for any plan to be considered permanent.
- Focus on strategic *thinking*, not just planning, by linking long-range goals to day-to-day operations.

The Strategic Management Process

One of the most important tasks a business owner must perform is to look ahead—to peer into the future—and then devise a strategy for meeting the challenges and opportunities it presents. Strategic management, the best way to accomplish this vital task, is a continuous process that consists of nine steps:

Step 1. Develop a clear vision and translate it into a meaningful mission statement.

Step 2. Assess the company's strengths and weaknesses.

Step 3. Scan the environment for significant opportunities and threats facing the business.

Step 4. Identify the key factors for success in the business.

Step 5. Analyze the competition.

3.

Develop a strategic plan for a business using the nine steps in the strategic planning process.

- Step 6.** Create company goals and objectives.
- Step 7.** Formulate strategic options and select the appropriate strategies.
- Step 8.** Translate strategic plans into action plans.
- Step 9.** Establish accurate controls.

Step 1. Develop a Clear Vision and Translate It into a Meaningful Mission Statement

VISION Throughout history, the greatest political and business leaders have been visionaries. Whether the vision is as grand as Martin Luther King Jr.'s "I Have a Dream" speech or as simple as Ray Kroc's devotion to quality, service, cleanliness, and value at McDonald's, the purpose is the same: to focus everyone's attention and efforts on the same target. The vision touches everyone associated with the company—employees, investors, lenders, customers, and the community. It is an expression of what entrepreneurs believe in and the values on which they build their businesses. Highly successful entrepreneurs are able to communicate their vision and their enthusiasm about that vision to those around them. "Strategic planning is worthless unless there is first a strategic vision," says entrepreneur and author John Naisbitt.¹⁵

A vision statement addresses the question "What kind of company do we want to be?" In his book *Daring Visionaries: How Entrepreneurs Build Companies, Inspire Allegiance, and Create Wealth*, Ray Smilor describes the importance of vision:¹⁶

Vision is the organizational sixth sense that tells us why we make a difference in the world. It is the real but unseen fabric of connections that nurture and sustain values. It is the pulse of the organizational body that reaffirms relationships and directs behavior.

A vision is the result of an entrepreneur's dream of something that does not exist yet and the ability to paint a compelling picture of that dream for everyone to see. A clearly defined vision helps a company in four ways:

1. **Vision provides direction.** Entrepreneurs who spell out the vision for their company focus everyone's attention on the future and determine the path the business will take to get there.
2. **Vision determines decisions.** The vision influences the decisions, no matter how big or how small, that owners, managers, and employees make every day in a business. This influence can be positive or negative, depending on how well defined the vision is. One writer explains, "Almost all workers are making decisions, not just filling out weekly sales reports or tightening screws. They will do what they think [is] best. If you want them to do as the company thinks best too, then you must [see to it that] they have an inner gyroscope aligned with the corporate compass."¹⁷ That gyroscope's alignment depends on an entrepreneur's values and how well he or she transmits them throughout the company.
3. **Vision motivates people.** A clear vision excites and ignites people to action. People want to work for a company that sets its sights high and establishes targets that are worth pursuing.
4. **Vision allows a company to persevere in the face of adversity.** Small companies, their founders, and their employees face a multitude of challenges as they grow. Having a vision that serves as a "guiding star" inspires everyone in the company to work through challenging times.

Vision is based on an entrepreneur's values. Successful entrepreneurs build their businesses around a set of three to six core values, which might range from respect for the individual and encouraging innovation to creating satisfied customers and making the world a better place to live. These values become the foundation on which the entire company and its strategy are built. Even though the environment in which a company operates may be under turbulent disruptions and changes, the core values on which it is built remain constant. Truly visionary entrepreneurs see their companies' primary purpose as much more than just "making money." When Henry C. Turner started Turner Construction Company in 1902 in New York City, he identified three core values: integrity (highest ethical standards), teamwork (people focused), and commitment (client driven). The company has grown into one of the largest construction and

building services company in the United States, handling more than 1,600 construction projects around the world in a typical year, and the same principles on which Turner founded the company continue to guide it. Some of Turner Construction's most famous projects include Bloomingdale's Department Store, LaGuardia Airport, Rock and Roll Hall of Fame and Museum, and Ericsson Stadium.¹⁸

Danny Meyer, an author and the owner of New York City's Union Square Café, compares a company's core values to the banks of a river. "[Core values] are the riverbanks that guide us as we refine and improve our performance. A lack of riverbanks creates estuaries and cloudy waters that are confusing to navigate. I want a crystal-clear, swiftly flowing stream."¹⁹ The best way to put an entrepreneur's core values into practice is to create a written mission statement that communicates the company's values to everyone it touches.

MISSION STATEMENT A mission statement addresses the first question of any business venture: "What business am I in?" Establishing the purpose of the business in writing must come first in order to give the company a sense of direction. The mission is the mechanism for making it clear to everyone the company touches "why we are here" and "where we are going." Because a mission statement reflects the company's core values, it helps create an emotional bond between a company and its stakeholders, especially its employees and its customers. Without a concise, meaningful mission statement, a small business risks wandering aimlessly in the marketplace, with no idea of where to go or how to get there.



ENTREPRENEURIAL PROFILE: Jerry and Janie Murrell: Five Guys Burgers and Fries

Jerry Murrell and his wife Janie opened the first Five Guys Burger and Fries in Arlington, Virginia, in 1986, naming the business after their five sons. "I liked hamburgers and French fries—good ones," says Murrell. "We thought we could do it right, and people just took to it." The Murrell's original vision and mission statement still guides the company: "To sell the best quality burgers possible and provide the best customer service in the community. To fulfill these standards, we focus on quality, service, and cleanliness." Five Guys Burgers and Fries specializes in burgers made with fresh ground beef, fries cooked in peanut oil, fresh-baked buns, and free toppings, such as lettuce, tomato, sautéed mushrooms, jalapeno peppers, and others. The Murrells spent years perfecting their system and by 2001 had added five more locations in the Washington, D.C., metro area. In 2002, they began franchising their successful restaurant concept and now have more than 1,100 locations in 47 states and six Canadian provinces.²⁰

Elements of a Mission Statement A sound mission statement need not be lengthy to be effective. Three key issues entrepreneurs and their employees should address as they develop a mission statement for their businesses include the following:

- The *purpose* of the company: What are we in business to accomplish?
- The *business* we are in: How are we going to accomplish that purpose?
- The *values* of the company: What principles and beliefs form the foundation of the way we do business?

A company's mission statement may be the most essential and basic communication that it puts forward. If the people on the plant, shop, retail, or warehouse floor don't know what a company's mission is, then, for all practical purposes, it does not have one! The mission statement expresses the company's character, identity, and scope of operations, but writing it is only half the battle, at best. The most difficult part is living that mission every day. *That's* how employees decide what really matters. To be effective, a mission statement must become a natural part of the organization, embodied in the minds, habits, attitudes, and decisions of everyone in the company every day.

A well-used mission statement serves as a strategic compass for a small company, guiding both managers and employees as they make decisions every day. Some companies use short, one- or two-sentence mission statements that are easy to remember and understand, and others create longer mission statements with multiple components. Consider the following examples:

- YouTube says that its mission is "to provide fast and easy video access and the ability to share videos frequently."²¹
- Starbucks' mission is to inspire and nurture the human spirit—one person, one cup, and one neighborhood at a time.²²

- Zahner's Clothiers, a second-generation men's clothing store in Vernon, Connecticut, founded in 1951 by Manny Zahner and now operated by his son Scott, has a simple mission: "To provide quality merchandise with classic styling in a relaxed environment with professional service delivered by knowledgeable salespeople."²³
- Trader Joe's mission is "to bring our customers the best food and beverage values and the information to make informed buying decisions."
- Gov Supply, a company that carries an inventory of more than 20,000 security items ranging from concrete barriers to bomb-resistant trash cans, says, "Our mission is to secure U.S. facilities and safeguard the lives of our citizens both domestically and abroad."²⁴

A company may have a powerful competitive advantage, but it is wasted unless (1) the owner has communicated that advantage to workers, who, in turn, are working hard to communicate it to customers and potential customers and (2) customers are recommending the company to their friends because they understand the benefits they are getting from it that they cannot get elsewhere. *That's* the real power of a mission statement.



Lessons from the Street-Smart Entrepreneur

Thriving on Change

Having faced the worst economic recession since the 1930s, many entrepreneurs recognize that their customers' buying behavior, and, perhaps more important, attitudes have changed, perhaps permanently. A recent survey by Citibank reports that 53 percent of small business owners say that they have reinvented their businesses to stay afloat or to remain competitive. "Small-business owners are especially adept at reinvention, whether because of obstacles or new visions for growth," says Maria Veltre, managing director of Citi Small Business. "Change is never easy, but neither is starting and running a business. We see our small-business clients embracing change and reinventing themselves to secure a rewarding future." What are the keys to thriving on constant change? Consider these tips from the Street-Smart Entrepreneur:

Tip 1. Get comfortable with chaos

The globalization of business, technology advancement, intense competition, and rapidly changing economic conditions mean that entrepreneurs can no longer expect long periods of stabilized economic prosperity. Instead, they must be prepared to face constant turbulence punctuated by opportunities for growth. Successful entrepreneurs make this important mental shift and are willing to reinvent their companies to capitalize on the opportunities that chaos creates. Chaos requires reinvention, and small companies are much more flexible and fleet-footed at reinventing themselves than their larger rivals.

Tip 2. Play to win, not to avoid losing

You've seen it in sports: A team, often the underdog, gets an early lead over a stronger competitor by being aggressive and then later in the game changes its strategy to one of playing not to lose its lead. The result is almost always the same: a loss. Successful entrepreneurs play to win. In 2008, as economic conditions eroded, Bandy Cohen, founder of TicketCity, a ticket brokering company in Austin, Texas, laid off workers, cut back

on marketing, and reduced managers' pay. Soon afterward, he came across a copy of an article that a local paper had published about his business. Its title: "Don't Be Afraid." Cohen realized that he had changed his strategy to one of avoiding a loss rather than striving for a win. He reenergized his company by hiring 10 new employees and pumping more money into marketing. Sales and profits increased immediately.

Tip 3. Stay in contact with your customers

Businesses that constantly realign their product and service offerings to meet their customers' changing needs have a competitive edge. Small companies maintain closer contact with their customers than large businesses, which gives them the advantage. Entrepreneurs who listen to their customers, conduct surveys, and polls, and focus groups and simply just spend time with customers find it easy to stay in tune with their customers' needs, expectations, and demands. Ashton and Elaine Barrington started Elaine's as a gift shop in Clinton, South Carolina, a small town with a population of 10,000. After a few years, feedback from their customers prompted them to add a coffee shop inside their store. Before the Barringtons decided to expand the coffee business to include a sandwich shop, they tested the idea first on a small scale. Customers gave their overwhelming approval, and the Barringtons remodeled their store, making Jitters, their coffee shop and café, a larger part of their store. When a severe recession caused sales of gift items to plummet, the Barringtons' decision to reinvent their business proved to be a wise one. "Jitters has been the salvation of our business," says Ashton.

Tip 4. Focus on providing value to your customers

In a severe recession, customers, even upscale ones, change their buying behavior and carefully evaluate every potential purchase, looking always for *value*. Companies that find creative ways to add value to their products and services and help their customers

Lessons from the Street-Smart Entrepreneur *(continued)*

solve problems will be the ones that succeed. A study by research firm Nielsen reports that customers' willingness to purchase innovative products and services in good and bad economic environments has remained constant over the last 30 years. Adding value does not have to be complex or expensive, nor does it require offering the lowest prices. Josh Davis and Bruno Tropeano, cofounders of Gelato Fiasco, have built a cult following for their luscious gelato by creating 32 unique flavors (cashew sea salt, hazelnut crunch, Maine wild blueberry, and others) each season in small, limited-edition batches compared to the five or six standard flavors its larger competitors offer. The Brunswick, Maine-based company sells its premium, all-natural gelato for \$6.50 per pint through 110 independent shops and Whole Foods and generates annual sales of \$1.1 million.

Tip 5. Look for new markets

In a chaotic environment, game changing companies look for more than ways to cut costs; they look for new markets to enter. How can you change your existing business model to reach another market, perhaps one that exists with your current customers? When sales of low-end vinyl-lined pools declined during a recession, the family owners of Sparkle Pool, a small company in Weston, West Virginia, decided to exit that market even though the company had been in the business for three generations. General manager Bob Pirner says that the family decided to shift its pool business toward upscale customers who want custom-designed pools and "aquascapes," an area in which the youngest generation of family members had been developing expertise.

Sparkle Pool's unique installations now range from \$50,000 to \$300,000, a significant increase over the typical \$12,000 to \$16,000 installation for a vinyl pool. In spite of the recession, entering the new market has allowed the company to increase its annual sales by 30 percent to more than \$1.2 million.

Tip 6. Hitch a ride on a wave

Like a surfer catching the perfect wave, successful entrepreneurs constantly watch for meaningful trends (not fads) and find ways to capitalize on them. Shortly after Bob Wills and his wife, Beth Nachreiner, purchased her family's cheese business, Cedar Grove Cheese located in Plain, Wisconsin, in 1989, "the whole Wisconsin dairy industry seemed to be going out of business," recalls Wills. To keep the 133-year-old company going, Wills and Nachreiner decided to tap into the growing trend in organic, all-natural food. Cedar Grove Cheese produces basic organic cheeses and artisanal cheeses made from cow, goat, sheep, and water buffalo milk and makes a concerted effort to minimize its environmental impact. The now-thriving company has 35 employees and produces between 4 million and 5 million tons of cheese per year.

Sources: Based on "Percentage of U.S. Small Business Owners Reporting Positive Business Conditions Nearly Doubles Since 2010," *Citigroup News*, June 6, 2012, www.citigroup.com/citi/news/2012/120606a.htm; Verne Harnish, "Five Ways to Get Your Strategy Right," *Fortune*, April 11, 2011, p. 42; Elaine Pofeldt, "David v. Goliath," *Fortune*, November 7, 2011, p. 50; Chris Pentilla, "Evolve," *Entrepreneur*, May 2009, pp. 43–45; Suzanne Barlyn, "New and Improved," *Wall Street Journal*, April 23, 2009, p. R4; Gwen Moran, "Whey of the Future," *Entrepreneur*, November 2011, p. 70.

Step 2. Assess the Company's Strengths and Weaknesses

Having defined the vision and the mission of the business, entrepreneurs can turn their attention to assessing company strengths and weaknesses. Competing successfully demands that a business create a competitive strategy that is built on and exploits its strengths and overcomes or compensates for its weaknesses. **Strengths** are positive internal factors that contribute to a company's ability to achieve its mission, goals, and objectives. **Weaknesses** are negative internal factors that inhibit a company's ability to achieve its mission, goals, and objectives.

An organization's strengths should originate in its core competencies because they are essential to its ability to remain competitive in each of the market segments in which it competes. The key is to build a successful strategy using the company's underlying strengths as its foundation and matching those strengths against competitors' weaknesses.



ENTREPRENEURIAL PROFILE: Chad and Eleanor Laurans: SimpliSafe SimpliSafe, a company cofounded by Chad and Eleanor Laurans that sells a simple yet effective wireless security system, relies on a strategy built on its strengths to compete successfully against much larger and more financially capable rivals in the home security industry. SimpliSafe's security systems offer customers significant benefits, including a low initial purchase price (starting at about \$300), no long-term contracts (only a \$15 pay-as-you-go monthly service fee), simple do-it-yourself installation, and a system that works with cell phones and requires no telephone line. The company, which promotes its "super secret formula: wireless technology + user-friendly product design + no contracts = happy customers who pay less and get more," generates more than \$15 million in annual sales.²⁵

One effective technique for taking a strategic inventory is to prepare a balance sheet of the company's strengths and weaknesses (see Table 4.1). The positive side should reflect important skills, knowledge, or resources that contribute to the company's success. The negative side should record honestly any limitations that detract from the company's ability

THREATS Sixty-five million years ago, a giant asteroid or comet smashed into the earth, causing catastrophic damage to the environment that lasted for years and wiped out the dinosaurs. Today, astronomers monitor the heavens with their telescopes, watching for “near-earth objects” that pose the same threat to our planet today. In the same way, small businesses must be on the lookout for threats that could destroy their companies. **Threats** are negative external forces that hamper a company’s ability to achieve its mission, goals, and objectives. Threats to the business can take a variety of forms, such as new competitors entering the local market, a government mandate regulating a business activity, an economic recession, rising interest rates, technology advances that make a company’s product obsolete, bad weather, and many others. Brendan Harrison, owner of Down to Earth, a landscaping and lawn care business in St. Louis, Missouri, saw his company’s sales shrivel when severe heat and drought devastated the Midwest. Harrison was able to keep his company going by adjusting his strategy to emphasize installations of permanent landscape features, such as retaining walls, rock gardens, patios, and others.²⁸

Movie theater owners face serious threats to their business from a variety of sources, including increasingly sophisticated home-theater systems that contain DVD and Blu-Ray players, huge high-definition, 3-D televisions, and surround-sound systems; pay-per-view movies available on demand; thieves who distribute black-market copies of films (sometimes before the original is released); and other forms of entertainment, ranging from iPods and YouTube to video games such as *Guitar Hero* and the Internet. The result has been an overall decline in movie ticket sales. In 1946, the average person went to the movies 28 times per year; today, the average person goes to a movie theater only 4.1 times per year.²⁹ Although theater owners cannot directly control the threats their businesses face, they must prepare strategic plans to shield their businesses from these threats. Several small theater chains, including Muvico, Cinema de Lux, CineBistro, Cinépolis Luxury Theaters, and others, are changing their strategies to encourage movie fans to return to the big screen. These chains are creating luxury theaters, offering concierge services, fully stocked bars, and upscale dinners, such as sushi, limoncello-tossed shrimp, and duck quesadillas served by waitstaff. Approximately 350 theaters out of the 5,750 cinemas in the United States now offer full-service restaurants, but the number is growing fast. “These theaters are the future of movie-going,” says industry veteran Jeffrey Katzenberg. In addition, the new theaters offer customers amenities such as online seat reservations, valet parking, stadium seating with plush reclining leather chairs with extra leg room, call buttons that summon waitstaff, digital systems that provide crisp images and superb sound (including subwoofers under each seat), interactive game rooms for children, and child care services. “We’re competing with a million things for people’s time,” says Jeremy Welman, COO of CineBistro Theaters. “We have to give them an experience that’s worth going out to.”³⁰

Table 4.2 provides a form that allows entrepreneurs to take a strategic inventory of the opportunities and threats facing their companies.

Table 4.3 provides an analytical tool that is designed to help entrepreneurs to identify the threats that pose the greatest danger to their companies.

Step 4. Identify the Key Factors for Success in the Business

KEY SUCCESS FACTORS Every business is characterized by a set of controllable factors that determine the relative success of market participants. Identifying, understanding, and manipulating these factors allow a small business to gain a competitive advantage in its market segment. By focusing efforts to maximize their companies’ performance on these key success factors,

TABLE 4.2 Identifying Opportunities and Threats

Opportunities (Positive External Factors)	Threats (Negative External Factors)

TABLE 4.3 Identifying and Managing Major Threats

Every business faces threats, but entrepreneurs cannot afford to be paranoid or paralyzed by fear when it comes to dealing with them. At the same time, they cannot afford to ignore threats that have the potential to destroy their businesses. The most productive approach to dealing with threats is to identify those that would have the most severe impact on a small company and those that have the highest probability of occurrence.

Research by Greg Hackett, president of management think tank MergerShop, has identified 12 major sources of risk that can wreak havoc on a company’s future. The following table helps entrepreneurs determine the threats on which they should focus their attention.

Source	Specific Threat	Severity (1 = Low, 10 = High)	Probability of Occurrence (0 to 1)	Threat Rating (Severity × Probability, Max = 10)
1. Channels of distribution				
2. Competition				
3. Demographic changes				
4. Globalization				
5. Innovation				
6. Waning customer or supplier loyalty				
7. Offshoring or outsourcing				
8. Stage in product life cycle				
9. Government regulation				
10. Influence of special interest groups				
11. Influence of stakeholders				
12. Changes in technology				

Once entrepreneurs have identified specific threats facing their companies in the 12 areas (not necessarily all 12), they rate the severity of the impact of each one on their company on a 1-to-10 scale. Then they assign probabilities (between 0 and 1) to each threat. To calculate the Threat Score, entrepreneurs simply multiply the severity of each threat by its probability. (Maximum Threat Score is 10.) The higher is a threat’s score, the more attention it demands. Typically, one or two threats stand out above all of the others, and those are the ones on which entrepreneurs should focus.

Source: Based on Edward Teach, “Apocalypse Soon,” *CFO*, September 2005, pp. 31–32.

entrepreneurs can achieve dramatic strategic advantages over their competitors. Companies that understand these key success factors tend to be leaders of the pack, whereas those who fail to recognize them become also-rans.

Key success factors come in a variety of different patterns depending on the industry. Simply stated, they are the factors that determine a company’s ability to compete successfully in an industry. Bruce Milletto, owner of Bellissimo Coffee Info-Group, a coffee business consulting firm, says that to be successful coffee shops must focus on three key success factors: high-quality coffee products, stellar customer service, and a warm, inviting ambience (with free wi-fi) that transforms a coffeehouse into a destination where people want to gather with their friends.

 **ENTREPRENEURIAL PROFILE: Martin and Kerry Mayorga: Mayorga Coffee** Martin and Kerry Mayorga started a coffee roasting business in 1998 and then opened a retail coffee store in Silver Springs, Maryland, that focuses on specialty imported coffee beans. With these key success factors in mind, Mayorga created a shop that looks more like a lounge than a retail store with its plush leather family-style seating. The Mayorgas also have added an entertainment factor by including musical entertainment and allowing customers to view the entire roasting process on its custom-made bean roaster, attractive extras for customers looking for a way to relax after a busy day at work.³¹

TABLE 4.4 Identifying Key Success Factors

List the key success factors that your business must possess if it is to be successful in its market segment.

Key Success Factor	How Your Company Rates
1	Low 1 2 3 4 5 6 7 8 9 10 High
2	Low 1 2 3 4 5 6 7 8 9 10 High
3	Low 1 2 3 4 5 6 7 8 9 10 High
4	Low 1 2 3 4 5 6 7 8 9 10 High
5	Low 1 2 3 4 5 6 7 8 9 10 High
Conclusions:	

large one, can excel on every key success factor it identifies. Therefore, as they begin to develop their strategies, successful entrepreneurs focus on surpassing their rivals on one or two key success factors to build a sustainable competitive edge. As a result, key success factors become the cornerstones of a company’s strategy. Simply stated, key success factors determine a company’s ability to compete in the marketplace. For example, the owner of a pizza restaurant identifies the following key success factors for his business:

- Tight cost control (labor costs, 16 to 22 percent of sales, and food costs, 24 to 32 percent of sales)
- Waste minimization
- Convenient location
- Consistent food quality
- Affordable prices
- Clean restaurants
- Friendly and attentive service from a well-trained waitstaff

These controllable variables determine the ability of any restaurant in his market segment to compete. Pizzerias that lack these key success factors are not likely to survive, whereas those that build these factors into their strategies prosper. However, before entrepreneurs can build a strategy on the foundation of the industry’s key success factors, they must identify them. Table 4.4 presents a form to help entrepreneurs identify the most important success factors and their implications for the company.

Step 5. Analyze the Competition

Ask small business owners to identify the greatest challenge they face, and one of the most common responses is *competition*. Small retailers increasingly are under fire from larger, more powerful rivals, including general retailers such as Walmart and Amazon and specialty big-box stores such as Home Depot, PetSmart, and Office Depot. Figure 4.2 shows the results of a recent study of the small business sector’s competitive health as measured by the Small Business Success Index, a composite of 28 measures of small business’s ability to compete. Note that only 48 percent of small businesses are either marginally or highly competitive.



ENTREPRENEURIAL PROFILE: Irving Shulman: Daffy’s Daffy’s, a family-owned discount retail chain in the New York City metropolitan area, recently closed all 19 of its stores in the face of mounting competition. Founded in 1961 by Irving Shulman, Daffy’s quickly became a popular shopping destination with high-traffic locations and its then-unique strategy of offering chic designer clothing at discount prices. Recently, the company’s sales declined as competition in the discount market grew more intense. Discounters such as T.J. Maxx and Ross Stores, fast-fashion retailers such as Sara and H&M, and flash sales sites Gilt Group, Beyond the Rack, Ideeli, and others expanded into Daffy’s market, siphoning off much of the best merchandise and eroding the company’s sales to the point that it became unprofitable. Daffy’s “couldn’t get access to products, and there were too many players,” says an industry expert. “Everybody is fighting for the same customer, and competitors just ate their lunch.”³²

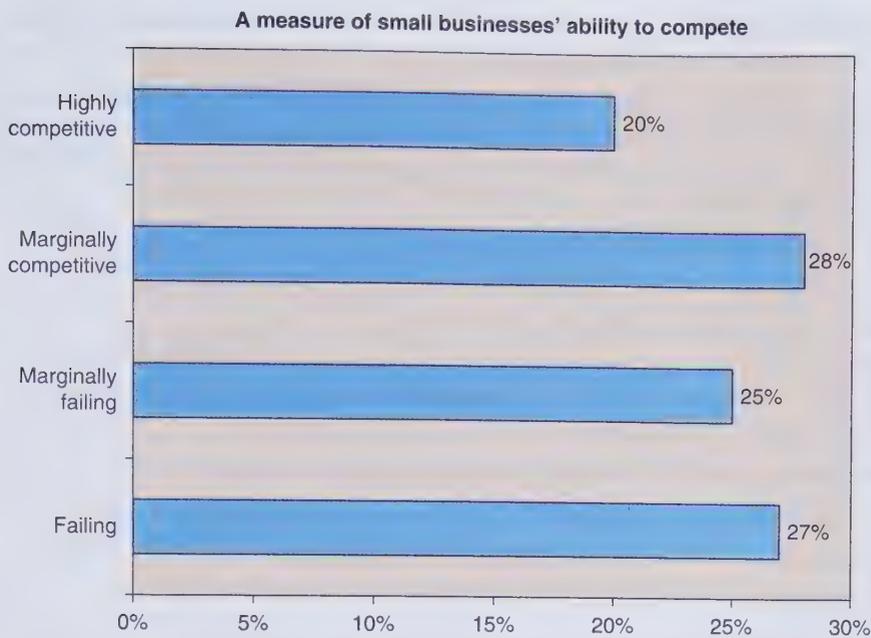


FIGURE 4.2
Small Business Success Index

Source: Based on “The State of Small Business Report: January 2011 Survey of Small Business Success,” February 9, 2011, Network Solutions and Robert H. Smith School of Business, University of Maryland.

Keeping tabs on rivals' strategic movements through competitive intelligence programs is a vital strategic activity. According to one small business consultant, “Like any general going into battle, entrepreneurs must know their competitors' strengths and weaknesses.”³³ Tracking competitors allows business owners to reap the following benefits:

- Avoid surprises from existing competitors' new strategies and tactics
- Identify potential new competitors
- Anticipate rivals' next strategic moves
- Improve reaction time to competitors' actions
- Improve their ability to differentiate their companies' products and services from those of competitors
- Refine their companies' competitive edge

Unfortunately, most small companies fail to gather competitive intelligence because their owners mistakenly assume that it is too costly or simply unnecessary. In reality, the cost of collecting information about competitors typically is minimal, but it does require discipline.

COMPETITOR ANALYSIS Sizing up the competition gives entrepreneurs a more realistic view of the market and their companies' position in it. Yet not every competitor warrants the same level of attention in a strategic plan. *Direct competitors* offer the same products and services, and customers often compare prices, features, and deals from these competitors as they shop. *Significant competitors* offer some of the same products and services. Although their product or service lines may be somewhat different, there is competition with them in several key areas. *Indirect competitors* offer the same or similar products or services only in a small number of areas, and their target customers seldom overlap yours. Entrepreneurs should monitor closely the actions of their direct competitors, maintain a solid grasp of where their significant competitors are heading, and spend only minimal resources tracking their indirect competitors. For instance, two of Philadelphia's landmark businesses, Pat's King of Steaks and Geno's Steaks, are direct competitors in the market for Philly cheesesteaks. Their locations—across the street from one another in South Philadelphia—make it easy for each to keep track of the other. Pat's, founded in 1930, and Geno's, founded in 1966, have been fierce but good-natured competitors for decades and were featured in the original 1976 film *Rocky*. They charge the same prices for their sandwiches, and both claim to be the home of the original Philly cheesesteak sandwich.³⁴

A competitive intelligence exercise enables entrepreneurs to update their knowledge of competitors by answering the following questions:

- Who are your major competitors, and where are they located? Bob Dickinson, president of Carnival Cruise Lines, considers his company's main competition to be land-based theme parks and casinos rather than other cruise lines. Why? Because 89 percent of American adults have never been on a cruise!³⁵
- What core competencies have they developed?
- How do their cost structures compare to yours? Their financial resources?
- How do they market their products and services?
- What do customers say about them? How do customers describe their products or services, their way of doing business, and the additional services they might supply?
- What are their key strategies?
- What are their strengths? How can your company surpass them?
- What are their primary weaknesses? How can your company capitalize on them?
- What messages are they communicating to their customers?
- Are new competitors entering the market?

A small business owner can collect a great deal of information about competitors through low-cost competitive intelligence methods, including the following:

- Read industry trade publications for announcements from competitors.
- Ask questions of customers and suppliers on what they hear competitors may be doing. In many cases, this information is easy to gather because some people love to gossip.
- Talk to employees, especially sales representatives and purchasing agents. Experts estimate that 70 to 90 percent of the competitive information a company needs already resides with employees who collect it in their routine dealings with suppliers, customers, and other industry contacts.³⁶
- Attend trade shows and collect competitors' sales literature.
- Watch for employment ads from competitors; knowing what types of workers they are hiring can tell you a great deal about their future plans.
- Conduct patent searches for patents that competitors have filed. This gives important clues about new products they are developing.
- Environmental Protection Agency reports can provide important information about the factories of manufacturing companies, including the amounts and the kinds of emissions released. A private group, Environmental Protection, also reports emissions for specific plants.³⁷
- Learn about the kinds and amounts of equipment and raw materials competitors are importing by studying the *Journal of Commerce Port Import Export Reporting Service (PIERS)* database. These clues can alert an entrepreneur to new products a competitor is about to launch.
- If appropriate, buy the competitors' products and assess their quality and features. Benchmark their products against yours. The owner of an online gift-basket company periodically places orders with his primary competitors and compares their packaging, pricing, service, and quality to his own.³⁸
- Obtain credit reports on each of your major competitors to evaluate their financial condition. Dun & Bradstreet and other research firms also enable entrepreneurs to look up profiles of competitors that can be helpful in a strategic analysis.
- Investigate Uniform Commercial Code filings. Banks file these with the state whenever they make loans to businesses. These reports often include the amount of the loan and what it is for.
- Publicly held companies must file periodic reports with the Securities and Exchange Commission, including quarterly 10-Q and annual 10-K reports. These are available at the commission's Web site.
- Check out the resources of your local library, including annual reports and press releases, which often announce important company news, can be an important source of

competitive intelligence. Many companies supply press releases through the *PR Newswire* (www.prnewswire.com). For local competitors, review back issues of the area newspaper for articles on and advertisements by competitors.

- Use the vast resources of the Internet to gather valuable competitive information at little or no cost. Entrepreneurs who use Google Alerts receive e-mails about articles, blogs, postings, or news stories about competitors. Entrepreneurs also have gained useful information by watching interviews on YouTube of managers from competing firms at trade shows and by viewing detailed PowerPoint presentations on SlideShare.
- Monitor competitors on social media. Perch, a social media tracking site, allows small business owners to monitor the events and promotions that local competitors are posting on social media sites.³⁹ In addition, employees often post informative work-related comments on Facebook, Twitter, LinkedIn, and other social media.
- Visit competing businesses periodically to observe their operations. Sam Walton, founder of Walmart, was famous for visiting competitors' operations to see what he could learn from them.
- Don't resort to unethical or illegal practices.

Using the information gathered, entrepreneurs should periodically evaluate their strongest competitors and develop strategic actions to improve their companies' competitive positions against each one.

Entrepreneurs can use the results of the competitive intelligence analysis to construct a competitive profile matrix for each market segment in which the firm operates. A **competitive profile matrix** allows entrepreneurs to evaluate their companies against major competitors on the key success factors for their market segments (refer to Table 4.4). The first step is to list the key success factors identified in step 4 of the strategic planning process and to attach weights to them reflecting their relative importance. Table 4.5 shows a sample competitive profile matrix for a small company. (For simplicity, the weights in this matrix sum add up to 1.00.) In this example, notice that product quality is the most important key success factor, which is why its weight (0.35) is the highest.

The next step is to identify the company's major competitors and to rate each one (and your company) on each of the key success factors:

If factor is a:	Rating is:
Major weakness	1
Minor weakness	2
Minor strength	3
Major strength	4

Once the rating is completed, the owner simply multiplies the weight by the rating for each factor to get a weighted score and then adds up each competitor's weighted scores to get a total weighted score. The results will show which company is strongest, which is the weakest, and

TABLE 4.5 Sample Competitive Profile Matrix

Key Success Factors (from Step 5)	Your Business		Competitor 1		Competitor 2	
	Weight	Rating	Weighted Score	Rating	Weighted Score	Weighted Score
	Ability to innovate	0.20	2	0.40	1	0.20
Customer service	0.25	4	1.00	1	0.25	0.50
Convenience	0.10	3	0.30	3	0.30	0.40
Product quality	0.35	4	1.40	2	0.70	0.70
Price sensitivity	0.10	2	0.20	4	0.40	0.30
Total	1.00		3.30		1.85	2.10

which of the key success factors each one is best and worst at meeting. The matrix shows entrepreneurs how their companies “measure up” against competitors on the industry’s key success factors and gives them an idea of which strategies they should employ to gain a competitive advantage over their rivals. For instance, the company in Table 4.5 should compete by emphasizing its product quality and its customer service (both are major strengths for the company but are weaknesses for its rivals) and not its product selection (which is a minor weakness for the company but a significant strength for its rivals).

Step 6. Create Company Goals and Objectives

Before entrepreneurs can build a comprehensive set of strategies, they must first establish business goals and objectives, which give them targets to aim for and provide a basis for evaluating their companies’ performance. Without them, entrepreneurs cannot know where their businesses are going or how well they are performing. Creating goals and objectives is an essential component of motivating and engaging employees. Unfortunately, a survey by Metrus Group reports that only 14 percent of companies say that their employees have a good understanding of the businesses’ goals and strategy.⁴⁰

GOALS Goals are the broad, long-range attributes that a business seeks to accomplish; they tend to be general and sometimes even abstract. Goals are not intended to be specific enough for a manager to act on but simply state the general level of accomplishment sought. What level of sales would you like for your company to achieve in five years? Do you want to boost your market share? Does your cash balance need strengthening? Would you like to enter a new market or increase sales in a current one? Do you want your company to be the leader in its market segment? Do you want to improve your company’s customer retention level? What return on your investment do you seek?

Setting too many goals is dangerous because an entrepreneur runs the risk of diluting the company’s resources and people’s time, focus, and energy.



ENTREPRENEURIAL PROFILE: Tony Petrucciani: Single Source Systems Tony Petrucciani, CEO of Single Source Systems, a software company in Fishers, Indiana, and his management team once set 15 annual goals in a planning session, but the company missed its sales target by 11 percent. “Nobody focused on any one thing,” he says. The next year, convinced that setting so many goals distracted everyone, including himself, Petrucciani reduced the number of goals the company pursued by 75 percent, and the company met its annual sales target.⁴¹

Researchers Jim Collins and Jerry Porras studied a large group of businesses and determined that one of the factors that set apart successful companies from unsuccessful ones was the formulation of very ambitious, clear, and inspiring long-term goals. Collins and Porras call them BHAGs (“Big Hairy Audacious Goals,” pronounced “bee-hags”) and say that their main benefit is to inspire and focus a company on important actions that are consistent with its overall mission. BHAGs are bold, daring, and exciting, and they operate on a long time frame, 10 to 30 years.⁴² In their classic book *Built to Last: Successful Habits of Visionary Companies*, Collins and Porras, explain the role of BHAGs to a company:

A true BHAG is clear and compelling and serves as a unifying focal point of effort and acts as a catalyst for team spirit. It has a clear finish line, so the organization can know when it has achieved the goal; people like to shoot for finish lines. A BHAG engages people—it reaches out and grabs them in the gut. It is tangible, energizing, highly focused.⁴³

Figure 4.3 shows that effective BHAGs originate at the intersection of a company’s mission, vision, and values, its core competencies, and its key success factors.

Defining broad-based goals helps entrepreneurs to focus on the next phase—developing specific, realistic objectives.

OBJECTIVES Objectives are more specific targets of performance. They define the things that entrepreneurs must accomplish if they are to achieve their goals and overall mission. Common objectives address profitability, productivity, growth, efficiency, markets, financial resources, physical facilities, organizational structure, employee well-being, and social responsibility. The objectives a company sets determine the level of success it achieves. Establishing profitability

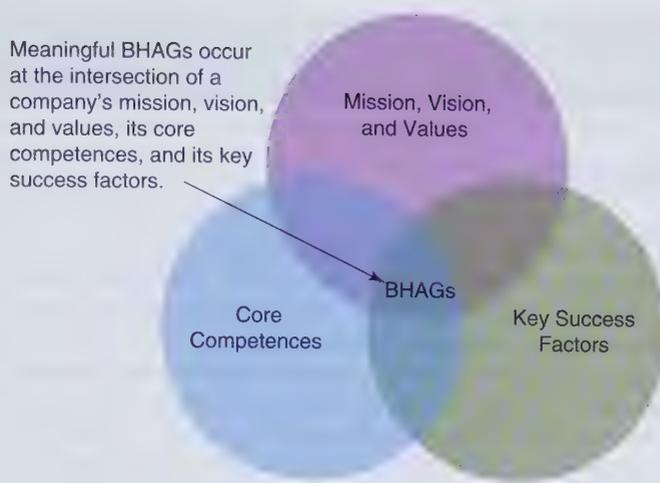


FIGURE 4.3

What Makes an Effective BHAG?

targets alone is *not* sufficient. Instead, entrepreneurs must set objectives and measure performance in those critical areas that determine their companies' ability to be profitable—a concept that Collins calls a company's true economic denominators. These economic denominators might be the cost of acquiring a customer, sales per labor hour, the customer retention rate, the rate of inventory turnover, or some other factor. Unfortunately, Collins claims that fewer than 10 percent of all companies understand what their true economic denominators are. We will discuss the importance of identifying true economic denominators (also called **critical numbers**) in Chapter 7.

Because objectives in one area of the company might conflict with one another, entrepreneurs must establish priorities. Which objectives are most important? Arranging objectives in a hierarchy according to their priority can help business owners resolve conflicts when they arise. Well-written objectives have the following characteristics:

They are specific. Objectives should be quantifiable and precise. For example, “to achieve a healthy growth in sales” is not a meaningful objective, but “to increase retail sales by 12 percent and wholesale by 10 percent in the next fiscal year” is precise and spells out exactly what management wants to accomplish.

They are measurable. Entrepreneurs should be able to plot their companies' progress toward their objectives; this requires a well-defined reference point from which to start and a scale for measuring progress.

They are assignable. Unless an entrepreneur assigns responsibility for an objective to an individual, it is unlikely that the company will ever achieve it. Creating objectives without giving someone responsibility for accomplishing them is futile.

They are realistic, yet challenging. Objectives must be within the reach of the organization or motivation evaporates. However, entrepreneurs and their employees must set challenging objectives. One business expert says that good objectives are “out of reach but not out of sight.”⁴⁴ (Remember the importance of BHAGs.) In other words, the more challenging an objective is (within realistic limits), the higher the performance will be. Set objectives that will test you, your business, and its employees; that's how companies become market leaders.

They are timely. Objectives must specify not only what is to be accomplished but also when it is to be accomplished. A time frame for achievement is important.

They are written down. This writing process does not have to be complex; in fact, entrepreneurs should make the number of objectives relatively small (from 5 to 15).

The strategic planning process works best when managers and employees are actively involved in jointly setting objectives. Developing a plan is top management's responsibility, but executing it falls to managers and employees; therefore, encouraging them to participate in the process broadens the plan's perspective and increases the motivation to make the plan work. In addition, managers and employees know a great deal about the organization and usually are willing to share their knowledge to make a company stronger.



Entrepreneurship in Action

Vizio: Disrupting Another Market

Before he turned 30, William Wang was a successful entrepreneur whose company, MAG Innovision, specialized in computer display screens. In 2002, Wang used \$600,000 from the sale of MAG Innovision to launch Vizio Inc., which has surged past industry icons such as Sony, Sharp, and Samsung to become the fastest-growing maker of flat-panel televisions in North America. Wang's well-executed cost leadership strategy, much of which he developed from the mistakes he made at MAG Innovision, is the key to the company's success. When he started Vizio ("Where vision meets value"), high-definition televisions sold for \$8,000, but Wang's vision was to offer quality products and to keep costs low, enabling his company to sell televisions at half the going price. "When I started this business, I believed we could do all of the things we're doing today," he says.

A lean operating strategy has been a hallmark of the Irvine, California-based company since its first day of operation. Outsourcing most functions, including tech support, warehousing, shipping, and research and development, and keeping its employee ranks lean hold operating costs well below the industry average. Vizio's overhead costs are less than 1 percent of its sales, far below the 10 percent of sales that those costs represent at its competition. "Every single dime counts," says Wang. Because concept development, marketing, and customer service are keys to success, Wang intentionally keeps them in-house. Vizio's distribution network is consistent with its low-cost strategy, relying on discount chains such as Sam's Club, Costco, and others to reach mass-market purchasers who tend to be price sensitive.

Wang recently extended Vizio's low-cost strategy to another maturing market that is ripe for a shake-up: personal computers. "If you rewind eight to ten years, the TV market looked similar to the PC market today," says Matt McRae, Vizio's chief technology officer. "It was a mature market with lots of companies. We did pretty well. We're now the number one TV company in the United States. We've done this before." Vizio introduced a line of computers and laptops that are as stylish as Apple's successful Macintosh line but run the Microsoft Windows software that drives 90 percent of the world's computers. The computers sport clean lines, machined lightweight aluminum bodies, and powerful, high-performance components. "PCs have become a sea of black plastic," says McRae. "We're building a product people want." What Vizio's computers don't include is the "bloatware," the preloaded software that clogs most other PCs, which means that Vizio's computers boot faster and run cleaner.

Maintaining consistency with its low price image, Vizio's computers are priced below Apple products and below competing PCs and laptops with prices that start at \$898. The company's

high-end computer, an all-in-one desktop with a crisp, 27-inch display, starts at just \$1,098. "Our target audience is people who can't afford a \$2,000 computer," says Wang. Vizio, which has a very small engineering staff, spent two years designing its line of computers and worked closely with key suppliers such as graphics card manufacturer Nvidia, chip maker Intel, and software designer Microsoft to optimize designs on the components and the systems that run them. "Vizio is doing a good job listening and taking advice from the experts on how to optimize hardware and software," says Steve Guggenheimer of Microsoft. Relying on experienced companies to assist in the design of its computers not only maximizes the machines' performance but also controls costs and allows Vizio to focus on providing a positive customer experience. Because the people who purchase computers are more likely to require technical support than those who purchase televisions, Vizio has decided to maintain all technical support services for computers in-house at its service center in Dakota Dunes, South Dakota. Vizio also keeps distribution costs under control by selling its computers through most of the same outlets that it uses to sell its popular line of televisions, including Walmart, Sam's Club, Amazon, Costco, and Target. The company also sells the computers through portable pop-up mini-stores made from old shipping containers that it sets up on college campuses, at music festivals, and other events. "If anyone says you can't disrupt a mature market, they're wrong," says McRae.

1. What challenges does Vizio face, as it attempts to introduce a new line of products into a mature industry?
2. Use the resources of the Internet to learn more about Vizio. Describe the company's strengths and weaknesses. What opportunities and threats does the company face?
3. Which of the three strategies described in this chapter is Vizio using? Do you think that Vizio's strategy for competing in the PC and laptop market will be successful? Explain.

Sources: Based on Matt Krantz, "TV Maker Tuning in to Computers," *Greenville News*, May 27, 2012, p. 8E; Shara Tibken, "Vizio Launches First PCs; Pricing Starts at \$898," *Wall Street Journal*, June 14, 2012, <http://online.wsj.com/article/BT-CO-20120614-716795.html>; Joanna Stern, "Vizio Aims to Stand Out in Laptop Market with Clean Software and Design," *ABC News*, June 15, 2012, <http://abcnews.go.com/Technology/vizio-aims-stand-laptop-market-clean-software-design/story?id=16571082>; Jason Gilbert, "Vizio Computer Prices Revealed, New Products to Be Released 'Imminently,'" *Huffington Post*, August 7, 2012, www.huffingtonpost.com/2012/06/15/vizio-computer-thinlight-notebook-all-in-one_n_1599933.html; Sara Wilson, "Picture It," *Entrepreneur*, July 2008, p. 43; Matt McClellan, "The Big Picture," *Smart Business Orange County*, June 2008, www.sbnonline.com/Local/Article/14706/77/0/The_big_picture.aspx; "Vizio Announces Grand Opening of a New Customer Service Based Sales and Support Center," *Reuters*, May 14, 2009, www.reuters.com/article/pressRelease/idUS137503+14-May-2009+PRN20090514.

Step 7. Formulate Strategic Options and Select the Appropriate Strategies

By this point in the strategic management process, entrepreneurs should have a clear picture of what their businesses do best and what their competitive advantages are. Similarly, they should know their companies' weaknesses and limitations as well as those of their competitors. The next step is to evaluate strategic options and prepare a game plan designed to achieve the company's mission, goals, and objectives.

STRATEGY A **strategy** is a road map an entrepreneur draws up of the actions necessary to fulfill a company's mission, goals, and objectives. In other words, the mission, goals, and objectives spell out the *ends*, and the strategy defines the *means* for reaching them. A strategy is the master plan that covers all of the major parts of the organization and ties them together into a unified whole. The plan must be action oriented—that is, it should breathe life into the entire planning process. Entrepreneurs must build a sound strategy based on the preceding steps that uses their company's core competencies as the springboard to success. Joseph Picken and Gregory Dess, authors of *Mission Critical: The 7 Strategic Traps That Derail Even the Smartest Companies*, write, "A flawed strategy—no matter how brilliant the leadership, no matter how effective the implementation—is doomed to fail. A sound strategy, implemented without error, wins every time."⁴⁵ A successful strategy is comprehensive and well integrated, focusing on establishing the key success factors that the entrepreneur identified in step 4.



ENTREPRENEURIAL PROFILE: David Deigan: Advanced Flexible Materials As a runner and former running coach, David Deigan knew that runners are susceptible to hypothermia after a race, particularly a marathon. In 1980, building on his work supplying insulating materials to the aerospace and window-film industries, Deigan launched Advanced Flexible Materials (AFM), to solve that problem. Today, AFM dominates its niche, making reflective insulation fabrics for products that range from gloves and sleeping bags to clothing and emergency blankets for consumer, commercial, and medical applications. However, AFM, with \$5 million in annual sales, is best known for its market-leading Heatsheets that athletes in 400 triathlons, cycling events, and marathons (including the New York City, London, and Cincinnati Flying Pig marathons) receive when they cross the finish line.⁴⁶

THREE STRATEGIC OPTIONS The number of strategies from which entrepreneurs can choose is infinite. When all of the glitter is stripped away, however, three basic strategies remain. In his classic book *Competitive Strategy*, Michael Porter defines these strategies: (1) cost leadership, (2) differentiation, and (3) focus.

Cost Leadership A company pursuing a **cost leadership strategy** strives to be the lowest-cost producer relative to its competitors in the industry. Many small companies attempt to compete by offering low prices, but low costs are a prerequisite for success. "You can't compete on price if you can't compete on cost," explains small business researcher Scott Shane.⁴⁷ Cost control on all fronts is paramount in companies that pursue this strategy. Economies of scale that are associated with large scale operations are a common source of a company's cost advantage (high volume = low per unit cost), which makes executing a successful cost leadership strategy difficult for small businesses. However, there are many ways to build a low-cost strategy. The most successful cost leaders know the areas in which they have cost advantages over their competitors and use them as the foundation for their strategies.

Low-cost leaders have a competitive advantage in reaching buyers whose primary purchase criterion is price, and they have the power to set the industry's price floor. This strategy works well when buyers are sensitive to price changes, when competing firms sell the same commodity products, and when companies can benefit from economies of scale. Not only is a low-cost leader in the best position to defend itself in a price war, but it also can use its power to attack competitors with the lowest price in the industry. "You have to be the lowest-cost producer in your patch," says the president of a small company that sells the classic commodity product—cement.⁴⁸



ENTREPRENEURIAL PROFILE: Neil Blumenthal, David Gilboa, Andrew Hunt, and Jeffrey Raider: Warby Parker Neil Blumenthal, David Gilboa, Andrew Hunt, and Jeffrey Raider, all graduates of the University of Pennsylvania and discovered that they all preferred designer eyeglasses but were put off by the \$500 prices they paid for them. They began researching the eyeglasses

4.

Discuss the characteristics of three basic strategies: low cost, differentiation, and focus.



Neil Blumenthal (l) and David Gilboa (r) of Warby Parker.

Source: Corbis Images.

industry and discovered that it was dominated by a few giant companies and that the typical pair of glasses carried a markup of 20 times its cost. “There’s no fundamental reason that glasses are so expensive,” says Gilboa. “It’s a couple of pieces of plastic and metal. It’s technology that was invented several hundred years ago, and there’s been little innovation on the product side or the distribution side.” The young entrepreneurs decided to change that and launched Warby Parker, an online retailer of eyeglasses that designs and sells 50 styles of prescription glasses and sunglasses for as little as \$95. “We thought there had to be a better way,” says Blumenthal. Building their business on an e-commerce platform enables them to eliminate the costs associated with brick-and-mortar stores, and the foursome has become quite adept at low-cost, guerrilla marketing techniques. They promote Warby Parker using various social media tools, including Facebook, Pinterest, and Twitter. Recently, a free Instagram “photo walk” event that started at the company’s New York City headquarters filled up quickly on Eventbrite, and the buzz it generated helped Warby Parker amass more than 19,000 Twitter followers, many of whom actively promote the brand. Creating their own stylish retro-inspired designs and outsourcing production enables the company to keep its production costs low. Warby Parker’s low-cost strategy is disrupting the once-staid industry and has attracted a \$12 million Series A round of venture capital funding. “They have developed great products and figured out new and cost-efficient ways to build and market them,” says one investor. The entrepreneurs also include a social component in their business model, working with nonprofit agencies around the world to give a pair of glasses to someone in need for every pair they sell (more than 150,000 pairs and counting).⁴⁹

Dangers exist in following a cost leadership strategy. Companies using this strategy are pursuing customers whose purchase decisions are driven almost exclusively by price and are not likely to be brand loyal. If another company dethrones a cost leader from its low-cost position, the former cost leader’s customer base can evaporate quickly. Some companies attempt to compete on price even though their cost structure is not the lowest in the market. Other companies focus exclusively on lower manufacturing costs, without considering the impact of purchasing, distribution, or overhead costs. Another danger is misunderstanding a company’s true cost drivers. For instance, one furniture manufacturer drastically underestimated its overhead costs and, as a result, was selling its products at a loss.

Pursuing a cost leadership strategy requires a company to constantly focus on controlling and lowering costs, but if executed properly, it can be an incredibly powerful strategic weapon.



ENTREPRENEURIAL PROFILE: Gary Levitt: Mad Mimi Before launching his e-mail marketing company, Mad Mimi, Gary Levitt was a professional skateboarder and a professional musician in his native South Africa. Eventually, he moved to New York City, where he started a small commercial music company that created jingles for a variety of clients, including the *Oprah Winfrey Show*, for which he created original music for six years. Accustomed to bootstrapping his music company, Levitt relied on e-mail marketing and e-newsletters to promote his business because they were low-cost methods. Intrigued by all that he had learned about developing e-mail marketing tools, Levitt decided to leave the music business to focus on providing price-conscious small businesses with effective, low-cost e-mail marketing tools and services. “I used to work from a coffee shop,” he says. He raised \$100,000 in start-up capital for Mad Mimi from friends and relatives and built a customer base by offering clients free advice and design work on newsletters and e-mail campaigns. As the company grew, Levitt retained his low-cost mind-set and a focus on simplicity. “I remember how painful and time consuming wrestling with complicated e-mail platforms was, so I built Mad Mimi with robust simplicity—something that is both simple and powerful.” Mad Mimi, with 95,000 registered users and annual sales approaching \$8 million, continues to keep costs low; all 24 employees telecommute from their homes, which allows the company to offer prices that start at just \$8 per month.⁵⁰

Differentiation A company following a **differentiation strategy** seeks to build customer loyalty by positioning its goods or services in a unique or different fashion. In other words, a company strives to be better than its competitors at something that its customers value. The primary benefit of successful differentiation is the ability to generate higher profit margins because of customers’ heightened brand loyalty and reduced price sensitivity. There are many ways to create a differentiation strategy, but the key is to be special at something that is important to customers

and offers them unique value such as quality, convenience, flexibility, performance, or style. “You’d better be on top of what it is your customers value and continually improve your offerings to better deliver that value,” advises Jill Griffin, a strategic marketing consultant.⁵¹ Any small company that can offer products or services that larger competitors do not, improve a product’s or service’s performance, reduce the customer’s risk of purchasing it, or enhance the customer’s status or self-esteem has the potential to differentiate.

Even in industries in which giant companies dominate, small companies that differentiate themselves can thrive even though they cannot compete effectively on the basis of price. For instance, the \$20 billion pet food industry is dominated by large companies, but several small companies are achieving success with differentiation strategies that are designed to resonate with their target customers.

ENTREPRENEURIAL PROFILE: Marie Moody: Stella and Chewy’s Taking a veterinarian’s advice, Marie Moody put her recently adopted dog, Chewy, on a special diet of organic beef that she purchased every week from Whole Foods. Chewy’s recovery was miraculous, and Moody noticed that her other adopted dog, Stella, was healthier, too. She believed that other pet owners might be interested in purchasing high-quality, wholesome, organic food for their pets rather than the cereal and meat by-product-based food sold by large companies. She began researching the market and learned that 81 percent of pet owners consider their pets to be full members of the family and that 46.3 million U.S. households own dogs. In 2003, Moody left her job in New York City’s fashion industry and used a \$50,000 loan from her father to launch from her apartment Stella and Chewy’s, a company that sells pet food made from freeze-dried all-natural, hormone- and antibiotic-free meats and organic fruits and vegetables. Her business grew, and in 2007, Moody used a guarantee from the Small Business Administration to secure a \$650,000 loan to open her own 12,000-square-foot factory in Muskego, Wisconsin. Recently, she expanded into a 50,000-square-foot factory in Milwaukee that produces more than 3 million pounds of natural dog food each year. Moody’s differentiation strategy has been successful; Stella and Chewy’s generates more than \$20 million in annual sales and is profitable.⁵²



Marie Moody with Stella and Chewy.

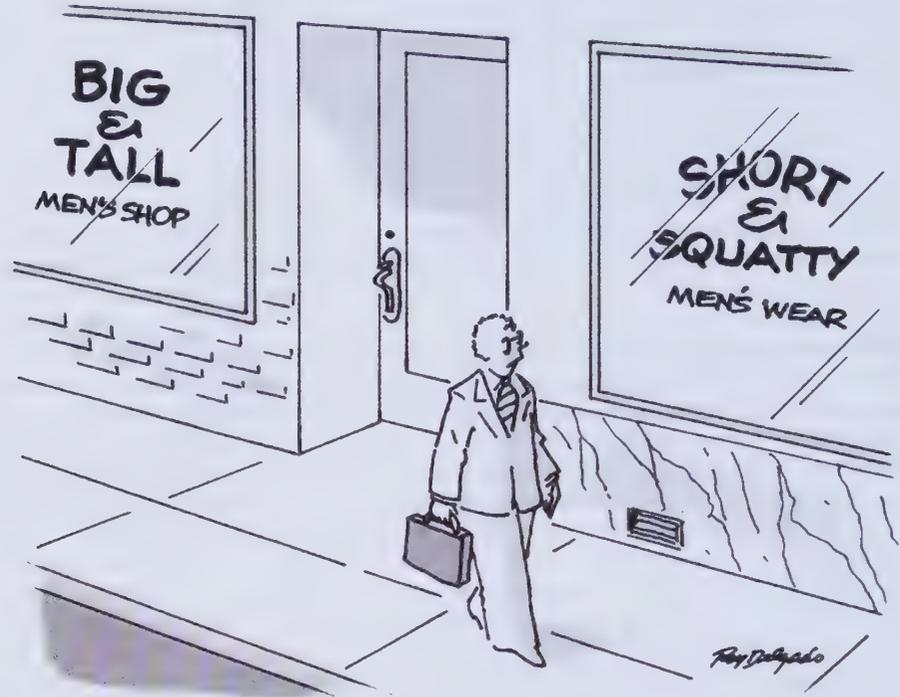
Source: Stella & Chewy’s.

The key to a successful differentiation strategy is to build it on a core competency, something the small company is uniquely good at doing in comparison to its competitors. Common bases for differentiation include superior customer service, special product features, complete product lines, a custom-tailored product or service, instantaneous parts availability, absolute product reliability, supreme product quality, extensive product knowledge, and the ability to build long-term, mutually beneficial relationships with customers. To be successful, a differentiation strategy must create the perception of value to the customer. No customer will purchase a good or service that fails to produce a *perceived* value, no matter how *real* that value may be. One business consultant advises, “Make sure you tell your customers and prospects what it is about your business that makes you different. Make sure that difference is on the form of a true benefit to the customer.”⁵³

ENTREPRENEURIAL PROFILE: Peter Keyes: Triton Logging Satisfying global demand for lumber means that every year the world loses a patch of forest equivalent in size to the state of Delaware. In fact, the World Resources Institute estimates that the planet already has lost 80 percent of its forest cover. Triton Logging, a small company in Victoria, British Columbia, has developed a unique solution to the problem of deforestation: harvesting trees from the millions of acres of forests that lie submerged beneath the world’s lakes, most of them the result of hydroelectric projects completed decades ago. Peter Keyes, Triton Logging’s CEO, estimates that 300 million trees worth \$50 billion lie underwater, available for harvesting with the right equipment, which Triton has developed. The company’s SHARC system uses GPS, video, and sonar equipment to guide barges outfitted with a specially designed saw capable of cutting trees at depths of more than 80 feet. The company recently signed a 25-year contract with the government of Ghana, where the company is harvesting trees worth between \$1 billion and \$2 billion beneath Lake Volta, which was created by the construction of a dam in 1965.⁵⁴

Pursuing a differentiation strategy includes risks. One danger is trying to differentiate a product or service on the basis of something that does not boost its performance or lower its cost to the customer. Another pitfall is trying to differentiate on the basis of something that customers do

Source: CartoonStock.



not perceive as important. Business owners also must consider how long they can sustain a product's or service's differentiation; changing customer tastes makes the basis for differentiation temporary at best. Imitations and "knockoffs" from competitors also pose a threat to a successful differentiation strategy. For instance, designers of high-priced original clothing see much cheaper knockoff products on the market shortly after their designs hit the market. Another danger of this strategy is overdifferentiating and charging so much that a company prices its products out of its target customers' reach. The final risk is focusing only on the physical characteristics of a product or service and ignoring important psychological factors, such as status, prestige, and image, which can be powerful sources of differentiation.

Focus A **focus strategy** recognizes that not all markets are homogeneous. In fact, in any given market, there are many different customer segments, each having different needs, wants, and characteristics. The principal idea of this strategy is to select one (or more) segment(s); identify customers' special needs, wants, and interests; and approach them with a good or service designed to excel in meeting these needs, wants, and interests. Focus strategies build on *differences* among market segments. Using a focus strategy, entrepreneurs concentrate on serving a niche in the market rather than trying to reach the entire market.

A successful focus strategy depends on a small company's ability to identify the changing needs of its targeted customer group and to develop the skills required to serve them. That means the owner and everyone in the organization must have a clear understanding of how to add value to the product or service for the customer.

Rather than attempting to serve the total market, a small company pursuing a focus strategy specializes in serving a specific target segment or niche that larger companies do not serve or cannot serve profitably. A focus strategy is ideally suited to many small businesses, which often lack the resources to reach the overall market. Their goal is to serve their narrow target markets more effectively and efficiently than do competitors that pound away at the broad market. Common bases for building a focus strategy include zeroing in on a small geographic area, targeting a group of customers with similar needs or interests (e.g., left-handed people), or specializing in a specific product or service (e.g., petite clothing).



ENTREPRENEURIAL PROFILE: Jay Lehman: Lehman's In 1955, Jay Lehman opened a hardware store, Lehman's, in Kidron, Ohio, a town of fewer than 1,000 residents situated in the midst of Ohio's Amish country, designed to cater to the needs of the 40,000 Amish residents in the surrounding area. Because the Amish eschew most forms of modern technology and prefer a simple lifestyle, the products in Lehman's are decidedly "old-fashioned" and are designed to preserve the Amish way of life. The 45,000-square-foot store is made up of four pre-Civil War buildings and carries a unique product line, including wooden buckets and shoulder yokes for carrying them, a full line of canning supplies, hand-powered ice cream churns, oil lamps, woodstoves, washboards, handmade pottery, and thousands of other items that were readily available to shoppers 100 years ago. Lehman has extended the customer base for his "low-tech superstore" beyond the local Amish population to become a major supplier of historically accurate artifacts for television shows and films, including the *Pirates of the Caribbean* series. Lehman's also has become a popular stop for environmentalists, gardeners, cooks, tourists, and the chronically nostalgic, and customers from all over the world shop on its Web site. "If you think building a niche business can't work, think again," says Lehman's daughter, Glenda Ervin, who is the company's vice president of marketing. "The secret to a successful niche business is realizing that it isn't about you. It's about the customer."⁵⁵



Jay Lehman, founder of Lehman's.

Source: Lehman's Hardware.

Like Jay Lehman, the most successful focusers build a competitive edge by concentrating on specific market niches and serving them better than any other competitor can. Essentially, this strategy depends on creating value for the customer either by being the lowest-cost producer or by differentiating the product or service in a unique fashion but doing so in a narrow target segment. Speedy service, a unique product or service, specialized knowledge, superior customer service, value pricing, and convenience are just some of the ways that companies using focus strategies meet their target customers' unique needs. To be worth targeting, a niche must be large enough to be profitable, reachable through marketing media, and capable of sustaining a business over time (in other words, not a passing fad). Many small companies thrive in small yet profitable niches, including the following:

- In 1975, J. M. Boswell started making pipes by hand and selling them at the retail store that he and his wife Gail operate in Chambersburg, Pennsylvania. With their signature fluted bowls, Boswell's pipes are functional works of art made from white heath briarwood, which he imports from Athens, Greece, and include a variety of styles, ranging from long-stemmed churchwarden pipes and shorter "nose warmer" pipes to fishing vest pipes and pipes made with deer antler accents. Today, Boswell's son Dan helps his father fill the more than 4,000 orders for pipes that the family-owned business receives from customers around the world. "All we do is make pipes," says J. M. "You've got to love it, and we do." Prices for the hand-crafted pipes range from \$70 to \$1,500. Some of Boswell's customers fly in for the day to shop and peruse the pipe museum located on the second floor of the retail store.⁵⁶
- Rico Elmore's idea for a niche business came to him while he was on his honeymoon in 2004 and wanted to buy a pair of sunglasses. Elmore, who is six feet three inches tall and weighs 300 pounds, tried on about 300 pairs of sunglasses, but all of the frames were too small to fit his head. "I knew I couldn't be the only person in the world with this issue," he says. In 2005, Elmore launched Fatheadz, a company that markets a complete line of sunglasses and prescription glasses for customers with large heads. Based in his hometown of Indianapolis, Indiana, Fatheadz has 10 employees and generates more than \$2 million in annual sales.⁵⁷
- The Peerless Handcuff Company, located in Springfield, Massachusetts, specializes in manufacturing carbon-steel handcuffs for law enforcement and military agencies around the world. James Milton Gill founded the company in 1914 after purchasing the patent from inventor George Carney for a new "swing through" handcuff design that allowed officers to slap cuffs on suspects with one hand. Gill's great-grandson, Christopher Gill, now manages the 25-employee, family-owned business that continues its record of success by focusing on its niche.⁵⁸

The rewards of dominating a niche can be huge, but pursuing a focus strategy does carry risks. Companies sometimes must struggle to capture a large enough share of a small market to be profitable. A niche must be big enough for a company to generate a profit. A successful focus

strategy also brings with it a threat: invasion by competitors. If a small company is successful in its niche, there is the danger of larger competitors entering the market and eroding or controlling it. Sometimes a company with a successful niche strategy gets distracted by its success and tries to branch out into other areas. As it drifts farther away from its core strategy, it loses its competitive edge and runs the risk of confusing or alienating its customers. Muddying its image with customers puts a company in danger of losing its identity.

A successful strategic plan identifies a complete set of success factors—financial, operating, and marketing—that, taken together, produce a competitive advantage for a small business. The resulting action plan distinguishes the firm from its competitors by exploiting its competitive advantages. The focal point of this entire strategic plan is the customer. The customer is the nucleus of any business, and a competitive strategy will succeed only if it is aimed at serving customers better than competitors do. An effective strategy draws out the competitive advantage in a small company by building on its strengths and by making the customer its focus. It also defines methods for overcoming a company's weaknesses, and it identifies opportunities and threats that demand action.



In the Entrepreneurial Spotlight

Strategies for Success

Most entrepreneurs who launch businesses face established rivals with greater name recognition, more resources, bigger budgets, and existing customer bases. How can a small start-up company compete effectively against that? It all boils down to creating a winning strategy and then executing it well. The entrepreneurs profiled here developed strategies for their companies that set them apart from their rivals and gave them a competitive edge in their respective markets.

Shaw & Tenney

Started in 1858 on the Stillwater River in Orono, Maine, by Frank Tenney, Shaw & Tenney is the one of the oldest manufacturers of marine products in the United States. Although owner Steve Holt, a former mechanical engineer, has added wooden masts, spars, flagpoles, and hand-woven baskets to its original product line of wooden paddles and oars, little else about the historic company has changed. "We are still manufacturing the same high quality products, using virtually unchanged designs," says Holt. "Some of the original machinery used in 1858 is still in operation today." Although the company's Web site generates some sales, the majority of Shaw & Tenney's sales originate from its existing base of satisfied customers who tell others about the superior quality of the company's signature paddles and oars and its passion for customer service. "We're known as an icon for our products," says Holt. "If you want a solid, one-piece, high-quality paddle or oar, you're going to end up calling us."

Holt credits much of the company's success to the master craftsmen who take great pride in producing the finest quality, hand-crafted wooden paddles and oars. "No one else in the world makes paddles and oars like this," says Holt. "Making these products takes a lot of eye-hand coordination. The key is the wood, but the craftsmen know how to respond to the wood." Because of the sheer beauty of Shaw and Tenney's paddles and oars, many customers treat them as works of art rather than tools for moving canoes and boats through water. "A lot of our paddles never touch the water," says Holt, noting that some customers purchase



Source: Jason P. Smith Photography.

them to hang on the walls of their homes, vacation getaways, or company board rooms. Shaw & Tenney sells about 3,000 paddles and oars each year to customers in all 50 states and through foreign distributors in Australia and Germany. The company recently partnered with another Maine icon, L.L.Bean, to create a line of limited-edition paddles in celebration of the centennial anniversary of Bean's founding. The paddles are made from spruce and pine trees, some of which are more than 500 years old, that were reclaimed from the bottom of Lake Quakish, where they sank on their way to sawmills in Millinocket more than 100 years ago. "L.L.Bean is an icon in the state," Holt says. "They're known all over the world. And in our little niche, Shaw & Tenney is known worldwide for making oars and paddles."

The Resort at Paws Up

Larry Lipson and his family own a 37,000-acre working cattle ranch on the banks of the scenic Blackfoot River (that inspired the novel and the film *A River Runs Through It* near Missoula, Montana). Recognizing that other people would enjoy the

breathtaking views and outdoor activities their ranch offered, Lipson built 28 luxuriously appointed cabins to rent to guests. Building on the success of their cabins, in 2005, Lipson started The Resort at Paws Up, four luxury camps where guests stay in safari-style tents that include all of the appointments of a luxury hotel room (including electricity and twice-daily house-keeping services) but with more spectacular views of rivers, lush meadows, and majestic mountains than most hotels can offer. Guests who go “glamping” (a mashup of “glamorous camping”) at Paws Up “rough it like royalty,” says Lipson. Guests sleep on king-size beds with designer linens; enjoy gourmet meals prepared by talented chefs; have access to a private master bathroom and Wi-Fi; sip cocktails while relaxing in comfortable, rustic furniture; and can summon an attentive camp butler for anything they need. “We refer to it as ‘nature served on a silver platter,’” he says. Although managing a ranch and a glamping resort can be challenging at times, Lipson says the benefits outweigh the costs. Revenues from Paws Up have increased each year even though nightly rates range from \$875 to \$3,275 per night. “We’ve discovered that there is very little price resistance among those who want to experience nature without giving up the creature comforts of a fine hotel,” says

Lipson. “We’ve not only made each successive camp that we’ve built more luxurious than the last, but we’ve also increased the nightly rate. What truly differentiates Paws Up is that we are a very high-end *resort* situated on one of the most beautiful ranches in the west.”

1. Which of the three strategies described in this chapter are these companies using? Explain.
2. What advantages does successful execution of their strategies produce for Shaw & Tenney and The Resort at Paws Up?
3. What are the risks associated with the strategies of these companies?

Sources: Based on Judith Ohikuare, “Behind the Scenes,” *Inc.*, May 2012, pp. 16–17; “Shaw and Tenney Paddle Company Turns 150 This Year,” *Canoe & Kayak*, April 30, 2008, www.canoekayak.com/canoe/shawandtenneypaddles; Nick McCrea, “Orono Company Offers New Line of Hand-Crafted Paddles for L.L. Bean’s Centennial,” *Bangor Daily News*, January 4, 2012, <http://bangordailynews.com/2012/01/04/business/orono-company-offers-new-line-of-handcrafted-paddles-for-l-l-beans-centennial>; John Holyoke, “Happy Birthday L.L. Bean,” *Bangor Daily News*, February 22, 2012, <http://bangordailynews.com/2012/02/22/outdoors/happy-birthday-l-l-bean>; Laura Roberts, “L.L. Bean Celebrates 100 Years with Help from Other Maine Businesses,” *WABI TV5*, January 4, 2012 www.wabi.tv/news/26510/l-l-bean-celebrates-100-years-with-help-from-other-maine-businesses; Geoff Carter, “Camping’s Extreme Makeover,” *Entrepreneur*, August 2011, pp. 59–63; “FAQs,” The Resort at Paws Up, www.pawsup.com/faqs.php.

Step 8. Translate Strategic Plans into Action Plans

When it comes to strategic planning, entrepreneurs typically do not lack vision. Success, however, requires matching vision with execution. No strategic plan is complete until it is put into action. Entrepreneurs must convert strategic plans into operating plans that guide their companies each day and become a visible, active part of their businesses. A small business cannot benefit from a strategic plan sitting on a shelf collecting dust.

IMPLEMENT THE STRATEGY To make the plan workable, business owners should divide the plan into projects, carefully defining each one by the following:

Purpose. What is the project designed to accomplish?

Scope. Which areas of the company will be involved in the project?

Contribution. How does the project relate to other projects and to the overall strategic plan.

Resource requirements. What human and financial resources are needed to complete the project successfully?

Timing. Which schedules and deadlines will ensure project completion?

Once entrepreneurs assign priorities to these projects, they can begin to implement the strategic plan. Involving employees and delegating adequate authority to them is essential because these projects affect them most directly. If an organization’s people have been involved in the strategic management process to this point, they will have a better grasp of the steps they must take to achieve the organization’s goals as well as their own professional goals. Early involvement of the workforce in the strategic management process is a luxury that larger businesses cannot achieve. Commitment to reaching the company’s objectives is a powerful force, but involvement is a prerequisite for achieving total employee commitment. The greater the level of involvement of those who implement a company’s strategy (often those at the lower levels of an organization) in the process of creating the strategy (often the realm of those at the top of an organization), the more likely the strategy is to be successful. Without a team of committed, dedicated employees, a company’s strategy, no matter how precisely planned, usually fails.

When putting their strategic plans into action, small companies must exploit all of the competitive advantages of their size by doing the following:

- Responding quickly to customers' needs.
- Remaining flexible and willing to change.
- Continually searching for new emerging market segments.
- Building and defending market niches.
- Erecting "switching costs" through personal service and special attention.
- Remaining entrepreneurial and willing to take risks.
- Acting with lightning speed to move into and out of markets as they ebb and flow.
- Constantly innovating.

Although it is possible for competitors to replicate a small company's strategy, it is much more difficult for them to mimic the way in which it implements and executes its strategy.

Step 9. Establish Accurate Controls

So far, the planning process has created company objectives and has developed a strategy for reaching them, but rarely, if ever, will the company's actual performance match stated objectives. Entrepreneurs quickly realize the need to control actual results that deviate from plans.

CONTROLLING THE STRATEGY Planning without control has little operational value, and a sound planning program requires a practical control process. The plans created in this process become the standards against which actual performance is measured. It is important for everyone in the organization to understand—and to be involved in—the planning and controlling process.

Controlling projects and keeping them on schedule means that the owner must identify and track key performance indicators. The source of these indicators is the operating data from the company's normal business activity; they are the guideposts for detecting deviations from established standards. Accounting, production, sales, inventory, and other operating records are primary sources of data an entrepreneur can use for controlling activities. For example, on a customer service project, performance indicators might include the number of customer complaints, orders returned, on-time shipments, and a measure of order accuracy.

To evaluate the effectiveness of their strategies and to link them to everyday performance, many companies are developing **balanced scorecards**, a set of measurements unique to a company that includes both financial and operational measures and gives managers a quick yet comprehensive picture of the company's total performance against its strategic plan. The key to linking strategy and day-to-day organizational performance is identifying the right factors and measurements to be included on the scorecard. (Recall the discussion of the true economic denominators or critical numbers in step 6 of the strategic management process, creating goals and objectives.) One writer says that a balanced scorecard

is a sophisticated business model that helps a company understand what's really driving its success. It acts a bit like the control panel on a spaceship—the business equivalent of a flight speedometer, odometer, and temperature gauge all rolled into one. It keeps track of many things, including financial progress and softer measurements—everything from customer satisfaction to return on investment—that need to be managed to reach the final destination: profitable growth.⁵⁹

Rather than sticking solely to the traditional financial measures of a company's performance, the balanced scorecard gives managers a comprehensive view from *both a financial and an operational perspective*. The premise behind such a scorecard is that relying on any single measure of company performance is dangerous. Just as a pilot in command of a jet cannot fly safely by focusing on a single instrument, an entrepreneur cannot manage a company by concentrating on a single measurement. The complexity of managing a business demands that an entrepreneur be

5.

Understand the importance of controls such as the balanced scorecard in the planning process.

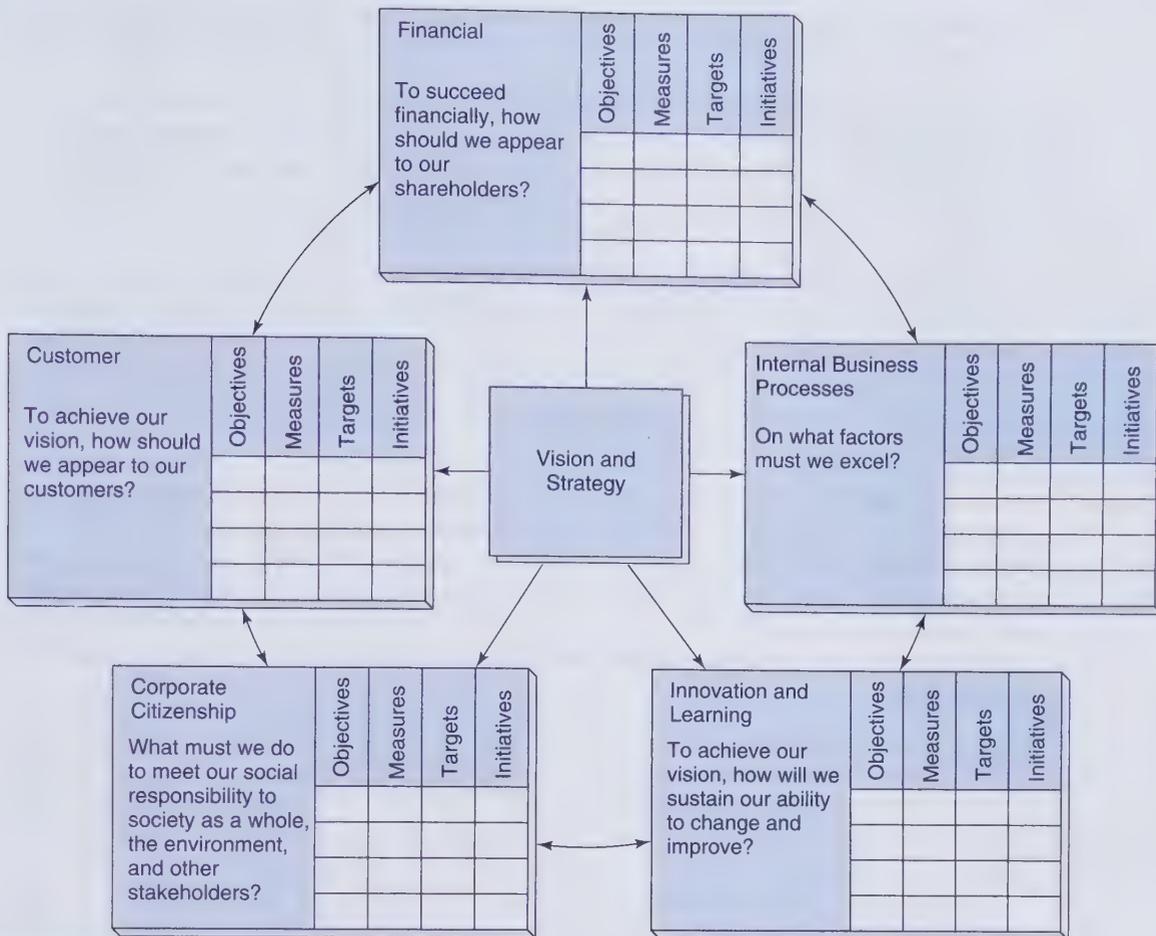


FIGURE 4.4
The Balanced Scorecard

Source: Adapted from Robert S. Kaplan, David P. Norton, "The Balanced Scorecard—Measures that Drive Performance," Harvard Business Review, Jan./Feb. 1992.

able to see performance measures in several areas simultaneously. Those measures might include traditional standards such as financial ratios or cash flow performance and gauges of product innovation, customer satisfaction, retention, and profitability as well as measures of vendor performance and inventory management.

Properly used, an entrepreneur can trace the elements on the company’s balanced scorecard back to its overall strategy and its mission, goals, and objectives. The goal is to develop a reporting system that does not funnel meaningful information to only a few decision makers but to make it available in a timely manner throughout the entire company, enabling employees at *all* levels to make decisions based on strategic priorities. A balanced scorecard reporting system should collect, organize, and display meaningful information that managers and employees need to make daily decisions that are congruent with the company’s overall strategy, and it must do so in a concise, easy-to-read, timely manner. When creating a balanced scorecard for a company, the key is to establish goals for each critical indicator of company performance and then create meaningful measures for each one. Although some elements will apply to many businesses, a company’s scorecard should be unique. The balanced scorecard looks at a business from five important perspectives (see Figure 4.4):⁶⁰

Customer Perspective How do customers see us? Customers judge companies by at least four standards: speed (how long it takes the company to deliver a good or service), quality (how well a company’s product or service performs in terms of reliability, durability, and accuracy), performance (the extent to which a good or service performs as expected), and service (how well a company meets or exceeds customers’ expectations of value). Because customer-related goals

are external, managers must translate them into measures of what the company must do to meet customers' expectations.

Internal Business Perspective On what factors must we excel? The internal factors that managers should focus on are those that have the greatest impact on customer satisfaction and retention and on company effectiveness and efficiency. Developing goals and measures for factors such as quality, cycle time, productivity, costs, and others that employees directly influence is essential.

Innovation and Learning Perspective Can we continue to improve and create value? This view of a company recognizes that the targets required for success are never static; they are constantly changing. If a company wants to continue its pattern of success, it cannot stand still; it must continuously improve. A company's ability to innovate, learn, and improve determines its future. These goals and measures emphasize the importance of continuous improvement in customer satisfaction and internal business operations.

Financial Perspective How do we look to shareholders? The most traditional performance measures, financial standards, tell how much the company's overall strategy and its execution are contributing to its bottom line. These measures focus on such factors as profitability, growth, and shareholder value. On balanced scorecards, companies often break their financial goals into three categories: survival, success, and growth. Companies use these measures to make sure that their strategies drive their budgets rather than allowing their budgets to determine their strategies.

Corporate Citizenship How well are we meeting our social responsibility to society as a whole, the environment, the community, and other external stakeholders? Even the smallest companies must recognize that they have a responsibility to be good business citizens. This part of the scorecard focuses on measuring a small company's social and environmental performance.

Although the balanced scorecard is a vital tool that helps managers keep their companies on track, it is also an important tool for changing behavior in an organization and for keeping everyone focused on what really matters. As conditions change, managers must make corrections in performances, policies, strategies, and objectives to get performance back on track. Increasingly, companies are linking performance on the metrics included in their balanced scorecards to employees' compensation. A practical control system is also economical to operate. Most small businesses have no need for a sophisticated, expensive control system. The system should be so practical that it becomes a natural part of the management process.

Conclusion

The planning process outlined here is designed to be as simple as possible, but it does *not* end with the nine steps outlined here; it is an ongoing process that entrepreneurs repeat. "Plans aren't the secret to success; planning is," says John Jantsch, entrepreneur and author of *Duct Tape Marketing*. "It's the continuous process of planning, acting, measuring, and planning [again] that moves the organization in the direction of its goals."⁶¹ With each round, the entrepreneur gains experience, and the steps become much easier.

This strategic planning process teaches entrepreneurs a degree of discipline that is important to their businesses' survival. It helps them to learn about their businesses, their competitors, and, most important, their customers. It forces them to recognize and evaluate their companies' strengths and weaknesses as well as the opportunities and threats facing them. It also encourages entrepreneurs to define how they will set their businesses apart from the competition. Although strategic planning cannot guarantee success, it does dramatically increase a small company's chances of survival in a hostile business environment.

Chapter Review

1. Understand the importance of strategic management to a small business.

Strategic planning, often ignored by small companies, is a crucial ingredient in business success. The planning process forces potential entrepreneurs to subject their ideas to an objective evaluation in the competitive market.

2. Explain why and how a small business must create a competitive advantage in the market.

The goal of developing a strategic plan is to create for the small company a competitive advantage—the aggregation of factors that sets the small business apart from its competitors and gives it a unique position in the market. Every small firm must establish a plan for creating a unique image in the minds of its potential customers.

3. Develop a strategic plan for a business using the nine steps in the strategic planning process.

Small businesses need a strategic planning process designed to suit their particular needs. It should be relatively short, be informal and not structured, encourage the participation of employees, and not begin with extensive objective setting. Linking the purposeful action of strategic planning to an entrepreneur's little ideas can produce results that shape the future.

Step 1. Develop a clear vision and translate it into a meaningful mission statement. Highly successful entrepreneurs are able to communicate their vision to those around them. The firm's mission statement answers the first question of any venture: What business am I in? The mission statement sets the tone for the entire company.

Step 2. Assess the company's strengths and weaknesses. Strengths are positive internal factors; weaknesses are negative internal factors.

Step 3. Scan the environment for significant opportunities and threats facing the business. Opportunities are positive external options; threats are negative external forces.

Step 4. Identify the key factors for success in the business. In every business, key factors that determine the success of the firms in it, so they must be an integral part of a company's strategy. Key success factors are relationships between a controllable variable (e.g., plant size, size of sales force, advertising expenditures, and product packaging) and a critical factor influencing the firm's ability to compete in the market.

Step 5. Analyze the competition. Business owners should know their competitors almost as well as they know their own companies. A competitive profile matrix is a helpful tool for analyzing competitors, strengths, and weaknesses.

Step 6. Create company goals and objectives. Goals are the broad, long-range attributes that the firm seeks to accomplish. Objectives are quantifiable and more precise; they should be specific, measurable, assignable, realistic, timely, and written down. The process works best when subordinate managers and employees are actively involved.

Step 7. Formulate strategic options and select the appropriate strategies. A strategy is the game plan the firm plans to use to achieve its objectives and mission. It must center on establishing for the firm the key success factors identified earlier.

Step 8. Translate strategic plans into action plans. No strategic plan is complete until the owner puts it into action.

Step 9. Establish accurate controls. Actual performance rarely, if ever, matches plans exactly. Operating data from the business serve as guideposts for detecting deviations from plans. Such information is helpful when plotting future strategies.

The strategic planning process does not end with these nine steps; rather, it is an ongoing process that the owner will repeat.

4. Discuss the characteristics of three basic strategies: low-cost, differentiation, and focus. Three basic strategic options are cost leadership, differentiation, and focus. A company pursuing a cost leadership strategy strives to be the lowest-cost producer relative to its competitors in the industry.

A company following a differentiation strategy seeks to build customer loyalty by positioning its goods or services in a unique or different fashion. In other words, the firm strives to be better than its competitors at something that customers value.

A focus strategy recognizes that not all markets are homogeneous. The principal idea of this strategy is to select one (or more) segment(s); identify customers' special needs, wants, and interests; and approach them with a good or service designed to excel in meeting these needs, wants, and interests. Focus strategies build on differences among market segments.

5. Understand the importance of controls such as the balanced scorecard in the planning process. Just as a pilot in command of a jet cannot fly safely by focusing on a single instrument, an entrepreneur cannot manage a company by concentrating on a single measurement. The balanced scorecard is a set of measurements unique to a company that includes both financial and operational measures and gives managers a quick yet comprehensive picture of the company's total performance.

Discussion Questions

- 4-1. Why is strategic planning important to a small company?
- 4-2. Explain the strategic management process.
- 4-3. What is competitive advantage? Why is it important for a small business to establish one?
- 4-4. What are strengths, weaknesses, opportunities, and threats? Give an example of each.
- 4-5. What is knowledge management? What benefits does it offer a small company?
- 4-6. Explain the characteristics of effective objectives. Why is setting objectives important?
- 4-7. What are business strategies? Explain the three basic strategies from which entrepreneurs can choose. Give an example of each one.
- 4-8. Discuss the characteristics of the three basic strategies: low cost, differentiation, and focus.
- 4-9. Comment on the statement, "Planning is a futile exercise without controlling."
- 4-10. What is a balanced scorecard? What value does it offer entrepreneurs who are evaluating the success of their current strategies?

CHAPTER 5

Choosing a Form of Ownership



Learning Objectives

On completion of this chapter, you will be able to:

1. Discuss the issues that entrepreneurs should consider when evaluating different forms of ownership.
2. Describe the advantages and disadvantages of the sole proprietorship.
3. Describe the advantages and disadvantages of the partnership.
4. Describe the advantages and disadvantages of the corporation.
5. Describe the features of the S corporation.
6. Describe the features of the limited liability company.
7. Discuss the alternative options for corporate form, both for-profit and nonprofit, available to social entrepreneurs.

Diligence is the mother of good luck.

—Benjamin Franklin

A man should never neglect his family for business.

—Walt Disney

1.

Discuss the issues that entrepreneurs should consider when evaluating different forms of ownership.

One of the first decisions an entrepreneur faces when starting a business is selecting the form of ownership for the new venture. Too often, entrepreneurs give little thought to the decision, which can lead to problems because it has far-reaching implications for the business and its owners—from the taxes the company pays and how it raises money to the owner's liability for the company's debts and his or her ability to transfer the business to the next generation. Although the decision is not irreversible, changing from one form of ownership to another can be expensive, time consuming, and complicated.

There is no single "best" form of business ownership. Each form has its own unique set of advantages and disadvantages. The key to choosing the right form of ownership is to understand the characteristics of each business entity and to know how they affect an entrepreneur's business and personal circumstances. The good news is that the United States remains a relatively easy country in which to start a business no matter what form of business ownership is chosen. According to the World Bank, the United States is the 13th-easiest country in which to start a business out of the 185 countries ranked. On average, it takes about six days and six procedures to start a business.¹ Table 5.1 summarizes the typical business start-up process in the United States across all forms of business ownership.

The following are some of the most important issues an entrepreneur should consider when choosing a form of ownership:

- **Tax considerations.** Graduated tax rates, the government's constant modification of the tax code, and the year-to-year fluctuations in a company's income require an entrepreneur to calculate the firm's tax responsibility under each ownership option every year. Changes in federal or state tax codes may have a significant impact on a company's "bottom line" and an entrepreneur's personal tax exposure.
- **Liability exposure.** Certain forms of ownership offer business owners greater protection from personal liability from financial problems, faulty products, and a host of other difficulties. Entrepreneurs must evaluate the potential for legal and financial liabilities and decide the extent to which they are willing to assume personal responsibility for their companies' obligations. Individuals with significant personal wealth or a low tolerance for the risk of loss may benefit from forms of ownership that provide greater protection of their personal assets.
- **Start-up and future capital requirements.** The form of ownership can affect an entrepreneur's ability to raise start-up capital. Some forms of ownership are better when obtaining start-up capital, depending on how much capital is needed and the source from which it is to be obtained. As a business grows, capital requirements increase and some forms of ownership make it easier to attract outside financing.
- **Control.** Certain forms of ownership require an entrepreneur to relinquish some control over the company. Before selecting a business entity, entrepreneurs must decide how much control they are willing to sacrifice in exchange for resources from others.

TABLE 5.1 Number of Days to Start a Business in the United States

Activity	Time	Cost
Reserve the company's business name (optional), file the company's articles of organization, and adopt the company's operating agreement	1 day	\$275 (USD \$200 filing fee, \$75 expedited service fee)
Apply for federal identification number (EIN) for tax and employer purposes	1 day	no charge
Register to collect state sales tax	1 day	no charge
Register as an employer with the Unemployment Insurance Division of the state Department of Labor	1 day	no charge
Arrange for workers' compensation insurance and disability insurance	1 day	no charge
Arrange for publication and submit certificate and affidavits of publication in local newspaper(s)	1 day	\$400

Source: "Ease of Doing Business in United States," *Doing Business 2019*, www.doingbusiness.org/data/exploreeconomies/united-states/#starting-a-business.

- **Managerial ability.** Entrepreneurs must assess their own ability to successfully manage their companies. If they lack skill or experience in certain areas, they may need to select a form of ownership that allows them to involve individuals who possess those needed skills or experience in the company.
- **Business goals.** The projected size and profitability of the business and any predetermined exit plans influence the form of ownership an entrepreneur chooses. Businesses often evolve into different forms of ownership as they grow, but moving from some formats can be complex and expensive. Legislation may change and make current ownership options no longer attractive.
- **Management succession plans.** When choosing a form of ownership, business owners must look ahead to the day when they will pass their companies on to the next generation or to a buyer. Some forms of ownership better facilitate this transition. In other cases, when the owner dies, so does the business.
- **Cost of formation.** Some forms of ownership are much more costly and involved to create. Entrepreneurs must weigh the benefits and the costs of the form they choose.
- **Cost of maintaining.** In addition to the cost of formation, there are ongoing fees and expenses associated with maintaining a business such as accounting and legal support that can vary based on the form of ownership the entrepreneur chooses.

Business owners can choose from five major forms of ownership: the sole proprietorship, the partnership, the C corporation, the S corporation, and the limited liability company. Social entrepreneurs also have choices in the form of business structure they choose for their ventures. This chapter describes the characteristics, advantages, and disadvantages of these forms of business ownership. Figure 5.1 provides an overview of the various forms of ownership.

The Sole Proprietorship

The **sole proprietorship** is the simplest and most popular form of ownership. This form of business ownership is designed for a business owned and managed by one individual. The sole proprietor is the only owner and ultimate decision maker for the business. Its simplicity and ease of formation makes the sole proprietorship the most popular form of ownership, comprising 72 percent of all businesses in the United States.

2.

Describe the advantages and disadvantages of the sole proprietorship.

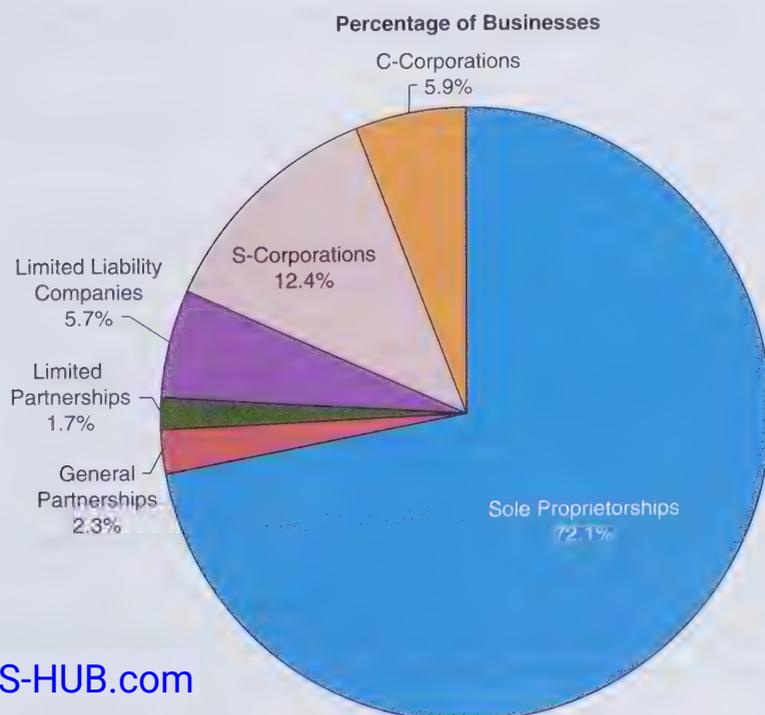


FIGURE 5.1
Forms of Business Ownership

Source: Based on "Number of Returns, Business Receipts, Net Income, and Deficit by Form of Business, Sector Tax Year 2008," Internal Revenue Service, 2012.

Advantages of a Sole Proprietorship

SIMPLE TO CREATE One attractive feature of the sole proprietorship is the ease and speed of its formation. “Sole proprietorships are easy to set up and require very little legal work, outside of a business license,” says Jason Deshayes, an Albuquerque-based CPA.² For example, if entrepreneurs want to form a business under their own names (J. Jolly Financial Consulting), they simply obtain the necessary business licenses from state, county, and/or local governments and begin operation. In many cases, an entrepreneur can complete all of the necessary steps in a single day because few barriers exist to creating a sole proprietorship. Table 5.2 summarizes the licenses and filings typical for most states and municipalities (specific requirements vary from state to state and city to city).

LEAST COSTLY FORM OF OWNERSHIP TO ESTABLISH In addition to being easy to set up, the sole proprietorship is generally the least expensive form of ownership to establish. There is no need to create and file the legal documents, such as those recommended for partnerships and required for corporations. An entrepreneur, for example, may simply contact the secretary of state’s office, select a business name, identify the location, describe the nature of the business, and pay the appropriate fees and license costs. Paying these fees and license costs gives the entrepreneur the right to conduct business in that particular jurisdiction and avoids aggravating penalties.

In many jurisdictions, entrepreneurs planning to conduct business under a trade name are usually required to acquire a Certificate of Doing Business Under an Assumed Name (also known as a Doing Business As or Fictitious Business Name) from the secretary of state. Some sole proprietors use their own names as their company names, such as Bob Smith Towing Service. Others prefer to come up with creative company names as a way of distinguishing themselves in the market and creating the right impression with their target customers.

The fee for the Certificate of Doing Business Under an Assumed Name is usually nominal. Acquiring this certificate involves conducting a search to determine that the name chosen for the business is not already registered as a trademark or service mark with the secretary of state. Filing this certificate also notifies the state of the owners of the business. Additionally, most states now require notice of the trade name to be published in a newspaper serving the trading area of the business.

TABLE 5.2 License and Other Filing Requirements for a Sole Proprietorship

State Requirements	
State business license	Used to track and monitor businesses for tax purposes and are required for businesses to operate lawfully in the state
Tax registration	Required for states with a sales tax
Occupational licenses	Certain professions require practitioners to obtain licenses (doctors, lawyers, accountants, real estate agents, private security guards, funeral directors, private investigators, barbers, and many others)
Local Requirements	
Register business name	Register with county clerk—the default name will be your name, but you can apply for “doing business as”
Local business licenses	License from the local government (city or county) to lawfully operate within their jurisdictions
Zoning permit	Demonstrates that the location of your business is approved by the city or county for your business’ usage and can also govern permitted signage, etc.
Health permit	For businesses with food preparation
Building permits	Approval to remodel or build a new space

Source: “State and Local Small Business Licenses for Start-Ups,” *FindLaw.com*, smallbusiness.findlaw.com/starting-a-business/state-and-local-small-business-licenses-for-start-ups.html



Lessons from the Street-Smart Entrepreneur

Get That Name Right!

Managers at Rise and Dine Restaurants, a chain of 15 breakfast and lunch restaurants based in Columbus, Ohio, decided to change the name of the business to Sunny Street Café. Market research showed that customers associated the name “Rise and Dine” with breakfast only and that many of them were unaware that the chain also was open for lunch. “We want our customers to know that we offer an extensive lunch menu with plenty of variety,” says COO Joe Deavenport. “Our tagline, ‘A Bright Spot for Breakfast and Lunch,’ will resonate well with our target audience and capture the essence of our brand.”

As Sunny Street Café’s experience shows, choosing a memorable business name can be one of the most enjoyable—and most challenging—aspects of starting a business. Some entrepreneurs invest as much in the creation of their business names as they do in developing their business ideas. Ideally, a business name should convey the expertise, value, and uniqueness of the company and its products or services. Darrin Piotrowski saw a need for fast, affordable, reliable computer service in his native New Orleans, Louisiana; borrowed \$300 from his mother; and started Rent-a-Nerd as a part-time business from his apartment. The clever name caught people’s attention, and Piotrowski’s customer service kept them coming back. The business grew quickly, and Piotrowski soon quit his job to run Rent-a-Nerd full-time.

Gerald Lewis, owner of CDI Designs, a brand consulting company that specializes in helping retail food businesses, says that the right name is essential. “In retailing, the market is so segmented that [a name must] convey very quickly what the customer is going after,” he says. “For example, if it is a warehouse store, it has to convey that impression. If it’s an upscale store selling high-quality food, it has to convey that impression. The name combined with the logo is very important in doing that.”

Whatever the image you want to communicate to your customers, try the following process from the Street-Smart Entrepreneur:

1. Decide the most appropriate single quality of the business that you want to convey. Avoid sending a mixed or inappropriate message. Remember that a name is the first and single most visible attribute of a company. Your business’s name will appear on all advertising and printed materials and, if done effectively, will portray its personality, stand out in a crowd, and stick in the minds of consumers. Remember: The more your name communicates about your business to your customers, the less effort you have to expend to educate them about what your company does.
2. Select a name that is short, attention getting, and memorable. Avoid names that are hard to spell, pronounce, or remember.
3. Be creative and have fun with a name but follow the guidelines of good taste. When Paul and Barbara Rasmussen

started a store in Vancouver, British Columbia, that sells manufactured and custom-made sofas, they decided to name it Sofa So Good.

4. Make sure the name has longevity and does not limit your business. Although many small businesses operate locally, choosing a “local” name restricts a company that wants to expand its area of operation. For example, the name “Richmond Bakery” may not be suitable if the company wants to expand beyond the borders of Richmond.
5. Select a name that creates a positive image for your business. Is Rent-a-Wreck attractive because you think you will save money on a car rental, or does the name put you off because you question the reliability of their cars? Lord of the Fries is a Melbourne, Australia-based business that specializes in selling fresh, hand-cut fries topped with a variety of international sauces.
6. Once you have selected a name, try it out on friends and family. Does the name resonate, or does it create looks of bewilderment?
7. Once you are comfortable with your choice, conduct a name search to make sure that no one else in your jurisdiction has already claimed the name. This is an especially important task for companies whose Web site addresses use the company name. Registering a name with the proper office provides immediate protection.

Another useful tactic to coming up with a great name is to visualize your customers. What are your customers like? What are their ages, genders, lifestyles, and locations? What characteristics of your company are most important to your customers? Classic examples of companies that have used this approach include ServiceMaster, In-N-Out Burgers, and Value-Rite. According to Dave Batt, president of marketing consulting firm Everest Communications Inc. in Geneva, Illinois, “The more targeted your product or service is to a specific demographic, the more specific your name should be to appeal to that target.”

The number of potential names for a company is almost limitless. Coming up with the right one can help you create a lasting brand image for your business. Choosing a name that is distinctive, memorable, and positive can go a long way toward helping you achieve success in your business venture. What’s in a name? Everything!

Sources: Based on Andrew Raskin, “The Name of the Game,” *Inc.*, February 2000, pp. 31–32; Rhonda Adams, “Sometimes Business Success Is All in the Name,” *Business*, July 23, 2000, p. 3; Thomima Edmark, “What’s in a Name?,” *Entrepreneur*, October 1999, pp. 163–165; Steve Nubie, “Naming Names—Why a Good Business Plan Can Help You Name Your Company,” *Entrepreneur*, May 2000, www.entrepreneur.com/magazine/businessstartupmagazine/2000/may/26080.html; “How to Name Your Business” *Entrepreneur*, April 23, 2005, www.entrepreneur.com/startupbasics/startupbasics/namingyourbusiness/article21774.html; “Rent-a-Nerd Life Story,” Rent-a-Nerd, www.rent-a-nerd.net/about_us/about_us.shtml.

PROFIT INCENTIVE One major advantage of operating as a sole proprietorship is that once the owner has paid all of the company's expenses, the entrepreneur keeps the remaining after tax profits. The profit incentive is a powerful one, and, among entrepreneurs, profits represent an excellent way of "keeping score" in the game of the business.

TOTAL DECISION-MAKING AUTHORITY Because sole proprietors are in total control of operations, they can respond quickly to changes. The ability to respond quickly is an asset in a rapidly shifting market, and the freedom to set the company's course of action is both a major motivational and a strategic force. For people who thrive on seeking new opportunities, the freedom of fast, flexible decision making is vital. The entrepreneur solely directs the operations of the business.

NO SPECIAL LEGAL RESTRICTIONS The proprietorship is the least regulated form of business ownership. In a time when government demands for information seem never-ending, this feature has merit.

EASY TO DISCONTINUE If an entrepreneur decides to discontinue operations, he or she can terminate the business quickly, even though he or she will still be personally liable for all of the business's outstanding debts and obligations.

Although these advantages of a proprietorship are extremely attractive to most individuals contemplating starting a new business, it is important to recognize that this form of ownership has some significant disadvantages.

Disadvantages of the Sole Proprietorship

UNLIMITED PERSONAL LIABILITY The greatest disadvantage of a sole proprietorship is the unlimited personal liability of the owner; the sole proprietor is *personally* liable for all business debts. In the eyes of the law, the entrepreneur and the business are one in the same. The proprietor owns all of the business's assets, and if the business fails, creditors can force the sale of those assets to cover its debts. The company's debts are the owner's debts. If unpaid business debts remain, creditors can also force the sale of the proprietor's *personal* assets to cover repayment. State laws vary, but most states require creditors to leave the failed business owner a minimum amount of equity in a home, a car, and some personal items. The reality: *Failure of the business can ruin a sole proprietor financially.*

LIMITED ACCESS TO CAPITAL If the business is to grow and expand, a sole proprietor often needs additional financial resources. However, many proprietors already have invested their available resources into their businesses and may have used their personal assets as collateral on existing loans. Therefore, it may be difficult for sole proprietors to borrow additional funds. A sole proprietorship is limited to whatever capital the owner can contribute and whatever money the owner can borrow. Unless proprietors have substantial personal wealth, they may find it difficult to raise additional money while maintaining sole ownership. Most banks and other lending institutions have well-defined formulas for determining a borrower's eligibility.

LIMITED SKILLS AND ABILITIES A sole proprietor may not possess the full range of skills running a successful business requires. An entrepreneur's education, training, and work experiences may have taught him or her a great deal, yet there are areas in which their decision-making ability will benefit from the insight of others. Many business failures occur because owners lack skill, knowledge, and experience in areas that are vital to business success. Owners may tend to push aside problems they do not understand or do not feel comfortable with in favor of those they can solve more easily. Unfortunately, the problems they set aside seldom solve themselves.

FEELINGS OF ISOLATION Running a business alone allows an entrepreneur maximum flexibility, but it also creates feelings of isolation; there is no one to turn to for help in solving problems or getting feedback on a new idea. Most entrepreneurs report that they sometimes feel alone and frightened when they must make decisions knowing that they have nowhere to turn for advice or guidance. The weight of each critical decision rests solely on the proprietor's shoulders.

LACK OF CONTINUITY FOR THE BUSINESS If the proprietor dies, retires, or becomes incapacitated, the business automatically terminates. Lack of continuity is inherent in a sole proprietorship. Unless a family member or employee can take over, the future of business could be in jeopardy. Because people look for secure employment and the opportunity for advancement, proprietorships often have trouble recruiting and retaining good employees. If no one is trained to run the business, creditors can petition the court to liquidate the assets of the dissolved business to pay outstanding debts.

A sole proprietorship is ideal for entrepreneurs who want to keep their businesses relatively small and simple. Some entrepreneurs, however, find that forming partnerships is one way to overcome the disadvantages of the sole proprietorship. For instance, a person who lacks specific managerial skills or has insufficient access to needed capital can compensate for those weaknesses by forming a partnership with someone who has complementary management skills or money to invest.



The Pain of Partnership

James and Richards met while working at Vitamin, a producer of energy drinks. They became great friends and shared a lot of experiences—both professional and personal—with each other.

James was in charge of the research and production at Vitamin; Richards ran the sales force. After working together for three years, both of them gained good experience in their respective areas and were ready to explore newer options. While working in the research department, James found a formulation for a new energy drink and decided to start his own company. He invited Richards to join him. Richards was impressed by the business idea of the new drink. Both of them agreed to work together and named their company Booster.

They discussed and evaluated different forms of ownership. Since it was a startup, James and Richards decided to go for a partnership, as they found it easier to form a partnership firm without too many legal formalities. The business was easy to establish and the initial costs were low. Since only two people were involved, it was easier to pool resources. The collective wisdom and experience of the partners enabled an effective decision-making process. They found the work quite flexible, and shared the risk and responsibilities. Richards was in charge of sales, finance, and administration; James managed research and production.

Booster seemed like a perfect partnership. Things seemed to be going well, and they even landed a major project.

As time went by, Richards decided that he wanted a “creative” job too. He spent most of his time formulating different energy drinks rather than looking for new business. James’s loyalty to Richards made him blind to many things that were

obvious to others. He believed that Richards was taking care of his side of the business. As it turned out, Richards was not very good at the tasks he had taken on. He made mistakes that reduced the expected profits. He was not making new sales contracts, which was supposed to be the main part of his job. If that were not enough, the feeling that he was letting his friend down made Richards feel worse. He began to avoid talking to James. He stopped coming into the office. Finally, he stopped returning phone calls.

By the time James realized what was happening to the business, it was too late. There were no new sales. What James thought was profits were the result of Richards not paying their bills. James was left with more than \$250,000 in unpaid bills and other debts, and a tearful message on the answering machine from Richards: “I’m moving out to London for a while. Sorry it didn’t work out.”

The business partnership between the two friends dissolved. It took James three years to dig himself out of the financial mess and get his new company up and running successfully.

1. How could have James and Richards avoided the problems that led to the end of their partnership?
2. Why is this situation a good example of the difficulty in maintaining partnerships between friends?
3. With reference to this case explain the advantages and disadvantages of the partnership form of business organization.

Source: www.companylawclub.co.uk/.../advantages_and_disadvantages_of_runn...

3.

Describe the advantages and disadvantages of the partnership.

The Partnership

A **partnership** is an association of two or more people who co-own a business for the purpose of making a profit. In a partnership, the co-owners (partners) legally share a business's assets, liabilities, and profits according to the terms of an established partnership agreement. The law does not require a written partnership agreement, also known as the articles of partnership, but it is wise to work with an attorney to develop an agreement that documents the exact status and responsibility of each partner. Partners may think they know what they are agreeing to, only to find that there was not a clear understanding about the role and obligation of each partner. The **partnership agreement** is a document that states all of the terms of operating the partnership for the protection of each partner involved. Every partnership should be based on a comprehensive written agreement. When problems arise between partners, the written document becomes invaluable. The partnership agreement should be developed *before* the business begins while everyone is getting along and there are no profits to squabble over.

When no partnership agreement exists, the Uniform Partnership Act, which will be discussed later in this chapter, governs the partnership, but its provisions may not be as favorable as a specific agreement drafted by the partners. Creating a partnership agreement is not necessarily costly. In most cases, the partners can review sample agreements and discuss each of the provisions in advance. Once they have reached an understanding, an attorney can draft the final document.

Banks often want to review the partnership agreement before lending the business money. Perhaps the most important benefit of a partnership agreement is that it addresses, in advance, sources of potential conflict that could result in partnership battles and the dissolution of a business that could have been successful. Documenting these details before they occur—especially for challenging issues such as profit splits, contributions, workloads, decision-making authority,

Source: CartoonStock.



dispute resolution, and others—helps avoid tension in a partnership that could lead to business failure or dissolution of the partnership.

A partnership agreement can include any terms the partners want (unless they are illegal). A standard partnership agreement includes the following information:

1. **Name of the partnership.**
2. **Purpose of the business.** What is the reason the partners created the business?
3. **Location of the business.**
4. **Duration of the partnership.** How long will the partnership last?
5. **Names of the partners and their legal addresses.**
6. **Contributions of each partner to the business, at the creation of the partnership and later.** This includes each partner's investment in the business. In some situations, a partner may contribute assets that are not likely to appear on the balance sheet. Experience, sales contracts, or a good reputation in the community may be some reasons for asking a person to join a partnership.
7. **Agreement on how the profits or losses will be distributed.**
8. **Agreement on salaries or drawing rights against profits for each partner.**
9. **Procedure for expansion through the addition of new partners.**
10. **Distribution of the partnership's assets if the partners voluntarily dissolve the partnership.**
11. **Sale of the partnership interest.** How can partners sell their interests in the business?
12. **Absence or disability of one of the partners.** If a partner is absent or disabled for an extended period of time, should the partnership continue? Will the absent or disabled partner receive the same share of profits as she did before her absence or disability? Should the absent or disabled partner be held responsible for debts incurred while unable to participate?
13. **Voting rights.** In many partnerships, partners have unequal voting power. The partners may base their voting rights on their financial or managerial contributions to the business.
14. **Decision-making authority.** When can partners make decisions on their own, and when must other partners be involved?
15. **Financial authority.** Which partners are authorized to sign checks, and how many signatures are required to authorize bank transactions?
16. **Handling tax matters.** The Internal Revenue Service requires partnerships to designate one person to be responsible for handling the partnership's tax matters.
17. **Alterations or modifications of the partnership agreement.** No document is written to last forever. Partnership agreements should contain provisions for making alterations or modifications. As a business grows and changes, partners often find it necessary to update their original agreement. In the event there is no written partnership agreement and a dispute arises, the courts apply the Uniform Partnership Act.



ENTREPRENEURIAL PROFILE: Lin Miao, Andrew Bachman, Lucas Brown, and Lee

Brown: Tatto Media Lin Miao partnered with fellow Babson College students Andrew Bachman, Lucas Brown, and Lee Brown to build an Internet marketing company, Tatto Media, that fundamentally changed the way advertisers pay for display advertising. They came up with a plan to shift Web-based marketing from paying for impressions to paying for performance. Tatto Media grew from a self-funded, bootstrapped dorm room venture into the third-largest ad network in the world, with revenues of more than \$100 million just four years after the business was founded. In 2011, the cofounders sold Tatto Media for more than \$60 million. Bachman attributes much of their success to launching with college students who were eager to build a company and not tainted by years of working in a corporate setting. Bachman recommends finding partners who complement each other's skills. Tatto Media brought together Miao's ability to create a vision for each project, the design and engineering skills of Lucas and Lee Brown to build the project, and Bachman's ability to sell.

The Uniform Partnership Act

The **Uniform Partnership Act** (UPA) codifies the body of law dealing with partnerships in the United States. Under the UPA, the three key elements of any partnership are common ownership interest in a business, sharing the business's profits and losses, and the right to participate in managing the partnership. Under the act, each partner has the right to do the following:

1. Share in the management and operations of the business.
2. Share in any profits the business might earn from operations.
3. Receive interest on additional advances made to the business.
4. Be compensated for expenses incurred in the name of the partnership.
5. Have access to the business's books and records.
6. Receive a formal accounting of the partnership's business affairs.

The UPA also describes the partners' obligations. Each partner is obligated to do the following:

1. Share in any losses sustained by the business.
2. Work for the partnership without salary.
3. Submit differences that may arise in the conduct of the business to majority vote or arbitration.
4. Give the other partners complete information about all business affairs.
5. Give a formal accounting of the partnership's business affairs.

To meet these obligations, partners must abide by the following duties:

- **Duty of loyalty.** Each partner has a fiduciary responsibility to the partnership and, as such, must always place the interest of the partnership above his or her personal interest. This is a duty that must be upheld in every case.
- **Duty of obedience.** This duty requires each partner to adhere to the provisions of the partnership agreement and the decisions made by the partnership.
- **Duty of care.** As the name implies, each partner is expected to behave in ways that demonstrate the same level of care and skill that a reasonable manager in the same position would use under the same circumstances. Failure to perform up to these duties is considered negligence.
- **Duty to inform.** All information relevant to the management of the business must be made available to all partners.

Beyond what the law prescribes, a partnership is based on mutual trust and respect. Any partnership missing those elements is destined to fail. Like sole proprietorships, partnerships also have advantages and disadvantages.

Advantages of the Partnership

EASY TO ESTABLISH Like the proprietorship, the partnership is relatively easy and inexpensive to establish. The owners must obtain the necessary business license and submit a minimal number of forms. In most states, partners must file a Certificate for Conducting Business as Partners if the business operates under a trade name.

COMPLEMENTARY SKILLS In successful partnerships, the parties' skills and abilities complement one another, strengthening the company's managerial foundation. The synergistic effect created when partners of equal skill and creativity collaborate effectively results in outcomes that reflect the contributions of all involved. In his book *The Illusions of Entrepreneurship*, Scott Shane says that businesses that are founded by teams of entrepreneurs (not necessarily partners) are more likely to succeed than those that are founded by a single entrepreneur.⁴



ENTREPRENEURIAL PROFILE: Norm Brodsky and Sam Kaplan: CitiStorage For years,

Norm Brodsky, founder of CitiStorage, a document storage company in New York City, resisted taking on a partner because he knew that many partnerships fail. But, in 2006, he brought his trusted friend Sam Kaplan in as a partner because he saw how Kaplan's values and

philosophies were similar to his own and that Kaplan's strengths were skills that he lacked. With his strong background in finance, Kaplan had an immediate impact on the company. He took over the management of CitiStorage's finances and introduced systems and practices that were rare in a small company. "While I still think it's a bad idea to start a business with one, I've come to realize that ending with a partner is another matter—especially if the other person is someone like Sam," says Brodsky.⁵

DIVISION OF PROFITS There are no restrictions on how partners may distribute the company's profits as long as they are consistent with the partnership agreement and do not violate the rights of any partner. The partnership agreement should articulate the nature of each partner's contribution and proportional share of profits. If the partners fail to create an agreement, the UPA states that the partners share equally in the partnership's profits, regardless of the proportional amount of their original capital contributions.

LARGER POOL OF CAPITAL A partnership can significantly broaden the pool of capital available to a business. Each partner's asset base will support a larger borrowing capacity than either partner would have had alone. This may become a critical factor because undercapitalization is a common cause of business failures.

ABILITY TO ATTRACT LIMITED PARTNERS Not every partner need take an active role in the operation of a business. Partners who take an active role in managing a company and who share in its rewards, liabilities, and responsibilities are **general partners**. Every partnership must have at least one general partner (although there is no limit on the number of general partners a business can have). General partners have unlimited personal liability for the company's debts and obligations and are expected to take an active role in managing the business.

Limited partners are financial investors who do not want to participate in the day-to-day affairs of the partnership and seek to limit their risk. Limited partners cannot take an active role in the operation of the company and have limited personal liability for the company's debts and obligations. If the business fails, limited partners lose only what they have invested in the partnership itself and no more. If limited partners are "materially and actively" involved in a business—defined as spending more than 500 hours a year in the company—they will be treated as general partners and will lose their limited liability protection. Silent partners and dormant partners are special types of limited partners. **Silent partners** are not active in a business but generally are known to be members of the partnership. **Dormant partners** are neither active nor generally known to be associated with the business.

A limited partnership can attract investors by offering them limited liability and the potential to realize a substantial return on their investments if the business is successful. Many individuals find it profitable to invest in high-potential small businesses but *only* if they avoid the disadvantages of unlimited liability. We will discuss limited partnerships in greater detail later in this chapter.

LITTLE GOVERNMENTAL REGULATION Like the proprietorship, the partnership form of ownership is not burdened with reporting requirements.

FLEXIBILITY Although not as flexible as sole proprietorships, partnerships can react quickly to changing market conditions. In large partnerships, however, getting all partners' approval on key decisions can slow down a company's ability to react. Unless the partnership agreement states otherwise, each partner has a single vote in the management of the company no matter how large his or her contribution to the partnership is.

TAXATION The partnership itself is not subject to federal taxation. It serves as a conduit for the profit or losses it earns or incurs; its net income or losses are passed through the individual partners as personal income, and the partners, not the business, pay income tax on their distributive shares. The partnership, like the proprietorship, avoids the "double-taxation" disadvantage associated with the corporate form of ownership. Partners receive a K-1 tax return, which they file with their personal tax returns that shows their share of the partnership's income on which they must pay taxes. The K-1 also is issued to owners of S corporations and limited liability companies because they, too, are pass-through entities when it comes to income taxes.



Lessons from the Street-Smart Entrepreneur

How to Avoid a Business Divorce

Starting a business with another person or team of people offers many advantages, including a greater chance for success than starting a business solo. Ben Cohen and Jerry Greenfield (Ben & Jerry's Homemade), Larry Page and Sergey Brin (Google), Steve Jobs and Steve Wozniak (Apple), and Evan Williams and Biz Stone (Twitter) are examples of successful business partnerships. However, operating a business with others also presents challenges in the form of personality conflicts, differing business philosophies, workload expectations, and a variety of other important issues. Like marriage partners, business co-owners experience together happiness and heartbreak, good times and bad times, and success and failure. In addition, some business partnerships, like some marriages, fall apart. However, a failed business partnership is often much harder to untangle than a failed marriage. Before going into business with someone else, consider the following advice from the Street-Smart Entrepreneur on how to avoid a business divorce.

Tip #1. Have shared vision and values

One of the biggest mistakes entrepreneurs make is jumping into a business with other people before they get to know their partners. Ideally, business co-owners should share a common vision for the business and common values on which they build the company's culture. Ben Cohen and Jerry Greenfield had so much success in building their company, Ben and Jerry's Ice Cream, as partners due in large part to their shared values. They made humanitarianism and philanthropy integral parts of their business. They found creative ways to combine profitability with social responsibility by creating a progressive approach to employee management.

Tip #2. Divide responsibilities based on ability, experience, and interest

One of the greatest advantages of creating a company with others is the ability to create a whole that is greater than the sum of its parts. To do so, however, requires each cofounder to do what he or she is best at doing. Alicia Rockmore and Sarah Welch, cofounders of Buttoned Up, Inc., an online company that sells organizational products aimed specifically at women, worked together on and off for eight years in their respective corporate jobs before they decided to take the entrepreneurial plunge together. Each woman brings to the business a different skill set, but what ties them together is "respect for each other's business judgment," says Welch.

Tip #3. Put it in writing

Before launching a business with someone else, take the time to put together an operating agreement in writing—whatever

form of ownership you choose. The document should spell out the division of responsibilities and duties, the decision-making process and authority, the division of profits, compensation, exit strategies, and other important matters. Avoid the tendency to go into business with someone else, no matter how close you may be, with nothing more than a handshake and high hopes. Steve Hindy and Tom Potter, who founded Brooklyn Brewery in 1987, found that putting things in writing was a critical decision for their business partnership. "One important thing that we did at the beginning was to draw up a partnership agreement that defined it financially and also defined a buy-sell agreement, in case one of us wanted out or in case of disputes," says Hindy. The written agreement allowed them to part ways amicably with a clearly defined process when Potter decided to retire in 2004.

Tip #4. Realize that conflicts will occur

Conflict is a natural part of any relationship. Co-owners will never agree on every aspect of operating a company. However, tempers tend to flare and disagreements arise when co-owners find themselves in a crucible, under pressure to make decisions or deal with a business crisis. The key is to have a mechanism such as an operating agreement in place for dealing with conflict when it does occur. The *worst* approach co-owners can take is to ignore or cover up the conflict. Unaddressed conflicts seldom resolve themselves.

Tip #5. Keep the lines of communication open

The best way to deal with conflict is to talk and work through it. That requires co-owners to maintain open lines of communication with one another. When Dr. Shaparak Kemarei and Dr. Marjaneh Hedayat decided to become partners in a laser hair-removal practice, they often called each other after business hours to discuss issues, a procedure that imposed on their family time. Soon they established a better way of maintaining daily communication: Twice a day they set aside a designated time to devote to discussing business issues and regularly select management books to read and discuss together. "Even if we don't agree, we talk about everything, come to an understanding, and move on," says Dr. Hedayat. "That's how a business grows."

Sources: Based on Shelly Banjo, "Before You Tie the Knot," *Wall Street Journal*, November 26, 2007, p. R4; Alexander Stein, "Make Your Partnership Work," *FSB*, May 2009, p. 19; Stacy Perman, "Contemplating a Business Partnership?," *Bloomberg Businessweek*, November 21, 2008, www.businessweek.com/stories/2008-11-21/contemplating-a-business-partnership-businessweek-business-news-stock-market-and-financial-advice; "Ben Cohen & Jerry Greenfield: Caring Capitalists," *Entrepreneur*, October 10, 2008, www.entrepreneur.com/article/197626.

Disadvantages of the Partnership

Business partnerships can be complicated and frustrating. Before taking on a partner, every entrepreneur should double-check the decision to be sure that the prospective business partner is adding value to the business. “I would never, ever, ever advise someone to go into a partnership unless it’s necessary,” says Clay Nelson, a Santa Barbara business adviser who works with partners.⁶ For some entrepreneurs, taking on a partner *is* necessary; for others, it is a mistake. Before entering into a partnership, entrepreneurs must consider their disadvantages.

UNLIMITED LIABILITY OF AT LEAST ONE PARTNER At least one member of every partnership must be a general partner. The general partner has unlimited personal liability for the partnership’s debts. In most states, certain property belonging to a proprietor or a general partner is exempt from attachment by creditors of a failed business. The most common is the homestead exemption, which allows the debtor’s home to be sold to satisfy debt but stipulates that a certain dollar amount be reserved to allow the debtor to find other shelter. State laws commonly exempt certain personal property items from attachments by creditors. For example, household furniture (up to a specified amount), clothing and personal possessions, government or military pensions, and bonuses are protected and cannot be seized to satisfy an outstanding business debt.

CAPITAL ACCUMULATION Although the partnership form of ownership is superior to the sole proprietorship when it comes to attracting capital, it also presents limitations. The partnership is generally not as effective in raising funds as the corporate form of ownership, which can acquire capital by selling shares of ownership to outside investors.

DIFFICULTY IN DISPOSING OF PARTNERSHIP INTEREST Most partnership agreements restrict how partners can dispose of their shares of the business. Usually, a partner is required to sell his or her interest to the remaining partners. Even if the original agreement contains such a requirement and clearly delineates how the value of each partner’s ownership will be determined, there is no guarantee that other partners will have the financial resources to buy the seller’s interest. When the money is not available to purchase a partner’s interest, the other partners may be forced to either accept a new partner or dissolve the partnership and distribute the remaining assets. Under previous versions of the UPA, when a partner withdrew from a partnership (an act called dissociation), the partnership automatically dissolved, which required the remaining partners to form a new partnership. Current provisions of the UPA, however, do not require dissolution and allow the remaining partners to continue to operate the business without the withdrawing partner. The withdrawing partner no longer has the authority to represent the business or to take part in managing it.

POTENTIAL FOR PERSONALITY AND AUTHORITY CONFLICTS In some ways, a partnership is similar to a marriage. The compatibility of partners’ work habits, goals, ethics, and general business philosophies are an important ingredient in a successful relationship. Friction among partners is inevitable and can be difficult to control. The key is to have in place a comprehensive partnership agreement and open lines of communication. The demise of many partnerships can often be traced to interpersonal conflicts and the lack of a partnership agreement to resolve those conflicts. Knowing potential partners well and having a conflict resolution plan in place result in better outcomes when dealing with the inevitable conflicts that occur when there is a fundamental difference of opinion on one or more critical business decisions.

PARTNERS ARE BOUND BY THE LAW OF AGENCY Each partner acts as an agent for the business and can legally bind the other partners to a business agreement. This agency power requires all partners to exercise good faith and reasonable care in performing their responsibilities. For example, if a partner signs a three-year lease for new office space, dramatically increasing the operation costs of the business beyond what the business can afford, the partnership is legally bound to that agreement.

Some partnerships survive a lifetime; others experience difficulties and ultimately are dissolved. In a partnership, the continued exposure to personal liability for partners’ actions may wear down the general partners. Knowing that they could lose their personal assets because of a partner’s bad business decision is a fact of life in partnerships. Conflicts between or among partners can force a business to close. Unfortunately, few partnerships have a mutually agreed on means for conflict resolution, such as mediation or arbitration, which can help partners resolve underlying conflicts and keep the business operating. Without such a mechanism, disagreements between partners can result in the partnership being dissolved and the business ceasing to operate.



Kathleen King, founder of Kathleen's Bake Shop.

Source: Kathleen King.



ENTREPRENEURIAL PROFILE: Kathleen King: Kathleen's Bake Shop Kathleen King had worked for 23 years building her business, Kathleen's Bake Shop, in Southampton, New York. To help with the growing tasks and responsibilities created by the success of her business, King took on two brothers as business partners. All three had an equal ownership share. Six months later, the two brothers teamed up to get ownership of King's business. She went to work and was confronted by her partners blocking the door and holding paperwork that would evict her from her own bakery. When she returned the following day, armed security guards were guarding the business to keep her out. King filed a lawsuit against the brothers. When the lawsuit was settled, she had accumulated \$200,000 in debt and was granted only the building the bakery was housed in. The brothers were granted the rights to keep the bakery's name and recipes. "They were allowed to use my recipes, but never once did they duplicate them in the quality and consistency that I did, so I felt in the big picture they really didn't have my recipes," says King. "They weren't interested in quality control—they were interested in the bottom line." In just a few more months, Kathleen's Bake Shop had accumulated \$600,000 in debt and eventually had to shut down. "I never saw something so valuable get destroyed so fast," says King. "And as they were driving everything into debt, it was still my name on the business."⁷

Limited Partnerships

A **limited partnership** is a modification of a general partnership. Limited partnerships are composed of at least one general partner and at least one limited partner. The general partner is treated, under law, in the same manner as in a general partnership, which means that he or she has unlimited personal liability for the partnership's debts. Limited partners are treated as *investors* in the business venture with limited liability and therefore can lose only the amount they have invested in the business. There is no limit on the number of limited partners in a limited partnership.

Most states recognize the ratified Revised Uniform Limited Partnership Act. To form a limited partnership, the partners must file a certificate of limited partnership in the state in which the partnership plans to conduct business. The certificate of limited partnership should include the following information:

- The name of the limited partnership.
- The general character of its business.
- The address of the office of the firm's agent authorized to receive summonses or other legal notices.
- The name and business address of each partner, specifying which ones are general partners and which are limited partners.
- The amount of cash contributions actually made and agreed to be made in the future by each partner.
- A description of the value of noncash contributions made or to be made by each partner.
- The times at which additional contributions are to be made by any of the partners.
- Whether and under what conditions a limited partner has the right to grant limited partner status to an assignee of his or her interest in the partnership.
- If agreed on, the time or the circumstances when a partner may withdraw from the firm (unlike the withdrawal of a general partner, the withdrawal of a limited partner does not automatically dissolve a limited partnership).
- If agreed on, the amount of or the method of determining the funds to be received by a withdrawing partner.
- Any right of a partner to receive distributions of cash or other property from the firm and the circumstances for such distributions.
- The time or circumstances when the limited partnership is to be dissolved.
- The rights of the remaining general partners to continue the business after the withdrawal of a general partner.
- Any other matters the partners want to include.

Although limited partners do not have the right to take an active role in managing the business, they can make management suggestions to general partners, inspect the business, and have

access to and make copies of business records. A limited partner is, of course, entitled to a share of the business's profits (or losses) as agreed and specified in the certificate of limited partnership.

Limited Liability Partnerships

Many states now recognize **limited liability partnerships** (LLPs), in which all partners in the business are limited partners, having only limited liability for the debts and obligations of the partnership. Most states restrict LLPs to certain types of professionals, such as attorneys, physicians, dentists, accountants, and others. Just as with any limited partnership, the partners must file a certificate of limited partnership in the state in which the partnership plans to conduct business. Just as with every partnership, an LLP does not pay taxes; its income is passed through to the limited partners, who pay personal taxes on their shares of the company's net income.

The Corporation

The corporation is the most complex of the forms of business ownership. A **corporation** is an artificial legal entity created by the state that can sue or be sued in its own name, enter into and enforce contracts, hold title to and transfer property, and be found civilly and criminally liable for violations of the law.⁸ The life of the corporation is independent of its owners, and shareholders can transfer their ownership in the business to others.

Corporations, also known as **C corporations**, are creations of the state. When a corporation is founded, it accepts the regulations and restrictions of the state in which it is incorporated and any other state in which it chooses to conduct business. A corporation that conducts business in the state in which it is incorporated is a **domestic corporation**. When a corporation conducts business in another state, that state considers it to be a **foreign corporation**. Corporations that are formed in other countries and conduct business in the United States are referred to as **alien corporations**.

Corporations have the power to raise capital by selling shares of ownership to outside investors. Some corporations have thousands of shareholders, and others have only a handful of owners. **Publicly held corporations** have a large number of shareholders, and their stock is usually traded on one of the large stock exchanges. **Closely held corporations** have shares that are controlled by a relatively small number of people, often family members, relatives, or friends. Their stock is not traded on any stock exchange but instead is passed from one generation to the next. Many small corporations are closely held.

In general, a corporation must report annually its financial operations to its home state's secretary of state. These financial reports become public record. If the corporation's stock is sold in more than one state, the corporation must comply with federal regulations governing the sale of corporate securities and stringent reporting requirements. There are substantially more reporting requirements for a corporation than for the other forms of ownership.

Requirements for Incorporation

Most states allow entrepreneurs to incorporate without the assistance of an attorney. Some states even provide incorporation kits to help in the incorporation process. Although it is less expensive for entrepreneurs to complete the process themselves, doing so may not be ideal because overlooking some provisions of the incorporation process creates legal and tax problems. In some states, the application process is complex, and the required forms are confusing. Entrepreneurs usually can find an attorney or an online service to help them incorporate their businesses for a reasonable fee.

Once the owners decide to form a corporation, they must choose the state in which to incorporate. If the business will operate in a single state, it usually makes sense to incorporate in that state. States differ—sometimes dramatically—in the requirements they place on the corporations they charter and in how they treat corporations chartered in other states. States also differ in the tax rates imposed on corporations, the restrictions placed on their activities, the capital required to incorporate, and the fees or organization tax charged to incorporate.

Every state requires a certificate of incorporation or charter to be filed with the secretary of state. The following information is generally required to be in the certificate of incorporation:

- **The corporation's name.** The corporations must choose a name that is not so similar to that of another firm in that state that it causes confusion or lends itself to deception. It must include the words *corporation*, *incorporated*, *company*, or *limited*, to notify the public that they are dealing with a corporation.

4.

Describe the advantages and disadvantages of the corporation.

- **The corporation's statement of purpose.** The incorporators must state in general terms the intended nature of the business. The purpose must, of course, be lawful. An illustration might be “to engage in the sale of office furniture and fixtures.” The purpose should be broad enough to allow for some expansion in the activities of the business as it develops.
- **The company's time horizon.** Most corporations are formed with no specific termination date and will continue “in perpetuity.” However, it is possible to incorporate for a specific duration of time, for example, a period of 50 years.
- **Names and addresses of the incorporators.** The incorporators must be identified in the articles of incorporation and are liable under the law to attest that all information in this document is correct. In some states, one or more of the incorporators must reside in the state the corporation is being created.
- **Place of business.** The post office address of the corporation's principal office must be listed. This address, for a domestic corporation, must be in the state in which incorporation takes place.
- **Capital stock authorization.** The articles of incorporation must include the amount and class (or type) of capital stock the corporation wants to be authorized to issue. This is not the number of shares it must issue; a corporation must also define the different classification of stock and any special rights, preferences, or limits each class has.
- **Capital required at the time of incorporation.** Some states require a newly formed corporation to deposit in a bank a specific percentage of the stock's par value before incorporating.
- **Provisions for preemptive rights, if any, that are granted to stockholders.** If granted preemptive rights state that stockholders have the right to purchase new shares of stock before they are offered to the public.
- **Restrictions on transferring shares.** Many closely held corporations—those owned by a few shareholders, often family members—require shareholders interested in selling their stocks to offer it first to the corporation. Shares the corporation itself owns are called **treasury stock**. To maintain control over their ownership, many closely held corporations exercise this right, known as the **right of first refusal**.
- **Names and addresses of the officers and directors of the corporation.**
- **Rules under which the corporation will operate.** Bylaws are the rules and regulations the officers and directors establish for the corporation's internal management and operation.

Once the secretary of state of the incorporating state approves a request for incorporation and the corporation pays its fees, the approved articles of incorporation become its **corporate charter**. With the corporate charter as proof that the corporation legally exists, the next order of business is to hold an organizational meeting for the stockholders to formally elect directors, who, in turn, appoint the corporate officers.

Corporations account for the greatest proportion of sales and profits than other forms of ownership, but like the preceding forms of ownership, they have advantages and disadvantages.

Advantages of the Corporation

LIMITED LIABILITY OF STOCKHOLDERS The primary reason most entrepreneurs choose to incorporate is to gain the benefit of limited liability, which allows investors to limit their liability to the total amount of their investments. This legal protection of personal assets outside the business is of critical concern to many investors. The shield of limited liability often is not impenetrable, however. Because start-up companies generally present higher levels of risk, lenders and other creditors usually require the owners to *personally* guarantee loans made to the corporation. Experts estimate that 95 percent of small business owners have to sign personal guarantees to get the financing they need. By making these guarantees, owners place their personal assets at risk (just as in a proprietorship) despite choosing the corporate form of ownership. The situation is similar to when a parent cosigns a loan for a child. Although the loan may be in the child's name and the child is responsible for making payments, the financial strength of the parent makes the loan possible. If the child defaults on the loan, the parent is responsible for paying back the loan as a result of the guarantee.

Court decisions have extended the personal liability of the owners to include, with respect to financial guarantees that banks and other lenders require, “piercing the corporate veil” more than

ever before. Courts are increasingly holding corporate owners personally liable for environmental, pension, and legal claims against their corporations. Courts will pierce the corporate veil and hold owners liable for the company's debts and obligations if the owners deliberately commit criminal or negligent acts when handling corporate business. Corporate shareholders most commonly lose their liability protection, however, because owners and officers have commingled corporate funds with their own personal funds. Failing to keep corporate and personal funds separate is often a problem, particularly in closely held corporations.

Steps to avoid legal difficulties include the following:

- **File all of the reports and pay all of the necessary fees required by the state in a timely manner.** Most states require corporations to file reports with the secretary of state on an annual basis. Failing to do so will jeopardize the validity of your corporation and will open the door for personal liability problems for its shareholders.
- **Hold annual meetings to elect officers and directors.** In a closely held corporation, the officers elected may *be* the shareholders, but that does not matter. Corporations formed by an individual are not required to hold meetings, but the sole shareholder must file a written consent form.
- **Keep minutes of every meeting of the officers and directors, even if it takes place in the living room of the founders.** It is a good idea to elect a secretary who is responsible for recording the minutes.
- **Make sure that the corporation's board of directors makes all major decisions.** Problems arise in closely held corporations when one owner makes key decisions alone without consulting the elected board.
- **Make it clear that the business is a corporation by having all officers sign contracts, loan agreements, purchase orders, and other legal documents in the corporation's name rather than their own names.** Failing to designate their status as agents of the corporation can result in the officer's being held personally liable for agreements they think they are signing on the corporation's behalf.
- **Keep corporate assets and the personal assets of the owner's separate.** Few things make courts more willing to hold shareholder's personally liable for a corporation's debts than commingling corporate and personal assets. In some closely held corporations, owners have been known to use corporate assets to pay their personal expenses (or vice versa) or to mix their personal funds with corporate funds into a single bank account. Protecting the corporation's identity by keeping it completely separate from the owner's personal identities is critical.



ENTREPRENEURIAL PROFILE: Richard Reinis: Krispy Kreme franchise Richard Reinis was an experienced attorney who had helped many of his clients avoid the risks of signing a personal guarantee. When he decided to open a Krispy Kreme franchise, he needed financing from a bank to get the business started, and that loan came with the requirement of a personal guarantee. Reinis decided it was worth the risk of signing the personal guarantee. However, the business failed, and the bank called his personal guarantee. "I paid dearly in sleepless nights, guilt, and shame," said Reinis. "I don't know how many years of my life this emotional strain cost me, but I know how many years I'll have to work to make up the loss." Given the personal risks that come with guarantees, Reinis recommends being open and honest with your spouse about any guaranteed loans. "Tell your family the truth about the personal guarantee, upfront," urges Reinis. "You can't put your home and bank accounts on the hook without telling your spouse. You'd be amazed how few businessmen tell their wives when they do this."⁹

ABILITY TO ATTRACT CAPITAL Corporations have proved to be the most effective form of ownership for accumulating large amounts of capital largely due to the protection of limited liability. Restricted only by the number of shares authorized in its charter (which can be amended), the corporation can raise money to begin business and expand as opportunity dictates by selling shares of its stock to investors. A corporation can sell its stock to a limited number of private investors, called a **private placement**, or to the public, referred to as a **public offering**. In fact, the ability to generate financing is one of the most significant advantages of a corporation. The need of major capital infusions. "If you're thinking about going public, there's no question that C corporations are the best vehicle," says Hillel Bennett, an

attorney who specializes in corporate law.¹⁰ Forming the business as a C corporation is best for businesses that plan to raise multiple rounds of venture capital funding, even if a public offering is not part of the plans for funding. “The C corporation is a venture capital firm’s clear-cut choice for the type of entity in which to place their investment,” says Ryan Roberts, a California attorney who specializes in technology startups. “When the to-be-venture-funded startup is a C corporation, various administrative and other burdens are minimized for the venture capital firm, which allows them (and their capital) to focus on developing the startup company’s business.”¹¹

ABILITY TO CONTINUE INDEFINITELY As a separate legal entity, a corporation can continue indefinitely or in perpetuity unless limited by its charter. Unlike a proprietorship or partnership in which the death of a founder ends the business, the corporation lives beyond the lives of those who created it. This perpetual life gives rise to the next major advantage of the corporation: transferable ownership.

TRANSFERABLE OWNERSHIP If stockholders in a corporation are displeased with the business’s progress, they can sell their shares to someone else. Millions of shares of stock representing ownership in companies are traded daily on the world’s stock exchanges. Shareholders can also transfer their stock through inheritance to a new generation of owners. Throughout these transfers of ownership, the corporation seamlessly continues to conduct business as usual. Because only a small number of people, often company founders, family members, or employees, own the stock of closely held corporations, the resale market for shares is limited, and the transfer of ownership may be difficult.

Disadvantages of the Corporation

COST AND TIME INVOLVED IN THE INCORPORATION PROCESS Corporations can be costly and time consuming to establish. As the owners give birth to this artificial legal entity, the gestation period can be prolonged. In some states, an attorney must handle the incorporation, but in most states, entrepreneurs can complete all of the required forms themselves. However, an entrepreneur must exercise great caution when incorporating without the help of an attorney. In addition to potential legal expenses, incorporating a business requires fees that do not apply to proprietorships or partnerships. Creating a corporation can cost between \$500 and \$3,000, with the average cost around \$1,500.

DOUBLE TAXATION As a separate legal entity, a corporation must pay taxes on its net income to the federal, most state, and many local governments. Before stockholders receive any net income as dividends, a corporation must pay these taxes at the corporate tax rate. Then stockholders must pay taxes on the dividends they receive from these same profits at the individual tax rate. Thus, a corporation’s profits are taxed twice—once at the corporate level and again at the individual level. This **double taxation** is a distinct disadvantage of the corporate form of ownership.

POTENTIAL FOR DIMINISHED MANAGERIAL INCENTIVES As corporations grow, they often require additional managerial expertise beyond that which the founder can provide. Because they created their companies and often have most of their personal wealth tied up in the business, entrepreneurs have an intense interest in ensuring their success and are willing to make sacrifices for their businesses. Professional managers an entrepreneur brings in to help run the business as it grows do not always have the same degree of dedication or loyalty to the company. As a result, the business may suffer without the founder’s energy, care, and devotion. One way to minimize this potential problem is to link managers’ (and even employees’) compensation to the company’s financial performance through profit-sharing or bonus plans. The corporation can directly tie managers’ and employees’ performances to the value of the firm by establishing **stock option** plans that allow employees to buy stock at discounted prices. Corporations also can stimulate managers’ and employees’ incentive on the job by creating an **employee stock ownership plan** in which managers and employees become part of the whole owners in the company.

LEGAL REQUIREMENTS AND REGULATORY RED TAPE Corporations are subject to more legal and financial requirements than other forms of ownership. Entrepreneurs must meet stringent requirements to accurately record and report business transactions in a timely

manner. They must hold annual meetings and consult the board of directors about major decisions that are beyond day-to-day operations. Managers may be required to submit major decisions to the stockholders for approval. Corporations that are publicly held must also file quarterly and annual reports with the Securities and Exchange Commission. Failure to follow state and federal regulations has led to problems for many corporations and their founders.

POTENTIAL LOSS OF CONTROL BY THE FOUNDERS When entrepreneurs sell shares of ownership in their companies, they relinquish some degree of control. In corporations that require large capital infusions, entrepreneurs may have to give up a significant amount of control, so much, in fact, that they become minority shareholders. Losing majority ownership—and therefore control—of their companies leaves founders in a precarious position. They no longer have the power to determine the company’s direction; “outsiders” do. The founders’ shares may become so diluted that majority shareholders may vote them out of their jobs. One study of the “founder’s dilemma” reports that 52 percent of business founders have been replaced as CEO by the time they receive the third round of venture capital financing (and in 73 percent of the replacements, the board fired the founder).¹²

Professional Corporations

A **professional corporation** offers professionals, such as lawyers, doctors, dentists, accountants, and others, the advantages of the corporate form of ownership. Corporate ownership is ideally suited for licensed professionals, who must always be concerned about malpractice lawsuits, because it offers limited liability. For example, if three doctors form a professional corporation, none of them would be liable for the malpractice of the other. (Of course, each would be liable for his or her own actions.) Professional corporations are created in the same way as regular corporations. They often are identified by the abbreviation P.C. (professional corporation), P.A. (professional association), or S.C. (service corporation).

The S Corporation

The Internal Revenue Service Code created the Subchapter S corporation in 1954. Now known as the S corporation, this form of ownership has undergone modifications in its legal requirements. An **S corporation** is a distinction that is made only for federal income tax purposes and is, in terms of its legal characteristics, no different from any other corporation. Small businesses seeking S corporation status must meet the following criteria:

1. It must be a domestic (U.S.) corporation.
2. It cannot have a nonresident alien as a shareholder.
3. It can issue only one class of common stock, which means that all shares must carry the same distribution or liquidation rights. Voting rights, however, may differ. In other words, an S corporation can issue voting and nonvoting common stock.
4. It must limit its shareholders to individuals, estates, and certain trusts, although tax-exempt entities, such as employee stock ownership plans and pension plans, can be shareholders.
5. It cannot have more than 100 shareholders (increased from 75).
6. No more than 25 percent of the corporation’s gross revenues during three successive tax years can be from passive investment income.

By increasing the number of shareholders allowed in S corporations to 100, the new law makes succession planning easier for business owners. Founders now can pass their stock on to their children and grandchildren without worrying about exceeding the maximum allowable number of owners. The larger number of shareholders also gives S corporations greater ability to raise capital by attracting more investors.

The new law also allows S corporations to own subsidiary companies. Previously, the owners of S corporations had to establish separate businesses if they wanted to launch new ventures, even those closely related to the S corporation. This change is especially beneficial to entrepreneurs with several businesses in related fields. They can establish an S corporation as the “parent”

5.

Describe the features of the S corporation.

FIGURE 5.2
Tax Rate Comparison
of C Corporation Versus
S Corporation or LLC

C Corporation		S Corporation or LLC	
Net Income \$500,000			
	Corporate Tax Rates		Individual Tax Rates
\$-000	15%	\$-000	10%
\$50,000	25%	\$16,700	15%
\$75,000	34%	\$67,900	25%
\$100,000	39%	\$137,050	28%
\$335,000	34%	\$208,850	33%
\$10,000,000	35%	\$372,950	35%
\$15,000,000	38%		
\$18,333,333	35%		
Corporate	Tax Bill \$170,000	Shareholder	Tax Bill \$175,000
Dividend	\$330,000	Tax burden is split among owners based on percentage of ownership and paid with their personal tax returns.	
Individual Tax Bill	\$49,500		
Total	\$219,500	Tax savings by using S Corporation or LLC	\$44,500

company and then set up multiple subsidiaries as either S or C corporations as “offspring” under it. Because they are separate corporations, the liabilities of one business cannot spill over and destroy the assets of another.

Violating any of the requirements for an S corporation automatically terminates a company’s S status. If a corporation meets the criteria for an S corporation, its shareholders must elect to be treated as one. (The corporation must have been eligible for S status for the entire year.) To make the election of S status effective for the current tax year, an entrepreneur must file Internal Revenue Service (IRS) Form 2553 within the first 75 days of the tax year. All shareholders must consent to have the corporation treated as an S corporation. Figure 5.2 demonstrates the tax implications of an S corporation (or limited liability company) and a C corporation.

Advantages of an S Corporation

S corporations retain all of the advantages of a regular corporation, including continuity of existence, transferability of ownership, and limited personal liability for its owners. The most notable provision of the S corporation is that it passes all of its profits or losses through to the *individual* shareholders, and its income is taxed only *once* at the individual tax rate. Thus, electing S corporation status avoids the double taxation disadvantage of a C corporation. In essence, the tax treatment of an S corporation is exactly like that of a partnership; its owners report their shares of the company’s profits on their individual income tax returns and pay taxes on those profits at the individual rate, even if they never take the money out of the business.

Another advantage of the S corporation is that it avoids the tax C corporations pay on the assets that have appreciated in value and are sold. S corporations owners also enjoy the ability to make year-end payouts to themselves when net income is high. To minimize their tax bills, some S corporation owners pay themselves minimal salaries, which are subject to Social Security and Medicare taxes, and instead make large dividend distributions, which are not subject to those taxes, to themselves. In C corporations, owners have no such luxury because the IRS watches for excessive compensation to owners and managers. However, the IRS is trying to eliminate this loophole, arguing that it costs the U.S. Treasury billions of lost revenue annually.

Disadvantages of an S Corporation

Although tax implications should not be the sole criterion when choosing a form of ownership, they are important to business owners. Congress's constant tinkering with the tax code means that the tax advantages that the S corporation offers may not be permanent. S corporations lose their attractiveness if either personal income tax rates rise above those of C corporation rates or if C corporation rates fall below personal income tax rates.

In addition to the tax implications of choosing an S corporation, owners should consider the following factors in their decision:

- The size of the company's net profits
- The tax rates of its shareholders
- Strategic plans and their timing to sell the company or transition ownership
- The impact of the C corporation's double-taxation penalty on income distributed as dividends

When Is an S Corporation a Wise Choice?

Choosing S corporation status is usually beneficial to start-up companies that anticipate net losses and to highly profitable firms with substantial dividends to pay out to shareholders. In these cases, the owner can use the loss to offset other income or is in a lower tax bracket than the C corporation, thus reducing his or her tax bills. Companies that plan to reinvest most of their earnings to finance growth also find S corporation status favorable. Small business owners who intend to sell their companies in the future prefer S status over C status because the capital gains tax on the sale of the assets of an S corporation is lower than those on the sale of a C corporation.

Small companies with the following characteristics are *not* likely to benefit from S corporation status:

- Highly profitable companies with large numbers of shareholders in which most of the profits are passed on to shareholders as compensation or retirement benefits
- Shareholders who pay marginal tax rates that are higher than the marginal tax rates that C corporations pay
- Fast-growing companies that must retain most of their earnings to finance growth and capital spending
- Corporations in which the cost of employee benefits to shareholders exceeds the tax savings that S status produces

The Limited Liability Company

Like an S corporation, the limited liability company (LLC) is a hybrid structure that features elements of a partnership and a corporation. Because of the advantages it offers and its flexibility, the LLC is the fastest-growing form of business ownership. LLCs provide owners with many of the benefits of S corporations but are not subject to the restrictions imposed on S corporations. For instance, an LLC offers its owners limited liability without imposing any requirements on their characteristics or any ceiling on their numbers. LLCs do not restrict their members' ability to become involved in managing the company, unlike a limited partnership, which prohibits limited partners from participating in day-to-day management of the business.

Although an LLC can have just one owner, most have multiple owners (called *members*). LLCs offer its members the advantages of limited liability and avoiding the double taxation imposed on C corporations. Like an S corporation, an LLC does not pay income taxes; its income flows through to the members, who are responsible for paying income taxes on their shares of the LLC's net income. LLCs permit their members to divide income and thus tax liability as they see fit, just as in a partnership.

Creating an LLC is much like creating a corporation. Forming an LLC requires an entrepreneur to file the articles of organization with the secretary of state. The LLC's **articles of organization**, similar to the corporation's articles of incorporation, establish the company's name, its method of management (board managed or member managed), its duration, and the names and addresses of its organizers. In most states, the company's name must contain the words *limited liability company*, *limited company*, or the letters LLC or LC. LLCs can have a defined term of

6.

Describe the features of the limited liability company.

duration, or it can elect to be an “at-will” LLC that has no specific term of duration. However, the same factors that would cause a partnership to dissolve also cause an LLC to dissolve before its charter expires.

Although an operating agreement is not required by law, it is essential for entrepreneurs who form LLCs to create one. The LLC **operating agreement** is similar to a corporation’s bylaws and outlines the provisions governing the way the LLC will conduct business by defining members’ voting rights and power, their percentages of ownership, how profits and losses are distributed, and other important matters. To ensure that an LLC is classified as a partnership for tax purposes, an entrepreneur must carefully draft the operating agreement. The operating agreement must create an LLC that has more characteristics of a partnership than of a corporation to maintain this favorable tax treatment. Specifically, an LLC cannot have any more than two of the following four corporate characteristics:

1. **Limited liability.** Limited liability exists if no member of the LLC is personally liable for the debts or claims against the company. Because entrepreneurs choosing this form of ownership usually get limited liability protection, the operating agreement almost always contains this characteristic.
2. **Continuity of life.** Continuity of life exists if the company continues to exist despite changes in stock ownership. To avoid continuity of life, any LLC member must have the power to dissolve the company. Most entrepreneurs choose to omit this characteristic from their LLC’s operating agreements. Thus, if one member of an LLC resigns, dies, or declares bankruptcy, the LLC automatically dissolves and all remaining members must vote to keep the company going.
3. **Free transferability of interest.** Free transferability of interest exists if each LLC member has the power to transfer his or her ownership to another person without the consent from other members. To avoid this characteristic, the operating agreement must state the recipient of a member’s LLC stock cannot become a substitute member without the consent of the remaining members.
4. **Centralized management.** Centralized management exists if a group that does not include all LLC members has the authority to make management decisions and to conduct company business. To avoid this characteristic, the operating agreement must state that the company elects to be “member managed.”

Despite their universal appeal to entrepreneurs, LLCs present some disadvantages. For example, they can be expensive to create. Although LLCs may be ideally suited for an entrepreneur launching a new company, it may pose problems for business owners who are considering converting an existing business to an LLC. Switching to an LLC from a general partnership, a limited partnership, or a sole proprietorship reorganizing to bring in new owners is usually not a problem. However, owners of corporations and S corporations can incur large tax obligations if they convert their companies to LLCs.

Table 5.3 summarizes the key features of the sole proprietorship, the partnership, the C corporation, the S corporation, and the LLC.

TABLE 5.3 Characteristics of the Major Forms of Ownership

Characteristic	Sole Proprietorship	General Partnership	Limited Partnership	C Corporation	S Corporation	Limited Liability Company
Definition	A for-profit business owned and operated by one person	A for-profit business jointly owned and operated by two or more people	One general partner and one or more partners with limited liability and no rights of management	An artificial legal entity separate from its owners and formed under state and federal laws	An artificial legal entity that is structured like a C corporation but taxed by the federal government like a partnership.	A business entity that provides limited liability like a corporation but is taxed like a partnership. Owners are taxed as if they are members

TABLE 5.3 (continued)

Characteristic	Sole Proprietorship	General Partnership	Limited Partnership	C Corporation	S Corporation	Limited Liability Company
Ease of formation	Easiest form of business to set up. If necessary, acquire licenses and permits, register fictitious name, and obtain taxpayer identification	Easy to set up and operate. A written partnership agreement is highly recommended. Must acquire an employer ID number. If necessary, register fictitious name	File a Certificate of Limited Partnership with the secretary of state. Name must show that business is a limited partnership. Must have written agreement, and must keep certain records	File articles of incorporation and other required reports with the secretary of state. Prepare bylaws and follow corporate formalities	Must meet all criteria to file as an S corporation. Must file timely election with the IRS (within two and a half months of first taxable year)	File articles of organization with the secretary of state. Adopt operating agreement and file necessary reports with secretary of state. The name must show it is a limited liability company
Owner's personal liability	Unlimited	Unlimited for general partners, limited for limited partners	Limited	Limited	Limited	Limited
Number of owners	One	Two or more	At least one general partner and any number of limited partners	Any number	Maximum of 100 with restrictions as to who they are	One (a few states require two or more)
Tax liability	Single tax: personal tax rate	Single tax: partners pay on their proportional shares at their individual rate	Same as general partnership	Double tax: corporation pays tax and shareholders pay tax on dividends distributed	Single tax: owners pay on their proportional shares at individual rate	Single tax: members pay on their proportional shares at individual rate
Current maximum tax rate	39.6%	39.6%	39.6%	39% corporate plus 39.6% individual	39.6%	39.6%
Transferability of ownership	Fully transferable through sale or transfer of company assets	May require consent of all partners	Same as general partnership	Fully transferable	Transferable (but transfer may affect S status)	Usually requires consent of all members
Continuity of the business	Ends on death or insanity of proprietor or upon termination by proprietor	Dissolves on death, insanity, or retirement of a general partner (business may continue)	Same as general partnership	Perpetual life	Perpetual life	Perpetual life
Cost of formation	Low	Moderate	Moderate	High	High	High
Liquidity of the owner's investment in the business	Poor to average	Poor to average	Poor to average	High	High	High
Ability to raise capital	Low	Moderate	Moderate to high	Very high	High	High
Formation procedure	No special steps required other than buying necessary business	No written partnership agreement required (but highly advisable)	Must comply with state laws regarding limited partnership	Must meet formal requirements specified by state law	Must follow same procedures as C corporation, then elect S corporation	Must meet formal requirements specified by state law

Social Enterprises

7.

Discuss the alternative options for corporate form, both for-profit and nonprofit, available to social entrepreneurs.

Traditionally, social enterprises were established as nonprofit corporations. However, today we see social entrepreneurs setting up for-profit social ventures, funneling any excess cash and profits into the social cause they are supporting. We also see nonprofits setting up sister for-profit businesses that can generate profits that directly benefit the nonprofit. New forms of organization address the changing nature of the philanthropic sector of the economy. This section provides an overview of the various organizational forms available to social entrepreneurs.

Gabrielle Palermo, Susanna Young and Clay Tyler launched their award winning social enterprise, G3Box, out of the Arizona State University incubator SkySong.

Source: ASU SkySong.



In the Entrepreneurial Spotlight

From the Life on the Street to Running a Business

Magdalene is a residential program for women who have survived lives of prostitution, trafficking, addiction, and life on the streets. An unlikely entrepreneur, Reverend Becca Stevens, an Episcopal priest who serves as Chaplain at St. Augustine's at Vanderbilt University, is Magdalene's founder.

Residents can remain at Magdalene for two years, where they receive housing, food, medical and dental needs, therapy, education, and job training. The program does not charge the residents and receives no government funding. Residents live in six homes that are run by residents without the assistance of any live-in staff. The residents, who are women ranging from age 20 to 50, come to Magdalene from prison and from the streets.

"I met this guy that was a pimp, and he took me under his wing; he took real good care of me, fed me with dope, and gave me clothes, a place to live, and I thought I was just in heaven," says Tara, a resident who was a prostitute from the age of 17 to 33 before being forced to live on the street. "And then one day he told me, 'hit the block.'"

Magdalene has high success rates, with 72% percent of the women remaining clean and sober two and a half years after beginning the program. After four months, the women find work,

return to school and/or enter Magdalene's job training program called Thistle Farms.

Thistle Farms is a social enterprise that is run by the women of Magdalene. The name is symbolic for the women who work at Thistle Farms. "Thistles [are] weeds that people despise; we take them and make something beautiful," says Reverend Stevens. The women of Thistle Farms create handmade, natural bath and body products. One of the goals for Thistle Farms is to make body products that are as good for the earth as they are for the body. Purchases of the products directly benefit the women working in Thistle Farms by helping them earn a living wage. Thistle Farms employs more than 40 Magdalene residents or graduates who learn skills in manufacturing, packaging, marketing and sales, and administration. Thistle Farms is housed in an 11,000-square-foot sales and manufacturing facility. Its products are available in more than 200 stores across the country.

Reverend Stevens is launching another social enterprise to help support her work with the residents of Magdalene: the Thistle Stop Café, which will be located adjacent to the Thistle Farms building. Like Thistle Farms, Thistle Stop Café will give survivors of trafficking, prostitution, and addiction an opportunity to

learn valuable job skills to help them move toward financial independence. Thistle Stop Café will offer a welcoming atmosphere while serving coffees, teas, sandwiches, wraps, and baked goods that are healthy, local, and fair trade. A stage and a professional quality sound system will be included, offering a platform for the women and community members to share their poetry, music, and stories. Sharing stories of healing, hope, and love is a vital part of the Magdalene and Thistle Farms community. “A story in every cup,” the Café’s mantra, is highlighted by a collection of donated teacups, each with a personal story behind it. These beautiful contributions will be commemorated in a special coffee-table book, including a photograph and the story behind each teacup.

“To watch all this stuff happening around you is wonderful, and to watch all the transformation in women’s lives, who I think a lot of people gave up on,” says Reverend Stevens, who was one of 15 people named as Champions of Change by President Obama in 2011. “You don’t have to worry about changing the world. The idea of loving the whole world one person at a time is a great way to live your life. Don’t worry about big or small. I’m okay being a drop in the bucket, and I love the idea of a thousand more people with us being drops in the bucket too. I want

the women here to be employed, to have financial security, and to be able to change their lives.”

1. How do the social enterprises founded by Reverend Becca Stevens create a “triple bottom line” as a social venture? Explain.
2. What are the advantages to creating social enterprises like Thistle Farms and Thistle Stop Café that rely on earned income for their financial viability? Explain.
3. What are the limitations of using an earned income model for social enterprises like Thistle Farms and Thistle Stop Café?
4. What recommendations would you make to Becca Stevens about the future growth of her social enterprises? What opportunities do you see for growth? What cautions would you offer her about growing and expansion?

Sources: Molly Theobald, “Thistle Farms Cultivates a Better Alternative to Life on the Streets,” *Christian Science Monitor*, February 8, 2012, www.csmonitor.com/World/Making-a-difference/Change-Agent/2012/0208/Thistle-Farms-cultivates-a-better-alternative-to-life-on-the-streets; Melinda Clark, “Magdalene and Thistle Farms Offer Prostitutes a Chance for Regrowth,” *Huffington Post*, April 26, 2011, www.huffingtonpost.com/2011/04/26/magdalene-and-thistle-farms_n_854130.html; Rob Simbeck, “Divinity Grads Aim to Compensate for the Chaos in Contemporary Society,” *Vanderbilt Magazine*, Fall 2010, www.vanderbilt.edu/magazines/vanderbilt-magazine/2010/12/acts-of-faith; www.thistlefarms.org.

Nonprofit Organizations

A nonprofit organization uses its revenues to pursue social value rather than to create personal value for investors. A nonprofit is essentially a public good, which is not owned by any individuals. Its purpose is to serve the public good by providing services for specific purposes. Churches, public schools, public charities, public clinics and hospitals, political organizations, legal aid societies, volunteer services organizations, labor unions, professional associations, research institutes, and museums are examples of nonprofit organizations. Nonprofit organizations are organized under state law but are granted tax-exempt status through the IRS. Nonprofit organizations generate most of their revenues from grants from foundations and government agencies, as well as from tax-deductible donations from individuals.

Social entrepreneurs establishing nonprofits should follow these steps when forming their organizations:

- **File the certificate of incorporation.** Just like a for-profit entity, a nonprofit corporation must file with the state to become a legal entity. The major difference is that a nonprofit corporation must include a **purpose clause**, which defines the social purpose that the nonprofit will pursue as its mission. There is a delicate balance with defining the purpose clause because founders should state the goals of the organization broadly enough to provide program flexibility in the future but not be so broad as to include goals the nonprofit will not pursue.



Nonprofit organizations, such as Habitat for Humanity, exist to create social value and enjoy tax-exempt status. Habitat for Humanity has grown to become one of the top-ten homebuilders in the United States.

Source: © bawinner/Fotolia.

- **Select individuals to serve on the board of directors.** The members of a nonprofit board must be passionate about the purpose of the organization. It is best if they have previous nonprofit board experience so that they know what to expect and what is expected from them. Board members should be well respected and well connected in the local community to help attract other board members and help in fund-raising efforts. It is also beneficial to add board members with specific expertise in areas such as banking, real estate, nonprofit law, and accounting to help reduce the need to pay for this expertise.
- **Develop a mission statement.** The mission statement should clearly capture the organization's beliefs and values and define its overriding purpose that will guide the daily operation of the organization.
- **Establish bylaws and board policies.** The bylaws are the legal rules that define how the organization will operate, particularly the rules that the board and the executive leadership will follow as they guide the organization. The board policies set up specific rules for board members, such as conflict of interest policies, attendance policies, and financial oversight policies.
- **File required forms with the IRS.** Form SS-4 filed with the IRS gives the IRS the official name of the organization and leads to the issuance of an employer identification number, which is the corporate version of a social security number. Form 1023 is used to request tax-exempt status under Section 501(c)(3) with the IRS. It can take up to six months for the IRS to grant a nonprofit's tax-exempt status, which allows donors to deduct gifts to the organization on their personal tax returns and is required status to receive many grants.
- **Develop a fund-raising plan.** Since the Great Recession, fund-raising has been a major challenge for nonprofits. A nonprofit's fund-raising plan should be diversified with a combination of grants, donations, and even earned-income opportunities.

FOR-PROFIT SOCIAL VENTURES Rather than deal with the challenges of starting and maintaining a nonprofit, many social entrepreneurs are forgoing nonprofit status and setting up their organizations as traditional corporations or LLCs. Although their primary goal is creating social value, the for-profit structure requires financial viability by paying attention to the financial objectives that guide any corporation. The dual focus of these entities is known as a **double bottom line**—both social and financial objectives guide decision making and define true success.



Tom's Shoes is an example of a for-profit social enterprise. Profits from the sale of its shoes in the United States are used to give free shoes to needy children in developing countries around the globe.



ENTREPRENEURIAL PROFILE: Cooperative Home Care Associates Cooperative Home Care Associates (CHCA) is a for-profit, worker-owned cooperative in South Bronx, New York. CHCA's mission is to create social value by providing employment opportunities for low-income, predominantly minority women while also profitably improving the quality of the home health care industry. "According to recent statistics, CHCA offered above average wages and benefits to over 550 African-American and Latina women, 75 percent of whom had been dependent on public assistance," says Beth Anderson, managing director of Duke University's Center for the Advancement of Social Entrepreneurship. "Moreover, nearly 80% of CHCA's employees with over one year's seniority shared in the cooperative's ownership." CHCA now anchors a national cooperative network generating more than \$60 million annually in revenue and creating quality jobs for more than 1,600 individuals.¹³

Just like any for-profit corporation, for-profit social enterprises are subject to market forces. A disadvantage of these entities is that if they are not successful in achieving their financial objectives, the "other bottom line" of their social mission suffers. For example, ShoreBank Corporation was organized in Chicago, Illinois, as a for-profit bank holding company. Its mission was to demonstrate that a commercial bank could profitably invest in inner-city neighborhoods that other financial institutions were neglecting. ShoreBank defined its "triple bottom line" of economically improving inner-city communities, promoting environmental health, and operating profitably. Unfortunately, the bank suffered the fate of many commercial banks during the Great Recession, and after mounting losses and an inability to raise more funding, the Federal Deposit Insurance Corporation closed ShoreBank and transferred its assets to Citicorp's Loan Participation Bank.¹⁴

TABLE 5.4 The L3C Versus the Traditional LLC and Nonprofit

Type of Corporation	Organizational Purpose	Potential ROI	Private Sector Resources
LLC	Financial	5% or more	Market driven; making money and building wealth
L3C	Financial and mission related	Between 0% and 5%	Philanthropic source invests with a lower than market rate of return; philanthropic investment lowers the risk and raises potential ROI for subsequent investors
Nonprofit	Mission related	0% to negative 100%	Market incentives inadequate or nonexistent

Source: Americans for Community Development, www.americansforcommunitydevelopment.org.

NEW FORMS OF SOCIAL VENTURES The low-profit limited liability company (L3C) is a new form of organization that is a cross between a nonprofit and a for-profit LLC. The L3C was first approved in Vermont in 2008 and is now an option for social entrepreneurs in eight other states. The L3C builds on the structure of the existing LLC; it provides the liability protection of a corporation, can sell shares of ownership, and is not tax exempt. Unlike an LLC, L3Cs are specifically formed to pursue a social mission. The L3C is meant to integrate the best of both the nonprofit and the for-profit LLC by creating a market for investments in financially risky but socially beneficial activities. Table 5.4 compares the traditional LLC and nonprofit organizations with the L3C.

Chapter Review

- Discuss the issues that entrepreneurs should consider when evaluating different forms of ownership.
 - The key to choosing the “right” form of ownership is to understand the characteristics of each form and knowing how they affect an entrepreneur’s personal and business circumstances.
 - Factors to consider include tax implications, liability expense, start-up and future capital requirements, control, managerial ability, business goals, management succession plans, and cost of formation.
- Describe the advantages and disadvantages of the sole proprietorship.
 - A sole proprietorship is a business owned and managed by one individual and is the most popular form of ownership.
 - Sole proprietorships offer these advantages:
 - Simple to create
 - Least costly to begin
 - Owner has total decision-making authority
 - No special reporting requirement or legal restriction
 - Easy to discontinue
 - Sole proprietorships suffer from these disadvantages:
 - Unlimited personal liability of owner
 - Limited managerial skills and capabilities
 - Limited access to capital
 - Lack of continuity
- Describe the advantages and disadvantages of the partnership.
 - A partnership is an association of two or more people who co-own a business for the purpose to make a profit.
 - Partnerships offer these advantages:
 - Easy to establish
 - Complementary skills of partners
 - Division of profits
 - Large pool of capital available
 - Ability to attract limited partners
 - Little government regulation
 - Flexibility
 - Tax advantages
 - Partnerships impose these disadvantages:
 - Unlimited liability of at least one partner
 - Difficulty in disposing of partnership interest
 - Lack of continuity
 - Potential for personal and authority conflicts
 - Partners are bound by the law of agency
- Describe the advantages and disadvantages of the corporation.
 - A limited partnership operates like any other partnership except that it allows limited partners—primary investors who cannot take an active role in managing the business—to become owners without subjecting themselves to unlimited personal liability of the company’s debts.

- A corporation is a separate legal entity and the most complex of the three basic forms of ownership.
 - To form a corporation an entrepreneur must file the articles of incorporation with the state in which the company will incorporate.
 - Corporations offer these advantages:
 - Limited liability of stockholder
 - Ability to attract capital
 - Ability to continue indefinitely
 - Transferable ownership
 - Corporations suffer from these disadvantages:
 - Cost and time involved in incorporation
 - Double taxation
 - Potential for diminished managerial incentives
 - Legal requirement and regulatory red tape
 - Potential loss of control by the founders
5. Describe the features of the S corporation.
 - An S corporation offers its owners limited liability protection but avoids the double taxation of C corporations.
 - S corporations retain all of the advantages of a regular corporation, including continuity of existence, transferability of ownership, and limited personal liability for its owners.
 6. Describe the features of the limited liability company.
 - A limited liability company (LLC), like an S corporation, is a cross between a partnership and a corporation and offers many of the advantages of each. However, it operates without the restrictions imposed on an S corporation. To create an LLC, an entrepreneur must file the articles of organization and the operating agreement with the secretary of state.
 - LLCs can be expensive to create.
 7. Discuss the alternative options for corporate form, both for-profit and nonprofit, available to social entrepreneurs.
 - Traditionally, social enterprises were established as nonprofit corporations.
 - Social entrepreneurs have begun to set up for-profit social ventures, funneling any excess cash and profits into the social cause they are supporting. Nonprofits are setting up sister for-profit businesses that can generate profits that directly benefit the nonprofit.
 - A new form of organization called a low-profit limited liability company (L3C) has been introduced in nine states. It blends the advantages of both a nonprofit and an LLC for social entrepreneurs.

Discussion Questions

- 5-1. Which are the different forms of ownership available to an entrepreneur when starting a new venture?
- 5-2. Why are sole proprietorships the most popular form of ownership?
- 5-3. Describe the disadvantages of a sole proprietorship.
- 5-4. Why are the articles important to a successful partnership? What issues should the articles of partnership address?
- 5-5. What are the contents of a standard partnership agreement?
- 5-6. Explain the differences between a domestic corporation, a foreign corporation, and an alien corporation.
- 5-7. Describe the advantages and disadvantages of a corporation.
- 5-8. How does an S corporation differ from a regular corporation?
- 5-9. What role do limited partners play in a partnership? What will happen if a limited partner takes an active role in managing the business?
- 5-10. What advantages does a limited liability company offer over an S corporation? Over a sole proprietorship?
- 5-11. How is an LLC created? How does this differ from creating an S corporation?
- 5-12. Describe the features of an LLP.
- 5-13. What are the advantages to organizing as a nonprofit for a social entrepreneur? What are the critical steps a social entrepreneur must take to launch a nonprofit?
- 5-14. How can a for-profit pursue a social mission? What is meant by a “double bottom line” for such an organization?
- 5-15. What is an L3C? How is it similar to and how is it different than an LLC?

CHAPTER 6

Franchising and the Entrepreneur



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain the importance of franchising in the U.S. and global economy.
2. Define the concept of franchising.
3. Describe the different types of franchises.
4. Describe the benefits of buying a franchise.
5. Describe the limitations of buying a franchise.
6. Describe the legal aspects of franchising, including the protection offered by the Federal Trade Commission's Trade Regulation Rule.
7. Explain the right way to buy a franchise.
8. Describe a typical franchise contract and its primary provisions.
9. Explain current trends that are shaping franchising.
10. Describe the potential of franchising a business as a growth strategy.

With franchising, you don't have to reinvent the wheel; you just roll the wheel.

—Angelo Crowell, former National Football League player and current owner of two Jersey Mike's Subs franchises

Good judgment comes from experience. Experience comes from bad judgment.

—Bob Packwood

1.

Explain the importance of franchising in the U.S. and global economy.

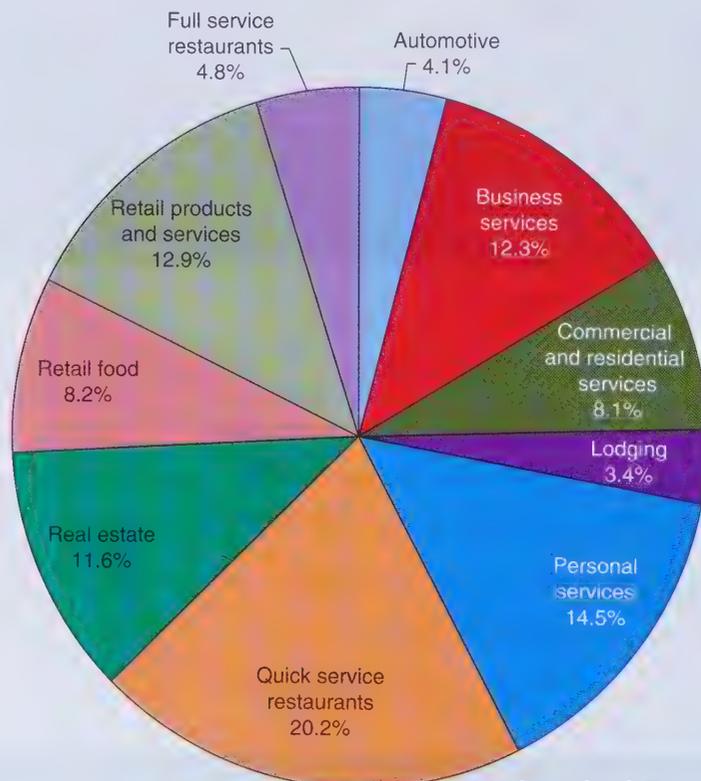
Miles Blauvelt began working in his father's Jiffy Lube franchise when he was just 14 years old. He started at the bottom of the organization and worked his way up to a management position in the business while earning his business degree from the University of Maryland at College Park. At the age of 23, Blauvelt, already an experienced manager, took over ownership of the franchise and became the youngest franchisee in the history of the Jiffy Lube chain. "I am thrilled to carry on the family tradition by taking over the business my father worked so hard to build," he says. Blauvelt already has implemented several new ideas that have increased the franchises' sales, including creating a business presence in social media, using direct mail advertisements, and supporting local charities and school sports programs to raise the company's visibility. "The thing I enjoy most about being a franchisee is owning my own business," says Blauvelt. "There is nothing more rewarding than being your own boss. I am accountable for all business-related issues to ensure that the center is operating smoothly."¹

Franchises like Miles Blauvelt's are an important part of the American business system. Much of franchising's popularity arises from its ability to offer those who lack business experience the chance to own and operate a business with a high probability of success. Franchising's reach now extends far beyond the traditional fast-food outlets and auto dealerships. Shoppers can buy nearly every kind of good or service imaginable through franchises—from insurance and health care to hardware and pet waste pickup (see Figure 6.1). More than 757,000 franchise outlets operate in the United States, generating more than \$802 billion in total economic output. Franchised businesses make up less than 3 percent of all businesses, but they employ more than 8.2 million people, generate \$304 billion in annual payroll, and add more than \$460 billion to the nation's gross domestic product.²

Franchising also has a significant impact on the global economy as well. American franchisors are expanding globally to reach their growth targets. A survey by the International Franchise Association reports that 61 percent of its members operate in international markets and that 74 percent of franchisors plan to accelerate the growth of their global franchised units in the near future. In addition, 32 percent of the units of the 200 largest U.S. franchisors are located outside the United States.³ Countries that are attracting the greatest attention for international expansion among franchisors include Brazil, Russia, India, China, and nations in the Middle East and North

FIGURE 6.1
Franchised Businesses by Product or Service Line

Source: 2012 Franchised Business Economic Outlook, International Franchising Association, January 2012, p. 2.



Africa region. With their fast-growing populations, rising levels of disposable income, spreading urbanization, and keen interest in American brands, these nations offer prime growth opportunities for U.S. franchisors.

What Is a Franchise?

In **franchising**, semi-independent business owners (franchisees) pay fees and royalties to a parent company (franchisor) in return for the right to become identified with its trademark, to sell its products or services, and often to use its business format and system. Franchisees do not establish their own autonomous businesses; instead, they buy a “success package” from the franchisor, who shows them how to use it. Franchisees, unlike independent business owners, don’t have the freedom to change the way they run their businesses—for example, shifting advertising strategies or adding new products—but they do have access to a formula for success that the franchisor has worked out. Fundamentally, when they buy their franchises, franchisees are purchasing a successful business model. The franchisor provides a business system and the expertise to make it work; the entrepreneur brings the investment, spirit, and drive necessary to implement the system successfully.

Many franchisees say that buying a franchise is like going into business *for* yourself but not *by* yourself. Although franchisees own their own outlets, they must operate them according to the system that the franchisor has developed. One writer explains,

The science of franchising is an exacting one; products and services are delivered according to tightly-wrapped operating formulas. There is no variance. A product is developed and honed under the watchful eye of the franchisor, then offered by franchisees under strict quality standards. The result: a democratization of products and services. Hamburgers that taste as good in Boston as in Beijing. Quick lubes available to everyone, whether they drive a Toyota or a Treblinka.⁴

Franchising is built on an ongoing relationship between a franchisor and a franchisee. The franchisor provides valuable services such as a proven business system, training and support, name recognition, and many other forms of assistance; in return, the franchisee pays an initial franchise fee as well as an ongoing percentage of his or her outlet’s sales to the franchisor as a royalty and agrees to operate the outlet according to the franchisor’s terms. Because franchisors develop the business systems their franchisees use and direct their distribution methods, they maintain substantial control over their franchisees. Entrepreneurs who insist on doing things their own way usually do not make good franchisees. Successful franchisors claim that failing to follow the formula that they have developed is one of the main reasons that franchisees fail. “First and foremost, franchising demands that you ‘follow the system,’” says Nicholas Bibby, a franchise consultant. “Whether the business is a major food brand or a home-based franchise, you must be a team player who is willing to follow the rules. If changing the order of things is among your favorite pastimes, think seriously about another form of self-employment. The best franchises simply have the best systems.”⁵ In other words, successful franchisees tend to follow the franchisor’s business recipe. This standardized, formulaic approach lies at the core of franchising success.

2. Define the concept of franchising.



Source: ZITS © 2011 Zits Partnership, Dist. By King Features.

Types of Franchising

3. Describe the different types of franchises.

Franchising includes three basic types of systems: trade-name franchising, product distribution franchising, and pure franchising. Each of these forms of franchising allows franchisees to benefit from the parent company's identity.

Trade-name franchising involves being associated with a brand name, such as True Value Hardware or Western Auto. In trade-name franchising, a franchisee purchases the right to become identified with the franchisor's trade name without distributing particular products exclusively under the manufacturer's name.

Product distribution franchising involves licensing the franchisee to sell specific products under the manufacturer's brand name and trademark through a selective, limited distribution network. This system is commonly used to market automobiles (General Motors and Toyota), gasoline products (Exxon Mobil and Chevron), soft drinks (Pepsi Cola and Coca-Cola), and other products.

Pure franchising (or **comprehensive franchising** or **business format franchising**) involves providing franchisees with a complete business format, including a license for a trade name, products or services to be sold, store or building design, methods of operation, a marketing plan, a quality control process, and a network of business support services. The franchisee purchases the right to use all the elements of a fully integrated business operation. Business format franchising is the most common and is the fastest growing of the three types of franchising. It is common among restaurants, hotels, business service firms, car rental agencies, automotive service and repair shops, and many other types of businesses. Business format franchises account for nearly 95 percent of all franchised outlets.⁶

The Benefits of Buying a Franchise

4. Describe the benefits of buying a franchise.

The primary reason for franchising's success is the mutual benefits it offers both franchisors and franchisees. The ideal franchising relationship is a partnership based on trust and a willingness to work together for mutual success (see Figure 6.2). The most successful franchisors are the ones that see their franchisees as business partners. They recognize that *their* success depends on their *franchisees'* success.

FIGURE 6.2
The Franchising Relationship

Source: Adapted from Economic Impact of Franchised Businesses: A Study for the International Franchise Association, National Economic Consulting Practice of PriceWaterhouseCoopers (New York: IFA Educational Foundation, 2004), pp. 3, 5.

Element	The Franchisor	The Franchisee
		
Site selection	Oversees and approves; may choose site	Chooses site with franchisor's approval
Design	Provides prototype design	Pays for and implements design
Employees	Makes general recommendations and training suggestions	Hires, manages, and fires employees
Products and services	Determines product or service line	Modifies only with franchisor's approval
Prices	Can only recommend prices	Sets final prices
Purchasing	Establishes quality standards; provides list of approved suppliers; may require franchisees to purchase from the franchisor	Must meet quality standards; must purchase only from approved suppliers; must purchase from supplier if required
Advertising	Develops and coordinates national ad campaign; may require minimum level of spending on local advertising	Pays for national ad campaign; complies with local advertising requirements; gets franchisor's approval on local ads
Quality control	Sets quality standards and enforces them with inspections; trains franchisees	Maintains quality standards; trains employees to implement quality systems
Support	Provides support through an established business system	Operates business on a day-to-day basis with franchisor's support

Franchisees get the opportunity to own a small business relatively quickly, and, because of the identification with an established product and brand, a franchise often reaches the break-even point faster than an independent business would. Still, most new franchise outlets don't break even for at least six to 18 months.



ENTREPRENEURIAL PROFILE: Allie and Hung Lam: Children's Lighthouse Learning

Center Copreneurs Allie and Hung Lam invested more than \$2 million to open a Children's Lighthouse Learning Center, a franchise that provides educational child care for children from six weeks to 12 years old, in Richmond, Texas. Their substantial investment covered the cost of franchise fees, land, building and furnishings, and hiring 35 staff members. The Lam's center was so successful that it reached its break-even point in just four months, prompting the couple to open a second center in Katy, Texas. Their second center reached its break-even point in just one month!⁷

Franchisees also benefit from the franchisor's business experience. In fact, *experience* in the form of a proven business system is, in essence, what a franchisee buys from a franchisor. The franchisor's knowledge, expertise, and experience in the industry provide a competitive advantage for franchisees. Given the thin margin for error in a start-up business, independent entrepreneurs cannot afford to make too many mistakes. In a franchising arrangement, the franchisor already has worked out the kinks in the system, often by trial and error, and franchisees benefit from that experience. Franchisors already have climbed up the learning curve and share with their franchisees the secrets to success that they have learned. This ability to draw on the franchisor's experience and benefit from their support acts as a safety net for entrepreneurs as they build their businesses.



ENTREPRENEURIAL PROFILE: Patrick Sinclair: Kona Ice

After Patrick Sinclair opened an independent shaved-ice shop in the Garden Oaks neighborhood in Houston, Texas, he saw an opportunity for a mobile shaved-ice business that he could take to customers. Rather than build his own truck, however, Sinclair decided to rely on the experience of a franchise. He researched franchise opportunities and found Kona Ice, a shaved-ice truck franchise based in Kentucky, and signed on to operate 10 trucks within the next several years. "I could have spent \$600,000 and gone through four or five prototypes," he says, "but there's value in skipping past a thousand mistakes. Kona Ice had already made those mistakes and ironed them out."⁸

Before jumping into a franchise, an entrepreneur should ask, "What can a franchise do for me that I cannot do for myself?" The answer depends on one's particular situation and is just as important as a systematic evaluation of any franchise opportunity. After careful deliberation, an entrepreneur may conclude that a franchise offers nothing that he or she cannot do on his or her own; on the other hand, it may turn out that a franchise is the key to success for an entrepreneur.



ENTREPRENEURIAL PROFILE: David Ambinder: Mr. Handyman

David Ambinder worked as an executive on Wall Street for 25 years before being laid off from Lehman Brothers just before the financial services company went bankrupt. Rather than take a chance on another corporate layoff, Ambinder decided to create his own job security by owning his own business. For Ambinder, the structure, support, and safety net of a franchise was ideal. "For me, it's the right move," he says. After investigating several franchise options, Ambinder opened a Mr. Handyman franchise, a company that provides skilled repairmen for a variety of home repair jobs, in Union, New Jersey.⁹

Ambinder is one of many corporate castoffs and dropouts who have discovered that franchising offers them the ideal blend of corporate support to which they are accustomed and the freedom of entrepreneurship.

Let's explore the advantages of buying a franchise.

A Business System

One major benefit of joining a franchise is gaining access to a tested business system. Tariq Faird, founder and CEO of franchisor Edible Arrangements, says that he learned the importance of a solid business system when he started working for McDonald's at age 15. "I loved the system," he says. When Faird started Edible Arrangements, he put into place the same types of systems that he learned to appreciate many years before at McDonald's and credits those with his company's success.¹⁰ In many cases, the systems that franchisors have developed over time allow entrepreneurs to get their businesses up and running much faster,

more efficiently, and more effectively than if they launched their own independent companies. Using the franchisor's business system as a guide, franchisees can be successful even though they may have little or no experience in the industry. Mark Daly, media director for Anytime Fitness, a franchise based in Hastings, Minnesota, that operates nearly 2,000 franchises in 49 states and 10 countries, says, "Previous experience in the fitness industry is not needed to own a successful club. All you need is the passion to help people and to follow the business model."¹¹

Management Training and Support

Franchisors want to give their franchisees a greater chance for success than independent businesses and offer management training programs to franchisees prior to opening a new outlet. Many franchisors, especially the well-established ones, also provide follow-up training and consulting services. This service is vital because most franchisors do not require a franchisee to have experience in the business. These programs teach franchisees the details they need to know for day-to-day operations as well as the nuances of running their businesses successfully. "Just putting a person in business, giving him a trademark, patting him on the [back], and saying, 'Good luck,' is not sufficient," says one franchise consultant.¹²

Training programs often involve both classroom and on-site instruction to teach franchisees the basic operations of the business—from producing and selling the goods or services to purchasing raw materials and completing paperwork. McDonald's is famous for Hamburger University, where franchisees and their employees go to learn the proper systems and procedures for operating a restaurant successfully. Training involves classroom instruction from 19 faculty members from around the world, hands-on activities, simulations of events that franchisees are likely to encounter, and computerized e-learning modules at one of seven Hamburger University centers around the world. More than 275,000 people have graduated from Hamburger University, earning their degrees in Hamburgerology.¹³ Additional training takes place in existing McDonald's restaurants over 12 to 24 months.

Franchisees at Zaxby's, a fast-casual chain of chicken restaurants, receive six weeks of training in a variety of venues before opening their stores. The first component of the program involves classroom training at Zaxby's headquarters, where they learn about the company's culture and expectations. Then franchisees go into Zaxby's restaurants, where they learn the details of daily operations from existing franchisees. For the final part of their training, franchisees return to headquarters to learn about Zaxby's franchise support system and to take a final written and hands-on test.¹⁴ Although these training programs are beneficial to running a successful franchise, franchisees should not expect a two- to five-week program to make them management experts. The necessary management skills for any business are too complex to learn in any single course.

Many franchisors supplement their start-up training programs with ongoing instruction and support to ensure franchisees' continued success. Franchisors often provide field support to franchisees in customer service, quality control, inventory management, and general management. Franchisors may assign field consultants to guide new franchisees through the first week or two of operation after the grand opening. Zaxby's offers its franchisees a Web-based Learning Center, where they can take refresher courses, view videos, listen to podcasts, participate in discussion boards, and access an online library.¹⁵

Hamburger University, the training ground for McDonald's franchisees.

Source: Mark Peterson/Corbis.



The support system that franchisees provide often is the key to franchisees' success.



ENTREPRENEURIAL PROFILE: Katie Reinisch: Red Mango Although Katie Reinisch had no experience in the yogurt business, she left her job as communications director in the Colorado legislature to open a Red Mango franchise in Denver with her husband. “We’d always wanted to own something instead of just getting a paycheck,” she says. After researching several franchise options, the couple settled on Red Mango, and the support system the franchisor offers was one of the deciding factors. “The company held my hand, gave me manuals, and gave me guidance every step of the way,” says Reinisch. Including assisting the couple in finding a high-traffic location that is drawing a highly diverse customer base. “It’s been hard and challenging and terrific,” she admits, “but this is the perfect job for me. It’s like hosting a party all of the time.”¹⁶

Brand-Name Appeal

Franchisees purchase the right to use a known and advertised brand name for a product or service, giving them the advantage of identifying their businesses with a widely recognized name. Customers recognize the identifying trademark, the standard symbols, the store design, and the products of an established franchise. In fact, a basic tenet of franchising is cloning the franchisor’s success. Customers can be confident that the quality and content of a meal at McDonald’s in Fort Lauderdale will be consistent with a meal at a San Francisco McDonald’s. Because of a franchise’s name recognition, franchisees who have just opened their outlets often discover a ready supply of customers eager to purchase their products or services. Entrepreneurs who launch independent businesses may have to work for years and spend many thousands of dollars in advertising to build a customer base of equivalent size. One franchising expert explains, “The day you open a McDonald’s franchise, you have instant customers. If you choose to open [an independent] hamburger restaurant, you’d have to spend a fortune on advertising and promotion before you’d attract [that many] customers.”¹⁷

Standardized Quality of Goods and Services

Many entrepreneurs choose to operate franchises because of the quality and selection of products and services that the franchisor has developed, a task that could take many years to accomplish independently. Amy McAnarney, president of retail client services for H&R Block, a tax preparation franchise with more than 4,500 locations across the United States, says that franchisees are drawn to the company because of its well-known brand and “the products and services that H&R Block brings.” Franchisees have access to the latest tax code software, expert advice from the company’s Tax Institute, and extensive, ongoing training for all tax preparers. In addition, the company provides its franchisees with a full complement of revenue-enhancing products, including prepaid debit cards, savings accounts, and lines of credit.¹⁸

Because a franchisee purchases a license to sell the franchisor’s product or service for the privilege of using the associated brand name, the quality of the goods or service franchisees sell determines the franchisor’s reputation. Building a sound reputation in business can be a slow process, but destroying a good reputation takes no time at all. If some franchisees are allowed to operate at substandard levels, the image of the entire chain suffers irreparable damage; therefore, franchisors demand strict compliance with uniform standards of quality and service throughout the chain. Many franchisors conduct periodic inspections of local facilities to assist in maintaining acceptable levels of performance. Maintaining quality is so important that most franchisors retain the right to terminate the franchise contract and to repurchase the outlet if the franchisee fails to comply with established standards.

National Advertising Programs

An effective advertising program is essential to the success of virtually all franchise operations. Marketing a brand-name product or service over a wide geographic area requires a far-reaching advertising campaign. A regional or national advertising program benefits all franchisees, and most franchisors have one. In fact, one study reports that 79 percent of franchisors require franchisees to contribute to a national advertising fund (the average amount is 2 percent of sales).¹⁹ Typically, these advertising campaigns are organized and controlled by the franchisor, but franchisees actually pay for the campaigns. In fact, they are financed by each franchisee’s contribution of a percentage of sales, usually 1 to 5 percent, or a flat monthly fee. For example, Subway franchisees pay 4.5 percent of gross revenues to the Subway national advertising program. The

franchisor pools these funds to create a cooperative advertising program, which has more impact than if the franchisees spent the same amount of money separately. The result is that franchisees associated with a well-developed system do not have to struggle for recognition in the local marketplace as much as an independent owner might.

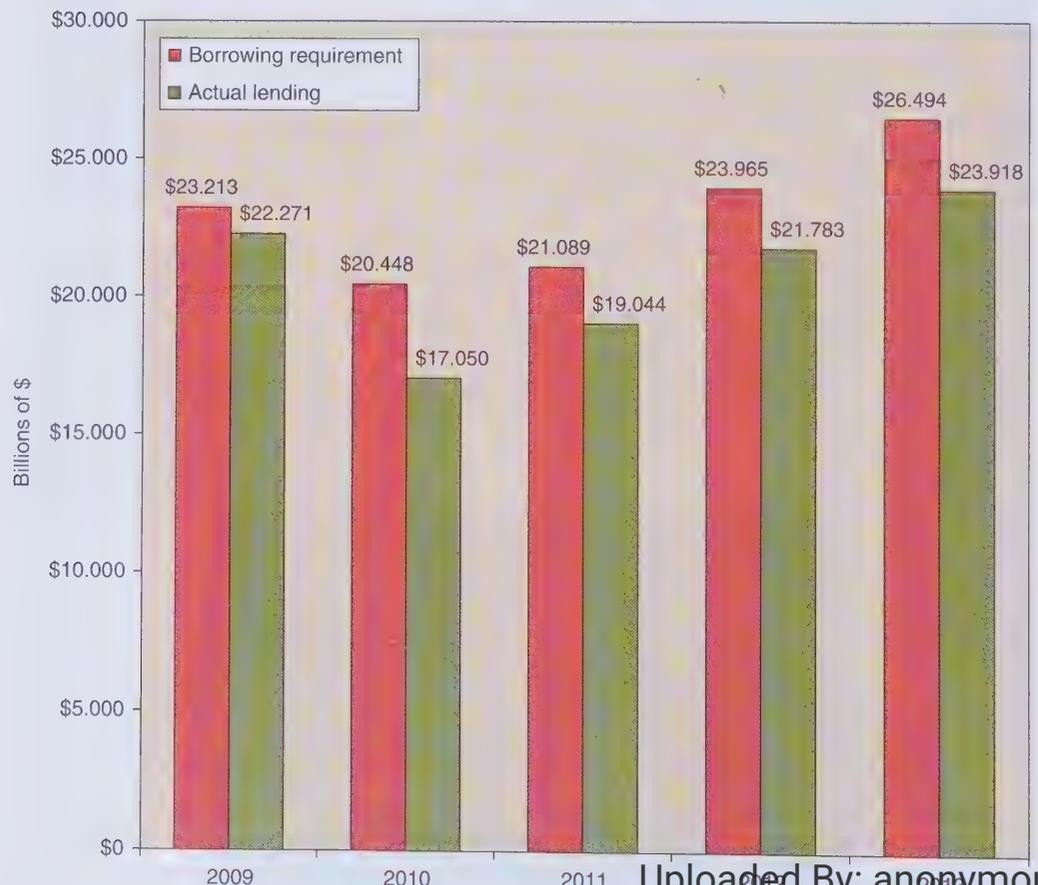
Many franchisors also require franchisees to spend a minimum amount on local advertising. In fact, 41 percent of franchisors require their franchisees to invest in local advertising (once again, the average amount is 2 percent of sales).²⁰ To supplement Wendy's national advertising efforts (to which franchisees contribute 3.25 percent of gross sales), Wendy's requires franchisees to spend at least 0.75 percent of gross sales on local and regional advertising. Some franchisors assist franchisees in designing and producing local advertising. Many companies help franchisees create promotional plans and provide press releases, advertisements, and special materials, such as signs and banners for grand openings and special promotions.

Financial Assistance

Purchasing a franchise can be just as expensive (if not more so) than launching an independent business. Although franchisees typically invest a significant amount of their own money in their businesses, most of them need additional financing. According to a recent study by the International Franchise Association, more than 80 percent of franchisors say that limited access to credit has slowed their ability to expand.²¹ The study estimates the funding gap between the capital that franchises need to grow and the capital that lenders actually provide at between 20 and 23 percent per year for the last several years (see Figure 6.3). In the most recent year analyzed, franchises requested \$26.5 billion in new lending capital, but lenders provided only \$23.9 billion, leaving a significant funding gap that represents about 6,400 franchises that were not created.²² Some franchisors are willing to provide at least a portion of that additional financing through their own internal financing programs. A basic principle of franchising is to use franchisees' money to grow the franchisor's business, but some franchisors realize that because start-up costs have reached breathtakingly high levels, they must provide financial help for franchisees. In fact, a study by

FIGURE 6.3
Franchise Lending Activity

Source: Based on data from Small Business Lending Matrix and Analysis, FRANData, Volume V, March 2013, p. 18.



FRANdata, a franchising research company, reports that 20 percent of franchisors offer direct financing to their franchisees.²³ Small franchise systems are more likely to provide direct financial assistance to franchisees than are larger, established franchisors. Once a franchisor locates a suitable prospective franchisee, it may offer the qualified candidate direct financial assistance in the form of financing for equipment or inventory purchases or even the franchise fee. To make their franchises more affordable to prospective franchisees, some franchisors have reduced their fees and waived royalty payments for the first few months of a new franchise's operation. Huddle House, a restaurant chain founded in Decatur, Georgia, in 1964 by John Sparks, recently started a program that cuts \$5,000 from the initial franchise fee (which ranges from \$12,500 to \$25,000) and contributes \$5,000 to help new franchisees with their marketing efforts.²⁴

Traditionally, financial assistance from franchisors takes a form other than direct loans, leases, or short-term credit. Franchisors usually assist qualified franchisees with establishing relationships with banks, nonbank lenders, and other sources of funds. The support and connections from the franchisor enhance a franchisee's credit standing because lenders recognize the lower failure rate among established franchises. Tight credit standards in the last several years have made this benefit all the more important to prospective franchisees. "Today, if franchisors want to keep their growth engines humming, they must work with lenders to help their franchisees receive loan approvals to open new stores," says Lex Lane, a top manager at United Capital Business Lending.²⁵

The International Franchise Association and the Consumer Bankers Association have created the Franchise Registry, a program that is designed to increase franchise lending by providing bank financing and loan guarantees to franchisees through the Small Business Administration (SBA) (more on the SBA's loan guarantee programs is provided in Chapter 17). The Franchise Registry streamlines and expedites the loan application process for franchisees who pass the screening tests at franchises that are members of the Registry. More than 3,000 franchises ranging from AAMCO Transmissions (automotive repair) to Zaxby's (fast-food chicken restaurants) participate in the Franchise Registry program. Approximately 6.3 percent of all SBA loan guarantees go to franchisees, and the amount typically ranges from \$250,000 to \$500,000.²⁶

BoeFly offers an online service for fees that range from \$100 to \$500 that matches franchisees' loan request with more than 2,200 national, regional, and local lenders. Mohammed Azam recently used BoeFly's loan matching service to connect with eight potential lenders and acquire an SBA-guaranteed loan to finance the purchase of his first Great Clips hair salon franchise.²⁷

Proven Products and Business Formats

A franchisee is purchasing the franchisor's experience, expertise, products, and support. A franchise owner does not have to build a business from scratch. Rather than relying solely on personal ability to establish a business and attract a clientele, the franchisee can depend on the methods and systems of an established business. These standardized procedures and operations greatly enhance the franchisee's chances of success and avoid the most inefficient type of learning—trial and error. "When we say 'Do things our way,' it's not just an ego thing on the part of the franchisor," says an executive at Subway Sandwiches and Salads. "We've proven it works."²⁸

Reputable franchisors also invest resources in researching and developing new products and services, improving on existing ones, and tracking market trends that influence the success of its product line. Many franchisees cite this as another key benefit of the franchising arrangement.

Centralized Buying Power

Some franchisees have a significant advantage over independent small businesses because of their franchisors' centralized and large-volume buying power. If franchisors sell goods and materials to franchisees—and not all do—they may pass on to franchisees any cost savings through volume discounts. Other franchisors negotiate quantity discounts with vendors on behalf of their franchisees. For example, 7-Eleven, the largest operator of convenience stores in the world with more than 50,000 outlets, is able to negotiate discounts for its franchisees with suppliers that the owner of a single, independently operated convenience store could not match.

Site Selection and Territorial Protection

A proper location is critical to the success of any small business, and franchises are no exception. In fact, franchise operators consider the three most important factors in franchising to be *located*

location, and *location*. Becoming affiliated with a franchise may be the best way to get into prime locations. McDonald's, for example, is well known for its ability to obtain prime locations in high-traffic areas for its restaurants. Although choosing a location is the franchisee's responsibility, the franchisor reserves the right to approve the final site. Many franchisors will conduct an extensive location analysis for new outlets (usually for a fee). A thorough demographic and statistical analysis of potential locations is essential to selecting the site that offers the best potential for success. You will learn more about this in Chapter 18.

Some franchisors offer territorial protection, which gives the franchisee the right to exclusive distribution of brand-name goods or services within a particular geographic area. Under such an agreement, a franchisor agrees not to sell another franchised outlet or to open a company-owned unit within the franchisee's defined territory. The size and description of a franchisee's territory varies from one franchise to another. For example, one restaurant franchise agrees not to license another franchisee within a three-mile radius of existing locations. The purpose of this protection is to prevent an invasion of existing franchisees' territories and the accompanying dilution of sales. The owner of a fast-food franchise saw his store's sales decline from \$15,000 per week to \$8,000 per week when another franchisee opened a second outlet in the same small Connecticut town. Because the franchisor offered no territorial protection, however, the owner of the original franchise could do nothing about his nearby competitor from the same chain.²⁹

Unfortunately for franchisees, fewer franchisors now offer their franchisees territorial protection, and franchise owners may find that they are in close proximity to each other. As competition for top locations escalates, disputes over the placement of new franchise outlets have become a source of friction between franchisors and franchisees. Existing franchisees charge that franchisors are encroaching on their territories by granting new franchises in such close proximity that their sales are diluted. Franchise experts consistently cite territorial encroachment as the number one threat to franchisees.

Increased Chance for Success

Investing in a franchise is not risk free. New franchise companies enter the market each year, and many do not survive. Not surprisingly, the failure rate for young franchise systems is higher than that of older, more established ones.³⁰ A study by The Coleman Report of SBA loans to more than 580 franchises shows that the failure rate of franchisees in these systems over a recent 10-year period averaged 17.2 percent but ranged from 0 to 94 percent, depending on the chain.³¹ Despite the fact that franchising offers no guarantees of success, experts contend that franchising is less risky than building a business from the ground up. The tradition of success for franchises is attributed to the broad range of services, assistance, guidelines, and the comprehensive business system the franchisor provides. "Every franchisor has its products, services, marketing, and business systems in place," says a top small business lender at TD Bank. "If you plug a franchisee into that model, he or she has a better chance of success than a non-franchised business start-up."³² A recent study of franchises reports that the success rate of franchisees is higher when a franchise system does the following:

- Requires franchisees to have prior industry experience
- Requires franchisees to actively manage their stores (no "absentee" owners)
- Has built a strong brand name
- Offers training programs designed to improve franchisees' knowledge and skills³³



ENTREPRENEURIAL PROFILE: Carney brothers: Pizza Hut Franchise

Frank and Dan Carney founded the most famous chain of pizzerias by borrowing \$600 from their mother and converting a 600-square-foot bar into a restaurant. They opened their first restaurant in Wichita, Kansas in 1958. A year later, the first franchise store was opened in Topeka, Kansas. By 1966, there were 145 franchises operating in the United States. The familiar red roof that still tops the restaurants was introduced in 1969. By 1971, Pizza Hut was the number one restaurant in the world by both sales volume and operating locations. In 1972, Pizza Hut went public on the New York Stock Exchange and expanded internationally with a restaurant opening in Costa Rica. In 1977, the brothers sold Pizza Hut to PepsiCo. Today, Pizza Hut is a subsidiary of Yum! Brands and one of the world's leading restaurant franchises with approximately 34,000 restaurants, take-out delivery, and kiosks in more than 100 countries.³⁴

The risk involved in purchasing a franchise is two-pronged: success—or failure—depends on the franchisee’s managerial skills and motivation and on the franchisor’s business experience, system, and support. Many franchisees are convinced that franchising has been the key to their success in business.

Drawbacks of Buying a Franchise

The benefits of franchising can mean the difference between success and failure for some entrepreneurs. However, prospective franchisees must understand the disadvantages of franchising before choosing this method of doing business. Perhaps the biggest drawback of franchising is that a franchisee must sacrifice some freedom to the franchisor. Other disadvantages are discussed in the following sections.

Franchise Fees and Ongoing Royalties

Virtually every franchisor imposes some type of fees and demands a share of franchisees’ sales revenue in return for the use of the franchisor’s name, products or services, and business system. The fees and the initial capital requirements vary among the different franchisors. The total investment required for a franchise varies from around \$3,000 for some home-based service franchises to \$13.5 million or more for hotel and motel franchises. For example, Jan-Pro, a commercial cleaning franchise, requires a capital investment that ranges from just \$3,145 to \$50,405, and Snap Fitness, a 24-hour fitness center, estimates that the total cost of opening a franchise ranges from \$76,100 to \$361,700. Sonic Drive In Restaurants, a chain that sells a variety of fast-food items that range from breakfast dishes and hot dogs to hamburgers and slushies in the retro atmosphere of a 1950s curbside diner, requires an investment of \$1.1 million to \$3.05 million, depending on land acquisition and building construction costs.

Financial requirements that franchisors stipulate often create a stumbling block for many would-be franchisees. Franchisors do not want their franchisees to take on so much debt that their franchises are not sustainable; therefore, minimum requirements for net worth and available cash can be extremely high for franchises that require significant up-front investments. Hardees, the quick service hamburger chain with an estimated total investment that ranges from \$1.2 million to \$1.6 million, requires franchisees to have a minimum net worth of \$1 million and available cash of \$300,000.

Start-up costs for franchises often include a variety of fees. Most franchises impose a franchise fee up front for the right to use the company name. The average up-front fee that franchisors charge is \$25,147.³⁵ Sonic Drive In Restaurants, the fast-food chain, charges a franchise fee of \$45,000, and Subway’s franchise fee is \$15,000. Other franchise start-up costs might include a location analysis, site purchase and preparation, construction, signs, fixtures, equipment, management assistance, and training. Some franchise fees include these costs, but others do not. Before signing any contract, a prospective franchisee should determine the total cost of a franchise, something every franchisor is required to disclose in its Franchise Disclosure Document (see the “Franchising and the Law” section later in this chapter).

Franchisors also impose continuing royalty fees as revenue-sharing devices. The royalty usually involves a percentage of gross sales with a required minimum or a flat fee levied on the franchise. (In fact, 82 percent of franchisors charge a royalty based on a percentage of franchisees’ sales.³⁶) Royalty fees range from 1 to 11 percent, and the average royalty rate is 6.7 percent.³⁷ Subway charges franchisees a royalty of 8 percent of gross sales, which is payable weekly, and Snap Fitness charges a flat royalty of \$449 per month. These ongoing royalties increase a franchisee’s overhead expenses significantly. Because the franchisor’s royalties and fees (the total fees the average franchisor collects amount to 8.4 percent of a franchisee’s sales) are calculated as a percentage of a franchisee’s sales, the franchisor gets paid—even if the franchisee fails to earn a profit.³⁸ Sometimes unprepared franchisees discover (too late) that a franchisor’s royalties and fees are the equivalent of the normal profit margin for a franchise. To avoid this problem, prospective franchisees should determine exactly how much their fees will be and then weigh the benefits of the services the fees cover. One of the best ways to do this is to itemize what you are getting for your money and then determine whether the cost is reasonable. Getting details on all expenses—the amount, the time of payment, and the financing arrangements—is important. It is equally important for franchisors to find out which items, if any, are included in the initial franchise fee and which fees represent additional expenditures.

5.

Describe the limitations of buying a franchise.

Strict Adherence to Standardized Operations

Although franchisees own their businesses, they do not have the autonomy of independent owners. Franchisors must ensure the quality and integrity of their brands and require franchisees to abide by the terms of the franchise agreement that governs the franchisor–franchisee relationship. That agreement requires franchisees to operate their outlets according to the principles spelled out in the franchisor’s operations manual. Typical topics covered in the manual include operating hours, dress codes, operating policies and procedures, product or service specifications, and confidentiality requirements. At times, strict adherence to franchise standards may become a burden to some franchisees.

To protect their public image, franchisors require their franchisees to maintain certain operating standards. If a franchise consistently fails to meet the minimum standards established for the business, the franchisor may terminate its license. Many franchisors determine compliance with standards by using periodic inspections and mystery shoppers. Mystery shoppers work for a survey company and, although they look like any other customer, are trained to observe and then later record on a checklist a franchise’s performance on key standards such as cleanliness, speed of service, employees’ appearances and attitudes, and others. Michael Mershimer owns a company that employs an army of 300,000 freelance mystery shoppers and works for many franchises. Mershimer once caught a franchisee of a large ice cream chain who purchased tubs of cheaper ice cream and used a hot iron on the containers to transfer the products to the official franchisor’s branded tubs. Franchises that detect franchisees who are violating the company’s standardized operations typically send a “notice to cure” the problem. If the franchisee fails to comply, the franchisor sends a letter demanding that the franchisee comply with standards within 10 days. If the franchisee refuses, the franchisor sends notice that the franchisee’s contract is terminated.³⁹

Restrictions on Purchasing

To maintain quality standards, franchisors sometimes require franchisees to purchase products, supplies, or special equipment from the franchisor or from approved suppliers. For example, KFC requires that franchisees use only seasonings blended by a particular company because a poor image for the entire franchise could result from some franchisees using inferior products to cut costs. The franchise contract spells out the penalty for using unapproved suppliers, which usually is termination of the franchise agreement.

Before signing with a franchisor, prospective franchisees should investigate the prices that the franchisor and approved suppliers charge for supplies.



ENTREPRENEURIAL PROFILE: Marty Tate: Quiznos Several franchisees in the Quiznos sandwich chain filed a class-action lawsuit against the franchisor alleging that the company requires franchisees to buy practically all of their supplies—including the meat and the cheese for sandwiches, bathroom soap, payroll and accounting systems, and even the piped-in music—from the franchisor or its approved suppliers at inflated prices, which caused their stores to be unprofitable. “We can’t make money,” says Marty Tate, a franchisee who owns a Quiznos outlet in Pennsylvania. He claims that 40 percent of his sales go to cover food costs, the ongoing royalty, and franchise advertising fee.⁴⁰

For many years, franchisors could legally set the prices they charge for the products they sell to franchisees but could not control the retail prices franchisees charge for products. However, a 1997 Supreme Court decision opened the door for franchisors to establish maximum prices that franchisees can charge. Many franchisors do not impose maximum prices, choosing instead to provide franchisees with suggested prices, but some do establish price limits. For instance, Burger King requires franchisees to charge no more than \$1 for items on its Value Menu. Franchisees filed a lawsuit against the franchisor, claiming that Burger King did not have the right to dictate maximum prices under the franchise agreement. Franchisees argued that being forced to sell a double cheeseburger for \$1 caused them to lose more than 10 cents per sandwich. A federal court judge ruled that the franchisor did have the right to set maximum prices for the products its franchisees sell. In response to franchisees’ concerns, Burger King removed the double cheeseburger from the Value Menu, which allowed franchisees to raise its price to \$1.19, and replaced it with the BK Dollar Double, a sandwich that has two beef patties, two slices of cheese.⁴¹

Franchisors also influence the prices that their franchisees charge in other ways. A common technique is to offer discount coupons that franchisees must honor. One sandwich company's franchisees complained that the franchisor's discount coupons were cutting into their profit margins so severely that they could not make a profit on sales of the discounted items. "This company never saw a discount it didn't like," says one franchisee. "Those great discounts are financed solely by franchisees."⁴²

Limited Product Line

In most cases, the franchise agreement stipulates that franchisees can sell only those products approved by the franchisor. Franchisees must avoid selling any unapproved products through their outlets unless they are willing to risk cancellation of their franchise licenses. Franchisors strive for standardization in their product lines so that customers, wherever they may be, know what to expect. Some companies allow franchisees to modify their product or service offerings to suit regional or local tastes, but only with the franchisor's approval.



ENTREPRENEURIAL PROFILE: Laura Leigh and Kealon Drake: Moe's Southwest Grill

Laura Leigh Drake and her husband Kealon invested in a Moe's Southwest Grill franchise in Birmingham, Alabama. After hearing many of her customers rave about the food but complain that they could not finish a regular burrito, Laura Leigh developed a burrito that was larger than a child's burrito but smaller than the company's huge "regular" burrito. She pitched her new product idea, which she named the Joey Junior, to the company's new owner, who agreed to test the smaller burrito across the chain. The Joey Junior went on to become one of the best-selling items on the Moe's menu.⁴³



The idea for the Joey Junior burrito, one of the most popular items on Moe's Southwest Grill's menu, came from one of the company's franchisee's, Laura Leigh Drake.

Source: Boston Globe/Getty Images.

A franchise may be required to carry an unpopular product or be prevented from introducing a desirable one by the franchise agreement. Some franchises discourage franchisees from deviating from the standard "formula" in any way, including experimenting with new products and services. However, other franchisors encourage and even solicit new ideas and innovations from their franchisees.



ENTREPRENEURIAL PROFILE: Herb Peterson: McDonald's

Santa Barbara, California, McDonald's franchisee Herb Peterson created the highly successful Egg McMuffin in 1972 while experimenting with a Teflon-coated egg ring that gave fried eggs rounded corners and a poached appearance. Peterson put his round eggs on English muffins, adorned them with Canadian bacon and melted cheese, and showed his creation to McDonald's CEO, Ray Kroc. Even though Kroc had just eaten lunch, he devoured two of them and was sold on the idea. The catchy name came about later when the Krocs were having dinner with another McDonald's executive, Fred Turner, and his wife, Patty, who suggested the Egg McMuffin name. In 1975, McDonald's became the first fast-food franchise to open its doors for breakfast, and the Egg McMuffin became a staple on the breakfast menu, which accounts for 15 percent of McDonald's sales. McDonald's franchisees also came up with the ideas for the Big Mac and the Happy Meal.⁴⁴

Market Saturation

Franchisees in fast-growing systems reap the benefits of the franchisor's expanding reach, but they also may encounter the downside of a franchisor's aggressive growth strategy: market saturation. As the owners of many fast-food, sandwich shops, and yogurt and ice cream franchises have discovered, market saturation is a very real danger. One researcher has determined that only one place in the contiguous 48 states, a high plain in northwestern Nevada, is more than 100 miles from a McDonald's restaurant.⁴⁵ Fast-growing franchises in particular run the risk of having outlets so close together that they cannibalize sales from one another. Franchisees of one fast-growing ice cream chain claim that the franchisor's rapid expansion has resulted in oversaturation in some markets, causing them to struggle to reach their break-even points. Some franchisees saw their sales drop precipitously and were forced to close their outlets.

Although some franchisors offer franchisees territorial protection, others do not. Territorial encroachment has become a hotly contested issue in franchising as growth-seeking franchisors have exhausted most of the prime locations and are now setting up new franchises in close proximity to existing ones. In some areas of the country, franchisees are upset, claiming that their markets are oversaturated and their sales are suffering.

TABLE 6.1 A Franchise Evaluation Quiz

Taking the emotion out of buying a franchise is the goal of this self-test developed by Franchise Solutions, Inc., a franchise consulting company in Portsmouth, New Hampshire. Circle the number that reflects your degree of certainty or positive feelings for each of the following 12 statements: 1 is low; 5 is high.

	Low	High
1. I would really enjoy being in this kind of business.	1	2 3 4 5
2. This franchise will meet or exceed my income goals.	1	2 3 4 5
3. My people-handling skills are sufficient for this franchise.	1	2 3 4 5
4. I understand fully my greatest challenge in this franchise, and I feel comfortable with my abilities.	1	2 3 4 5
5. I have met with the company management and feel compatible.	1	2 3 4 5
6. I understand the risks with this business and am prepared to accept them.	1	2 3 4 5
7. I have researched the competition in my area and feel comfortable with the potential market.	1	2 3 4 5
8. My family and friends think this is a great opportunity for me.	1	2 3 4 5
9. I have had an adviser review the disclosure documents and the franchise agreement.	1	2 3 4 5
10. I have contacted a representative number of the existing franchisees; they were overwhelmingly positive.	1	2 3 4 5
11. I have researched this industry and feel comfortable about the long-term growth potential.	1	2 3 4 5
12. My background and experience make this franchise an ideal choice.	1	2 3 4 5

The maximum score on the quiz is 60. A score of 45 or below means that either the franchise opportunity is unsuitable or that you need to do more research on the franchise you are considering.

Source: Roberta Maynard, "Choosing a Franchise," *Nation's Business*, October 1996, p. 57.

Limited Freedom

When franchisees purchase their franchises and sign their contracts, they agree to sell the franchisor's product or service by following its prescribed formula. When McDonald's rolls out a new national product, for instance, all franchisees put it on their menus. Franchisors want to ensure success, and most monitor their franchisees' performances closely. Strict uniformity is the rule rather than the exception. This feature of franchising is the source of the system's success, but it also gives many franchisees the feeling that they are reporting to a "boss." Entrepreneurs who want to be their own bosses and to avoid being subject to the control of others most likely will be frustrated as franchisees. "It's their system, so they get to write the rule book," says Joe Libava, The Franchise King. "If you spend \$200,000 on a franchise and think you're going to be an independent entrepreneur, you're going to be disappointed."⁴⁶ In short, highly independent, "go-my-own-way" individuals probably should not choose the franchise route to business ownership, which requires playing by someone else's rules. Table 6.1 offers a Franchise Evaluation Quiz designed to help potential franchisees decide whether a franchise is right for them.

No Guarantee of Success

As some failed franchisees have learned, purchasing a franchise does not provide a guarantee of success. Franchise systems that are built on poorly conceived and untested business models, that do not screen prospective franchisees properly, or that provide inadequate training and support for their franchisees are not likely to succeed. Any new business venture, including a franchise, involves some level of risk. However, by carefully evaluating franchisors using the procedure outlined in this chapter, prospective franchisees can select a franchisee that increases the probability that they will succeed.

Franchising and the Law

The franchising boom of the late 1950s brought with it many prime investment opportunities. However, the explosion of legitimate franchises also ushered in a dark period for many franchisors who defrauded their franchisees. By the 1970s, franchising was rife with fraudulent

6.

Describe the legal aspects of franchising, including the protection offered by the Federal Trade Commission's Franchise Regulation Rule.

practitioners. Thousands of people lost millions of dollars to criminals and unscrupulous operators who sold flawed business concepts and phantom franchises to unsuspecting investors. In an effort to control the rampant fraud in the industry and the potential for deception inherent in a franchise relationship, California in 1971 enacted the first Franchise Investment Law. This law and those of 14 other states* that have since passed similar laws requires franchisors to register their franchises and file a **Franchise Disclosure Document (FDD)** with the state and deliver a copy to prospective franchisees before any offer or sale of a franchise. In October 1979, the Federal Trade Commission (FTC) adopted similar legislation at the national level that established full disclosure guidelines on 20 topics for any company selling franchises and was designed to give potential franchisees the information they needed to protect themselves from unscrupulous franchisors.

In 2008, the FTC revised the requirements of the FDD to include specific information on 23 topics. All franchisors must disclose this detailed information on their operations at least 14 days before a franchisee signs a contract or pays any money. The FDD applies to all franchisors, even those in the 35 states that lack franchise registration laws. The purpose of the regulation is to assist potential franchisees' investigations of a franchise deal and to introduce consistency into the franchisor's disclosure statements. The FTC also established a "plain English" requirement for the FDD that prohibits legal and technical jargon and makes a document easy to read and understand. The FTC's philosophy is not so much to prosecute abusers as to provide information to prospective franchisees and help them to make intelligent decisions. Although the FTC requires each franchisor to provide a potential franchisee with this information, it does not verify its accuracy. Prospective franchisees should use this document only as a starting point for their investigations.

In its FDD, a franchisor must include a sample franchise contract, audited financial statements for three years, and information on the following 23 items:

1. Information identifying the franchisor and its affiliates and describing the franchisor's business experience and the franchises being sold.
2. Information identifying and describing the business experience of each of the franchisor's officers, directors, and managers responsible for the franchise program. Prospective franchisees should be wary of franchises whose executives lack franchise experience.
3. A description of the lawsuits in which the franchisor and its officers, directors, and managers have been involved. Although most franchisors have been involved in some type of litigation, an excessive number of lawsuits, particularly if they relate to the same problem, is alarming. Another red flag is an excessive number of lawsuits brought against the franchisor by franchisees. "The history of the litigation will tell you the future of your relationship [with the franchisor]," says the founder of a maid-service franchise.⁴⁷
4. Information about any bankruptcies in which the franchisor and its officers, directors, and managers have been involved.
5. Information about the initial franchise fee and other payments required to obtain the franchise, the intended use of the fees, and the conditions under which the fees are refundable.
6. A table that describes all of the other fees that franchisees are required to pay after start-up, including royalties, service fees, training fees, lease payments, advertising or marketing charges, and others. The table also must include the due dates for the fees.
7. A table that shows the components of a franchisee's total initial investment. The categories covered are preopening expenses, the initial franchise fee, training expenses, equipment, opening inventory, initial advertising fee, signs, real estate (purchased or leased), equipment, opening inventory, security deposits, business licenses, initial advertising fees, and other expenses, such as working capital, legal and accounting fees. Also included is an estimate of amount of working capital a franchisee should have on hand to sustain the company in its first three months of operation. (Franchisees should be aware that the actual amount of capital required to keep a franchise going until it generates positive cash flow is probably much higher.) These estimates, usually stated as a range, give prospective franchisees an idea of how much their total start-up costs will be.

8. Information about quality requirements of goods, services, equipment, supplies, inventory, and other items used in the franchise and where franchisees may purchase them, including required purchases from the franchisor. When interviewing existing franchisees, prospective franchisees should ask whether the prices they pay for products and services are reasonable.
9. A cross-reference table that shows the location in the FDD and in the franchise contract of the description of the franchisee's obligations under the franchise contract.
10. A description of the financial assistance (if any) that is available from the franchisor in the purchase of the franchise. Although many franchisors do not offer direct financial assistance to franchisees, they may have special arrangements with lenders who may provide franchisees with financing.
11. A description of all obligations the franchisor must fulfill to help a franchisee prepare to open and operate a unit, including site selection, advertising, computer systems, pricing, training (a table describing the length and type of training is required), and other forms of assistance provided to franchisees. This list and description of the support services the franchisor provides usually is the longest section of the FDD.
12. A description of any territorial protection that the franchise receives and a statement as to whether the franchisor may locate a company-owned store or other franchised outlets in that territory. The franchisor must specify whether it offers exclusive or nonexclusive territories. Given the controversy in many franchises over market saturation, franchisees should pay close attention to this section. Prospective franchisees should recognize the risks associated with purchasing a franchise that provides no territorial protection or exclusive territories.
13. All relevant information about the franchisor's trademarks, service marks, trade names, logos, and commercial symbols, including where they are registered. Prospective franchisees should look for a strong trade or service mark that is registered with the U.S. Patent and Trademark Office.
14. Similar information on any patents, copyrights, and proprietary processes the franchisor owns and the rights franchisees have to use them.
15. A description of the extent to which franchisees must participate personally in the operation of the franchise. Many franchisors look for "hands-on" franchisees and discourage or even prohibit "absentee owners."
16. A description of any restrictions on the goods or services that franchises are permitted to sell and with whom franchisees may deal. The agreement usually restricts franchisees to selling only those items that the franchisor has approved.
17. A table that describes the length of the franchise contract, the conditions under which the franchise may be repurchased or refused renewal by the franchisor, transferred to a third party by the franchisee, and terminated or modified by either party. This section also addresses the methods established for resolving disputes, usually either mediation or arbitration, between franchisees and the franchisor.
18. A description of the involvement of celebrities and public figures in the franchise. Less than 1 percent of franchise systems use public figures as part of their promotional strategies.⁴⁸
19. A complete statement of the basis for any financial performance claims made to the franchisee, including the percentage of existing franchises that have actually operated at or above the averages that the franchisor provides. Franchisors that make financial performance claims must include them in the FDD, and the claims must "have a reasonable basis" at the time they are made. However, franchisors are *not* required to make any financial performance claims at all; in fact, about 80 percent of franchisors do not, primarily because of liability concerns about committing their numbers to writing.⁴⁹
20. A table that displays system-wide statistical information about the expansion or the contraction of the franchise over the last three years. This section allows prospective franchisees to determine whether a franchise is growing or shrinking and how fast. A large number of closures may indicate that the franchisor's promotional claims have been un-

favor with customers. The tables in this section show the current number of franchises, the number of franchises projected for the future and the states in which they are to be sold, the number of franchises terminated, the number of agreements the franchisor has not renewed, the number of franchises that have been sold to new owners, the number of outlets the franchisor has repurchased, and a list of the names and addresses (organized by state) of other franchisees in the system and of those who have left the system within the last year. Contacting some of the franchisees who have left the system can alert would-be franchisees to potential problems with the franchise.

21. The franchisor's audited financial statements. Prospective franchisees can use this information to determine how stable the franchisor is.
22. A copy of all franchise and other contracts (leases, purchase agreements, and others) that the franchisee will be required to sign.
23. A standardized, detachable "receipt" to prove that the prospective franchisee received a copy of the FDD. The FTC now allows franchisors to provide the FDD to prospective franchisees electronically.

The typical FDD can be several hundred pages long, but every potential franchisee should read and understand it. Unfortunately, many do not, which often results in unpleasant surprises for franchisees. The information contained in the FDD does not fully protect potential franchisees from deception, nor does it guarantee success. The FDD does, however, provide enough information to begin a thorough investigation of the franchisor and the franchise deal, and prospective franchisees should use it to their advantage.



Entrepreneurship in Action

After the Cheering Stops

Jamal Mashburn beat the odds. Just 1.2 percent of college basketball players end up playing professional basketball, but Mashburn (whose nickname was "Monster Mash") made the leap from the University of Kentucky to the National Basketball Association (NBA), playing for the Dallas Mavericks and the New Orleans Hornets, where he was selected to play in the All Star Game. Since retiring from the NBA, Mashburn has beaten the odds again; 60 percent of professional basketball players (and 78 percent of professional football players) are bankrupt within two years of retiring from the game.

Not Mashburn, who was already thinking about his exit plan when he entered the NBA. His exit strategy included investing in franchises with a group of investors, including his former college coach, Rick Pitino. Just six years after retiring from professional basketball, Mashburn is a co-owner of 37 Papa John's restaurants, 34 Outback Steakhouses, three Dunkin' Donuts shops, and the largest Toyota dealership in Kentucky. Other professional athletes who have found success in franchising include Drew Brees (Super Bowl MVP and quarterback for the New Orleans Saints), Junior Bridgeman (former NBA player for the Milwaukee Bucks), Keyshawn Johnson (former wide receiver, Super Bowl champion, and Panera Bread franchisee), Reggie Bush (National Football League [NFL] star and Panera Bread franchisee), and Venus Williams (tennis professional and Jamba Juice franchisee).

Brees owns three Jimmy John's Gourmet Sandwiches outlets in New Orleans and plans to open more. He first learned about the franchise in Indiana where he was attending Purdue University.

enjoyed eating there. After arriving in New Orleans to play for the Saints, Brees says that he "missed Jimmy John's so much" that he decided to introduce the city to the pleasures of Jimmy John's sandwiches. Although Brees has full-time managers in his restaurants, he often stops by to make sure things are running smoothly and to do some bootstrap marketing. He recently caused a traffic jam outside his first franchise when he tweeted to his nearly 1.2 million followers that he was going to eat lunch there.

Michael Stone, who played in the NFL for seven years, believes that franchising is an ideal fit for professional athletes and formed the Professional Athletes Franchise Initiative, an organization that encourages athletes to explore franchising as a postsports career. Stone says that franchising is a good fit for retired professional athletes because it requires many of the same skills to succeed. Athletes implement the game plan that their coaches create to win a game. Similarly, franchisees must execute the franchisor's game plan to operate their outlets successfully. Junior Bridgeman's experience lends credibility to Stone's observation. After a 12-year career in the NBA, Bridgeman invested in several Wendy's restaurants. Today, Bridgeman is the owner of 162 Wendy's and 121 Chili's restaurants that generate \$507 million in annual sales.

Because their playing (and earning) time is relatively short (the average professional football player's career lasts just 3.5 years), professional athletes must plan for their second careers as soon as they sign their professional contracts. "Before they know it, they're out of the league, and their income drops significantly," says Robert Luna, a financial adviser to several athletes. "Unlike a young physician, who will be making a lot more money

Entrepreneurship in Action (continued)

10, 20, or 30 years down the road, [a professional athlete] is getting it all up front.

Steve Caldeira, president of the International Franchise Association, sees athletes as a good fit for franchising. “[They] are strong leaders in the ultra-competitive sports arena, so they inherently understand the importance of working as a team and as part of a system to achieve success.” Angelo Crowell, who played in the NFL for the Buffalo Bills for seven years before injuries ended his career, became a Jersey Mike’s sandwich shop franchisee, opening two outlets in Tallahassee, Florida. Crowell had been a fan of the chain since he was a teenager in high school. When he discovered that the territory near his home was available, Crowell and his wife Kim decided to purchase the rights to develop it. Crowell says that as the owner, he is involved in the daily operations of the franchise.

1. What benefits does franchising offer professional athletes such as those described here?

2. Do you agree with Michael Stone that franchising is a good fit for athletes? Explain.
3. What steps should prospective franchisees, whether they are athletes or not, take to ensure that franchising is the right path to business ownership for them and that they select the right franchise?

Sources: Jason Daley, “Playing for Keeps,” *Entrepreneur*, February 2012, pp. 82–87; Jan Norman, “Franchising Courts Pro Athletes,” *Orange County Register*, November 10, 2011, www.ocregister.com/articles/franchising-326406-athletes-franchise.html; “The All Franchising Team,” *Franchise Help*, October 17, 2011, www.franchisehelp.com/blog/top-professional-athletes-who-own-franchises; Russ Wiles, “Pro Athletes Often Fumble the Financial Ball,” *USA Today*, April 22, 2012, www.usatoday.com/sports/story/2012-04-22/Pro-athletes-and-financial-trouble/54465664/1; Susan Langenhennig, “Drew Brees Hungry to Expand Jimmy John’s Sandwich Shop’s Reach into Local Market,” *Times-Picayune*, July 1, 2012, www.nola.com/dining/index.ssf/2012/07/drew_brees_takes_a_run_at_sand.html; Michael Stone, “Angelo and Kim Crowell Implement the Jersey Mike’s Game Plan,” Professional Athletes Franchise Initiative, www.thepafi.org/2010/11/angelo-and-kim-crowell-implement-the-jersey-mikes-gameplan.

The Right Way to Buy a Franchise

The FDD can help potential franchisees to identify and avoid dishonest franchisors. The best defenses a prospective entrepreneur has against making a bad investment decision or against unscrupulous franchisors are preparation, common sense, and patience. A thorough investigation before investing in a franchise reduces the risk of being hoodwinked into a nonexistent franchise or a system that is destined to fail. Asking the right questions and resisting the urge to rush into an investment decision helps potential franchisees avoid unscrupulous franchisors.

Despite existing disclosure requirements, dishonest franchisors are still in operation, often moving from one state to another just ahead of authorities. Potential franchisees must beware. Franchise fraud has destroyed the dreams of many hopeful franchisees and has robbed them of their life savings. Because dishonest franchisors tend to follow certain patterns, well-prepared franchisees can avoid getting burned. The following clues should arouse the suspicion of an entrepreneur about to invest in a franchise:

- Claims that the franchise contract is “the standard one” and that “you don’t need to read it.” There is no standard franchise contract.
- A franchisor who fails to give you a copy of the required disclosure document, the FDD, at your first face-to-face meeting.
- A marginally successful prototype store or no prototype at all.
- A poorly prepared operations manual outlining the franchise system or no manual (or system) at all.
- An unsolicited testimonial from “a highly successful franchisee.” Scam artists will hire someone to pose as a successful franchisee, complete with a rented luxury car and expensive-looking jewelry and clothing, to “prove” how successful franchisees can be and to help close the sale. Use the list of franchisees in item 20 of the FDD to find real franchisees and ask them plenty of questions.
- An unusual amount of litigation brought against the franchisor. In this litigious society, companies facing lawsuits is a common situation. However, too many lawsuits are a sign that something is amiss. This information is found in item 3 of the FDD.
- Verbal promises of large future earnings without written documentation. Remember: If franchisors make financial performance claims, they *must* document them in item 19 of the FDD.
- A high franchisee turnover rate or a high termination rate. This information is found in item 20 of the FDD.

7.

Explain the right way to buy a franchise.

- Attempts to discourage you from allowing an attorney to evaluate the franchise contract before you sign it.
- No written documentation to support claims and promises.
- A high pressure sale—sign the contract now or lose the opportunity. This tactic usually sounds like this: “Franchise territories are going fast. If you hesitate, you are likely to miss out on the prime spots.”
- Claiming to be exempt from federal laws requiring complete disclosure of franchise details in a FDD. If a franchisor has no FDD, run—don’t walk—away from the deal.
- “Get-rich-quick schemes,” promises of huge profits with only minimum effort.
- Reluctance to provide a list of present franchisees for you to interview.
- Evasive, vague answers to your questions about the franchise and its operation.

Not every franchise “horror story” is the result of dishonest franchisors. In fact, most franchising problems are due to franchisees buying legitimate franchises without proper research and analysis. They end up in businesses they do not enjoy and that they are not well suited to operate. The steps outlined in the following sections will help any potential franchisee make the right franchise choice.

Evaluate Yourself

Henry David Thoreau’s advice to “know thyself” is excellent advice for prospective franchisees. Before looking at any franchise, entrepreneurs should study their own traits, goals, experience, likes, dislikes, risk orientation, income requirements, time and family commitments, and other characteristics. Knowing how much you can afford to invest in a franchise is important, but it is not the only factor to consider. The following are valuable questions for the entrepreneur to ask:

- Will you be comfortable working in a structured environment?
- What kinds of franchises fit your desired lifestyle?
- Do you want to sell a product or a service?
- Do you enjoy working with the public?
- Do you like selling?
- What hours do you expect to work?
- Do you want to work with people, or do you prefer to work alone?
- Which franchise concepts mesh best with your past work experience?
- What activities and hobbies do you enjoy?
- What income do you expect a franchise to generate?
- How much can you afford to invest in a franchise?
- Will you be happy with the daily routine of operating the franchise?

Most franchise contracts run for 10 years or more, making it imperative that prospective franchisees conduct a complete inventory of their interests, likes, dislikes, and abilities before buying a franchise.

Research the Market

Entrepreneurs should research the market in the areas they plan to serve before shopping for a franchise:

- How fast is the surrounding area growing?
- In which areas is that growth occurring fastest?
- Is the market for the franchise’s product or service growing or declining?
- How strong is the competition?
- Who are your potential customers?
- What are their characteristics?
- What are their income and education levels?

- What kinds of products and services do they buy?
- What gaps exist in the market?

Investing time in the local library or on the Internet to determine whether an area has a sufficient number of the franchise's target customers is essential to judging an outlet's potential for success.

Solid market research should tell a prospective franchisee whether a particular franchise is merely a passing fad or a long-term trend. Steering clear of fads and into long-term trends is a key to sustained success in franchising. The secret to distinguishing between a fad that will soon fizzle and a meaningful trend that offers genuine opportunity is finding products or services that are consistent with fundamental demographic and lifestyle patterns of the population. That requires sound market research that focuses not only on local market opportunities but also on the "big picture." For instance, a growing number of aging Baby Boomers is creating an opportunity for franchises that provide cleaning, in-home care, and home improvement services.

Consider Your Franchise Options

Tracking down information on prospective franchise systems is easier now than ever before. Franchisors publish information about their systems on the Internet. These listings can help potential franchisees find a suitable franchise within their price ranges. Many cities host franchise trade shows throughout the year, where hundreds of franchisors gather to sell their franchises. Many business magazines such as *Entrepreneur, Inc.*, and others devote at least one issue and a section of their Web sites to franchising, where they often lists hundreds of franchise opportunities. Another useful resource is *Bond's Franchise Guide* (Source Book Publications), which provides detailed profiles of nearly 900 North American franchisors and lists of franchise attorneys, consultants, and service providers.

Get a Copy of the FDD and Study It

Once you narrow down your franchise choices, contact each franchise and get copy of the FDD. Then read it! The FDD is an important tool in your search for the right franchise. When Ali Saifi was looking for a franchise, he reviewed disclosure documents from 130 different franchises before selecting Subway. Today, Saifi owns 390 Subway restaurants that employ 4,000 people and generate more than \$200 million in annual sales.⁵⁰

When evaluating a franchise opportunity, what should a potential franchisee look for? Although there is no guarantee of success, the following characteristics make a franchisor stand out:

- **A unique concept or marketing approach.** "Me-too" franchises are no more successful than "me-too" independent businesses. Pizza franchisor Papa John's has achieved an impressive growth rate by emphasizing the quality of its ingredients, whereas Domino's is known for its fast delivery.
- **A profitable business model.** A franchisor should have a track record of profitability, and so should its franchisees. If a franchisor is not profitable, its franchisees are not likely to be either. Franchisees who follow the business format should expect to earn a reasonable rate of return after paying all franchise royalties, fees, and advertising contributions.
- **A solid brand name and a registered trademark.** Name recognition is difficult to achieve without a well-known, protected, and federally registered trademark. "Having a federally registered, recognized, protected brand name is one of the most critical factors for any franchise," says the director of a franchise consulting and law firm.⁵¹
- **A business system that works.** A franchisor should have in place a system that is efficient and is well documented in its manuals. After all, a proven business system lies at the heart of what a franchisee purchases from a franchisor.
- **A solid training program.** One of the most valuable components of a franchise system is the training it offers franchisees. The system should be relatively easy to learn.
- **Affordability.** A franchisee should not have to take on an excessive amount of debt to purchase a franchise. Being forced to borrow too much money to open a franchise outlet can doom a business from the outset. Respectable franchisors verify prospective franchisees' financial qualifications as part of the screening process.

- **A positive relationship with franchisees.** The most successful franchises are those that see their franchisees as partners—and treat them accordingly. “You want companies that award franchises, not sell them,” says one franchise consultant.⁵² One indication of a positive franchisor–franchisee relationship is the existence of a franchisee advisory council, a group of franchisees selected by their peers to provide advice to the franchisor on topics ranging from marketing strategies and new products to operating procedures and training.

The FDD covers the 23 items discussed earlier and includes a copy of the company’s franchise agreement and any contracts accompanying it. Although the law requires a FDD to be written in plain English rather than “legalese,” it is best to have an attorney with franchise experience to review the FDD and discuss its provisions with you. The franchise contract summarizes the details that will govern the franchisor–franchisee relationship over its life. The contract outlines exactly the rights and the obligations of each party and sets the guidelines that govern the franchise relationship. Franchise contracts typically are long term; 50 percent run for 15 years or more, making it extremely important for prospective franchisees to understand their terms before they sign a contract.

Particular items in the FDD that entrepreneurs should focus on include the franchisor’s experience (items 1 and 2), the current and past litigation against the franchisor (item 3), the fees and total investment (items 5, 6, and 7), and the franchisee turnover rate for the previous three years (item 20). The **franchisee turnover rate**, the rate at which franchisees leave the system, is one of the most revealing items in the FDD. If the turnover rate is less than 5 percent, the franchise probably is sound; however, a rate approaching 20 percent is a sign of serious, underlying problems in a franchise. Although virtually every franchisor has been involved in lawsuits, an excessive amount of litigation against a franchisor over a particular matter should alert a prospective franchisee to potential problems down the road. Determining what the cases were about and whether they have been resolved is important.

Talk to Existing Franchisees

Although the FDD contains valuable information, it is only the starting point for researching a franchise opportunity thoroughly. Perhaps the best way to evaluate the reputation of a franchisor is to interview (in person) several franchise owners who have been in business at least one year about the positive and the negative aspects of the agreement and the franchisor–franchisee relationship and whether the franchisor delivered what it promised. Knowing what they know now, would they buy the franchise again? Another useful technique is to monitor franchisees’ blogs, where prospective franchisees can learn the “real story” of running a franchise.

Another revealing exercise is to spend an entire day with at least one (preferably more) franchisee to observe firsthand what it is like to operate a franchise unit. Some prospective franchisees work in an existing outlet, sometimes without pay, to get a sense of what the daily routine is like. Item 20 of the FDD lists all of a company’s current franchisees and former franchisees who have left the system within the last year and their contact information, which makes it easy for potential franchisees to contact them. It is wise to interview former franchisees to get their perspectives on the franchisor–franchisee relationship. Why did they leave?

Table 6.2 provides some important questions to ask current franchisees.

Ask the Franchisor Some Tough Questions

Take the time to visit the franchisor’s headquarters and ask plenty of questions about the company and its relationship with its franchisees. You will be in this relationship a long time, and you need to know as much about it as possible beforehand. Many franchisors offer “discovery days,” events to which they invite prospective franchisees to their headquarters to meet face-to-face and to see the franchisor’s operation in action firsthand. Important questions to ask include the following:

- What skills does a successful franchisee need? (Then consider how you measure up.)
- What is the franchisor’s philosophy concerning the franchisor–franchisee relationship?
- How do franchisees and the franchisor resolve conflicts? (Ask for specific examples.)
- What are the most common causes of the problems that franchisees encounter?

TABLE 6.2 Questions to Ask Existing Franchisees

A key ingredient in any prospective franchisee's evaluation of a franchise opportunity is visiting existing franchisees and asking them questions about their relationship with the franchisor. "What you need to know from franchisees is what the franchisor does that makes it worth the fees," says one franchise consultant. The following questions will reveal how well the franchisor supports its franchisees and the nature of the franchisor–franchisee relationship.

- How much did it cost to start your franchise? Did you encounter unexpected costs?
- How much training did you receive at the outset? How helpful was it?
- How prepared were you when you opened your franchise?
- Does the franchisor provide you with adequate ongoing support? How much? Are you pleased with the level of support you receive? What is the nature of this support?
- Is the company available to answer your questions? How often do you contact the company? What is the typical response?
- How much marketing assistance does the franchisor provide? Is it effective? How can you tell?
- Do franchisees have input into the development of new products or services?
- Which of your expectations has the franchisor met? Failed to meet?
- How often does someone from the franchise check on your operation? What is the purpose of those visits?
- What is a "typical day" like for you? How do you spend most of your time?
- Which day-to-day tasks do you enjoy performing most? Least?
- How much did your franchise generate in sales last year? How much do you expect it to generate in sales this year? What has been the pattern of your outlet's sales since you started?
- Is your franchise making a profit? If so, how much? What is your net profit margin?
- How long did you operate before your outlet began to earn a profit? Is your outlet consistently profitable?
- What is your franchise's break-even point? How long did it take for your franchise to reach the break-even point?
- Has your franchise met your expectations for return on investment?
- Is there a franchisee association? Do you belong to it? What is its primary function?
- Does the franchisor sponsor system-wide meetings? Do you attend? Why?
- Does the franchisor listen to franchisees?
- What changes would you recommend the franchisor make in its business system?
- Where do you purchase supplies, equipment, and products for your franchise? Are the prices you pay reasonable?
- How much freedom do you have to run your business?
- Does the franchisor encourage franchisees to apply their creativity to running their businesses, or does it frown on innovation in the system?
- Has the franchisor given you the tools you need to compete effectively?
- How much are your royalty payments and franchise fees? What do you get in exchange for your royalty payments? Do you consider it to be a good value?
- Are you planning to purchase additional territories or franchises? Why?
- Has the franchisor lived up to its promises?
- Looking back, what portions of the franchise contract would you change?
- What are communications with the franchisor like?
- How would you describe franchisees' relationship with the franchisor? How would you describe your relationship with the franchisor?
- Are most franchisees happy with the franchise system? With the franchisor?
- What advice would you give to someone considering purchasing a franchise from this franchisor?
- Knowing what you know now, would you buy this franchise again?

Sources: Based on Carol Tice, "How to Research a Franchise," *Entrepreneur*, January 2009, pp. 112–119; Andrew A. Caffey, "Analyze This," *Entrepreneur*, January 2000, pp. 163–167; Roger Brown, "Ask More Questions of More People Before Deciding, Then Plan to Work Very Hard," *Small Business Forum*, Winter 1996/1997, pp. 91–93; Roberta Maynard, "Choosing a Franchise," *Nation's Business*, October 1996, pp. 56–63; Andrew A. Caffey, "The Buying Game," *Entrepreneur*, January 1997, pp. 44–49; and David Davis, "A Perfect Match," *Business Start-Ups*, July 1997, pp. 44–49.

- How much input do franchisees have into the system?
- What are the franchisor's future expansion plans? How will they affect your franchise?
- Are you entitled to an exclusive territory?
- What kind of earnings can you expect? (If the franchisor made no earnings claims in item 19 of the FDD, why not?)
- Has the franchisor terminated any franchisee's contracts? If so, why?
- How many franchisees have failed? Why?
- Does the franchisor have a well-formulated strategic plan?

Make Your Choice

The first lesson in franchising is “Do your homework before you get out your checkbook.” Only after conducting a thorough analysis of a franchise opportunity can you make an informed choice about which franchise is right for you. Then it is time to put together a solid business plan to serve as your road map to success with the franchise you have selected. The plan also is a valuable tool for attracting financing to purchase your franchise. We will discuss the process of creating a business plan in Chapter 8.



ENTREPRENEURIAL PROFILE: Rocco Valluzo: Microtel Inn and Suites Rocco Valluzo, a second-generation McDonald's franchisee, decided to make the leap from the restaurant business to the hotel business after his wife stayed at a Microtel Inns and Suites and marveled at the smoothly operating business system. Before signing on with Microtel, Valluzo did his homework. In addition to evaluating the local market and conducting a location analysis, Valluzo says that he “toured properties and looked at the franchise cost and what the service fees would be.” His preparation has paid off. His hotel reached its break-even point within six months of opening, and he already is making plans to open three more locations. “The key to success is having the support of the franchisor,” he says.⁵³



Lessons from the Street-Smart Entrepreneur

Make Sure You Select the Right Franchise

Bill Adams spent 21 years in the U.S. Special Operations (“the Green Berets”) division of the military. After retiring from the armed forces, Adams started two businesses and sold them before he and his wife Lysa purchased an iFly franchise, a company that operates high-speed wind tunnels in which customers can practice their skydiving technique or just fly around on a column of air. Adams's first experience with a wind tunnel occurred during his training as a Green Beret when the concept was considered top secret. After a week of training, he recalls thinking, “That's the most fun I've ever had. Someone should perfect that technology.” Lysa, also an experienced skydiver, reveled in her first indoor skydiving experience. “Everyone should have one of these in their backyard,” she thought. The couple's research led them to iFly, and after months of work that included finding new financing after their original lender backed out, the Adamses opened their \$10 million iFly indoor skydiving franchise in Seattle, Washington. Their business has been so successful that the Adamses are planning to open one new iFly franchise in carefully selected locations across the United States every 18 months.

Bill and Lysa Adams found their ideal franchise, but finding the right franchise is no easy task. The results are well worth the effort—if you make the right choice. The Street Smart

Entrepreneur identifies the most common mistakes that first-time franchisees make:

Mistake 1. Not knowing what they want in a franchise. Start by evaluating your personal and business interests. What type of work and activities do you enjoy? Which ones do you dislike? What are your financial expectations? Failing to define your goals increases the chance you will make the wrong choice.

Mistake 2. Buying a franchise they cannot afford. Franchises can be expensive, and you must know how much you can afford to spend before you go shopping for a franchise. A surefire recipe for failure is buying a franchise that breaks your budget. Franchises are available in a myriad of price ranges, from just a few thousand dollars to several million dollars. Determine the price range that best fits your budget before you begin reviewing franchise packages.

Mistake 3. Failing to ask current and former franchisees about the franchise. One of the best ways to determine what your franchise experience will be is to talk with current and former franchisees. Item 20 of the FDD provides the necessary information for you to contact these people.

Lessons from the Street-Smart Entrepreneur (continued)

Visit their operations and ask them *lots* of questions about the franchise system and how well it works, the franchisor, and the franchisor–franchisee relationship. This is one of the best ways to get the *real* story about how well a franchise system works.

Mistake 4. Failing to read the fine print. The FDD is a valuable document for potential franchisees but only for those who actually read it and use it to make a franchising decision. After you narrow down your potential franchise choices, get their FDDs and review them. Many potential franchisees find it helpful to go through the FDD and the franchise contract with an experienced franchise attorney who can point out potential problem areas.

Mistake 5. Failing to get professional help. Inexperienced franchise shoppers believe that paying attorneys and accountants to help them understand the FDD and the franchise contract is a waste of money. Wrong! The franchise contract governs the franchisor–franchisee relationship, and most contracts run for at least 10 years. Make sure you understand its terms clearly before you sign a franchise contract.

Mistake 6. Buying in too early. Buying into a new franchise concept offers advantages (refer to Figure 6.4). However, doing so involves some risk because some new franchise operations have not worked the “bugs” out of their business systems or are not prepared to teach their systems effectively to franchisees. Established franchises have proven track records of success and typically involve less risk, but that security comes at a higher price. If you are considering buying into a new franchise, be extra diligent in your investigation of the opportunity.

Mistake 7. Neglecting the signs of a struggling franchise system. Buying a franchise is no guarantee of success, and prospective franchisees must watch for indications that a franchise is struggling to avoid buying into a system that is floundering. Telltale signs include a high franchisee turnover rate, franchisees who cannot generate reasonable profits under the franchisor’s system, a franchise system that constantly changes (usually an indication that the system does not work), and sour relationships between franchisees and the franchisor.

Mistake 8. Falling for exaggerated earnings claims. One question of paramount interest to potential franchisees is

“How much money can I expect to earn from a franchise?” Item 19 of the FDD includes a statement of the basis for any earnings claims that franchisors make. Any financial representations that a franchisor makes must represent the earnings that an average franchisee can expect, not the results of the top-performing franchise. However, the FDD does not require franchisors to make earnings claims. In fact, fewer than 20 percent of franchisors make any earnings claims in their FDDs. “An earnings claim is an opportunity to showcase your company,” says Charlie Simpson, a top manager at Great Clips, a hairstyling franchise with more than 2,700 salons. “[Doing so] provides instant credibility with a candidate.” Remember: Any earnings claims franchisors make must be backed by *facts*. If a franchise does not provide any information on franchisees’ expected earnings, what is the reason? Potential franchisees need access to statistics on expected earnings so that they can assemble reasonable financial forecasts for their business plans.

Mistake 9. Neglecting to check the escape clause. Most franchise contracts include options for getting out of the franchise relationship for both the franchisor and the franchisee. Under what circumstances can the franchisor end the relationship? Under what circumstances can you end the relationship? What is the cost associated with terminating the franchise agreement?

Mistake 10. Assuming that the franchise will run itself. Some franchisees buy franchises with the expectation that they will be able to write a check to the franchisor, put the franchise system in place, and then sit back and watch the money roll in. It doesn’t work that way! Building a successful franchise takes just as much hard work as building a successful independent business. “I work six days a week,” says Rick Warman, who owns a business that operates 31 outlets of multiple franchise concepts, including Papa John’s, Schlotzsky’s Deli’s, and Jenny Craig.

Sources: Based on Jason Daley, “Blowin’ in the Wind,” *Entrepreneur*, February 2012, p. 116; “Rich Warman,” *Empire Builders TV*, www.franchising.com/empirebuilders/franchisees/rich_warman; Eddy Goldberg and Kerry Pipes, “How Much Can I Earn?,” *Franchising.com*, August 18, 2008, www.franchising.com/articles/385; Andrew A Caffey, “Watch Your Step,” *Entrepreneur B.Y.O.B.*, August 2002, p. 82, adapted from Todd D. Maddocks, “Write the Wrong,” *Entrepreneur B.Y.O.B.*, January 2001, pp. 152–155; Kerry Pipes, “Franchisee Lifestyles,” *Franchise Update*, www.franchise-update.com/fuadmin/articles/article_FranchiseeLifestyles5.htm; “Franchise How-To Guides: The Paper Trail,” *Entrepreneur*, www.entrepreneur.com/franchises/buyingafanchise/howtoguides/article36392-4.html.

Franchise Contracts

Franchising’s popularity as a business system has created growing pains that have resulted in an increase in the number of franchise-related lawsuits. “Litigation sends a signal to the franchisor and others that something is wrong,” says a franchise industry analyst.⁵⁴ A common source of much of this litigation is the interpretation of the franchise contract’s terms. Most often, difficulties arise after the agreement is in operation. Because a franchisor’s attorney prepares franchise contracts, the provisions favor the franchisor, giving minimal protection to franchisees. Franchise contracts typically include arbitration clauses, which require disputes to go to arbitration and restrict franchisees’ ability to file lawsuits. A franchise contract summarizes the details that will govern the franchisor–franchisee relationship over its life. It outlines exactly the rights and the obligations of each party and sets the guidelines that govern the franchise relationship. To protect potential franchisees from having to rush into a contract without clearly understanding it, the FTC requires that franchisees receive a completed contract with all revisions at least five business days before signing it.

8.

Describe a typical franchise contract and its primary provisions.

Every potential franchisee should have an attorney evaluate the franchise contract and review it with the investor before he signs anything. Many franchisees don't discover unfavorable terms in their contracts until *after* they have invested in a franchise. By then, however, it's too late to negotiate changes. Although most large, established franchisors are not willing to negotiate the franchise contract's terms ("The contract is what it is"), many smaller franchises will negotiate some terms, especially for highly qualified candidates. Figure 6.4 describes the advantages and the disadvantages of buying a new versus an established franchise.

Although franchise contracts cover everything from initial fees and continuing payments to training programs and territorial protection, three terms are responsible for most franchisor–franchisee disputes: termination of the contract, contract renewal, and transfer and buyback provisions.

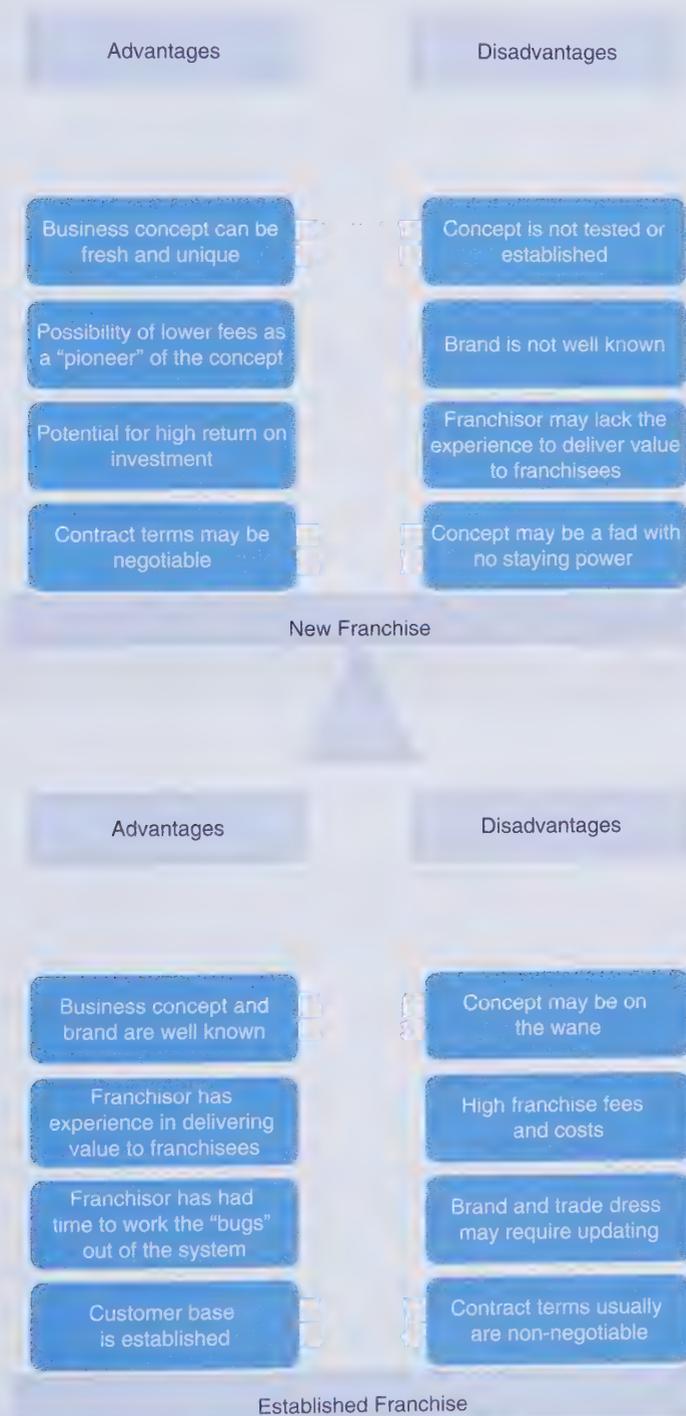


FIGURE 6.4

Advantages and Disadvantages of Buying and New vs. an Established Franchise

Termination

One of the most litigated subjects of a franchise agreement is the termination of the contract by either party. Most contracts prevent franchisees from terminating the agreement but allow franchisors to terminate the agreement “with or without cause.” Therefore, prospective franchisees must be sure they know exactly under what circumstances the franchisor can terminate the contract. Generally, the franchisor has the right to cancel a contract if a franchisee fails to abide by the terms of the agreement, declares bankruptcy, fails to make required payments on time, or fails to maintain quality standards.

Renewal

Franchisors usually retain the right to renew or refuse to renew franchisees’ contracts. If a franchisee fails to make payments on schedule or does not maintain quality standards, the franchisor has the right to refuse renewal. In most cases, the franchisor has no obligation to offer contract renewal to the franchisee when the contract expires.

When a franchisor grants renewal, the two parties draw up a new contract. Frequently, the franchisee must pay a renewal fee and may be required to fix any deficiencies of the outlet or to modernize and upgrade it. The FTC’s Trade Regulation Rule (item 17) requires the franchisor to disclose these terms before any contracts are signed.

Transfer and Buybacks

Unlike owners of independent businesses, franchisees typically are not free to sell their businesses to just anyone. Under most franchise contracts, franchisees cannot sell their franchises to a third party or transfer them to others without the franchisor’s approval. In most instances, franchisors approve a franchisee’s request to sell an outlet to another person. Many franchise contracts contain a right of first refusal clause, which means that franchisees must offer to sell their outlets to the franchisor first.



In the Entrepreneurial Spotlight

The Allure of Franchising

Neil Erlich knew that he wanted to be an entrepreneur when he helped start a contracting business when he was just 14 years old. During his junior year at Sonoma State University, Erlich, with help from his father, a corporate executive, began investigating franchise options that would suit his interests and skills. They honed in on the automotive service industry and reviewed the FDDs of several franchises, including Meineke, Jiffy Lube, and Midas, before settling on Express Oil Change. Erlich was particularly impressed with the support that Express Oil Change offered its franchisees. When Erlich graduated with a business degree, his father put up \$375,000 to help him purchase and set up the \$1.5 million franchise operation. Erlich, who is the youngest franchisee in the Express Oil Change system, sees the franchisor’s support as one of the greatest benefits of choosing to open a franchise rather than an independent business of his own. “[The franchisor] is there for you,” he says. “It’s very comforting.”

Like Erlich, a growing number of college graduates and twenty-something adults who are disenchanted with the prospects of a dull job in the corporate grind are looking to franchising as a promising career choice. Indeed, franchising is attracting people of all ages and backgrounds, from corporate dropouts and retired Baby Boomers and corporate cast-offs. “People say, I put 20 years into a company, and because

they ran into some tough times, they let me go,” explains Ray Titus, head of the United Franchise Group. “They think, ‘Do I want to put myself into a position where I may get laid off again?’ Instead, they take control of their future by running their own businesses.” For many of them, franchising is the perfect fit.

Retirees who are looking for second careers also are turning to franchising as well. “They’ve got school-of-hard-knocks experience and business skills that they can apply on day one at a franchise,” says Michael Shay of the International Franchise Association. Judy Divita, a retired corporate human resources manager, and her husband Charlie, a retired college professor and consultant, decided to embark on second careers as franchisees rather than stop working. After researching franchise opportunities, they opened a Firehouse Subs franchise in Columbia, South Carolina, not far from where Charlie had taught at the University of South Carolina. Over the next nine years, the Divitas opened five more sandwich shops in Columbia, including one on the university campus. In addition to their built-in market of college students, they target the players on the athletic teams that come to campus to participate in more than 400 sporting events ranging from baseball and football to basketball and volleyball each year. The Divitas have won First Franchise Award, Franchise of the Year Award and the MVP Award Winner for Innovation

from *Multi-Unit Franchisee* magazine. Their nine outlets generate \$4.5 million in annual sales, and the couple's goal is to have 13 Firehouse Subs locations within 10 years. "The franchise gives you the basic things to put you in business pretty quickly," says Charlie. "You have to take it beyond that and be creative to come up with novel ways of doing things that are particular to your company and your community."

In 1984, at age 19, Atour Eyvazian escaped his war-torn homeland of Iran across a range of rugged mountains, only to be arrested as he crossed into neighboring Turkey. After spending 40 days in jail, he was able to bribe his captors with money that his mother had sewed into his jeans. He emigrated to the United States, learned to speak English, and took a job as a janitor at a Jack in the Box franchise in California. After just two years, Eyvazian's ability and work ethic enabled him to become a manager of the quick-service restaurant and to earn an undergraduate and a master's degree in business administration. Over the next several years, he climbed the corporate ranks to become the company's manager of guest service systems with responsibility for more than 700 restaurants. In 2007, 42-year-old Eyvazian and his family moved to Houston, Texas, where he had the opportunity to become a franchisee of Jack in the Box. Today, the award-winning franchisee owns 109 Jack in the Box franchises in the Houston area, making him the largest individual operator in the chain.

Franchising can be the ideal path to owning a business for people in almost any phase of professional life, whether they are retirees looking for a new direction and extra income or recent college graduates who are ready to embark on exciting careers. "Boosted by a brand name, training, advertising, and an established business plan, a franchise can ease the struggle and the risk of opening a business and still let you call some shots," says one business writer.

1. These examples show people at different stages of their professional lives choosing to become business owners with the help of a franchise. What conclusions can you draw from their stories about the appeal of franchising?
2. What are the advantages and the disadvantages of investing in a franchise?
3. Suppose that one of your friends who is about to graduate is considering purchasing a franchise. What advice would you offer him or her before signing the franchise contract?

Sources: Based on Helen Bond, Home Field Advantage, *Multi-Unit Franchisee*, Issue III, 2012, pp. 18–24; Helen Bond, "A Life of Service," *Multi-Unit Franchisee*, Issue III, 2012, pp. 32–36; Deborah L. Cohen, "Young Entrepreneurs Bypass Corporate Rat Race," *Reuters*, August 20, 2009, www.reuters.com/article/deborahCohen/idUSTRE57J2XS20090820; Allison Ross, "Unemployed Pinning Hopes on Franchise Ventures," *Palm Beach Post*, May 11, 2009, pp. 1F, 6F.

Trends in Franchising

Franchising has experienced three major growth waves since its beginning. The first wave occurred in the early 1970s when fast-food restaurants used the concept to grow rapidly. The fast-food industry was one of the first to discover the power of franchising, but other businesses soon took notice and adapted the franchising concept to their industries. The second wave took place in the mid-1980s as the U.S. economy shifted heavily toward the service sector. Franchises followed suit, springing up in every service business imaginable—from maid services and copy centers to mailing services and real estate. The third wave began in the early 1990s and continues today. It is characterized by new, low-cost franchises that focus on specific market niches. In the wake of major corporate downsizing and the burgeoning costs of traditional franchises, these new franchises allowed would-be entrepreneurs to get into proven businesses faster and at lower costs. These companies feature start-up costs that range from \$3,000 to \$250,000 and span a variety of industries—from leak detection in homes and auto detailing to day care and cost-reduction consulting. Other significant trends in franchising include the following:

9.

Explain current trends that are shaping franchising.

Changing Face of Franchisees

Franchisees today are a more diverse group than in the past, providing business ownership opportunities for minorities, women, and veterans. The International Franchise Association reports that minorities own 20.5 percent of franchises, compared to 14.2 percent of nonfranchised businesses.⁵⁵ Many franchisors have established diversity programs to encourage members of minority groups to become franchisees and to help them overcome the obstacles they face to business ownership, particularly access to capital. In 2006, Domino's Pizza, now with nearly 10,000 stores in more than 70 countries, established its Delivering the Dream program, which offers minority entrepreneurs financial grants, reduced franchise fees, and guarantees on loans up to \$250,000 through GE Franchise Finance. Al Daniels, an African-American navy veteran, was one of the early beneficiaries of the Delivering the Dream program and now owns eight Domino's locations and plans to open more.⁵⁶

Modern franchisees also are better educated, are more sophisticated, have more business acumen, and are more financially secure than those of just 20 years ago. People of all ages and backgrounds are choosing franchising as a way to get into business for themselves. Franchising also is attracting experienced businesspeople who are opening franchises in their second careers and whose goal is to own multiple outlets that cover entire states or regions. Many of

them are former corporate managers—either corporate castoffs or corporate dropouts—looking for a new start on a more meaningful and rewarding career. They have the financial resources, management skills and experience, and motivation to operate their franchises successfully. Experts estimate that 35 to 40 percent of new franchisees are people who have experienced a layoff or some type of job displacement.⁵⁷



Harry Young, Molly Maid franchisee.

Source: Molly Maid Inc.



ENTREPRENEURIAL PROFILE: Harry and Emelie Young: Molly Maid Harry Young and his wife Emelie moved to Austin, Texas, where he took a job in information technology at a large corporation. Traveling 300 days a year was beginning to take its toll on Harry, and the Youngs decided to purchase a Molly Maid housecleaning services franchise. Harry kept his corporate job for a few more years while Emelie managed the franchise. “We set up a system right out of the corporate world,” says Harry, and Emelie followed the Molly Maid franchise model meticulously. When Harry decided to leave the corporate world to join the franchise, Emelie had built it into an operation with \$1.2 million in annual sales. Today, the Youngs Molly Maid franchise employs 100 people and generates \$4 million in annual sales.⁵⁸

Multiple-Unit Franchising

Thirty years ago, the typical franchisee operated a single outlet. Today, however, modern franchisees strive to operate multiple franchise units. In **multiple-unit franchising**, a franchisee opens more than one unit in a broad territory within a specific time period. According to the International Franchise Association, 20 percent of franchisees are multiple-unit owners, a number that is expected to continue to grow over the next several years. These multiple-unit franchisees own 55 percent of all franchise units. Although the typical multiple-unit franchisee owns 4.5 outlets, it is no longer unusual for a single franchisee to own 25, 75, or even 100 units.⁵⁹



ENTREPRENEURIAL PROFILE: Tommy Haddock: Bojangles Tommy Haddock, who purchased his first Bojangles restaurant franchise in 1980, recently opened his forty-seventh Bojangles outlet and has number 48 under construction. Even though Bojangles outlets cost \$1.4 to \$1.6 million to build, they typically generate \$1.7 million in annual sales. “I’m opening stores at a faster pace now than ever before,” he says.⁶⁰

Franchisors have discovered that multiple-unit franchising is an efficient way to do business. For a franchisor, the time and cost of managing 10 franchisees each, owning 12 outlets are much less than managing 120 franchisees each owning one outlet. A multiple-unit strategy also accelerates a franchise’s growth rate. Michael Ansley, who started his career in franchising as a partner in a Buffalo Wild Wings restaurant shortly after graduating from college, now owns 22 Buffalo Wild Wings franchises in Michigan and Florida. He recently signed an area development agreement with the fast-growing franchise to open 16 more locations over the next several years.⁶¹ Not only is multiple-unit franchising an efficient way to expand quickly, but it also is effective for franchisors who are targeting foreign markets, where having experienced local representatives who know the territory is essential.

The popularity of multiple-unit franchising has paralleled the trend toward increasingly experienced, sophisticated franchisees who set high performance goals that a single outlet cannot meet. Michael Ansley, the Buffalo Wild Wings franchisee, says that owning multiple units was part of his plan “from day one. One restaurant was not going to be enough,” he says. “I’m not wired to stay in one place. I’m always looking for the next challenge.”⁶² For franchisees, multiple-unit franchising offers the opportunity to achieve rapid growth without leaving the safety net of the franchise. In addition, franchisees may be able to build fast-growing companies at bargain prices when franchisors offer discounts on their standard fees for buyers who purchase multiple units.

Although operating multiple units offers advantages for both franchisors and franchisees, there are dangers. Operating multiple units requires franchisors to focus more carefully on selecting the right franchisees—those who are capable of handling the additional requirements of multiple units. The impact of selecting the wrong franchise owners is magnified when they operate multiple units and can create huge headaches for the entire chain. Franchisees must be aware of the dangers of losing their focus and becoming distracted if they take on too many units. In addition, operating multiple units means more complexity because the number of business problems franchisees face also is multiplied.

International Opportunities

One of the major trends in franchising is the internationalization of American franchise systems. Increasingly, franchising is becoming a major export industry for the United States; in

fact, two-thirds of the members of the International Franchise Association say that international markets will be important to the success of their franchise operations.⁶³ Franchises based in the United States are expanding rapidly into international markets to boost sales and profits as the domestic market becomes increasingly saturated. Currently, about 3,000 of Dunkin' Donuts's 10,000 outlets are located in foreign markets, but the company has plans to increase the number of foreign outlets to 10,000 over the next few years. Reflecting the views of many U.S.-based franchisors, Nigel Travis, CEO of Dunkin' Brands Group, the parent company of Dunkin' Donuts, says, "We will grow faster internationally than domestically." The company is targeting India and China, where it currently operates 80 stores that sell more than coffee and doughnuts, including savory bagels with toppings such as spinach, roasted red peppers, and garlic mayonnaise. In China, Dunkin' Donuts sells a green tea-flavored Mochi Ring Donut made from sticky rice. Yum! Brands, the parent company of Taco Bell, Pizza Hut, KFC, A&W All-American Food, and Long John Silver's, has more than 38,000 franchised restaurants in 120 countries. The company, which derives more than 70 percent of its profit from international locations, already has a significant presence in China and plans to expand its operations there and in India.⁶⁴

As they venture into foreign markets, franchisors have learned that *adaptation* is one key to success. Although they keep their basic systems intact, franchises that are successful in foreign markets quickly learn how to change their concepts to adjust to local cultures and to appeal to local tastes. "We're not naïve enough to replicate a U.S. Hampton [hotel] and plop it into country X," says Phil Cordell, a global manager for the fast-growing hotel chain that has locations in Europe, Asia, and South America.⁶⁵ Fast-food chains in other countries often must make adjustments to their menus to please locals' palates. In India, a nation that is predominantly Hindu and Muslim and reveres cows, beef-based sandwiches do not appear on menus. Instead, fast-food franchises sell sandwiches made from chicken, lamb, and vegetable patties, and some franchises' Indian menus are strictly vegetarian. Venezuelan diners prefer mayonnaise with their french fries, and in Chile, customers want avocado on their hamburgers. In Japan, McDonald's (known as "Makudonarudo") franchises sell shrimp burgers (Ebi Filet-O), rice burgers, seaweed soup, vegetable croquette burgers, and katsu burgers (cheese wrapped in a roast pork cutlet topped with katsu sauce and shredded cabbage) in addition to their traditional American fare. In the Philippines, the McDonald's menu includes a spicy Filipino-style burger, spaghetti, and chicken with rice. In France, McDonald's, known as "McDo" to locals, sells the McBaguette, a specialty burger made of Charolais beef topped with local Emmental cheese and mustard on a baguette. In Spain, the chain's menu includes gazpacho, a tomato-based vegetable soup that originated in the southern province of Andalusia. In some countries in Europe, McDonald's franchises sell beer. In China, Burger King offers localized menu items such as pumpkin porridge, deep-fried twisted dough sticks called *you tiao*, and *shaobing*, a toasted sesame seed cake that is a traditional Chinese snack.



In the Entrepreneurial Spotlight

The Middle East: A Hot Spot for Franchising

As franchisors in the United States have found wringing impressive growth rates from the domestic market increasingly difficult, they have begun to export their franchises to international markets. A severe recession and a slow recovery have made foreign markets all the more attractive to U.S. franchisors. One of the fastest-growing areas for U.S. franchisors is the Middle East and North Africa region (MENA). With residents of many countries enjoying the wealth generated by rich oil reserves and the region's strong interest in U.S. brands, MENA offers both experienced and new franchisors excellent expansion opportunities. The area's oppressive desert heat compels the population to spend a great deal of time inside, and large shopping malls are a popular destination for many because they serve as social hubs.

"It's a very social culture, and going to malls and socializing is a big part of people's day," says Jonathan Spiel, who sold the first franchise of his Brooklyn, New York-based Tea Lounge to a franchisee in Kuwait. "The malls there are unbelievable. Every brand you can think of is there."

Most U.S. franchisors' first foray into international markets is in either Canada or Mexico because of the countries' proximity and ease of doing business, but others have bravely entered fast-growing, less familiar regions such as the Middle East. Candace Nelson opened Sprinkles Cupcakes, a cupcakes-only bakery in Beverly Hills, California, in 2005 and over the next seven years expanded to 10 company-owned locations in five states. In 2012, Nelson signed a franchise agreement to open 34 outlets in

In the Entrepreneurial Spotlight *(continued)*

the Middle East with M.H. Alshaya Company, a leading international retail franchise operator of more than 55 brands, including Starbucks, P.F. Changs, H&M, Cheesecake Factory, Pinkberry, Shake Shack, and Pottery Barn. The agreement will take Sprinkles into 10 countries across the region, including Bahrain, Egypt, Jordan, Kuwait, Lebanon, Morocco, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. "Our cupcakes are a sophisticated update on an American classic and have developed a strong international fan base overseas," says Nelson.

Hans Hess started Elevation Burger, a restaurant that serves high-quality, organic hamburgers and hand-cut fries cooked in olive oil, in 2002 in Falls Church, Virginia, and began franchising in 2008. Hess had sold just 12 franchises in the United States when he received an inquiry from Ali Askanani, CEO of TABCO International Food Catering, about opening an Elevation Burger franchise in Kuwait. Although Hess had not intended to take his franchise into international markets quite so soon, he realized that this was a golden opportunity. In the fall of 2010, Askanani opened the first international location of Elevation Burger in the Avenues Mall, Kuwait's largest mall (more than 3 million square feet), located in one of the Middle East's premier retail and leisure destinations. Askanani has opened a second Elevation Burger location in Kuwait's Al Hamra Mall, which features more than 100 stores, including other U.S.-based franchises. "We will be expanding throughout Kuwait," he says. Hess has signed several more franchising deals in other countries in the Middle East, where he says Elevation Burger's restaurant sales are more than double those of their counterparts in the United States.

The Middle East is drawing established franchisors as well. Mike Shattuck, CEO of Focus Brands International, which owns Auntie Anne's Pretzels, Carvel (ice cream), Cinnabon (cinnamon rolls), Moe's Southwest Grill (Mexican), and Schlotzsky's Deli (sandwiches), is developing franchisees in the Middle East. Walid Hajj learned about Focus Brands's franchises while he was a student at Harvard University. After graduating, Hajj returned to Dubai to work in the family business, a company that handles distribution for U.S.- and European-based franchises. When he learned that Focus Brands was planning to expand into the Middle East, he "jumped at the opportunity." Hajj formed a company, Cravia, that operates 32 Cinnabon locations, most of which are cobranded outlets that include Seattle's Best Coffee.

As in every global market, franchisors must adapt their products to suit local tastes and customs. "With proper due diligence and research on the countries you want to go into, changes are usually minor," says Jeff Abbott of iFranchise. In the Middle East, for example, food items must be *halal*, compliant with Islamic dietary requirements, and most companies make sure that their supply chains meet the standards. Subway, the sandwich chain, has experienced rapid growth in the number of outlets in the MENA region and, other than promoting its meat products as *halal*, has made only minor changes to its menu.

Some U.S. franchisors' products are somewhat foreign to residents of the Middle East, but the people there are willing to experiment with new concepts and have a strong affinity for U.S. brands. Cravia's Hajj faced some challenges when he introduced Cinnabon's cinnamon rolls to customers in Dubai. "We had to educate the locals with heavy sampling," he says. "There is already a local taste for cinnamon; it was something they just never customized to." Hajj also worked with the



A Cinnabon outlet in Dubai.

Source: Bloomberg/Getty Images.

chefs at Cinnabon to launch Datebon, a roll made from dates, which are a popular treat in the region. "It's done really well, which shows that we are in touch with local *taştes*," says Hajj. "There's a huge value in making minor modifications [to the product line]."

When targeting international markets, Popeye's, a quick-service chicken franchise with a Cajun bent, prefers to expand into countries in which people have a propensity for spicy flavors, which also makes the Middle East an attractive region. "We actually look at the cayenne pepper index, the propensity of a country to eat cayenne pepper," says CEO Cheryl Bachelder. Popeye's already has locations in Dubai, Abu Dhabi, Kuwait, Saudi Arabia, and Turkey and is planning for further expansion.

1. What steps should U.S.-based franchisors take when establishing outlets in foreign countries?
2. Describe the opportunities and the challenges U.S. franchisors face when entering global markets such as the countries of the MENA region.
3. Use the Web as a resource to develop a list of at least five suggestions that will help new franchisors looking to establish outlets in the MENA region.

Sources: Based on "Jason Daley, "New Market Opportunities," *Entrepreneur*, March 2012, pp. 88–97; Mark Brandau, "Middle East Seen as a Hot Growth Market," *Nation's Restaurant News*, June 13, 2012, <http://nrrn.com/article/restaurants-see-middle-east-hot-growth-market>; Jeremiah McWilliams, "Fast Food Chains Heading Overseas, Fast," *Atlanta Journal-Constitution*, April 29, 2010, www.ajc.com/news/business/fast-food-chains-heading-overseas-fast/nQfc2; Brenda Urban, "Sprinkles Cupcakes to Open 34 Locations in the Middle East," *Business Wire*, June 19, 2012, www.businesswire.com/news/home/20120619006452/en/Sprinkles-Cupcakes-Open-34-Locations-Middle-East; "Elevation Burger to Open in Kuwait," *Franchise Wire*, June 22, 2010, www.franchisewire.com/article.php?id=5100; "Elevation Burger Opens Second Location in Kuwait," *FranSmart*, June 8, 2012, <http://fransmart.com/news/70/59/Elevation-Burger-Opens-2nd-Location-In-Kuwait.html>; Diane Brady, "Small U.S. Franchises Head to the Middle East," *Bloomberg Business Week*, June 21, 2012, www.businessweek.com/articles/2012-06-21-small-u-dot-s-dot-franchises-head-to-the-middle-east

Smaller, Nontraditional Locations

Given the challenges of finding financing and the high cost of building full-scale locations, franchisors are searching out nontraditional locations in which to build smaller, less expensive outlets. Based on the principle of **intercept marketing**, the idea is to put a franchise's products or services directly in the paths of potential customers, wherever that may be. Franchises are putting scaled-down outlets on college campuses, in sports arenas, in museums and hospitals, on airline flights, and in zoos. Customers are likely to find a mini-Wendy's inside the convenience store at a Mobil gas station, a Subway sandwich shop in a convenience store, a Dunkin' Donuts outlet in the airport, or a Red Mango kiosk at a sports stadium or arena. Subway has more than 8,000 franchises in nontraditional locations that range from airports and military bases to college campuses and convenience stores. The company has restaurants located in a Goodwill store in Greenville, South Carolina, and inside the True Bethel Baptist Church in Buffalo, New York. Perhaps Subway's most unusual location was a temporary restaurant that served only the construction workers building the skyscraper at 1 World Trade Center in New York City. As work progressed on the 105-story building, a hydraulic lift elevated the restaurant, which was housed inside 36 shipping containers welded together.⁶⁶

Many franchisees have discovered that the sales volume per square foot at smaller outlets in nontraditional locations often exceeds that at full-sized outlets at just a fraction of the cost. Doc Popcorn, a franchise that sells flavored popcorn (including "sinfully cinnamon" and "hoppin' jalapeno") offers franchisees the option of opening full-scale stores, mall kiosks, or mobile carts at price points that range from \$70,000 to \$150,000 and that can accommodate a variety of potential locations.⁶⁷ Dunkin' Donuts recently opened 10 locations on college campuses across the United States. The outlets range from full retail stores to small kiosks that fit into small spaces in campus centers, students unions, dining commons, and other high-traffic areas.⁶⁸ Establishing outlets in innovative locations will be a key to continued franchise growth in the domestic market.

Conversion Franchising

The trend toward **conversion franchising**, in which owners of independent businesses become franchisees to gain the advantage of name recognition, will continue. In a franchise conversion, the franchisor gets immediate entry into new markets and experienced operators; franchisees get increased visibility and often experience a significant sales boost. It is not unusual for entrepreneurs who convert their independent stores into franchises to experience an increase of 20 percent or more in sales because of the instant name recognition the franchise offers.

Refranchising

Another trend that has emerged over the last several years is franchises selling their company-owned outlets to franchisees. Known as **refranchising**, the goal is to put outlets into the hands of operators, who tend to run their franchises more efficiently than the franchisor can. Since 2007, McDonald's has reduced the percentage of company-owned stores in the chain from 23 to 19 percent. Burger King recently sold 96 company-owned restaurants in Orlando, Florida, to longtime franchisee Guillermo Perales, bringing the total number of outlets that Perales owns to 172.⁶⁹ Burger King's goal is to have all of its restaurants owned by franchisees, and the sale means that 92 percent of its outlets are franchise operations. Refranchising not only increases franchisors' profitability because it generates more royalty income for franchisors but also provides capital to finance their international expansion.

Area Development and Master Franchising

Driving the trend toward multiple-unit franchising are area development and master franchising. Under an **area development** arrangement, a franchisee earns the exclusive right to open multiple outlets in a specific area within a specified time. Pizza Patrón, a Dallas-based chain of pizza restaurants aimed at the Hispanic market, recently announced an area development agreement with one of its most successful franchisees, SA Pizza Inc., to develop eight new outlets in San Antonio, Texas, within 31 months. SA Pizza has been a Pizza Patrón franchisee for nine years, has won the company's Patrón of the Year award for excellence twice, and has been a leader

in innovation, building the franchise's first stand-alone outlet and its first double drive-through store. Pizza Patrón operates 104 franchises in seven states and has more than 80 outlets under development.⁷⁰

A **master franchise** (or **subfranchise**) gives a franchisee the right to create a semi-independent “subfranchising” operation in a particular territory to recruit, sell, and support other franchisees. A master franchisee buys the right to develop subfranchises within a territory or, sometimes, an entire country. Like multiple-unit franchising, subfranchising “turbocharges” a franchisor’s growth. Many franchisors use master franchising to open outlets in international markets because the master franchisees understand local laws and the nuances of selling in local markets. Papa Murphy’s International recently signed a master franchise agreement with MAM Foodco LLC, a food company in Dubai, United Arab Emirates, owned by Mohamed Aaly Maghrabi, to manage the opening of 100 Papa Murphy’s Take N’ Bake Pizza outlets in the Middle East. The master franchise deal is the company’s first foray outside of North America.⁷¹

Cobranding

Some franchisors also are discovering new ways to reach customers by teaming up with other franchisors selling complementary products or services. A growing number of companies are **cobranding** (or **combination franchising**) outlets—combining two or more distinct franchises under one roof. This “buddy system” approach works best when the two franchise ideas are compatible and appeal to similar customers. At one location, a Texaco gasoline station, a Pizza Hut restaurant, and a Dunkin’ Donuts, all owned by the same franchisee, work together in a piggyback arrangement to draw customers. Focus Brands, which owns the Schlotzsky’s Deli, Cinnabon, Carvel Ice Cream, Cold Stone Creamery, Auntie Anne’s Pretzels, and Moe’s Southwest Grill, has had success pairing one of its restaurant franchises with a dessert franchise. The company also is expanding its tribranded locations that combine Schlotzsky’s Deli (sandwiches), a Cinnabon (cinnamon buns), and a Carvel (ice cream) into a single location. Franchisees who operate cobranded outlets find that sales throughout various day parts are more consistent than single-brand franchises that see significant swings from peak to nonpeak times.⁷² Cobranding does increase the operational complexity of an operation, but if properly selected, cobranded franchises can magnify many times over the sales and profits of separate, self-standing outlets.

Combination (co-branded) franchise—two franchises in one location.

Source: © Helen Sessions/Alamy.



Serving Dual-Career Couples and Aging Baby Boomers

Now that dual-career couples have become the norm, the market for franchises offering convenience and timesaving devices is booming. Customers are willing to pay for products and services that will save them time or trouble, and franchises are ready to provide them. For instance, Maid Brigade, a residential cleaning franchise with nearly 500 locations across the United States and Canada that has been franchising since 1979, aims its cleaning service at busy professionals who prefer to “spend their time pursuing careers, hobbies and enjoying family and friends” rather than cleaning their homes.⁷³ Other areas in which franchising is experiencing rapid growth include home delivery of meals, pet day care centers, continuing education and training (especially computer and business training), leisure activities (such as hobbies, health spas, and travel-related activities), products and services aimed at home-based businesses, and health care.

A number of franchises are aiming at one of the nation’s largest population segments: aging Baby Boomers. About 40.2 million people, or 12.4 percent of the U.S. population, are 65 or older, and by 2030 that number is expected to double to 72 million. A survey by the American Association of Retired Persons shows that 90 percent of senior citizens want to remain in their homes as they age, which is creating a great business opportunity for franchises such as Home Instead Senior Care, a company with nearly 900 franchises that provides in-home non-health care services to senior citizens. The company expects its domestic sales to grow at 10 percent a year and its international sales to grow at 30 percent a year for the foreseeable future.⁷⁴

Franchising as a Growth Strategy

Entrepreneurs with established and tested business models can use franchising as a growth strategy by becoming franchisors. Franchising enables business owners to use other people’s money to grow their businesses with minimal capital investment on the part of the franchisor. Franchisees put up the funds to start their businesses, infuse capital into the franchising operation through franchise fees, and generate ongoing cash flow for the franchisor from ongoing royalty fees and other charges. In short, franchising accelerates a small company’s growth. However, selling franchises changes the scope of a business and requires entrepreneurs to take on new and different roles. According to one franchise expert, “Franchising is more than selling services or products. You will be an educator, trainer, psychologist, minister, and perpetual hand-holder to your franchisees. You also will be a fee collector, extracting an initial fee and then collecting royalties for the life of the franchise.”⁷⁵

To create a successful franchise operation, a business must meet the criteria outlined in the following sections.

Unique Concept

To make a successful franchise operation, a business must have a unique concept that gives it a competitive edge in the marketplace. For instance, an entrepreneur may develop a new twist on fast food, a better way to exercise, or a new process for removing dents from cars.

Replicable

To make a successful franchise operation, an entrepreneur’s business model must be replicable. Can potential franchisees reproduce the success of the original unit regardless of location? Is there a business system in place that an entrepreneur can teach to franchisees? In addition, is the owner willing to relinquish some control to these new owners? Franchising requires an entrepreneur to leave the business’s daily operations (and its reputation) largely in the hands of franchisees.



ENTREPRENEURIAL PROFILE: Chelsea and Scott Sloan: Uptown Cheapskates While studying for her business degree at the University of Utah, Chelsea Sloan began trading e-mails with her brother Scott about starting a used fashion clothing business. They built a business plan that helped refine their concept and in 2008 launched Uptown Cheapskate, a business that buys and resells trendy, name-brand clothing that customers exchange for cash or credit at the store. Their concept relies on a proprietary inventory management system that took eight months

10.

Describe the potential of franchising a business as a growth strategy.

to develop and that includes prices for thousands of items. The business was an immediate hit, and realizing that their concept was easily replicable, the entrepreneurs began selling franchises almost immediately. Today, Uptown Cheapskates has 16 franchises in 12 states with eight more under development.⁷⁶

Expansion Plan

When entrepreneurs make the decision to franchise, they must develop a sound expansion plan. New franchisors must consider issues such as the speed of growth, territorial development, support services, staffing, and fee structure. The entire plan demands a well-conceived strategy for supporting franchisees and a rigorous financial analysis.

Due Diligence

Launching a successful franchise requires undertaking an extensive due diligence process that includes researching legal issues, preparing a franchise disclosure document, registering necessary trademarks, creating a Web site, and writing training manuals for franchisees. New franchisees discover that they have two new roles: selling franchises and servicing franchisees. “Franchising is like starting an entirely new business venture within the existing business structure,” says Jim Thomas, a former top manager of the Taco Time International franchise. “The business now becomes a legally responsible support system with an entirely new set of responsibilities.”⁷⁷

Legal Guidance

Enlisting professional assistance from a franchise attorney is essential. One of the most important roles of the franchise attorney is to prepare the FDD. Every franchisor must provide to prospective franchisees an FDD that covers the 23 items discussed earlier in this chapter. Recall that 15 states require registration of the FDD before the franchisor can sell franchises. Obtaining legal approval, producing audited financial statements, and marketing the franchise concept is not cheap. Entrepreneurs can expect to invest a minimum of \$100,000 to \$750,000 to launch a franchise business.⁷⁸

Support for Franchisees

Once a franchise operation is running, the franchisor must have the resources available to train franchisees in the operation of the business system, assist them through the start-up phase, and provide ongoing product support for them.

Conclusion

Franchising has proved its viability in the U.S. economy and has become a key part of the small business sector because it offers many would-be entrepreneurs the opportunity to own and operate a business with a greater chance for success. Despite its impressive growth rate to date, the franchising industry still has a great deal of room left to grow, especially globally. Current trends combined with international opportunities indicate that franchising will continue to play a vital role in the global economy.

Chapter Review

1. Explain the importance of franchising in the U.S. economy.
 - Through franchised businesses, consumers can buy nearly every good or service imaginable—from singing telegrams and computer training to tax services and waste-eating microbes.
 - More than 757,000 franchise outlets operate in the U.S. economy, generating more than \$802 billion in

total economic output. Franchises also employ more than 8.2 million people and contribute more than \$460 billion to U.S. GDP.

2. Define the concept of franchising and describe the different types of franchises.
 - Franchising is a method of doing business involving a continuous relationship between a franchisor and a franchisee. The franchisor retains control

- of the distribution system, whereas the franchisee assumes all of the normal daily operating functions of the business.
- There are three types of franchising: trade-name franchising, where the franchisee purchases only the right to use a brand name; product distribution franchising, which involves a license to sell specific products under a brand name; and pure franchising, which provides a franchisee with a complete business system.
3. Describe the benefits and limitations of buying a franchise.
 - The franchisor has the benefits of expanding his business on limited capital and growing without developing key managers internally. The franchisee also receives many key benefits: management training and counseling, customer appeal of a brand name, standardized quality of goods and services, national advertising programs, financial assistance, proven products and business formats, centralized buying power, territorial protection, and greater chances for success.
 - Potential franchisees should be aware of the disadvantages involved in buying a franchise: franchise fees and profit sharing, strict adherence to standardized operations, restrictions on purchasing, limited product lines, potentially ineffective training programs, and less freedom.
 4. Describe the legal aspects of franchising, including the protection offered by the FTC's Trade Regulation Rule.
 - The FTC's Trade Regulation Rule is designed to help the franchisee evaluate a franchising package. It requires each franchisor to disclose information covering 23 topics at least 10 days before accepting payment from a potential franchisee. This document, the franchise disclosure document (FDD), is a valuable source of information for anyone considering investing in a franchise.
 5. Explain the right way to buy a franchise.
 - To buy a franchise the right way requires that you evaluate yourself, research your market, consider your franchise options, get a copy of the franchisor's FDD and study it, talk to existing franchisees, ask the franchisor some tough questions, and make your choice.
 6. Describe a typical franchise contract and some of its provisions.
 - The amount of franchisor–franchisee litigation has risen steadily over the past decade. Three terms are responsible for most franchisor–franchisee disputes: termination of the contract, contract renewal, and transfer and buyback provisions.
 7. Explain current trends shaping franchising.
 - Trends influencing franchising include international opportunities; the emergence of smaller, nontraditional locations; conversion franchising; multiple-unit franchising; master franchising; cobranding franchising; and products and services targeting busy dual career couples and aging Baby Boomers.
 8. Explain the advantages and challenges franchising offers a business as a growth strategy.
 - Franchising a business can be an effective method to grow a business using the investments of the franchisees. It does involve a highly litigious and regulated process that demands specialized legal professions and imposes an entirely new set of administrative demands on the business to establish and administer this complex system.

Discussion Questions

- 6-1. What is franchising?
- 6-2. Explain the importance of franchising in the global economy.
- 6-3. How does franchising benefit franchisees? Franchisors?
- 6-4. Discuss the advantages and the disadvantages of franchising for the franchisee.
- 6-5. Joe Libava, The Franchise King, says, "If you are comfortable following someone else's rules and have a strong desire to be in business for yourself, franchise ownership is an option you should explore. However, if you don't have a very good track record of toeing the line—and instead prefer to make your own rules—becoming a franchise owner may not be the way to get into business for yourself." Do you agree? Explain.
- 6-6. How beneficial to franchisees is a quality training program? What types of entrepreneurs may benefit most from this training?
- 6-7. Why might an independent entrepreneur be dissatisfied with a franchising arrangement?
- 6-8. Explain the right way to buy a franchise.
- 6-9. Describe a typical franchise contract and its primary provisions.
- 6-10. What is the function of the FTC's Trade Regulation Rule? What function does the FDD perform?
- 6-11. Outline the rights the Trade Regulation Rule gives all prospective franchisees.
- 6-12. What is the source of most franchisor–franchisee litigation? Whom does the standard franchise contract favor?

- 6-13.** Describe the current trends affecting franchising within the United States and internationally.
- 6-14.** One franchisee says, “Franchising is helpful because it gives you somebody (the franchisor) to get you going, nurture you, and shove you along a little. However, the franchisor won’t make you successful. That depends on what you bring to the business, how hard you are

prepared to work, and how committed you are to finding the right franchise for you.” Do you agree? Explain.

- 6-15.** What are the criteria a business should consider in order to create a successful franchise operation?
- 6-16.** Explain with suitable examples how franchisors have learned that *adaptation* is one key to business success.

CHAPTER 7

Buying an Existing Business



Learning Objectives

On completion of this chapter, you will be able to:

1. Understand the advantages of buying an existing business.
2. Understand the disadvantages of buying an existing business.
3. Explain the four steps in the search stage for buying the *right* business.
4. Describe the five steps of the deal stage for buying a business the *right* way.
5. Understand the transition stage for buying a business the *right* way.

Opportunity is missed by most people because it is dressed in overalls and looks like work.

—Anonymous

The pessimist sees difficulty in every opportunity, the opportunist sees an opportunity in every difficulty.

— L. P. Jacks

The entrepreneurial experience always involves risk. Buying a franchise, as discussed in Chapter 6, is one approach that can help reduce the risk for an entrepreneur. Another way to reduce the risk associated with entrepreneurship is to purchase an existing business rather than start a new venture. Purchasing an existing business can be a good approach, particularly as the entrepreneurs in the Baby Boom Generation are now reaching retirement age and are seeking to sell their businesses. “I tell the kids at school . . . you will soon be talking to a 67-year-old guy who is a little bit tired of what he’s doing, who’s already talked to his son and his daughter, and the family options don’t exist,” says Dan Steppe, director the University of Houston’s Wolff Center for Entrepreneurship. “The seller will enable the buyer to buy his company fairly inexpensively.”¹ In addition, the recent recession created a buyer’s market for acquiring small businesses due to the weak economic conditions that continue to this day.

Buying an existing business requires a great deal of analysis and evaluation to ensure that what the entrepreneur is purchasing meets his or her needs and expectations. Exercising patience and taking the necessary time to research a business before buying it are essential to getting a good deal. Research conducted by Pepperdine University’s Graziadio School of Business and Management found that 87 percent of the purchases of small to medium-size business took less than one year to complete, with most taking six to eight months.² In too many cases, the excitement of being able to implement a “fast entry” into the market causes an entrepreneur to rush into deal and make unnecessary mistakes in judgment.

Before buying any business, an entrepreneur must conduct a thorough analysis of the business and the opportunity that it presents. According to Russell Brown, author of *Strategies for Successfully Buying or Selling a Business*, “You have access to the company’s earnings history, which gives you a good idea of what the business will make, and an existing business has a proven track record; most established organizations tend to stay in business and keep making money.”³ If vital information such as audited financial statements and legal clearances are not available, an entrepreneur must be especially diligent before buying a business.

Wise entrepreneurs conduct thorough research before negotiating a purchase price for a business. The following questions provide a good starting point:

- Is this the type of business that you would like to operate?
- Does this business match your experience, knowledge, and talents?
- Will this business offer a lifestyle you find attractive?
- What are negative aspects of owning this type of business?
- Are there any skeletons in the company closet that might come back to haunt you?
- Is this the best market and the best location for this business?
- Are there important demographic, population, or political changes in the community where the business is located that could affect future sales favorably or unfavorably?
- Do you know the critical factors that must exist for this business to be successful?
- Do you have the experience required to operate this type of business? If not, will the current owner be willing to stay on for a time to teach you the “ropes”?
- Does the present building meet all state and federal accessibility guidelines? If not, what will it take to bring the facility up to code?
- If the business is profitable, why does the current owner(s) want to sell? Can you verify the current owner’s reason for selling?
- Does the business have a good reputation with its customers and in the community?
- If the business is currently in decline, do you have a plan to return the business to profitability? How confident are you that your turnaround plan will work?
- Have you examined other similar businesses that are currently for sale or that have sold recently to determine what a fair market price for the company is?

The time and energy invested in the evaluation of an existing business will earn significant dividends by allowing an entrepreneur to acquire a business that will continue to be successful or to avoid purchasing a business that is heading for failure.



Buying an established business can reduce the risk of the entrepreneurial experience.
Source: © Manor Photography/Alamy.

Buying an Existing Business

Advantages of Buying an Existing Business

The following are some of the most common advantages of purchasing an existing business.

SUCCESSFUL BUSINESSES OFTEN CONTINUE TO BE SUCCESSFUL A business that has been profitable for some time often reflects an owner who has established a solid customer base, developed successful relationships with critical suppliers, and mastered the day-to-day operation aspects of the business. All of these factors are positive and may be keys to continued success. When things have gone well, it is important for a new owner to make changes slowly and retain the relationships with customers, suppliers, and staff that have made the business a success. This advantage often accompanies the second advantage, using the experience of the previous owner.

LEVERAGING THE EXPERIENCE OF THE PREVIOUS OWNER In cases in which the business has a history of success, a new owner may negotiate with the current owner to stay on as a consultant for a time. This allows a smooth transition during which the seller introduces the new owner to customers and suppliers and shows the new owner the secrets of making the company work. The previous owner can also be very helpful in unmasking the unwritten rules of business—whom to trust, expected business behavior, and many other critical intangibles. Hiring the previous owner as a consultant for the first few months can be a valuable investment for both parties. Learning from the previous owner's experience is extremely helpful.

OWNING A BUSINESS GUARANTEES A JOB As long as you work for someone else, you are at the mercy of that employer and that business. Businesses can be sold or closed down, leaving employees in a state of uncertainty or out of work. Owning a business puts the entrepreneur in charge of his or her own destiny.



ENTREPRENEURIAL PROFILE: Linda Jamerson and Ken McDonald: Aluminum Case Company

Linda Jamerson and her husband, Ken McDonald, had been trying to purchase a business for three years. Although they wanted to work for themselves, they needed high profits rather quickly to generate the income they needed to meet their personal monthly expenses. That is why they chose to buy an existing business rather pursue a start-up. During their search, two promising deals to buy companies fell through. However, when they found the ideal opportunity, the Aluminum Case Company, they were eager to move ahead. "Our criteria were a manufacturing company with a good reputation and growth potential that had been ignored," said Jamerson. "Aluminum Case Company had a large and varied customer base, a unique product niche, a good reputation and capacity for huge growth. They had no Web presence and had not automated their engineering or equipment, so we felt we could make a quick impact on sales." However, they ran into a roadblock on the purchase when they tried to find traditional bank financing to help fund the purchase. "We were discouraged at how little funding our regular bank—and a few others—were willing to lend," says Jamerson. Then they came across a company that specializes in self-directed IRAs and alternative small business financing. Jamerson and McDonald set up a new retirement plan through which they were able to buy Aluminum Case Co. The company's sales grew 60 percent the first year after the

1.

Understand the advantages of buying an existing business.

THE TURNKEY BUSINESS Starting a company can be a daunting, time-consuming task, and buying an existing business is one of the fastest pathways to entrepreneurship. When things go well, purchasing an existing business saves the time and energy required to plan and launch a new business. The buyer gets a business that is already generating cash and perhaps profits as well. The day the entrepreneur takes over the ongoing business is the day revenues begin. Tom Gillis, an entrepreneur, and management consultant in Houston, Texas, says, “Acquiring an established company becomes attractive in three situations: when you haven’t found ‘the idea’ that really turns you on and you find it in an existing business; when you have more money than you have time to start a business from scratch; and when you want to grow but lack a compatible product, service, location or particular advantage that is available from an owner who wants out.” According to Gillis, the critical question is, “What do I gain by acquiring this business that I would not be able to achieve on my own?”⁵

SUPERIOR LOCATION When the location of the business is critical to its success, purchasing a business that is already in the right location may be the best choice. In fact, the existing business’s greatest asset may be its location. A location that provides a significant competitive advantage may be reason enough for an entrepreneur to decide to buy instead of launch. Opening a second-class location and hoping to draw customers often proves fruitless.

EMPLOYEES AND SUPPLIERS ARE IN PLACE Experienced employees who choose to continue to work for the business are a significant resource because they can help the new owner learn the business. In addition, an existing business has an established set of suppliers with a history of business transactions. Vendors can continue to supply the business while the new owner assesses the products and services of other vendors. Thus, the new owner can take the time needed to evaluate alternate suppliers.

INSTALLED EQUIPMENT WITH KNOWN PRODUCTION CAPACITY Acquiring and installing new equipment exerts a tremendous strain and uncertainty on a fledgling company’s financial resources. The buyer of an existing business can determine the condition of the plant and equipment, its capacity, its life expectancy, and its value before buying the business. In many cases, the entrepreneur can purchase the existing physical facilities and equipment at prices that are significantly below their replacement costs. In some businesses, purchasing these assets may be the best part of the deal.

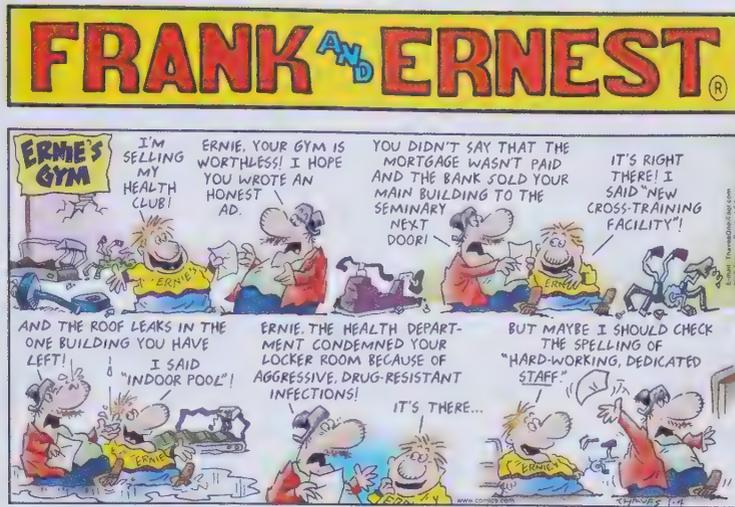
INVENTORY IN PLACE The proper mix and amount of inventory is essential to both cost control and sales volume. A business with too little inventory imposes limitations on satisfying customer demand, and too much inventory ties up excessive amounts capital, increases costs, reduces profitability, and increases the likelihood of cash flow problems. Many successful established business owners have learned a proper balance of inventory. Knowing the “right” amount of inventory to keep on hand can be extremely valuable, especially for buyers of businesses that experience seasonal fluctuations, that sell perishable items, or that must meet the needs of high-volume customers.

ESTABLISHED TRADE CREDIT Previous owners also have established trade credit relationships of which the new owner can take advantage. The business’s proven track record gives the new owner leverage in negotiating favorable trade credit terms. No supplier wants to lose a good customer.

EASIER ACCESS TO FINANCING Investors and bankers often perceive the risk associated with buying an existing business with a solid history of performance to be lower than that of an unknown start-up. This may make it easier for the new owner to secure financing. A buyer can point to the existing company’s track record and to the plans for improving it to convince potential lenders to finance the purchase. Many lenders will finance 50 to 75 percent of the purchase price of a business, depending on a number of factors such as the industry in which it operates, its track record of success, and its profits, cash flow, assets, and collateral.⁶ In addition, in many business purchases, buyers use a built-in source of financing: the seller.

HIGH VALUE Some existing businesses are real bargains. If the current owner must sell quickly, he or she may have established a bargain price for the company that is below its actual worth. Any special skills or training required to operate the business limit the number of potential buyers; therefore, the more specialized the business is, the greater the likelihood is that a buyer can find a bargain. If the owner wants a substantial down payment or the entire bill in cash, there may be few qualified buyers, but those who do qualify may be able to negotiate a good deal.

Source: Bob Thaves/Universal Uclick.



Disadvantages of Buying an Existing Business

Buying an existing business does have disadvantages that are important to consider.

CASH REQUIREMENTS One of the most significant challenges to buying a business is acquiring the necessary funds for the initial purchase price. “[Because] the business concept, customer base, brands, and other fundamental work have already been done, the financial cost of acquiring an existing business is usually greater than starting one from nothing,” observes the Small Business Administration.⁷

THE BUSINESS IS LOSING MONEY A business may be for sale because it is no longer—or never has been—profitable. Owners can use various creative accounting techniques that make a company’s financial picture appear to be much more positive than it actually is. The maxim “let the buyer beware” is sound advice in the purchase of a business. Any buyer who is unwilling to conduct a thorough analysis of the business usually ends up paying a much higher price down the road when the business turns out to be struggling.

Although buying a money-losing business is risky, it is not necessarily taboo. If a business analysis indicates that the company is poorly managed, suffering from neglect, or overlooking a prime opportunity, a new owner may be able to turn it around. However, buying a struggling business without a well-defined plan for solving the problems it faces is an invitation to disaster.



ENTREPRENEURIAL PROFILE: Heather Baker: Saddles and Paddles While working for the local government in Exeter Quay in the United Kingdom, Heather learned that a local bike shop and hire center was up for sale. The shop was located on Exeter’s historic Quayside—a spot popular among both tourists and locals taking advantage of the traffic-free cycling routes. Heather felt it was a business opportunity with some potential. She wrote a well-researched business plan and decided to buy the shop. The main obstacle was finance. After a few months of negotiations, she was able to secure the finance and her offer was accepted. She became the proud owner of Saddles and Paddles. Heather made a few changes in the business procedures, which resulted in an increase of nearly 30% in sales, with bike hire going up by 60% and bike servicing by 170% at the end of the 2013 financial year.⁸

Unprofitable businesses often result from at least one of the following problems:

- Excessively high wage and salary expenses due to excess pay or inefficient use of personnel
- Excessively high compensation for the owner
- Excessively high rental or lease rates
- High-priced maintenance costs or service contracts
- Poor location or too many locations for the business to support

2.

Understand the disadvantages of buying an existing business.

- Prices that are too low
- Low profit margins

If the business is profitable but does not have adequate cash flow, the following potential problems often are the cause:

- High inventory levels
- Inadequate accounts receivable collection efforts
- Losses due to employee theft, shoplifting, and fraud

Like Philip Schram, a potential buyer usually can trace the causes of a company's lack of profitability by analyzing a company and its financial statements. The question is, Can the new owner take steps to resolve the problems and return the company to profitability and positive cash flow?

PAYING FOR ILL WILL Just as proper business dealings can create goodwill, improper business behavior or unethical practices can create ill will. A business may look great on the surface, but customers, suppliers, creditors, or employees may have negative feelings about their dealings with it. Too many business buyers discover—after the sale—that they have inherited undisclosed credit problems, poor supplier relationships, soon-to-expire leases, lawsuits, building code violations, and other problems created by the previous owner. Vital business relationships may have begun to deteriorate, but their long-term effects may not yet be reflected in the company's financial statements. Ill will can permeate a business for years. The only way to avoid these problems is to investigate a prospective purchase target thoroughly *before* moving forward in the negotiation process.

CURRENT EMPLOYEES ARE UNSUITABLE If a new owner plans to make changes in a business, current employees may not suit the company's needs. Some workers may have a difficult time adapting to the new owner's management style and the new vision for the company. Previous managers may have kept marginal employees because they were close friends or had been with the company for a long time. The new owner, therefore, may have to make some very unpopular termination decisions. For this reason, employees may feel threatened by new ownership. In some cases, employees who may have wanted to buy the business themselves but could not afford it are resentful. They may see the new owner as the person who “stole” their opportunity. Bitter employees are not likely to be productive workers and may have difficulty fitting into the new management structure.

LOCATION HAS BECOME UNSATISFACTORY What was once an ideal location may no longer be because of changing demographic patterns. Recently opened malls and shopping centers, new competitors, or traffic pattern changes can spell disaster, especially for a small retail shop. Prospective buyers must evaluate the current market in the area surrounding the business as well as its potential for future growth and expansion. Researching all zoning, traffic, and land development plans with appropriate jurisdictions, such as the city, county, or state, is important as well.

OBSELETE OR INEFFICIENT EQUIPMENT AND FACILITIES Potential buyers sometimes neglect to have an expert evaluate a company's building and equipment before they purchase it. They may discover too late that the equipment is obsolete and inefficient, which increases operating expenses to excessively high levels. Modernizing equipment and facilities is seldom inexpensive.

CUSTOMERS MAY BE LOYAL TO PREVIOUS OWNERS Customers can base their purchasing decisions on personal loyalties to the owner of the business. For some businesses, this can have a modest impact on the performance of these businesses after they are sold. For example, customers of restaurants and retail businesses may have gotten to know the previous owners over the years and may be skeptical about how the new owners will operate the business going forward. In other businesses, customer loyalty and trust of previous owners can make the retention of old customers highly uncertain. This is particularly true with service businesses in which the owners are highly active in the day-to-day operation of the company and interact directly with the customers. For example, businesses providing ongoing services such as lawn care, bookkeeping, house cleaning, car repair, and others often experience a high rate of turnover in customers when a business is sold to new owners. It is important to understand the degree of any personal relationship that the previous owner has with customers and their loyalty to the previous owners before making a final decision to buy a business.

THE CHALLENGE OF IMPLEMENTING CHANGE Planning for change is much easier than implementing it. Methods and procedures the previous owner used create precedents that can be difficult or awkward for a new owner to change. For example, if the previous owner granted volume-based discounts to customers, it may be difficult to eliminate that discount without losing some of those customers. The previous owner's policies—even those that are unwise—can influence the changes the new owner can make. Implementing changes to reverse a downward sales trend in a turnaround situation can be just as difficult as eliminating unprofitable procedures. Convincing alienated customers to return can be an expensive and laborious process that may take years.

OBSOLETE INVENTORY Inventory has value only when it is salable. Too many potential owners make the mistake of trusting a company's balance sheet to provide them with the value of its inventory. The inventory value reported on a company's balance sheet is seldom an accurate reflection of its real market value. A company's inventory may reflect the value at the time of purchase, but inventory, especially technologically related inventory, can depreciate quickly. The value reported on the balance sheet reflects the original cost of the inventory, *not* its actual market value. In fact, inventory and other assets reported as having value may be completely worthless because they are outdated and obsolete. It is the buyer's responsibility to discover the *real* value of the assets before negotiating a purchase price for the business.

VALUING ACCOUNTS RECEIVABLE Like inventory, accounts receivable rarely are worth their face value. The prospective buyer should age the accounts receivable to determine their collectability. The older the receivables are, the less likely they are to be collected and, consequently, the lower their actual value. Table 7.1 shows a simple but effective method of evaluating accounts receivable once the buyer ages them.

THE BUSINESS MAY BE OVERPRICED Most business sales involve the purchase of the company's assets rather than its stock. A buyer must be sure which assets are included in the deal and what their real value is. Many people purchase businesses at prices far in excess of their true value. If a buyer accurately values a business's accounts receivable, inventories, and other assets, he or she will be in a better position to negotiate a price that will allow the business to be profitable. Making payments on a business that was overpriced is a millstone around the new owner's neck, making it difficult to keep the business afloat.

Purchasing an existing business can be a time-consuming process that requires a great deal of effort and is often difficult to complete. Repeated studies report that more than half of all business acquisitions fail to meet the buyer's expectations. This statistic alone should provide a warning about the need to conduct a systematic and thorough analysis prior to negotiating any deal.

TABLE 7.1 Valuing Accounts Receivable

A prospective buyer asked the current owner of a business about the value of her accounts receivable.

The owner's business records showed \$101,000 in accounts receivable. However, when the prospective buyer aged them and then multiplied the resulting totals by his estimated probabilities of collection, he discovered their *real* value.

Age of Accounts (Days)	Amount	Probability of Collection	Value (Amount × Probability of Collection)
0–30	\$40,000	95%	\$38,000
31–60	\$25,000	88%	\$22,000
61–90	\$14,000	70%	\$9,800
91–120	\$10,000	40%	\$4,000
121–150	\$7,000	25%	\$1,750
151+	\$5,000	10%	\$500
Total	\$101,000		\$76,050

Had he blindly accepted the “book value” of these accounts receivable, this prospective buyer would have overpaid by nearly \$25,000 for them!

FIGURE 7.1
Process of Buying a Business



The remainder of this chapter examines the stages that entrepreneurs go through when buying a business: (1) search stage, (2) deal stage, and (3) transition stage (see Figure 7.1).

The Search Stage

When buying a business, entrepreneurs must search for a business that fits best with their background and personal aspirations. There are four steps to conduct an effective search for the right business to buy:

- Conduct a self-inventory.
- Develop a list of the key criteria that define the “ideal business.”
- Seek the help of others in developing a list of potential candidates for acquisitions that meet your criteria.
- Thoroughly investigate the potential acquisition targets that best meet your criteria.

Self-Inventory

The first step in buying a business is conducting a “self-inventory” to determine the ideal business. The following questions produce valuable insights into the best type of business an entrepreneur should consider buying. The answers to these questions provide an important personal guide that help avoid a costly mistake:

- What business activities do you enjoy most? What activities do you enjoy the least?
- Which industries interest you most? Which interest you the least?
- What kind of business do you want to buy?
- What kinds of businesses do you want to *avoid*?
- In what geographic area do you want to live and work?
- What do you expect to get out of the business in terms of income, wealth, and the ability to meet your nonfinancial goals in life?
- What are your long-term goals for work and retirement? What types of businesses will help you meet these goals?
- How much time do you want to set aside for your interests outside of work—family, hobbies, volunteer work, community organizations, and so forth—and how well will different kinds of businesses allow you to continue with these activities?
- How much can you put into the business—in both time and money?
- What business skills and experience do you have? Which ones do you lack?
- How easily can you transfer your existing skills and experience to other types of businesses? In what kinds of businesses would that transfer be easiest?
- How much risk are you willing to take?
- What size company do you want to buy?
- How much can you afford to spend on a company?

Answering those and other questions *beforehand* will allow you to develop a list of criteria that a company must meet before it becomes a purchase candidate.

Develop a List of Criteria

Based on the answers to the self-inventory questions, the next step is to develop a list of criteria that a potential business acquisition must meet. Investigating every business that you find for sale is a waste of time. The goal is to identify the characteristics of the “ideal business” for you so that you can focus on the most viable candidates as you wade through a multitude of business opportunities. These criteria provide specific parameters against which you can evaluate potential acquisition candidates.

Potential Candidates

Once you know the criteria and parameters for the ideal candidate, you can begin your search. One technique is to start at the macro level and work down. Drawing on the resources of the Internet and the library, government publications, and industry trade associations and reports, buyers can discover which industries are growing fastest and offer the greatest potential for future growth. For entrepreneurs with a well-defined idea of what they are looking for, another effective approach is to begin searching in an industry in which they have experience or knowledge.

Typical sources for identifying potential acquisition candidates include the following:

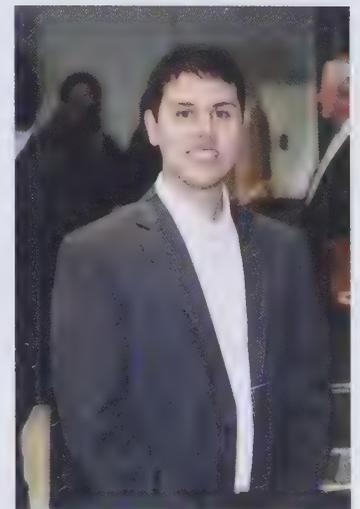
- The Internet, where several sites such as *Bizbuysell.com*, *Bizquest*, and others, include listings of companies for sale
- Bankers
- Accountants
- Attorneys
- Investment bankers
- Trade associations
- Industry contacts such as suppliers, distributors, customers, and others
- Contacting owners of businesses you would like to buy (even if they’re not advertised “for sale”)
- Newspaper and trade journal listings of businesses for sale (e.g., the “Business Opportunities” section of the *Wall Street Journal*)
- “Networking” through social and business contact with friends and relatives

Business brokers, professionals who help buy and sell business for others, can be a valuable resource. Business brokers typically charge a commission based on the value of the sale, ranging from 6 to 10 percent.⁹ Much like the role a real estate agent plays when purchasing a home, a good business broker handles the many details and helps facilitate the transaction. The broker is, however, working for the *seller*, not the buyer. Always ask brokers about their success rates. “My standard answer is that I aim for 80 percent or better,” says business broker Barbara Taylor. “Beware of a broker who tries to justify a low close ratio by quoting dismal industry statistics.” Low success rates may mean that the broker is not effective. However, it may also mean that they go for quantity of deals over quality. Either way, steer clear of brokers with low closing rates.¹⁰

Buyers should consider all businesses that meet their criteria—even those that may not be listed for sale. Just because a business does not have a “for sale” sign in the window does not mean it is not for sale. In fact, the hidden market of companies that might be for sale but are not advertised as such is one of the richest sources of top-quality businesses. Getting the word out that a buyer has an interest in buying a particular type of business often leads to the discovery of many rich business opportunities.



ENTREPRENEURIAL PROFILE: Sean Bandawat: Jacob Bromwell, Inc. Sean Bandawat started two Internet businesses while he was a student at the University of Southern California Marshall School of Business. However, when he graduated, he decided to buy an existing company. The company he chose to purchase was Jacob Bromwell, which was established in 1819. Jacob Bromwell is the 34th-oldest continuously operated company in the United States. “I was attracted to the idea of having an established customer base, established revenue figures, and established assets,” says Bandawat. Jacob Bromwell produces handcrafted, historically correct American products, including the Original Popcorn Popper, Frontier Frying Pan, and Classic Tin Cup. “For the last decade, the company has witnessed a major increase in customers and sales,” says Sean Bandawat. “It took six months of



Sean Bandawat.

due diligence to truly understand why. After months of analyzing the business from every angle, we actually discovered that the company's decline had nothing to do with a decline in demand for these products." The new owner has expanded distribution by securing agreements with the QVC network, catalog companies such as the Vermont Country Store, and specialty retailers nationwide. "With the economy being so uncertain, consumers now more than ever want to buy American-made products that remind them of the past and bring them back to simpler times. That's the real story behind the products we're selling."¹¹

Investigation

The final step in the search process for buying a business is to investigate the businesses that meet the key criteria and are of interest to the entrepreneur. Most people selling a business require the prospective buyer to sign a confidentiality agreement, also known as a nondisclosure agreement (NDA). An NDA is a legally binding contract that defines the information that is covered under the agreement and the purpose of supplying this information. An NDA is a specific promise not to disclose any of the information to other parties and not to use it in any other way (e.g., starting a competing company). The NDA also includes how long the buyer and seller must keep the information confidential and what the parties must do with the information provided if the deal does not go forward. There are three parts to the initial investigation of the business deal once both parties sign the NDA: researching the customer base, analyzing competitors, and determining the seller's motivation for selling.

RESEARCH THE CUSTOMER BASE An entrepreneur should analyze both existing and potential customers before purchasing an existing business. Discovering why customers buy from the business and developing a profile of the existing customer base allows the buyer to identify a company's strengths and weaknesses. The entrepreneur should answer the following questions:

- Does the business have a well-defined customer base? Is it growing or shrinking?
- Who are its customers in terms of race, age, gender, and income level?
- What do customers expect the business to do for them?
- What needs are they satisfying when they buy from the company?
- How often do customers buy?
- Do they buy in seasonal patterns?
- How loyal are present customers?
- Why do some potential customers *not* buy from the business?
- How easily can the company attract new customers? Will the new customers be significantly different from existing customers?
- Is the customer base from a large geographic area, or do they all live near the business?

Analyzing the answers to those questions helps the potential owner develop a marketing plan. Ideally, the entrepreneur will keep the business attractive to existing customers and change features of its marketing plan to attract new customers.

COMPETITOR ANALYSIS A potential buyer must identify the company's direct competitors that are the businesses in the immediate area that sell the same or similar products or services. The potential profitability and survival of the business may depend on the strategies of these competitors. In addition to analyzing direct competitors, buyers should evaluate the trend in the level of competition. Answering the following questions provides valuable insight:

- How many similar businesses have entered the market in the last five years?
- How many similar businesses have closed in the past five years?
- What caused them to fail?
- Has the market already reached the saturation point? Being a late comer in a saturated market is plagued with challenges.

When evaluating the competitive environment, the prospective buyer should answer additional questions:

- What are the characteristics that have led to the success of the company's direct competitors?

- How do competitors' sales volumes compare with those of the business the entrepreneur is considering?
- What unique services do competitors offer?
- How well organized and coordinated are the marketing efforts of competitors?
- How strong are competitors' reputations?
- What are their strengths and weaknesses?
- How can you gain market share in this competitive environment? Can you offer the product or service better, faster, or cheaper?

The intent of the competitor analysis is to determine the company's current competitive situation and the competitive landscape facing the firm in the future. In addition, gathering information about how the company stacks up against its competitors through articles written about the business and interviews with industry insiders and experts provides meaningful insight.

MOTIVATION OF THE SELLER Why does the owner want to sell? Every prospective business owner should investigate the *real* reason the business owner wants to sell. In addition to a planned retirement, the most common reasons businesses are for sale usually fall into three categories:¹²

- The seller is not making enough money in the business.
- The seller has a personal reason for selling, such as health, boredom, or burnout.
- The seller is aware of pending changes in the business or the business environment that will adversely affect its future.

These changes may include a major competitor entering the market, a degraded location, lease problems, cash flow issues, supplier shifts, or a declining customer base. In other cases, owners decide to cash in their business investments and diversify into other types of assets. Every prospective buyer should investigate *thoroughly* the reason a seller gives for selling a business. Remember: Let the buyer beware!



ENTREPRENEURIAL PROFILE: Doug Bolton: The Floor Show When Doug Bolton moved from Wisconsin to Lake Tahoe, California, in 1983, he obtained his independent contractor's license and opened The Floor Show, a flooring and remodeling retail store. Because Lake Tahoe is made up primarily of vacation homes, the properties have high turnover rates. New owners want to make their vacation homes fit their tastes, so there is a steady demand for carpets, flooring, kitchen cabinets, countertops, and window treatments. Bolton and his wife wanted to work fewer hours and spend more time outdoors, so they put the business up for sale for \$318,000. The building is not included in the sales price, but it is available for purchase separately from Bolton's landlord. Sales at The Floor Show had declined by over 25 percent in the two years prior to putting the business up for sale, from more than \$1 million to less than \$750,000. The Boltons managed to cut expenses, so their profit margins remained at about 15 percent.¹³

Businesses do not last forever, and most owners know when the time has come to sell. Some owners do not feel obliged to disclose to potential buyers the whole story of their motivation for selling. In every business sale, the buyer bears the responsibility of determining whether the business is a good value. Visiting local business owners may reveal general patterns about the area and its overall vitality. The local chamber of commerce also may have useful information. Suppliers and competitors may be able to shed light on why a business is for sale. Combining this information with an analysis of the company's financial records, a potential buyer should be able to develop a clear picture of the business and its real value.

REVIEW FINANCES Because both parties have signed an NDA, the buyer should seek detailed financial information including at least three years of past financial statements. The buyer should also tour all facilities and do an initial inspection of equipment and inventory. The prospective buyer can conduct a more detailed analysis of the finances and facilities if the acquisition moves ahead from the search stage to the deal stage.



Lessons from the Street-Smart Entrepreneur

Don't Get Burned When You Buy a Business

Rather than experience the expense, sweat, and toil of starting a new business, many entrepreneurs buy an existing business from someone who has gone through the process of starting a venture and proving its worth. Buying a business, however, is rife with potential pitfalls, and an unprepared entrepreneur can easily get burned. The Street-Smart Entrepreneur offers the following tips for buying an existing business:

- **Recognize that you are not just buying a company; you are buying a livelihood and a lifestyle.** Buyers of small businesses are not just buying assets and inventories and leases; they are also choosing a lifestyle. When you buy a business you are buying two things—a job running the business and an asset that should provide you with a return. The business should provide a reasonable salary for the new owner. It also should provide a return on the investment in the business over time that comes from the profits the business earns after paying a salary to the owner. The business may be the single most significant determinant of your future lifestyle; therefore, choose it carefully.
- **Explore seller financing.** Recent turbulence in the financial industry has made banks hesitant to make loans to business buyers. Fortunately, buyers have a built-in source of capital available: the seller. In a typical deal, the buyer makes a down payment to the seller that ranges from 20 to 70 percent of the purchase price. The seller takes a note for the balance, which the buyer repays over 3 to 10 years. When Alex Shlepakov, founder of Network One, a business based in Elk Grove Village, Illinois, that provides network support services to small businesses, decided to sell the company, he offered to finance a portion of the selling price. Shlepakov accepted a large down payment from the buyers and agreed to finance the balance over two and a half years. Shlepakov says that providing financing is a tangible way for sellers to demonstrate confidence in the business that they are selling.
- **Use professional advisers.** When it comes to conducting due diligence on a potential target company, smart entrepreneurs turn to professionals—accountants, attorneys, business brokers, and others—for valuable insight and advice. Choose professionals who specialize in buying and selling businesses. When buying a business the devil is in

the details. Experienced advisers will protect the buyer from financially disastrous terms and unnecessary risks when structuring the purchase agreement.

- **Link the final price to customer retention.** In many small businesses, particularly service businesses, a significant part of what a buyer is receiving is the existing client or customer base. In sales of these businesses, the agreed-on price often depends on the company's ability to retain a certain percentage of customers. If the company's customer base declines after the buyer takes over, the agreement calls for a reduction in the selling price.
- **Get the seller to stick around.** Buyers usually benefit from having the previous owner stay on during the transition period following the sale. The complexity of the business and the new owner's familiarity with the industry determine whether the time frame is a few weeks or a few years. The previous owner may have years of experience and knowledge of the industry and the local community that prove to be highly valuable to the buyer. Negotiating a deal for the seller to stay on for a time takes a great deal of pressure off of an inexperienced buyer.
- **Do your homework on valuation techniques.** As you have learned in this chapter, valuing a business is partly an art and partly a science. Smart entrepreneurs educate themselves in advance about the various methods practitioners in the industry use to value businesses. Remember that a common technique for estimating the value of a business is to apply a multiple to its earnings before interest and taxes (EBIT). However, the multiples used vary significantly across industries.

In many ways, buying a business is easier than starting a business from scratch, but buying a business poses a unique set of challenges and potential pitfalls. Following these tips from the Street-Smart Entrepreneur lowers the probability that you will get burned when you buy a business.

Source: Based on Arden Dale and Simona Covell, "Sellers Offer a Financial Hand to Their Buyers," *Wall Street Journal*, November 13, 2008, p. B6; Joseph Anthony, "Seven Tips for Buying a Business," Microsoft Small Business Center, www.microsoft.com/smallbusiness/resources/startups/business_opportunities/7_tips_for_buying_a_business.aspx#bio1.

The Deal Stage

Once the entrepreneur has identified the specific business to be purchased, the process moves into the deal stage. The deal stage includes a valuation of the business, formalizing the financing of the purchase, negotiating the details of the purchase, signing a letter of intent, and conducting due diligence. This section examines each of these steps.

4.

Describe the five steps of the deal stage for buying a business the *right* way.

Methods for Determining the Value of a Business

Business valuation is partly an art and partly a science. It is important for the prospective buyer to understand that valuation is the point in the process of buying a business at which many deals fail. A survey of business brokers found that a gap between the price that the seller wanted versus the actual valuation was the largest cause of deals being terminated before closing.¹⁴ The sheer number of variables that influence the value of a privately owned business makes establishing a price difficult. These factors include the nature of the business itself, its position in the market or industry, the outlook for the market or industry, the company's financial status and stability, its earning capacity, intangible assets (such as patents, trademarks, and copyrights), the value of similar companies that are publicly owned, and many others. The median selling price of a private company is \$420,000 according to a database compiled by Business Valuation Resources, a company that tracks private company transactions (see Figure 7.2).¹⁵

Assessing the value of the company's tangible assets usually is straightforward, but assigning a price to the intangible assets, such as goodwill, almost always creates controversy. The seller expects the value of the goodwill to reflect the hard work and long hours invested in building the business. Valuing goodwill often is an emotional issue for sellers because their businesses are tied closely to their egos. The buyer, however, is willing to pay only for those intangible assets that produce extra income. How can a buyer and a seller arrive at a fair price? There are few hard-and-fast rules in establishing the value of a business, but the following guidelines can help:

- There is no single best method for determining a business's worth because each business sale is unique. A practical approach is to estimate a company's value using several techniques, review those values, and then determine the range in which most of the values converge.
- The deal must be financially feasible for both parties to be viable. The seller must be satisfied with the price received for the business, and the buyer cannot pay an excessively high price that requires heavy borrowing that strains cash flow from the outset.

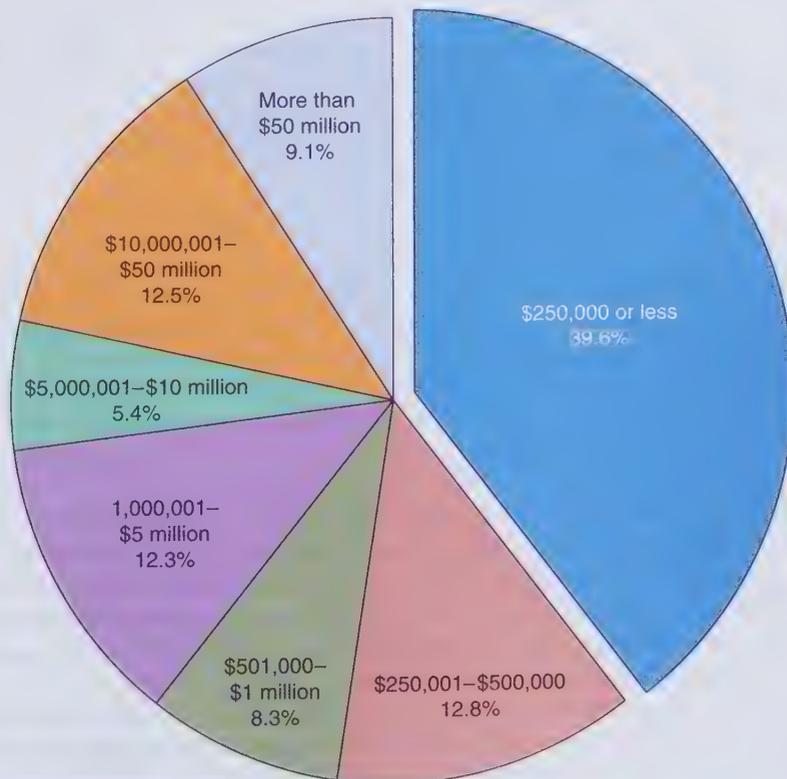


FIGURE 7.2
Selling Prices of Private Companies

Source: Based on Business Valuation Resources, January 16, 2013; www.bvmarketdata.com/defaulttextonly.asp?f=Database%20Chart.

- The buyer should have access to all business records.
- Valuations should be based on facts, not feelings or fiction.
- The two parties should deal with one another openly, honestly, and in good faith.

The main reason that buyers purchase existing businesses is to get their future earning potential. The second most common reason is to obtain an established asset base; it is much easier to buy assets than to build them. Although some valuation methods take these goals into consideration, many business sellers and buyers simplify the process by relying on rules of thumb to estimate the value of a business. For instance, one rule for valuing sporting goods stores is 30 percent of its annual sales plus its inventory.¹⁶ Other rules use multiples of a company's net earnings to value the business. Although the multipliers vary by industry, most small companies sell for 2 to 12 times their EBIT, with an average selling price of between 6 and 7 times EBIT.¹⁷ For instance, a study by Business Valuation Resources of 2,168 business sales over a recent three-year period shows that the median selling price of a restaurant is 2.45 times EBIT, the median price of a car wash is 6.27 times EBIT, and the median price of business consulting service is 11.56 times EBIT.¹⁸ Factors that increase the value of the multiplier include proprietary products and patents; a strong, diversified customer base; above-average growth rate; a strong, balanced management team; and dominant market share. Factors that decrease the value of the multiplier include generic, "me-too" products; dependence on a single customer or a small group of customers for a significant portion of sales; reliance on the skills of a single manager (e.g., the founder); declining market share; and dependence on a single product for generating sales.¹⁹

This section describes three basic techniques—the balance sheet method, the earnings approach, the market approach,—and several variations on them for determining the value of a hypothetical business, Kuyper Electronics.

BALANCE SHEET TECHNIQUE The balance sheet method computes the book value of a company's **net worth**, or **owner's equity** (net worth = assets – liabilities) and uses this figure as the value. A common criticism of this technique is that it oversimplifies the valuation process. The problem with this technique is that it fails to recognize reality: Most small businesses have market values that exceed their reported book values.

The first step is to determine which assets are included in the sale. In most cases, the owner has some personal assets that he or she does not want to sell. Professional business brokers can help the buyer and the seller arrive at a reasonable value for the collection of assets included in the deal. Remember that net worth on a financial statement will likely differ significantly from actual net worth in the market. Figure 7.3 shows the balance sheet for Kuyper Electronics. This balance sheet shows that the company's net worth is as follows:

$$\$278,990 - \$114,325 = \$151,766$$

Variation: Adjusted Balance Sheet Technique A more realistic method for determining a company's value is to adjust the book value of net worth to reflect the actual market value. The values reported on a company's books may either overstate or understate the true value of assets and liabilities. Typical assets in a business sale include notes and accounts receivable, inventory, supplies, and fixtures. If a buyer purchases notes and accounts receivable, he or she should estimate the likelihood of their collection and adjust their value accordingly (refer to Table 7.1).

In manufacturing, wholesale, and retail businesses, inventory is usually the largest single asset in the sale. Taking a physical inventory count is the best way to determine accurately the condition and quantity of goods to be transferred. The sale may include three types of inventory, each having its own method of valuation: raw materials, work in process, and finished goods. Before accepting any inventory value, a buyer should evaluate the condition of the goods to avoid being stuck with inventory that he or she cannot sell.

Fixed assets transferred in a sale might include land, buildings, equipment, and fixtures. Business owners frequently carry real estate and buildings on their books at their original purchase prices, which typically are well below their actual market value. Equipment and fixtures,

ASSETS**Current Assets**

Cash		\$11,655
Accounts receivable		15,876
Inventory		56,523
Supplies		8,574
Prepaid insurance		5,587
Total current assets		<u>\$98,215</u>

Fixed Assets

Land		\$24,000
Buildings	\$141,000	
less accumulated depreciation	<u>51,500</u>	89,500
Office equipment	\$12,760	
less accumulated depreciation	<u>7,159</u>	5,601
Factory equipment	\$59,085	
less accumulated depreciation	<u>27,850</u>	31,235
Trucks and autos	\$28,730	
less accumulated depreciation	<u>11,190</u>	17,540
Total fixed assets		<u>\$167,876</u>

Total Assets**\$266,091****LIABILITIES****Current Liabilities**

Accounts payable		\$19,497
Mortgage payable		5,215
Salaries Payable		3,671
Note Payable		10,000
Total current liabilities		<u>\$38,383</u>

Long-Term Liabilities

Mortgage payable		\$54,542
Note payable		21,400
Total long-term liabilities		<u>\$75,942</u>

Total Liabilities**\$114,325****OWNER'S EQUITY**

Owner's Equity (Net Worth)		\$151,766
Total Liabilities + Owner's Equity		<u>\$266,091</u>

FIGURE 7.3**Balance Sheet for Kuyper Electronics, June 30, 2015**

depending on their condition and usefulness, may increase or decrease the value of the business. Appraisals of these assets on insurance policies are helpful guidelines for establishing market value. In addition, business brokers can be useful in determining the current value of fixed assets. Some brokers use an estimate of what it would cost to replace a company's physical assets (less a reasonable allowance for depreciation) to determine their value. As indicated by the adjusted balance sheet in Figure 7.4, the adjusted net worth for Kuyper Electronics is \$279,738 – \$114,325 = \$165,413, which indicates that some of the entries on its books did not accurately reflect market value.

Business valuations based on any balance sheet methods suffer one major drawback: They do not consider the future earnings potential of the business. These techniques value assets at

FIGURE 7.4**Adjusted Balance Sheet
for Kuyper Electronics,
June 30, 2015**

ASSETS		
Current Assets		
Cash		\$11,655
Accounts receivable		10,051
Inventory		39,261
Supplies		7,492
Prepaid insurance		5,587
Total current assets		<u>\$74,046</u>
Fixed Assets		
Land		\$52,000
Buildings	\$177,000	
less accumulated depreciation	<u>51,500</u>	115,500
Office equipment	\$11,645	
less accumulated depreciation	<u>7,159</u>	4,486
Factory equipment	\$50,196	
less accumulated depreciation	<u>27,850</u>	22,346
Trucks and autos	\$22,550	
less accumulated depreciation	<u>11,190</u>	11,360
Total fixed assets		<u>\$205,692</u>
Total Assets		<u>\$279,738</u>
LIABILITIES		
Current Liabilities		
Accounts payable		\$19,497
Mortgage payable		5,215
Salaries Payable		3,671
Not Payable		10,000
Total current liabilities		<u>\$38,383</u>
Long-Term Liabilities		
Mortgage payable		\$54,542
Note payable		21,400
Total long-term liabilities		<u>\$75,942</u>
Total Liabilities		<u>\$114,325</u>
OWNER'S EQUITY		
Owner's Equity (Net Worth)		\$165,413
Total Liabilities + Owner's Equity		<u>\$279,738</u>

current prices and do not consider them as tools for creating future profits. An additional omission is that balance sheet methods do not attach value to intangible assets of the business such as goodwill.

EARNINGS APPROACH The earnings approach is an approach to valuation that is favored by finance professionals and experienced entrepreneurs because it considers the future income potential of the business. That is what an entrepreneur really is buying with an existing business—its ability to generate returns on their investment into the future.

Variation 1: Adjusted Earnings Method The easiest approach to calculating the value of a business based on its earnings is known as the adjusted earnings method.

Although it does not have the sophistication of the other methods, it is quite commonly used and is accurate enough for many small businesses. This simple method starts with earnings before interest, taxes, depreciation, and amortization (EBITDA) because this is a good measure of the true cash earnings of a business. The buyer deducts interest and taxes because they likely will change with a new owner. Depreciation and amortization will also change because the new owner's accountants will reset the values and time lines that generate these noncash expenses. The buyer normally adjusts the EBITDA reported by the seller to help determine the true value of the business going forward. Because entrepreneurs rarely pay themselves market-based salaries, the buyer replaces the salary of the previous owner with a market-based salary for a typical CEO of a similar-size company. Next, the buyer adds back all personal expenses (such as an auto lease or country club membership) that the current owner runs through the business. Finally, the buyer deducts the costs required to bring inventories up to necessary levels and updating equipment. Suppose that a prospective buyer discovers the following values for Kuyper Electronics:

Reported EBITDA	\$200,000
Add: Current owner's salary	50,000
Subtract: Market salary for CEO	(75,000)
Add: Personal expenses	10,000
Subtract: Inventory needed	(25,000)
Subtract: Equipment updates	<u>(40,000)</u>
Adjusted EBITDA	\$120,000

Note that the adjusted EBITDA is significantly lower than the EBITDA reported on Kuyper Electronics' income statement. Had the buyer simply used the reported EBITDA, the price paid for buying the business would have been significantly higher!

The buyer then uses the adjusted EBITDA to project future potential earnings using an *earnings multiple*. Recall that the typical earnings multiple is from two to twelve times EBITDA with an average multiple of between 6 and 7. Five factors determine the actual multiple used in a business sale. First, the recent trend of earnings in the business influence the multiple. A business with flat or declining earnings over the three years leading up to the sale will have a much lower multiple than one that has shown a consistently strong growth in recent earnings. Second, the buyer must take into account the growth trends of the overall industry. Third, the buyer must give consideration to market conditions in the industry by looking at multiples from comparable companies that have sold recently. Fourth, the buyer must consider strategic factors such as unique patents or proprietary process into determining the earnings multiple. For example, an engineering firm in Minnesota recently sold for a multiple of 25 times EBITDA because the company had a proprietary patented technology that several larger firms wanted to control. Finally, the structure of the deal itself will have an impact. Buyers who pay with cash typically pay a lower multiple than buyers who rely on owner financing or a stock purchase. There is no hard-and-fast rule for establishing an earnings multiple. Most businesses sell for a multiple of six to seven times their earnings. Buyers make adjustments in the multiple, higher *or lower*, based on the factors discussed above. Suppose that taking into account the factors described earlier, the buyer who is considering Kuyper Electronics uses a multiple of 4. The estimated value of the business is as follows:

$$\$120,000 \times 4 = \$480,000$$

Although the adjusted earnings method tends to be an approach to valuation that is much more art than science, it is a commonly used method of valuation for small businesses.

Variation 2: Excess Earnings Method This method combines both the value of a company's existing assets (less its liabilities) and an estimate of its future earnings potential to determine the selling price for the business. One advantage of the **excess earnings method** is that it offers an estimate of goodwill. **Goodwill** is the difference between an established, successful business and one that has yet to prove itself. Goodwill is based on the company's

reputation and its ability to attract customers. This intangible asset often creates problems in a business sale. A common method of valuing a business is to compute its tangible net worth and then to add an often arbitrary adjustment for goodwill. However, a buyer should not accept blindly the seller's arbitrary adjustment for goodwill because it is likely to be inflated.

The excess earnings method provides a reasonable approach for determining the value of goodwill. It measures goodwill by the amount of profit the business earns above that of the average firm in the same industry. It also assumes that the owner is entitled to a reasonable return on the company's adjusted tangible net worth.

Step 1. Compute adjusted tangible net worth. The buyer computes the company's adjusted tangible net worth. Total tangible assets (adjusted for market value) minus total liabilities yields adjusted tangible net worth. In the Kuyper Electronics example shown in Figure 7.4, the adjusted tangible net worth is $\$279,738 - \$114,325 = \$165,413$.

Step 2. Calculate the opportunity costs of investing in the business. Opportunity costs represent the cost of forgoing a choice; what income does the potential buyer give up by purchasing the business? If the buyer chooses to purchase the assets of a business, he or she cannot invest his or her money elsewhere. Therefore, the opportunity cost of the purchase is the amount that the buyer could have earned by investing the same amount in a similar risk investment.

Three components determine the rate of return used to value a business: (1) the basic, risk-free return; (2) an inflation premium; and (3) the risk allowance for investing in the particular business. The basic, risk-free return and the inflation premium are reflected in investments such as U.S. Treasury bonds. To determine the appropriate rate of return for investing in a business, the buyer must add to this base rate a factor reflecting the risk of purchasing the company. The greater the risk involved, the higher the rate of return. An average-risk business typically indicates a 20 to 25 percent rate of return. For Kuyper Electronics, the opportunity cost of the investment is $\$165,413 \times 25\% = \$41,353$.

The second part of the buyer's opportunity cost is the salary that he or she could have earned working for someone else. For the Kuyper Electronics example, if the buyer purchases the business, he or she must forgo a salary of, say, \$75,000 that he or she could have earned working elsewhere. Adding these amounts yields a total opportunity cost of $41,353 + 75,000 = \$116,353$.

Step 3. Project net earnings. The buyer must estimate the company's net earnings for the upcoming year *before* subtracting the owner's salary. Averages can be misleading; therefore, the buyer must be sure to investigate the *trend* of net earnings. Have the earnings risen steadily over the past five years, dropped significantly, remained relatively constant, or fluctuated wildly? Past income statements provide useful guidelines for estimating earnings, but, as you have seen, the buyer often must adjust the earnings. In the Kuyper Electronics example, the buyer and an accountant project the buyer's adjusted net earnings to be \$195,000 (earnings of \$120,000 plus the buyer's anticipated salary of \$75,000).

Step 4. Compute extra earning power. A company's **extra earning power** is the difference between forecasted earnings (step 3) and total opportunity costs of investing (step 2). Many small businesses that are for sale do not have extra earning power (i.e., excess earnings), and they show marginal or no profits. The extra earning power of Kuyper Electronics is: $\$195,000 - \$116,353 = \$78,647$.

Step 5. Estimate the value of intangibles. The buyer can use the business's extra earning power to estimate the value of its intangible assets. Multiplying the extra earning power by a years-of-profit figure yields an estimate of the intangible assets' value. The years-of-profit figure for a normal-risk business typically ranges from three to four. A high-risk business may have a years-of-profit figure of one, whereas a well-established firm might use a figure of seven.

Rating the company on a scale of 1 (low) to 7 (high) on the following factors allows an entrepreneur to calculate a reasonable years-of-profit figure to use to estimate the value of the intangibles:²⁰

Factor	Score						
	1	2	3	4	5	6	7
1. Risk	More risky			Less risky			
2. Degree of competition	Intense competition			Few competitors			
3. Industry attractiveness	Fading			Attractive			
4. Barriers to entry	Low			High			
5. Growth potential	Low			High			
6. Owner's reason for selling	Poor performance			Retiring			
7. Age of business	Young			10+ years old			
8. Current owner's tenure	Short			10+ years			
9. Profitability	Below average			Above average			
10. Location	Problematic			Desirable			
11. Customer base	Limited and shrinking			Diverse and growing			
12. Image and reputation	Poor			Stellar			

To calculate the years-of-profit figure, the entrepreneur adds the score for each factor and divides by the number of factors (12). For Luxor Electronics, the scores are as follows:

Risk	3
Degree of competition	2
Industry attractiveness	4
Barriers to entry	2
Growth potential	4
Owner's reason for selling	6
Age of business	6
Owner's tenure	6
Profitability	4
Location	4
Customer base	3
Image and reputation	5
Total	49

Thus, for Kuyper Electronics, the years-of-profit figure is: $49 \div 12 = 4.1$, and the value of intangibles is $\$78,647 \times 4.1 = \$321,141$.

Step 6. Determine the value of the business. To determine the value of the business, the buyer simply adds together the adjusted tangible net worth (step 1) and the value of the intangibles (step 5). Using this method, the value of Kuyper Electronics is $\$165,413 + \$321,141 = \$486,554$.

Both the buyer and the seller should consider the tax implications of transferring goodwill. Because the *buyer* can amortize both the cost of goodwill and a covenant over 15 years, the tax treatment of either would be the same. However, the *seller* would prefer to have the amount of the purchase price in excess of the value of the assets allocated to goodwill, which is a capital asset. The gain on the capital asset is at lower capital gains rates. If that same amount were allocated to a restrictive covenant (which is negotiated with the seller personally, not the business), the seller must treat it as ordinary income, which is taxed at regular rates that currently are higher than the capital gains rates.

Variation 3: Capitalized Earnings Approach Another earnings approach capitalizes expected net earnings to determine the value of a business. The buyer should prepare his own pro forma income statement and should ask the seller to prepare one also. Many appraisers use a five-year weighted average of past sales (with the greatest weights assigned to the most recent years) to estimate sales for the upcoming year.

Once again, the buyer must evaluate the risk of purchasing the business to determine the appropriate rate of return on the investment. The greater the perceived risk, the higher the return the buyer will require. Risk determination is always somewhat subjective, but it is a necessary consideration for proper evaluation.

The **capitalized earnings approach** divides estimated net earnings (after subtracting the owner’s reasonable salary) by the rate of return that reflects the risk level. For Kuyper Electronics, the capitalized value (assuming a reasonable salary of \$75,000) is as follows:

$$\frac{\text{Net earnings (after deducting owner's salary)}}{\text{Rate of return}} = \frac{\$195,000 - \$75,000}{25\%} = \$480,000$$

Companies with lower risk factors offer greater certainty and, therefore, are more valuable. For example, a lower rate of return of 10 percent yields a value of \$1,200,000 for Kuyper Electronics, whereas a 50 percent rate of return produces a value of \$240,000. Most normal-risk businesses use a rate-of-return factor ranging from 20 to 25 percent. The lowest risk factor that most buyers would accept for any business ranges from 15 to 18 percent.

Variation 4: Discounted Future Earnings Approach This variation of the earnings approach assumes that a dollar earned in the future is worth less than that same dollar today. Using the **discounted future earnings approach**, the buyer estimates the company’s net income for several years into the future and then discounts these future earnings back to their present value. The resulting present value is an estimate of the company’s worth. The present value represents the cost of the buyers’ giving up the opportunity to earn a reasonable rate of return by receiving income in the future instead of today.

To visualize the importance of present value and the time value of money, consider two \$1 million sweepstakes winners. Rob wins \$1 million in a sweepstakes, and he receives it in \$50,000 installments over 20 years. If Rob invests every installment at 8 percent interest, he will have accumulated \$2,288,098 at the end of 20 years. Lisa wins \$1 million in another sweepstakes, but she collects her winnings in one lump sum. If Lisa invests her \$1 million today at 8 percent, she will have accumulated \$4,660,957 at the end of 20 years. The dramatic difference in their wealth—Lisa is now worth nearly \$2,373,000 more—is the result of the time value of money.

The discounted future earnings approach has five steps:

Step 1. Project earnings for five years into the future. One way is to assume that earnings will grow by a constant amount over the next five years. Perhaps a better method is to develop three forecasts—pessimistic, most likely, and optimistic—for each year and find a weighted average using the following formula:

$$\text{Forecasted earnings for year } i = \frac{\text{Pessimistic earnings for year } i + 4 \times \text{Most Likely earnings for year } i + \text{Optimistic earnings years } i}{6}$$

The most likely forecast is weighted four times greater than the pessimistic and optimistic forecasts; therefore, the denominator is the sum of the weights (1 + 4 + 1 = 6). For Kuyper Electronics, the buyer’s earnings forecasts are as follows:

Year	Pessimistic	Most Likely	Optimistic	Weighted Average
2016	\$100,000	\$120,000	\$135,000	\$119,167
2017	108,000	128,000	145,000	127,500
2018	115,000	140,000	160,000	139,167
2019	119,000	150,000	170,000	148,167
2020	125,000	162,000	182,000	159,167

The buyer must remember that the further into the future he or she forecasts, the less reliable the estimates will be.

Step 2. Discount these future earnings using the appropriate present value factor. The appropriate present value factor can be found by looking in published present value tables or by solving the equation

$$1/(1 + k)^t$$

where k = rate of return
and t = time (year 1, 2, 3 . . . n).

The rate that the buyer selects should reflect the rate he or she could earn on a similar risk investment. Because Kuyper Electronics is a normal-risk business, the buyer chooses 25 percent.

Year	Income Forecast (Weighted Average)	Present Value Factor (at 25 Percent)	Net Present Value
2016	\$119,167	.8000	\$95,333
2017	127,500	.6400	81,600
2018	139,167	.5120	71,253
2019	148,167	.4096	60,689
2020	159,167	.3277	52,156
Total			\$361,031

Step 3. Estimate the income stream beyond five years. One technique suggests multiplying the fifth-year income by $1/(\text{rate of return})$. For Kuyper Electronics, the estimate is as follows:

$$\text{Income beyond year 5} = \$159,167 \times (1/25\%) = \$636,667$$

Step 4. Discount the income estimate beyond five years using the present value factor for the sixth year. For Kuyper Electronics,

$$\text{Present value of income beyond year 5: } \$636,667 \times 0.2621 = \$166,898$$

Step 5. Compute the total value of the business.

$$\text{Total value: } \$361,031 + \$166,898 = \$527,929$$

The primary advantage of this technique is that it values a business solely on the basis of its future earnings potential, but its reliability depends on making accurate forecasts of future earnings and on choosing a realistic present value factor. The discounted future earnings approach is especially well suited for valuing service businesses, whose asset bases are often small, and for companies experiencing high growth rates.

MARKET APPROACH The **market (or price/earnings) approach** uses the price/earnings ratios of similar businesses to establish the value of a company. The buyer must use businesses whose stocks are publicly traded in order to get a meaningful comparison. A company's price/earnings ratio (P/E ratio) is the price of one share of its common stock in the market divided by its earnings per share (after deducting preferred stock dividends). To get a representative P/E ratio, the buyer should average the P/Es of as many similar businesses as possible.

The buyer multiplies the average price/earnings ratio by the private company's estimated earnings (after deducting the owner's salary) to compute a company's value. For example, suppose that the buyer found four companies comparable to Kuyper Electronics but whose stock is publicly traded. Their price/earnings ratios are as follows:

Company 1	3.9
Company 2	3.8
Company 3	4.3
Company 4	4.1
Average	4.025

This average P/E ratio produces a value of \$483,000:

$$\begin{aligned} &\text{Value average P/E ratio} \times \text{Estimated net earnings} \\ &4.025 \times \$120,000 = \$483,000 \end{aligned}$$

The most significant advantage of the market approach is its simplicity. However, the market approach method does have several disadvantages, including the following:

1. **Necessary comparisons between publicly traded and privately owned companies.** The stock of privately owned companies is illiquid, and therefore the P/E ratio used is often subjective and lower than that of publicly held companies.
2. **Unrepresentative earnings estimates.** The private company's net earnings may not realistically reflect its true earnings potential. To minimize taxes, owners usually attempt to keep profits low and rely on benefits to make up the difference.
3. **Finding similar companies for comparison.** Often, it is extremely difficult for a buyer to find comparable publicly held companies when estimating the appropriate P/E ratio.
4. **Applying the after-tax earnings of a private company to determine its value.** If a prospective buyer is using an after-tax P/E ratio from a public company, he or she also must use the after-tax earnings from the private company.

Despite its drawbacks, the market approach is useful as a general guideline to establishing a company's value.

THE BEST METHOD? Which of these methods is best for determining the value of a small business? Simply stated, there is no single best method. These techniques will yield a range of values, and buyers should look for values that might cluster together and then use their best judgment to determine their offering price. The final price will be based on both the valuation used and the negotiating skills of both parties. Like all assets, a business is ultimately worth what the highest bidder is willing to pay with terms and conditions that are most acceptable to the seller.



In the Entrepreneurial Spotlight

Bond Coffee

Mel Bond's career included entrepreneurship, mergers and acquisitions, and wealth management in Nashville, Tennessee. His daughter Kathleen followed her father's footsteps, graduating with a degree in entrepreneurship from Belmont University in 2011.

A year after Kathleen graduated from college, Mel found an advertisement for a coffee shop for sale in Nashville.

"Hey, wouldn't it be fun to buy it? Kathleen could manage it," said Mel. "We could sell baked goods and play James Bond movies on the TV while we made lattes for customers."

But the \$100,000 price seemed too high.

Several months later, Mel noticed the business listing again. The price had dropped to \$60,000. "This time, the family got excited," recalls Kathleen. "This was something we might actually be able to do!"

They contacted the broker in charge of selling the coffee shop to set up a meeting. The owner explained his reasons for selling. The business was not profitable. Although sales had increased monthly for more than a year, the owner and his partner had been losing about \$4,000 per month for some time. The shop had been open for about four years. They had done minimal advertising, mostly in print ads that did little to increase business. Mel and Kathleen expanded the menu to include



Mel and Kathleen Bond, owners of Bond Coffee

Source: Kathleen Bond.

Uploaded By: anonymous

sandwiches and salads, which did increase sales but still did not result in reaching the break-even point. The owner shared financial summaries for the past four years.

The owners had not updated the decor of the coffee shop since they opened it, and the furniture was beginning to look worn. There were some problems with management and customer service. It was clear that if the Bonds bought the shop, they would have to make some physical improvements to it. In addition, they would have to change the culture to a more customer-focused approach.

The location was in a growing part of Nashville near downtown known as the Gulch, where there were 900 residential apartments and condominiums within walking distance of the coffee shop. An apartment complex with 295 units was under construction, and another one was due to be completed within a year. A local developer also was building a hotel. The Gulch was home to several bars and restaurants, an organic grocery store, and other retail stores. On the weekends, Nashville tourists frequented the Gulch.

After reviewing the financial statements provided by the current owner, the Bond family estimated that they would have to increase sales by 30 percent to reach the shop's breakeven point. The price of \$60,000 included all equipment and furniture in the business, from the espresso machine to the tables and chairs. The estimated value of the existing equipment was \$8,000. The rest of the price was goodwill, based on the business's location, established brand, and consumer base. The Bonds estimated that it would require about another \$60,000 to make the necessary improvements in the coffee shop.

"Purchasing a coffee shop, as opposed to opening a new location, gave us some unique advantages," says Kathleen. "First, the purchase saved us a significant amount in start-up costs. To start a coffee shop from scratch, we would have needed at least \$100,000 in renovation and equipment alone. By purchasing

the shop, we were able to obtain all of the equipment needed and a location for \$60,000 plus the cost of renovations. Another advantage was the lease. Many businesses rent commercial property, signing leases that range from three- to five-year commitments. With the purchase of the business, we were able to assume a lease—one with only one year left before renewal. If we found that we could not break even, this gave us the ability to exit after only one year. Purchasing a business also saved us from many of the headaches of learning the best strategies for a particular market. The current owner had already tried many things with advertising, hiring, equipment, and recipes, scheduling employees and, of course, the menu. These were mistakes that the previous owners had made and that we would be able to avoid."

The Bonds made an offer to the owner, which he accepted. Due diligence, which took two weeks, included examining all of the financial data, reviewing payroll and employee turnover records, learning more about existing business practices, and carefully reviewing tax returns to verify the shop's earnings. The owner agreed to spend two weeks training Kathleen Bond, who would manage the business for the family when the store reopened after they made the necessary renovations.

1. What was the motivation behind the owner's decision to sell the coffee shop? Why do you think it took a drop in the sale price to entice the Bond family to make an offer? Explain.
2. How common is it to buy a small business without seeking owner financing? How are these deals typically structured?
3. Do you expect that the Bonds will be able to turnaround the coffee shop and make it profitable? What steps do you recommend they take to ensure a good return on their investment?

Negotiating the Deal

Once an entrepreneur has established a reasonable value for the business, the next step in making a successful purchase is negotiating a suitable deal. Most buyers do not realize that the price they pay for a company often is not as crucial to its continued success as the terms of the purchase. In other words, *the structure of the deal—the terms and conditions of payment—is more important than the actual price the seller agrees to pay.*

Wise business buyers attempt to negotiate the best price they can, but they pay more attention to negotiating favorable terms: how much cash they pay out and when, how much of the price the seller is willing to finance and for how long, the interest rate at which the deal is financed, and others. The buyer's primary concern is to ensure that the deal does not endanger the company's financial future and that it preserves the company's cash flow.

On the surface, the negotiation process may appear to be strictly adversarial. Although each party may be trying to accomplish objectives that are at odds with those of the opposing party, the negotiation process does not have to be conflict oriented. The process goes more smoothly and faster if the two parties work to establish a cooperative relationship based on honesty and trust from the outset. A successful deal requires both parties to examine and articulate their respective positions while trying to understand the other party's position. Recognizing that neither of them will benefit without a deal, both parties must work to achieve their objectives while making certain concessions to keep the negotiations alive.

To avoid a stalled deal, both buyer and seller should go into the negotiation with a list of objectives ranked in order of priority. Prioritizing desired outcomes increases the likelihood that you will get all you want from the bargain. Knowing which terms are most important (and which ones are least important) enables the parties to make concessions without

regret and avoid getting bogged down in unnecessary details. If, for instance, the seller insists on a term that the buyer cannot agree to, the seller can explain why he cannot concede on that term and then offer to give up something in exchange.

THE “ART OF THE DEAL” Both buyers and sellers must recognize that no one benefits without an agreement. Both parties must work to achieve their goals while making concessions to keep the negotiations alive.

Figure 7.5 is an illustration of two individuals prepared to negotiate for the purchase and sale of a business. The buyer and seller both have high and low bargaining points in this example:

- The buyer would like to purchase the business for \$900,000 but would not pay more than \$1,300,000.
- The seller would like to get \$1,500,000 for the business but would not take less than \$1,000,000.
- If the seller insists on getting \$1,500,000, they will not sell the business to this buyer.
- Likewise, if the buyer stands firm on an offer of \$900,000, there will be no deal.

The bargaining process may eventually lead both parties into the *bargaining zone*, the area within which the two parties can reach an agreement. It extends from above the lowest price the seller is willing to take to below the maximum price the buyer is willing to pay. The dynamics of this negotiation process and the needs of each party ultimately determine whether the buyer and seller can reach an agreement and for what price.

The following negotiating tips can help parties reach a mutually satisfying deal:

- **Establish the proper mind-set.** Successful negotiations are built on a foundation of trust. The first step in any negotiation should be to establish a climate of trust and communication. Too often, buyers and sellers rush into putting their chips on the bargaining table without establishing a rapport with one another.
- **Know what you want to have when you walk away from the table.** What will it take to reach your business objectives? What would the perfect deal be? Although it may not be possible to achieve it, defining the perfect deal may help to identify which issues are most important to you.
- **Develop a negotiating strategy.** One of the biggest mistakes business buyers can make is entering negotiations with only a vague notion of the strategies they will employ. To be successful, it is necessary to know how to respond to a variety of situations that are likely to arise. Once you know where you want to finish, decide where you will start and remember to leave some room to give. Try not to be the first one to mention price. Let the other party do that and negotiate from there. Every strategy has an upside and a downside, and effective negotiators know what they are.

FIGURE 7.5
Identifying the
Bargaining Zone



- **Recognize the other party's needs.** For a bargain to occur, both parties must believe that they have met at least some of their goals. Asking open-ended questions can provide insight to the other side's position and enable you to understand why it is important.
- **Be an empathetic listener.** To truly understand what the other party's position is, you must listen attentively.
- **Focus on the issue, not on the person.** If the negotiation reaches an impasse, a natural tendency is to attack the other party. Instead, focus on developing a workable solution to accomplish your goals.
- **Avoid seeing the other side as "the enemy."** This attitude reduces the negotiation to an "I win, you lose" mentality that only hinders the process.
- **Educate; don't intimidate.** Rather than trying to bully the other party into accepting your point of view, explain the reasoning and the logic behind your proposal.
- **Be creative.** When negotiations stall or come to an impasse, negotiators must seek creative alternatives that benefit both parties or, at a minimum, get the negotiations started again.
- **Keep emotions in check.** A short temper and an important negotiation make ill-suited partners. The surest way to destroy trust and to sabotage a negotiation is to lose one's temper and lash out at the other party. Anger leads to poor decisions.
- **Be patient.** Sound negotiations often take a great deal of time, especially when one is buying a business from the entrepreneur who founded it. The seller's ego is woven throughout the negotiation process, and wise negotiators recognize this. Persistence and patience are the keys to success in any negotiation involving the sale of the business.
- **Don't become a victim.** Well-prepared negotiators are not afraid to walk away from deals that are not right for them.
- **Remember that "no deal" is an option.** What would happen if the negotiations failed to produce a deal? In most negotiations, walking away from the table is an option. In some cases, it may be the best option.

The Buyer's Goals The buyer seeks to realize the following goals:

- Get the business at the lowest price possible.
- Negotiate favorable payment terms, preferably over time.
- Get assurances that he is buying the business he thinks it is.
- Avoid enabling the seller to open a competing business.
- Minimize the amount of cash paid up front.

The Seller's Goals Entrepreneurs who are most effective at acquiring a business know how important it is to understand the complex emotions that influence the seller's behavior and decisions. For some sellers, this business has been their life and has defined their identity. They may have been the original founder and the person who created the business. For many entrepreneurs, their business defines who they are. They nurtured the business through its infancy and matured it, and now it is time to "let go." Sellers may be asking themselves, What will I do now? Where will I go each morning? Who will I be without "my business"? The negotiation process may bring these questions to light because it requires sellers to, in effect, put a price tag on their life's work. For these reasons, the potential buyer must negotiate in a manner that displays sensitivity and respect.

In general, the seller of the business is looking to accomplish the following goals:

- Get the highest price possible for the company.
- Sever all responsibility for the company's liabilities.
- Avoid unreasonable contract terms that might limit future opportunities.
- Maximize the cash from the deal.
- Minimize the tax burden from the sale.

THE STRUCTURE OF THE DEAL To make a negotiation work, the two sides must structure the deal in a way that is acceptable to both parties. Following are typical ways that parties structure business sales:

Straight Business Sale A straight business sale may be best for a seller who wants to step down and turn over the reins of the company to someone else. A study of small business sales in 60 categories found that 94 percent were asset sales. In an asset sale, the seller keeps all liabilities—those that are on the books and any that might emerge in the future due to litigation. That is why buyers favor asset sales. The remaining 6 percent involved the sale of stock. About 22 percent were for cash, and 75 percent included a down payment with a note carried by the seller. The remaining 3 percent relied on a note from the seller with no down payment. When the deal included a down payment, it averaged 33 percent of the purchase price. Only 40 percent of the business sales studied included covenants not to compete.²¹

Although selling a business outright is often the safest exit path for an entrepreneur, it is usually the most expensive. Sellers who want cash and take the money up front may face a significant tax burden. They must pay a capital gains tax on the sale price less their investments in the company. Nor is a straight sale an attractive exit strategy for those who want to stay on with the company or for those who want to surrender control of the company gradually rather than all at once.

Ideally, a buyer has already begun to explore the options available for financing the purchase. (Recall that many entrepreneurs include bankers on their teams of advisers.) If traditional lenders shy away from financing the purchase of an existing business, buyers often find themselves searching for alternative sources of funds. Fortunately, most business buyers discover an important source of financing built into the deal: the seller. Typically, a deal is structured so that the buyer makes a down payment to the seller, who then finances a note for the balance. The buyer makes regular principal and interest payments over time—perhaps with a larger balloon payment at the end—until the note is paid off. A common arrangement involves a down payment with the seller financing the remaining 20 to 70 percent of the purchase price over time, usually 3 to 10 years.

Sellers must be willing to finance a portion of the purchase price, particularly when credit is tight.



ENTREPRENEURIAL PROFILE: Rick Hunt: Risk Removal During a recent recession, Rick Hunt knew that he and his partners would have to accept a note for at least part of the purchase price of their Fort Collins, Colorado–based environmental services company, Risk Removal. With annual sales of \$3 million and a good reputation in a lucrative niche market (the company removes asbestos and lead paint from buildings), Risk Removal had attracted attention from several buyers, but none had been able to close a financing deal. Hunt hired a business broker, and within months, he and his partners had accepted an offer from a buyer who had experience in the business and could pay 25 percent of the purchase price in cash. A bank financed 50 percent of the price, and Hunt and his partners accepted a five-year promissory note at 7 percent interest for the remaining 25 percent.²²

The terms of the deal are vital to both buyer and seller. They cannot be so burdensome that they threaten the company's continued existence; that is, the buyer must be able to make the payments to the seller out of the company's cash flow.

Use a Two-Step Sale For owners wanting the security of a sales contract now but not wanting to step down from the company's helm for several years, a two-step sale may be ideal. The buyer purchases the business in two phases, getting 20 to 70 percent today and agreeing to buy the remainder within a specific time period. Until the final transaction takes place, the original owner retains at least partial control of the company.

Letter of Intent

Once the buyer and seller have negotiated the deal, they put the details of the structure of the sale into a *letter of intent*. The letter of intent is a firm commitment by both sides that they are ready to move toward closing the sale of the business. The letter clearly sets the price and any factors that may affect the actual price paid at closing. It also outlines the terms of the sale, including whether it is an asset sale or a stock sale and the nature of owner financing if it is part of the deal.

Any other specific deal points that are important to either side also should be included in the letter of intent. Finally, the letter of intent gives specific dates when the deal must close. Although both parties may be committed to closing the sale of the business, only 25 percent of deals make it from the letter of intent stage to the final closing. The old saying “the devil is in the details” holds true when buying a business. Many deals fall apart during the process of due diligence and during the creation of the closing documents for the sale of the business.

The Due Diligence Process

Due diligence involves studying, reviewing, and verifying all of the relevant information concerning the acquisition. The goal of the due diligence process is to discover exactly what the buyer is purchasing and avoid any unpleasant surprises *after* the deal is closed. Exploring a company’s character and condition through the Better Business Bureau, credit-reporting agencies, its bank, its vendors and suppliers, your accountant, your attorney, and through other resources is a vital part of making certain the entrepreneur is going to get a good deal on a business with the capacity to succeed. It is important invest in the due diligence process—you may choose to pay now or pay later.²³



ENTREPRENEURIAL PROFILE: Emma Cerulli and Sebastien Barthe: Em and Seb

Emma Cerulli and Sebastien Barthe purchased the assets of a failing catering company in Montreal, Quebec. They believed that it had a strong client base and a great deal of potential. Their client base grew to include area hospitals, law firms, and university departments. Barthe, who had been a head chef prior to buying the business, is responsible for the business operations. Cerulli brought her experience from culinary school at the Pacific Institute of Culinary Arts in Vancouver as well as what she had learned working in several well-known Montreal restaurants. However, after they purchased the business, they discovered that their overhead was much higher than they had estimated in their budgets based on company history because the financial information that they had received from the previous owner was inaccurate. Careful due diligence would have given them a more accurate picture of the real financial situation of the business. In addition, their labor costs were too high. “Although I believe labor cost is the main issue,” says Cerulli, “I’m afraid that if we lay people off, we won’t have enough staff to meet demand.” Despite with their best efforts, Cerulli and Barthe ultimately decided to close the business.²⁴

A thorough analysis of an intended acquisition usually requires an entrepreneur to assemble a team of advisers. Buying a business involves many complex legal, financial, tax, and business issues, and good advice can be a valuable tool. Many entrepreneurs involve an accountant, an attorney, an insurance agent, a banker, and sometimes a business broker to serve as consultants during the due diligence process.

The due diligence process involves investigating three critical areas of the business and the potential deal beyond those already evaluated earlier in the search and deal processes:

1. Confirming valuation: What is the real value of the business?
2. Legal issues: What legal aspects of the business are known or hidden risks?
3. Financial state: Is the business financially sound?

CONFIRMING VALUATION What is the true nature of the firm’s assets? A prospective buyer should evaluate the business’s assets to determine their true value. The buyer bases the valuation used to negotiate the deal on the financial statements provided by the seller. The buyer and the advising team must verify the actual value of the business through careful inspection of the business and its assets. Questions to ask about assets include the following:

- Are the assets really useful, or are they obsolete?
- Will the assets require replacement soon?
- Do the assets operate efficiently?

The potential buyer should check the condition of all equipment and the building. Even if the building is not part of the sale price, its condition will determine the ability of the business to operate effectively into the future. It may be necessary to hire a professional to evaluate the major components of the building—its structure and its plumbing, electrical, and heating and cooling systems. These evaluations are often expensive and time consuming and can have a negative impact on a buyer’s budget.

What is the status of the firm's existing inventory? Can the buyer sell all of it at full price, or is some of it damaged or outdated? How much of it would the buyer have to sell at a loss? Is it consistent with the image the new owner wants to project? A potential buyer may need an independent appraisal to determine the value of the firm's inventory and other assets because the current owner may have priced them far above their actual value. These items typically constitute the largest portion of a business's value, and a potential buyer should not accept the seller's asking price blindly. Remember that *book value is not the same as market value*. Value is determined in the market, not on a balance sheet. A buyer often can purchase equipment and fixtures at substantially lower prices than book value.

Other important factors that the potential buyer should investigate include the statuses of accounts receivable, the lease, business records, intangible assets, and the business location:

1. **Accounts receivable.** If the sale includes accounts receivable, the buyer must check their quality before purchasing them. How creditworthy are the accounts? What portion of them is past due? By aging the accounts receivable, the buyer can judge their quality and determine their *real* value. (Refer to Table 7.1.)
2. **Lease arrangements.** If the seller does not own the building, is the lease included in the sale? When does it expire? What restrictions does it have on renovation or expansion? What is the status of the relationship with the property owner? The buyer should determine beforehand any restrictions the landlord has placed on the lease. Does the lease agreement allow the seller to assign the lease to a buyer? The buyer must negotiate all necessary changes with the landlord and get them in writing prior to buying the business.
3. **Business records.** Accurate business records can be a valuable source of information and can tell the story of the company's pattern of success—or lack of it! Unfortunately, many business owners are sloppy record keepers. Consequently, a potential buyer and his or her team may have to reconstruct critical records. It is important to verify as much information about the business as possible. For instance, does the owner have current customer direct mail and e-mail lists? These can be valuable marketing tools for a new business owner.
4. **Intangible assets.** As we have seen, determining the value of intangible assets is much more difficult than computing the value of the tangible assets, yet intangible assets can be one of the most valuable parts of a business acquisition. Does the sale include intangible assets such as trademarks, patents, copyrights, or goodwill? Edward Karstetter, director of valuation services at USBX says, "The value placed on intangible assets such as people, knowledge, relationships, and intellectual property is now a greater proportion of the total value of most businesses than is the value of tangible assets such as machinery and equipment."²⁵
5. **Location and appearance.** The location and appearance of the building are important to most businesses because they send clear messages to potential customers. Every buyer should consider the location's suitability for today and for the near future. Potential buyers also should check local zoning laws to ensure that the changes they want to make are permissible. In some areas, zoning laws are very difficult to change and can restrict a business's growth.

LEGAL ISSUES What legal aspects of the business present risk? Business buyers face myriad legal pitfalls. The most significant legal issues involve liens, contract assignments, covenants not to compete, and ongoing legal liabilities.

Liens The key legal issue in the sale of any asset is typically the proper transfer of good title from seller to buyer. However, because most business sales involve a collection of assorted assets, the transfer of a good title is complex. Some business assets may have **liens** (creditors' claims) against them, and unless those liens are satisfied before the sale, the buyer must assume them and become financially responsible for them. One way to reduce this potential problem is to include a clause in the sales contract that states that any liability not shown on the balance sheet at the time of sale remains the responsibility of the seller. A prospective buyer should have

an attorney thoroughly investigate all of the assets for sale and their lien status before buying any business.

Contract Assignments A buyer must investigate the rights and the obligations he or she would assume under existing contracts with suppliers, customers, employees, lessors, and others. To continue the smooth operation of the business, the buyer must assume the rights of the seller under existing contracts. For example, the current owner may have four years left on a 10-year lease that he or she will assign to the buyer (if the lease allows assignment). A seller can assign most contractual rights unless the contract specifically prohibits the assignment or the contract is personal in nature. For instance, loan contracts sometimes prohibit assignments with **due-on-sale clauses**. These clauses require the buyer to pay the full amount of the remaining loan balance or to finance the balance at prevailing interest rates. Thus, the buyer cannot assume the seller's loan at a lower interest rate. In addition, a seller usually cannot assign his or her credit arrangements with suppliers to the buyer because they are based on the seller's business reputation and are personal in nature. If contracts such as these are crucial to the business operation and cannot be assigned, the buyer must negotiate new contracts.

The prospective buyer also should evaluate the terms of other contracts the seller has, including the following:

- Patent, trademark, or copyright registrations
- Exclusive agent or distributor contracts
- Insurance contracts
- Financing and loan arrangements
- Union contracts

Covenants Not to Compete One of the most important and most often overlooked legal considerations for a prospective buyer is negotiating a **covenant not to compete** (or a **restrictive covenant**) with the seller. Under a restrictive covenant, the seller agrees not to open a competing business within a specific time period and geographic area of the existing one. (The buyer must negotiate the covenant directly with the owner, not the corporation; if the corporation signs the agreement, the owner may not be bound by it.) However, the covenant must be a part of a business sale and must be reasonable in scope in order to be enforceable. Without this protection, a buyer may find his new business eroding beneath his or her feet.

Ongoing Legal Liabilities Finally, a potential buyer must look for any potential legal liabilities the purchase might expose. These typically arise from three sources:

1. Physical premises
2. Product liability claims
3. Labor relations

Physical Premises The buyer must first examine the physical premises for safety. Is the employees' health at risk because of asbestos or some other hazardous material? If the business is a manufacturing operation, does it meet Occupational Safety and Health Administration and other regulatory agency requirements?

Product Liability Claims The buyer must consider whether the product contains defects that could result in **product liability lawsuits**, which claim that a company is liable for damages and injuries caused by the products or services it sells. Existing lawsuits might be an omen of more to follow. In addition, the buyer must explore products that the company has discontinued because he or she might be liable for them if they prove to be defective. The final bargain between the parties should require the seller to guarantee that the company is not involved in any product liability lawsuits.

Labor Relations The relationship between management and employees is a key to a successful transition of ownership. Does a union represent employees in a collective bargaining agreement? The time to discover sour management–labor relations is before the purchase, not after.

The existence of liabilities such as these does not necessarily eliminate a business from consideration. Insurance coverage can shift risk from the potential buyer, but the buyer should

check to see whether the insurance covers lawsuits resulting from actions taken before the purchase. The buyer can also insist on a hold back of a percentage of the purchase price for a period of time to protect against unknown liabilities and other discrepancies. Despite conducting a thorough search, a buyer may purchase a business only to discover later the presence of hidden liabilities, such as unpaid back taxes or delinquent bills, unpaid pension fund contributions, undisclosed lawsuits, or others. Including a clause in the purchase agreement that imposes the responsibility for such hidden liabilities on the seller can protect a buyer from unpleasant surprises after the sale.

FINANCIAL STATE Is the business financially sound? Any investment in a company should produce a reasonable salary for the owner and a healthy return on the money invested. Otherwise, it makes no sense to purchase the business. Therefore, every serious buyer must analyze the records of the business to determine its true financial health. Accounting systems and methods can vary tremendously from one company to another, and buyers usually benefit from enlisting the assistance of an accountant. Some business sellers know all of the tricks to make profits appear to be higher than they actually are. For example, a seller might lower costs by gradually eliminating equipment maintenance or might boost sales by selling to marginal customers who will never pay for their purchases. Techniques such as these can artificially inflate a company's earnings, but a well-prepared buyer will be able to see through them. For a buyer, the most dependable financial records are audited statements, those prepared by a certified public accountant in accordance with generally accepted accounting principles. Unfortunately, most small businesses that are for sale do not have audited financial statements.

A buyer also must remember that he or she is purchasing the future earning potential of an existing business. To evaluate a company's earning potential, a buyer should review past sales, operating expenses, and profits as well as the assets used to generate those profits. The buyer must compare current balance sheets and income statements with previous ones and then develop pro forma statements for the next two or three years. Sales tax records, income tax returns, and financial statements are valuable sources of information.

Earnings trends are another area to analyze. Are profits consistent over time, or have they been erratic? If there are fluctuations, what caused them? Is this earnings pattern typical in the industry, or is it a result of unique circumstances or poor management? If poor management has caused these fluctuations, can a new manager make a difference? Some of the financial records that a potential buyer should examine include the income statement, balance sheet, tax returns, owner's compensation, and cash flow.

Income Statements and Balance Sheets for at Least Three Years It is important to review data from several years because creative accounting techniques can distort financial data in any single year. Even though buyers are purchasing the future earnings of a business, they must remember that many businesses intentionally show low profits to minimize the owners' tax bills. Low profits should prompt a buyer to investigate their causes. Specific entries should be verified using company records for all major categories of expenses and revenues. If the financial statements are not audited, the buyer should take care to validate the financial statements. It is best to seek the assistance of a reputable accountant with experience in acquisitions.

Income Tax Returns for at Least Three Years Comparing basic financial statements with tax returns can reveal discrepancies of which the buyer should be aware. Some small business owners "skim" from their businesses; that is, they take money from sales without reporting it as income. Owners who skim will claim their businesses are more profitable than their tax returns show. However, buyers should not pay for "phantom profits."

Cash Flow Most buyers understand the importance of evaluating a company's earnings history, but few recognize the need to analyze its cash flow. They assume that if earnings are adequate, there will be sufficient cash to pay all of the bills and to fund an adequate salary for them. *That is not necessarily the case.* Before closing any deal, a buyer should review the information with an accountant and convert the target company's financial statements into a cash flow forecast. This forecast must take into account not only existing debts and obligations but also any modifications or additional debts the buyer plans to make in the business. It should reflect the repayment of

financing the buyer arranges to purchase the company. The critical questions are the following: Can the company generate sufficient cash to be self-supporting? How much cash will it generate for the buyer?

A potential buyer must look for suspicious deviations from the average (in either direction) for sales, expenses, profits, assets, and liabilities. Are sales increasing or decreasing? Does the equipment's value on the balance sheet reflect its real value? Are advertising expenses unusually high? How is depreciation reflected in the financial statements?

Finally, a potential buyer should always be wary of purchasing a business if the present owner refuses to disclose the company's financial records. In that case, the buyer's best course of action is to walk away from the deal. Without access to information about the business, a buyer cannot conduct a proper analysis.



Entrepreneurship in Action

What's the Deal?

Dividend.com

Paul Rubillo launched *Dividend.com* in 2008 after a 15-year career on Wall Street. The Web site ranks 1,600 dividend-paying stocks on their relative strength, overall yield attractiveness, dividend reliability, and earnings growth. The site also includes research reports and news updates written by Rubillo, who uses a freemium model, in which users can access some of the material for free, but much of the more valuable information is available for a \$99 annual subscription.

Dividend.com has more than 85,000 unique visitors each month. It is ranked in the top five among Google searches that use the words "dividend" or "dividend stock." The site has 1,300 premium subscribers, generating approximately \$160,000 in annual subscriptions, and more than 8,000 readers who have signed up for free electronic newsletters that Rubillo publishes weekly.

Rubillo wants to sell *Dividend.com* to an individual or a company with experience selling stocks and bonds that would like access to his database of wealthy subscribers and sees the benefit of the domain name and the traffic it generates each month. A business valuation adviser has told him that his asking price of \$1.975 million is in line with comparable high-value Internet domains linked to finance. For example, *Invest.com* sold for \$1 million in 2007.

Rubillo wants to sell *Domain.com* to launch a baseball news site called *Hotstove.com*. "Goodbye, Wall Street; hello, sports," says Rubillo.

Corbin-Pacific

Mike Corbin started building handmade motorcycle seats in 1965. He transformed his passion into a business, Corbin-Pacific, which sells more than \$14 million worth of custom seats, saddlebags, fenders, and other motorcycle gear. About 75 percent of sales are direct to consumers, and the remaining products are sold through motorcycle dealerships.

Revenues had declined over the years prior to Corbin's decision to sell the company he had founded. In fact, sales had

declined almost \$2 million from their peak of more than \$16 million in 2006. In addition, cash flow from the business had declined over that same time period from more than \$2.7 million in 2006 to a little more than \$700,000 in 2008.

Corbin-Pacific has 115 employees who work out of his 82,000-square-foot facility in Hollister, California. Corbin is selling the land on which the company is located separately for \$7.2 million, and its showroom in Daytona Beach, Florida, is for sale for \$3.2 million.

The purchase price of \$11.5 million is based on the value of the 1,500 seat molds and 82 patents and copyrights that are included in the sale. The molds are valued at \$9 million and equipment at \$1.5 million. The remainder of the price includes the value of inventory. Corbin has many loyal customers including celebrities such as Arnold Schwarzenegger and Jay Leno.

Corbin, 65, is ready to cash out of the business he has managed for more than 40 years. He hopes to find a buyer with the same enthusiasm he has for motorcycles. "You can't be successful in the motorcycle business unless you love these machines and the people that ride them," said Corbin.

1. Assume the role of a prospective buyer for these two businesses. How would you conduct the due diligence necessary to determine whether they would be good investments?
2. Do you notice any red flags or potential sticking points in either of these deals? Explain.
3. Which techniques for estimating the value of a business described in this chapter would be most useful to a prospective buyer of these businesses? Are the owners' asking prices reasonable?

Sources: Based on Darren Dahl, "Business for Sale: A Financial Website," *Inc.*, April 1, 2010, www.inc.com/magazine/20100401/business-for-sale-a-financial-website.html; Darren Dahl, "Business for Sale: A Motorcycle-Seat Manufacturer," *Inc.*, May 1, 2009, www.inc.com/magazine/20090501/business-for-sale-a-motorcycle-seat-manufacturer.html?nav=next.

5.

Understand the transition stage for buying a business the *right* way.

The Transition Stage

Once the deal stage is completed, the transition stage begins with the actual closing of the purchase. Closing the sale of a business is a complex legal process. Many deals fall apart at the closing table due to unforeseen surprises or last minute legal maneuvering by either the buyer or seller. Closing documents include the following:

- Asset purchase agreement—the formal agreement of the deal
- Bill of sale—transfers ownership
- Asset list—all assets that are included in the sale including tangible assets and intellectual property
- Buyer's disclosure statement
- Allocation of purchase price—a formal document that must be filed with the Internal Revenue Service at the end of the tax year that allocates the price among the various assets.
- Non-compete agreement
- Consulting/Training agreement
- Transfer of subsidiaries associated with business
- Transfer of utilities
- Transfer of Web sites, social media addresses, and phone numbers
- Documentation of new entity that will own the business and documentation of new bank account for that business
- Transfer of merchant accounts
- Notice to creditors
- Lease assignments
- Financing documents, security agreement, promissory note, and UCC Financing Statement if seller is financing all or part of the sale
- Sales tax and payroll tax clearance
- Escrow instructions
- Closing adjustments/proration
- Transfer of any third party contracts
- Corporate resolution authorizing sale of the corporate assets

Once the parties finalize the closing, the challenge of facilitating a smooth transition is next. No matter how well planned the sale is, there are always surprises. For instance, the new owner may have ideas for changing the business—perhaps radically—that cause a great deal of stress and anxiety among employees and with the previous owner. Charged with such emotion and uncertainty, the transition phase may be difficult and frustrating—and sometimes painful. To avoid a bumpy transition, a business buyer should do the following:

- Concentrate on communicating with employees. Business sales are fraught with uncertainty and anxiety, and employees need reassurance. Take the time to explain your plans for the company.
- Be honest with employees. Avoid telling them only what they want to hear.
- Listen to employees. They have intimate knowledge of the business and its strengths and weaknesses and usually can offer valuable suggestions. Keep your door and your ears open and come in as somebody who is going to be good for the entire organization.
- Devote time to selling the vision for the company to its key stakeholders, including major customers, suppliers, bankers, and others.
- Consider asking the seller to serve as a consultant until the transition is complete. The previous owner can be a valuable resource.

Chapter Review

1. Understand the advantages and disadvantages of buying an existing business.
 - The *advantages* of buying an existing business include the following: A successful business may continue to be successful, the business may already have the best location, employees and suppliers are already established, equipment is installed and its productive capacity known, inventory is in place and trade credit established, the owner hits the ground running, the buyer can use the expertise of the previous owner, and the business may be a bargain.
 - The *disadvantages* of buying an existing business include the following: An existing business may be for sale because it is deteriorating, the previous owner may have created ill will, employees inherited with the business may not be suitable, its location may have become unsuitable, equipment and facilities may be obsolete, change and innovation are hard to implement, inventory may be outdated, accounts receivable may be worth less than face value, and the business may be overpriced.
2. Describe the four steps in the search stage for buying the *right* business.
 - Conduct a self-inventory to determine what businesses fit with your experience, knowledge, background, and lifestyle preferences.
 - Develop a list of the key criteria that define the “ideal business.” These criteria will provide specific parameters against which the entrepreneur can evaluate potential acquisition candidates.
 - Seek the help of others in developing a list of potential candidates for acquisitions that meet your criteria. While you can start with Internet research, it is important to talk to experts from various professional disciplines, including bankers, attorneys, and accountants and with industry insiders and your professional network to get a good list of candidates. You may also want to contact specific companies directly to see if they have an interest in talking about a sale. Business brokers, professionals who help with selling private companies, can also be a source of acquisition candidates.
 - Thoroughly investigate the potential acquisition targets that best meet your criteria. Carefully research the business to learn more about its reputation and uncover any details about its past operations that may be of concern. Assess the motivation of the seller to determine the specific reasons, both personal and business, that are leading them to want to sell the company. Also, review the financial condition of the business in more detail.
3. Describe the five steps of the deal stage for buying a business the *right* way.
 - Valuation—Placing a value on a business is partly an art and partly a science. There is no single best method for determining the value of a business. The following techniques (with several variations) are useful: the earnings approach (excess earnings method, capitalized earnings approach, and discounted future earnings approach), the market approach, and the balance sheet technique (adjusted balance sheet technique).
 - Financing—determine how much, if any, of the purchase price will be financed by the previous owner and where the remaining financing will come from.
 - Negotiation:
 - Selling a business takes time, patience, and preparation to locate a suitable buyer, strike a deal, and make the transition. Sellers must always structure the deal with tax consequences in mind.
 - The first rule of negotiating is never confuse price with value. The party who is the better negotiator usually comes out on top. Before beginning negotiations, a buyer should identify the factors that are affecting the negotiations and then develop a negotiating strategy. The best deals are the result of a cooperative relationship based on trust.
 - Letter of intent—a firm commitment by both sides that they are ready to move toward closing the sale of the business.
 - Due diligence—studying, reviewing, and verifying all of the relevant information concerning the acquisition. The process of due diligence includes the following:
 - Confirming Valuation: What is the real value of the business?
 - Legal Issues: What legal aspects of the business are known or hidden risks?
 - Financial State: Is the business financially sound?
4. Describe the transition stage for buying a business the *right* way.
 - The closing process involves a significant set of legal documents that must all be carefully negotiated.
 - The transition process to the new owner involves clear, honest communication with employees; listening to employees to hear concerns and learn about the business; selling the vision to all key stakeholders; and seeking advice from the previous owner when necessary.

Discussion Questions

- 7-1. What advantages can an entrepreneur who buys a business gain over one who starts a business from scratch?
- 7-2. How would you go about determining the value of the assets of a business if you were unfamiliar with them?
- 7-3. Why do so many entrepreneurs run into trouble when they buy an existing business? Outline the steps involved in the *right* way to buy a business.
- 7-4. When evaluating an existing business that is for sale, what areas should an entrepreneur consider? Briefly summarize the key elements of each area.
- 7-5. How should a buyer evaluate a business's goodwill?
- 7-6. What is a restrictive covenant? Is it fair to ask the seller of a travel agency located in a small town to sign a restrictive covenant for one year covering a 20-square-mile area? Explain.
- 7-7. Explain the process of buying a business.
- 7-8. Why is it so difficult for buyers and sellers to agree on a price for a business?
- 7-9. What may be the motivations of a businessman to sell his business?
- 7-10. Explain the buyer's position in a typical negotiation for a business. Explain the seller's position. What tips would you offer a buyer about to begin negotiating the purchase of a business?
- 7-11. How do you identify the bargaining zone in the bargaining process?

CHAPTER 8

New Business Planning Process: Feasibility Analysis, Business Modeling, and Crafting a Winning Business Plan



Learning Objectives

On completion of this chapter, you will be able to:

1. Present the steps involved in conducting a feasibility analysis.
2. Identify the components of the business model canvas and explain how to use them to develop a viable business model.
3. Explain the benefits of building an effective business plan.
4. Describe the elements of a solid business plan.
5. Explain the three tests every business plan must pass.
6. Explain the “five Cs of credit” and why they are important to potential lenders and investors.
7. Understand the keys to making an effective business plan presentation.

Businesses are like dogs at a fancy dog show. Each one may look different, but they all have the same essential moving parts.

—Patrick van der Pijl

A wise man will make more opportunities than he finds.

—Francis Bacon

For many entrepreneurs, the easiest part of launching a business is coming up with an idea for a new business concept or approach. Business success, however, requires much more than just a great new idea. Once entrepreneurs develop an idea for a business, the next step is to subject it to a feasibility analysis to determine whether they can transform the idea into a viable business. A **feasibility analysis**, which is the first of three steps in planning for a new business, is the process of determining whether an entrepreneur's idea is a viable foundation for creating a successful business. Its purpose is to determine whether a business idea is worth pursuing. If the idea passes the feasibility analysis, the entrepreneur moves on to the next step of the new business planning process. If the idea fails to pass muster, the entrepreneur drops it and moves on to the next opportunity. He or she has not wasted valuable time, money, energy, and other resources launching a business that is destined to fail because it is based on a flawed concept. Although it is impossible for a feasibility study to guarantee an idea's success, conducting a study reduces the likelihood that entrepreneurs will waste their time pursuing fruitless business ventures.

Conducting a feasibility study is *not* the same as developing a business model or building a full-blown business plan; all three play important but separate roles in the start-up process. A feasibility study answers the question “*Should* we proceed with this business idea?” Its role is to serve as a filter, screening out ideas that lack the potential for building a successful business, *before* an entrepreneur commits the necessary resources to develop and test a business model or to build a business plan. A feasibility study is primarily an *investigative* tool. It is designed to give an entrepreneur a picture of the market, sales, and profit potential of a particular business idea. Will a ski resort located here attract enough customers to be successful? Will customers in this community support a sandwich shop with a retro rock-and-roll theme? Can we build the product at a reasonable cost and sell it at a price customers are willing and able to pay? Does this entrepreneurial team have the ability to implement the idea successfully?

The business model answers the question “*How* would we proceed with this business idea?” Developing a business model, which is the second step in planning a new business, helps an entrepreneur to fully understand all that will be required to launch and build the business. Business modeling is another step that determines the potential for success for the new venture. It is a visual process that examines how all the moving parts of the business must fit together in a unified whole to build a successful venture. It is the step in the planning process in which entrepreneurs test their concepts and use what they learned from real customers to refine their business models before committing the resources to grow the business to its full potential.

A business plan is a tool that builds on the foundation of the feasibility study and business model but provides a more comprehensive and detailed analysis than the first two steps in the new business planning process. Together with a well-developed business model, it functions primarily as a planning tool, describing in greater detail how to transform an idea into a successful business. Its primary goals are to expand on the business model to guide entrepreneurs as they launch and operate their businesses and to help them acquire the financing needed to launch.

Feasibility studies are particularly useful when entrepreneurs have generated multiple ideas for business concepts and must winnow their options down to the “best choice.” They enable entrepreneurs to explore quickly the practicality of each of several potential paths for transforming an idea into a successful business venture. Sometimes the result of a feasibility study is the realization that an idea simply won't produce a viable business—no matter how it is organized. In other cases, the process of developing a business model and business plan shows an entrepreneur that the business idea is a sound one but that it must be organized in a different fashion to be profitable.

If an idea proves feasible, the entrepreneur's next step is to leverage the findings of the feasibility analysis to develop a business model and then build a business plan. The primary goals of the business plan are to guide entrepreneurs as they launch and operate their businesses and to help them acquire the necessary financing to launch. A well-constructed business plan may be the best possible insurance against failure. Research suggests that, whatever their size, companies that engage in business planning outperform those that do not. A business plan offers the following:

- A systematic, realistic evaluation of a venture's chances for success in the market
- A way to determine the principal risks facing the venture
- A “game plan” for managing the business successfully
- A tool for comparing actual results against targeted performance
- An important tool for attracting capital in the challenging hunt for money

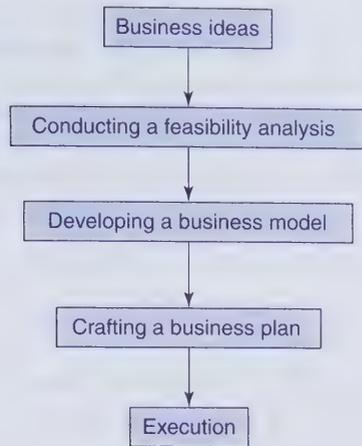


FIGURE 8.1
New Business Planning
Process

The feasibility study, the business model, and the business plan all play important but separate roles in the start-up process (see Figure 8.1). This chapter describes how to build and use these vital business documents, and it will help entrepreneurs create business plans that will guide them on their entrepreneurial journey and help them attract the capital they need to launch and grow their businesses.

Conducting a Feasibility Analysis

A feasibility analysis consists of four interrelated components: an industry and market feasibility analysis, a product or service feasibility analysis, a financial feasibility analysis, and an entrepreneur feasibility analysis (see Figure 8.2). “A feasibility analysis is a chance to open your eyes, ask yourself some very tough questions, then check to see whether your idea, as originally conceived, needs to be modified, refocused, or changed dramatically. (Or perhaps even scrapped altogether),” says Rhonda Abrams, nationally syndicated columnist, author, and successful entrepreneur.¹

1. Present the steps involved in conducting a feasibility analysis.

Industry and Market Feasibility Analysis

When evaluating the feasibility of a business idea, an analysis of the industry and targeted market segments serves as the starting point for the remaining three components of a feasibility analysis. The focus in this phase is twofold: (1) to determine how attractive an industry is overall as a “home” for a new business and (2) to identify possible niches a small business can occupy profitably.

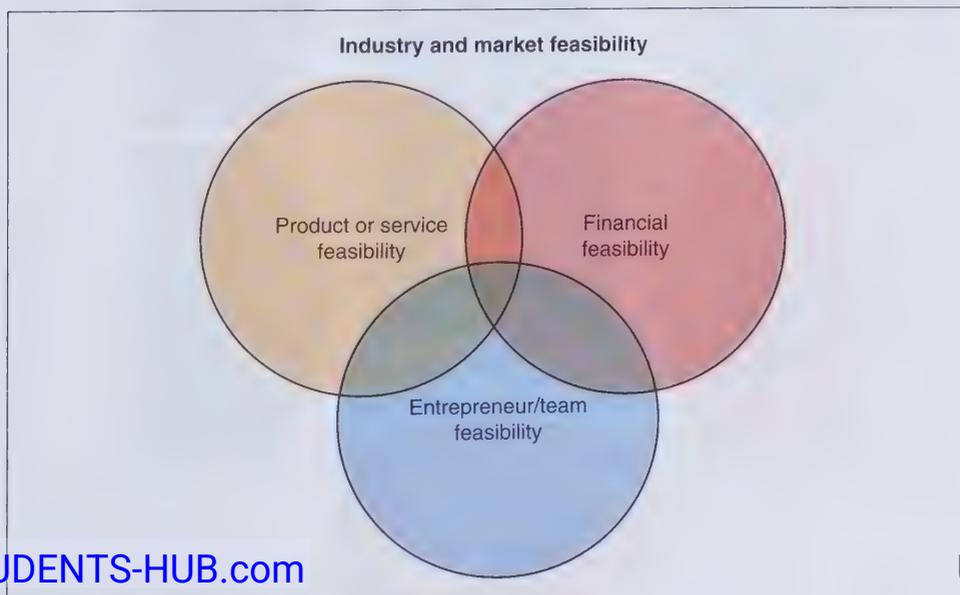


FIGURE 8.2
Elements of a Feasibility
Analysis

The first step in assessing industry attractiveness is to paint a picture of the industry with broad strokes, assessing it from a “macro” level. Most opportunities for new businesses within an industry are due to changes taking place in that industry. For example, although the Internet disrupted business for the established major corporations in the music industry, the fundamental changes it created in how customers listen to and purchase music have created many opportunities for entrepreneurs within this industry. Answering the following questions will help establish this perspective:

- How large is the industry?
- How fast is it growing?
- Is the industry as a whole profitable?
- Is the industry characterized by high profit margins or razor-thin margins?
- How essential are its products or services to customers?
- What trends are shaping the industry’s future?
- What threats does the industry face?
- What opportunities does the industry face?
- How crowded is the industry?
- How intense is the level of competition in the industry?
- Is the industry young, mature, or somewhere in between?

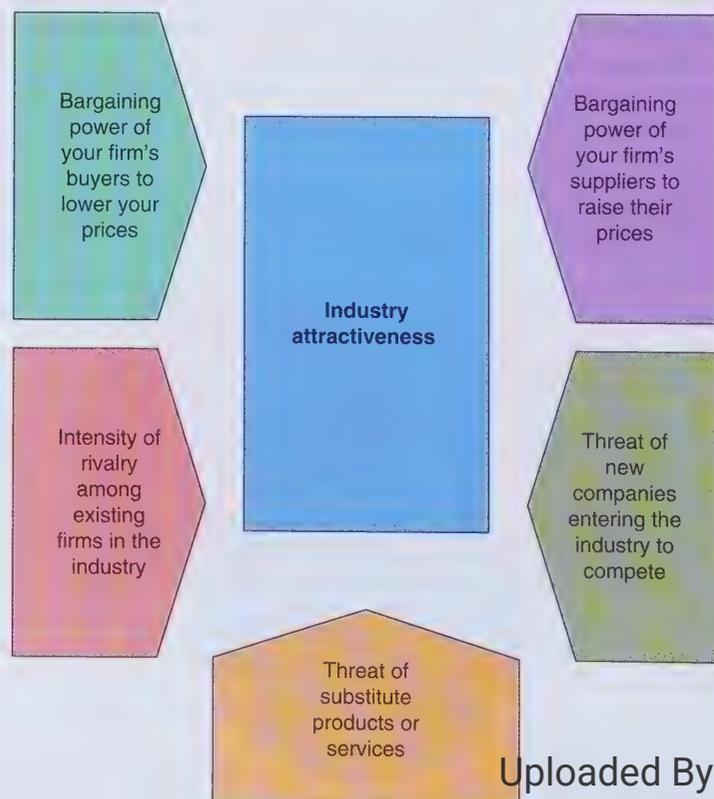
Addressing these questions helps entrepreneurs determine whether the potential exists for sufficient demand for their products and services.

A useful tool for analyzing an industry’s attractiveness is Porter’s “five forces” model developed by Michael E. Porter of the Harvard Business School (see Figure 8.3). Five forces interact with one another to determine the setting in which companies compete and hence the attractiveness of the industry: (1) the rivalry among competing firms, (2) the bargaining power of suppliers, (3) the bargaining power of buyers, (4) the threat of new entrants, and (5) the threat of substitute products or services.

FIGURE 8.3

Porter’s Five Forces Model

Source: Based on Michael E. Porter, “How Competitive Forces Shape Strategy,” *Harvard Business Review* 57, no. 2 (March–April 1979), pp. 137–145. Reprinted by permission of Harvard Business School Publishing.



RIVALRY AMONG COMPANIES COMPETING IN THE INDUSTRY The strongest of the five forces in most industries is the rivalry that exists among the businesses competing in a particular market. Much like the horses running in the Kentucky Derby, businesses in a market are jockeying for position in an attempt to gain a competitive advantage. When a company creates an innovation or develops a unique strategy that transforms the market, competing companies must adapt or run the risk of being forced out of business. This force makes markets a dynamic and highly competitive place. Generally, an industry is more attractive under the following conditions:

- The number of competitors is large or, at the other extreme, quite small (fewer than five).
- Competitors are not similar in size or capability.
- The industry is growing at a fast pace.
- The opportunity to sell a differentiated product or service is present.

BARGAINING POWER OF SUPPLIERS TO THE INDUSTRY The greater the leverage that suppliers of key raw materials or components have, the less attractive is the industry. For instance, because they supply the chips that serve as the “brains” of PCs and because those chips make up a sizable portion of the cost of a computer, chip makers such as Intel and Advanced Micro Devices exert a great deal of power over computer manufacturers such as Dell, Toshiba, and Acer. Generally, an industry is more attractive under the following conditions:

- Many suppliers sell a commodity product to the companies in it.
- Substitute products are available for the items suppliers provide.
- Companies in the industry find it easy to switch from one supplier to another or to substitute products (i.e., “switching costs” are low).
- When the items suppliers provide the industry account for a relatively small portion of the cost of the industry’s finished products.

BARGAINING POWER OF BUYERS Just as suppliers to an industry can be a source of pressure, buyers also have the potential to exert significant power over businesses, making it less attractive. When the number of customers is small and the cost of switching to competitors’ products is low, buyers’ influence on companies is high. Famous for offering its customers low prices, Walmart, the largest company in the world, is also well known for applying relentless pressure to its 21,000 suppliers for price concessions, which it almost always manages to get.² Generally, an industry is more attractive under the following conditions:

- Industry customers’ “switching costs” to competitors’ products or to substitutes are relatively high.
- The number of buyers in the industry is large.
- Customers demand products that are differentiated rather than purchase commodity products that they can obtain from any supplier (and subsequently can pit one company against another to drive down price).
- Customers find it difficult to gather information on suppliers’ costs, prices, and product features—something that is becoming much easier for customers in many industries to do by using the Internet.
- When the items companies sell to the industry account for a relatively small portion of the cost of their customers’ finished products.

THREAT OF NEW ENTRANTS TO THE INDUSTRY The larger the pool of potential new entrants to an industry, the greater is the threat to existing companies in it. This is particularly true in industries where the barriers to entry, such as capital requirements, specialized knowledge, access to distribution channels, and others, are low. Generally, an industry is more attractive to new entrants under the following conditions:

- The advantages of economies of scale are absent. Economies of scale exist when companies in an industry achieve low average costs by producing huge volumes of items (e.g., computer chips).

• Capital requirements to enter the industry are low.

- Cost advantages are not related to company size.

- Buyers are not extremely brand loyal, making it easier for new entrants to the industry to draw customers away from existing businesses.
- Governments, through their regulatory and international trade policies, do not restrict new companies from entering the industry.

THREAT OF SUBSTITUTE PRODUCTS OR SERVICES Substitute products or services can turn an entire industry on its head. For instance, many makers of glass bottles have closed their doors in recent years as their customers—from soft-drink bottlers to ketchup makers—have switched to plastic containers, which are lighter, less expensive to ship, and less subject to breakage. Printed newspapers have seen their readership rates decline as new generations of potential readers turn to their iPads and smart phones for sources of news that are constantly updated. Generally, an industry is more attractive under the following conditions:

- Quality substitute products are not readily available.
- The prices of substitute products are not significantly lower than those of the industry’s products.
- Buyers’ cost of switching to substitute products is high.

After surveying the power that these five forces exert on an industry, entrepreneurs can evaluate the potential for their companies to generate reasonable sales and profits in a particular industry. In other words, they can answer the question “Is this industry a good home for my business?” Table 8.1 provides a matrix that allows entrepreneurs to assign quantitative scores to the five forces influencing industry attractiveness. Note that the *lower* the score for an industry, the *more* attractive it is.

The next step in assessing an industry is to identify potentially attractive niches that exist in the industry. Many small businesses prosper by sticking to niches in a market that are too small to attract the attention of large competitors. The key question that entrepreneurs address is “Can we identify a niche that is large enough to produce a profit, or can we position our company uniquely in the market to differentiate it from the competition in a meaningful way?” Entrepreneurs who have designed successful focus or differentiation strategies for their companies can exploit these niches to their advantage.

TABLE 8.1 Five Forces Matrix

Assign a value to rate the importance of each of the five forces to the industry on a 1 (not important) to 5 (very important) scale. Then assign a value to reflect the extent to which each force poses a threat to the industry. Multiply the importance rating in column 2 by the threat rating in column 3 to produce a weighted score. Add the weighted scores in column 3 to get a total weighted score. This score measures the industry’s attractiveness. The matrix is a useful tool for comparing the attractiveness of different industries.

Force	Importance (1 = Not Important, 5 = Very Important)	Threat to Industry (1 = Low, 3 = Medium, 5 = High)	Weighted Score Col 2 × Col 3
Rivalry among companies competing in the industry	5	2	10
Bargaining power of suppliers in the industry	2	2	4
Bargaining power of buyers	2	4	8
Threat of new entrants to the industry	3	4	12
Threat of substitute products or services	4	1	4
Total			38

Minimum Score = 5 (Very attractive)
Maximum Score = 125 (Very unattractive)

Questions entrepreneurs should address in this portion of the feasibility analysis include the following:

- Which niche(s) in the market will we occupy?
- How large is this market segment, and how fast is it growing?
- What is the basis for differentiating our product or service from competitors?
- Do we have a superior business model that will be difficult for competitors to reproduce?

Companies can shield themselves from some of the negative impact of these five forces by finding a niche and occupying it.



ENTREPRENEURIAL PROFILE: Kurt Nelson, Tyler Seymour, and Drew Burchfield:

Aloompa Kurt Nelson, Tyler Seymour, and Drew Burchfield have found success in a niche in the rapidly growing and highly competitive smart phone app development business. Their company, Aloompa, creates a variety of apps for the music industry. Their first big success came from a music festival called Bonnaroo, which attracts 60,000 rock music fans to its rural Tennessee venue. Their success with this first festival led to 25 additional music festival customers within their first two years of business. While other app developers are trying to create apps that reach a wide audience of smart phone users, the owners of Aloompa are finding success within a very specific niche within the music industry. Although Aloompa has not become a brand name to smart phone users, the company is well known and has a strong position within the market niche of music festival organizers.³



Aloompa co-founders Kurt Nelson, Tyler Seymour, and Drew Burchfield.

Source: Belmont University.

Generally, a niche strategy is a good way to enter the market for a new business. It usually takes fewer resources for the start-up due to lower marketing costs and the ability to start on a smaller scale. Success rates tend to be higher for niche businesses because they have less direct competition. Without much competition, niche businesses can charge higher prices, which allows for quicker positive cash flow during the start-up phase and better margins once they become profitable.

However entrepreneurs should be aware of the following risks that are associated with a niche strategy:

- **Entering a niche requires adaptability in your initial plan.** While developing their business models, entrepreneurs can misjudge what customers in a niche market actually need. Unless they are willing and able to adjust their business model to react to the realities of the market niche, the business will fail if it does not offer the customers what they really want.
- **Niches change.** Even if an entrepreneur evaluates the market correctly in the beginning, niche markets (like any market) change over time. Success in a niche requires that entrepreneurs adapt as the market changes. Too many entrepreneurs get stuck doing the same thing or offering the same product while their customers' needs and wants evolve. Even though it is a niche, the market is not isolated and is subject to the same forces and trends that can impact any market.
- **Niches can go away.** Although many niches can last for years, no market is forever. Niches can dry up—sometimes quite suddenly. Again, adaptation can offer some hope, but if the decline is too rapid, niche businesses can fail.
- **Niches can grow.** Although significant growth in a market may not sound bad, it can attract more competitors. If a market grows large enough, it can attract some very large competitors. At some point, an entrepreneur's cozy market niche can become quite crowded. Eventually, it may no longer be a true market niche, which requires that the entrepreneur adapt his or her business strategies to meet this more competitive market. Growing competition forces prices downward, while at the same time pushes the cost of business upward due to increased marketing costs, greater expectations from customers, and higher labor costs due to more competition for qualified staff.

Although finding a market niche is the most common and a relatively safe entry strategy for new entrepreneurial businesses, it still requires continued attention to competitive forces in the

Product or Service Feasibility Analysis: Is There a Market?

Once entrepreneurs discover that sufficient market potential for their product or service idea actually exists, they sometimes rush in with exuberant enthusiasm ready to launch a business without actually considering whether they can actually produce the product or provide the service at a reasonable cost. A product or service feasibility analysis determines the degree to which a product or service idea appeals to potential customers and identifies the resources necessary to produce the product or provide the service. This portion of the feasibility analysis addresses the question “Are customers willing to purchase our goods and services?” Entrepreneurs need feedback from potential customers to answer this question. Conducting **primary research** involves collecting data firsthand and analyzing it; **secondary research** involves gathering data that has already been compiled and is available, often at a very reasonable cost or sometimes even free. In both types of research, gathering both quantitative and qualitative information is important to drawing accurate conclusions about a product’s or service’s market potential. Primary research tools include customer surveys, focus groups, building prototypes, conducting in-home trials, and “windshield” research. One goal of primary and secondary research is to find support to validate the business concept. However, an overly optimistic entrepreneur may overlook important information about the true feasibility of the business if he or she searches only for information that affirms starting the business. It also is important to search for information that does *not* support the concept. Depending on the nature and severity of any negative evidence, the entrepreneur can either (1) adapt the concept if it is possible to do so or (2) abandon the idea entirely if necessary.

CUSTOMER SURVEYS AND QUESTIONNAIRES Keep them short. Word your questions carefully so that you do not bias the results and use a simple ranking system (e.g., a 1-to-5 scale, with 1 representing “definitely would not buy” and 5 representing “definitely would buy”). Test your survey for problems on a small number of people before putting it to use. Web surveys are inexpensive, easy to conduct, and provide feedback fast. Do not survey only people you know or those who are convenient to reach. Rather, survey people who represent the target market of the business.

FOCUS GROUPS A focus group involves enlisting a small number of potential customers (usually 8 to 12) to provide feedback on specific issues about a product or service (or the business idea itself). Listen carefully for what focus group members like and don’t like about your product or service as they tell you what is on their minds. The founders of one small snack food company that produced apple chips conducted several focus groups to gauge customers’ acceptance of the product and to guide many key business decisions, ranging from the product’s name to its packaging. Consider creating virtual focus groups on the Web; one small bicycle retailer conducts 10 online focus groups each year at virtually no cost and gains valuable marketing information from them. Feedback from online customers is fast, convenient, and in real time.

PROTOTYPES An effective way to gauge the viability of a product is to build a prototype of it. A prototype is an original, functional model of a new product that entrepreneurs can put into the hands of potential customers so that they can see it, test it, and use it. Prototypes usually point out potential problems in a product’s design, giving inventors the opportunity to fix them even before they put the prototype into customers’ hands. The feedback customers give entrepreneurs based on prototypes often leads to design improvements and new features, some of which the entrepreneurs might never have discovered on their own. Makers of computer software frequently put prototypes of new products into customers’ hands as they develop new products or improve existing ones. Known as *beta tests*, these trials result in an iterative design process in which software designers collect feedback from users and then incorporate their ideas into the product for the next round of tests.

IN-HOME TRIALS One technique that reveals some of the most insightful information into how customers actually use a product or service is also the most challenging to coordinate: in-home trials. An **in-home trial** involves sending researchers into customers’ homes to observe them as they use the company’s product or service. However, in-home trials can be expensive to conduct and therefore may not be affordable for the budgets of most entrepreneurs.

“WINDSHIELD” RESEARCH A good source of information is to observe customers interacting with existing businesses within an industry. For example, before she purchased a new car, the author was willing to

commit funding for a new coffee shop, he required that the entrepreneur get traffic counts at local competitors' outlets. He observed heavy demand and often long lines, which helped provide support for the need for a new coffee shop.

Secondary research should be used to support, not replace, primary research. Secondary research, which is usually less expensive to collect than primary data, includes the sources discussed in the following sections.

TRADE ASSOCIATIONS AND BUSINESS DIRECTORIES To locate a trade association, use *Business Information Sources* (University of California Press) or the *Encyclopedia of Associations* (Gale Research). To find suppliers, use the *Thomas Register of American Manufacturers* (www.thomasnet.com/) or *Standard and Poor's Net Advantage* (www.netadvantage.standardandpoors.com/NetAd/demo/pubLibrary.htm). The *American Wholesalers and Distributors Directory* includes information on more than 28,000 wholesalers and distributors.

INDUSTRY DATABASES Several online business databases are available through university libraries, such as BizMiner, Encyclopedia of American Industries, Encyclopedia of Emerging Industries, Encyclopedia of Global Industries, Encyclopedia of Products & Industries—Manufacturing, IBISWorld, Manufacturing & Distribution USA: Industry Analyses, Statistics and Leading Companies, and Market Share Reporter. These databases offer a rich variety of information on specific industries, including statistical analyses, geographic reports, trend analyses, and profiles.

DEMOGRAPHIC DATA To learn more about the demographic characteristics of customers in a particular area, entrepreneurs should tap the treasure trove of data available from the U.S. Census Bureau (www.census.gov). There, entrepreneurs can learn about a population's age, income levels, housing status, education attainment, travel time to work, languages spoken, and many other characteristics.

FORECASTS Many government agencies, including the Department of Commerce, offer forecasts on topics ranging from interest rates to the number of housing starts. A government librarian can help you find what you need.

MARKET RESEARCH Someone may already have compiled the market research you need. Web sites that provide access to market research reports include Market Research (www.marketresearch.com), Companies and Markets (www.companiesandmarkets.com/Home/ContactUs), and Transparency Market Research (www.transparencymarketresearch.com). Many entrepreneurs find the market research they need by using an Internet search engine to conduct focused searches.

ARTICLES Magazine and journal articles pertinent to your business are a great source of information. In addition to online resources, entrepreneurs can use the *Reader's Guide to Periodical Literature*, the *Business Periodicals Index* (similar to the *Reader's Guide* but focuses on business periodicals), and *Ulrich's Guide to International Periodicals* to locate the ones you need.

LOCAL DATA Your state department of commerce and your local chamber of commerce will very likely have useful data on the local market of interest to you. Call to find out what is available.

THE INTERNET Entrepreneurs can benefit from the vast amount of market research information available on the Internet. This is an efficient resource with up-to-date information, and much of it is free. Entrepreneurs must use caution, however, to ensure the credibility of online sources.

Financial Feasibility Analysis: Is There Enough Margin?

The third component of a feasibility analysis involves assessing the financial feasibility of a proposed business venture. At this stage of the process, a broad financial analysis that examines the basic economic feasibility is sufficient. This component of the feasibility analysis answers the question "Can this business generate adequate profits?" If the business concept passes the overall feasibility analysis, an entrepreneur should conduct a more thorough financial analysis when developing the business model and creating a full-blown business plan. The major elements to be included in a financial feasibility analysis include the initial capital requirement, estimated earnings, time out of cash, and the resulting return on investment.

CAPITAL REQUIREMENTS Just as a boy scout needs fuel to start a fire, an entrepreneur needs capital to start a business. Some businesses require large amounts of capital, but others do not. Typically, service businesses require less capital to launch than do manufacturing or retail businesses. Start-up companies often need capital to purchase equipment, buildings, technology, and other tangible assets as well as to hire and train employees, promote their products and services, and establish a presence in the market. A good feasibility analysis provides an estimate of the amount of start-up capital an entrepreneur needs to get the business up and running.



ENTREPRENEURIAL PROFILE: Paul Graham: Y Combinator After graduating from college, Paul Graham wanted to start his own business but was not able to find finance. In a J Crew catalog, he noticed that it has a return policy on clothes brought from its stores. During his college days, Graham used to spend lot of money on clothes at J Crew. He called up their customer service and enquired. It seemed too good to be true. He packed his clothes and sent them back. Within a few weeks, he got a check and co-founded Y Combinator, an investment firm with investment banker Jessica.⁴

It is important to keep in mind that the typical start-up in the United States is able to successfully launch with an average of only \$10,000,⁵ and one in five start-ups get launched with no funding at all.⁶ How do entrepreneurs get started with so little funding? Most entrepreneurs employ a variety of techniques called bootstrapping. **Bootstrapping** is the process of finding creative ways exploit opportunities to launch and grow businesses with the limited resources available for most start-up ventures. It includes a variety of strategies and techniques that cover all of the functions of running a business, including marketing, staffing, inventory and production management, cash flow management, and the administrative processes needed to keep a business operating.⁷

You will learn more about finding sources of business funding, both debt and equity, in Chapters 16 and 17.

ESTIMATED EARNINGS In addition to producing an estimate of the start-up company's capital requirements, an entrepreneur also should forecast the earning potential of the proposed business. Industry trade associations and publications such as the *RMA Annual Statement Studies* offer guidelines on preparing sales and earnings estimates for specific types of businesses. From these, entrepreneurs can estimate the financial results they and their investors can expect to see from the business venture if the start-up is executed according to plan.

TIME OUT OF CASH A common cause of business failure is running out of cash before the business is able to reach breakeven and support itself through the cash flow from operations. According to a study by U.S. Bank, four out of five small business failures can be attributed to “starting out with too little money.”⁸ During the planning stage, an entrepreneur should estimate the total cash required to sustain the business until the business achieves break-even cash flow. This estimate should be based on a less than optimistic scenario because there are almost always unexpected costs and delays in the start-up and growth phases of a new business. For an operating business, to calculate the time until the business runs out of cash, simply take the negative cash flow from the business each month (its “burn rate”) and divide it by the amount of available cash in the business. This gives the number of months the business can survive at its current rate of negative cash flow. Ideally, the business will be able to grow quickly enough to avoid reaching a cash crisis.

RETURN ON INVESTMENT The final aspect of the financial feasibility analysis combines the estimated earnings and the capital requirements to determine the rate of return the venture is expected to produce. One simple measure is the rate of return on the capital invested, which is calculated by dividing the estimated earnings the business yields by the amount of capital invested in the business. This aspect of financial feasibility is generally of most concern to investors. Although financial estimates at the feasibility analysis stage typically are rough, they are an important part of the entrepreneur's ultimate “go” or “no-go” decision about the business ventures. A venture must produce an attractive rate of return relative to the level of risk it requires. This risk–return tradeoff means that the higher the level of risk a prospective business involves,

the higher the rate of return it must provide to the entrepreneur and investors. Why should an entrepreneur take on all of the risks of starting and running a business that produces a mere 3 or 4 percent rate of return when he or she could earn that much in a risk-free investment at a bank or other financial institution? Many entrepreneurs ignore this important calculation because they tend to get wrapped up in the emotion and excitement of their business ideas. You will learn more about developing detailed financial forecasts for a business start-up in Chapter 14.

Entrepreneur Feasibility: Is This Idea Right for Me?

Even if the industry and market are favorable, there is strong evidence that there is demand for the product or service in the market, and the concept appears financially feasible, there is one last component of feasibility to examine—the readiness of the entrepreneur (or the entrepreneurial team) to successfully launch the venture. Many new businesses require an entrepreneur to have a certain set of knowledge, experiences, and skills to have any chance of being successful. This is called **entrepreneurial readiness**. Some of these skills are simple. For example, starting a landscaping business requires an entrepreneur to know how to operate a lawnmower and other equipment. Being successful in a landscaping business also requires one to have some level of knowledge about plants and grasses. Other new businesses may require a higher level of knowledge and skills. For example, starting an accounting firm requires a high degree of knowledge and experience in the laws and practice of accounting. Entrepreneurs can gain the knowledge and skills that they need from previous jobs, from their formal education, or from their interests or hobbies. They can also acquire knowledge during the planning process. Entrepreneurial readiness also involves issues such as temperament, work ethic, focus, commitment, and others. Performing an entrepreneurial self-assessment can help evaluate entrepreneurial readiness (see Figure 8.4).

Another way to ensure that the necessary knowledge and skills are in place is through building a team. For example, an aspiring entrepreneur may have an idea for a new app for smart phones but may not have any programming or design skills. He or she should explore the possibility of adding people to the team with that skill set. If there is more than one entrepreneur starting the business, all of them should complete an assessment and use this as a launching point to examine their collective entrepreneurial feasibility.

Beyond the entrepreneur's readiness to start a business, the second aspect of entrepreneur feasibility is to assess whether the business can meet the financial and nonfinancial needs of the entrepreneur and the team. Will the business be able to generate enough profit to support everyone's income needs? If it is successful, will it also meet the wealth goals of the founding team? Just because a business is profitable does not mean that it is profitable enough to support the entrepreneur and his or her team. The amount required varies from entrepreneur to entrepreneur. A 22-year-old single entrepreneur fresh out of college has very different financial needs than does a 42-year-old married entrepreneur who has a mortgage, car payments, and tuition for private schools for his or her children! However, recall that making money is not the primary source of motivation for entrepreneurs; achievement is. Does the business fit with the goals and aspirations that the entrepreneur has outside of work? A business that demands extensive travel may not fit with an entrepreneur who has a goal of being highly involved with his or her family. A restaurant, which often demands that the entrepreneur be involved six or seven days a week, 52 weeks a year, may not be a good business model for an entrepreneur who wants to travel and take extended vacations.

Wise entrepreneurs take the time to subject their ideas to a feasibility analysis like the one described here, whatever outcome it produces. If the analysis suggests that transforming the idea into a viable business is not feasible, the entrepreneur can move on to the next idea, confident that he or she has not wasted valuable resources launching a business destined to fail. If the analysis shows that the idea has real potential as a profitable business, the entrepreneur can move to the final component of the feasibility analysis. The information gathered during the feasibility analysis serves as the foundation for designing and testing the business model and for building a sound business plan if the idea progresses to these stages of the business planning process.

Once entrepreneurs have subjected their business ideas to the four components of a feasibility assessment, they can turn to the next stage of the new business planning process: developing a business model.

FIGURE 8.4**Entrepreneurial Self-Assessment**

Source: This self-assessment is adapted from J. Cornwall and N. Carter, *University of St. Thomas Entrepreneurial Self-Assessment: Start-Up*, monograph published by the John M. Morrison Center for Entrepreneurship, University of St. Thomas, St. Paul, Minnesota, 1999. Used with permission.

Personal Aspirations and Priorities

- What gets you excited, gives you energy, and motivates you to excel?
- What do you like to do with your time?
- What drains energy from you?
 - In the work you do:
 - In personal relationships:
- How do you measure success in your personal life?
 - Family:
 - Friends and relationships:
 - Personal interests and hobbies:
 - Contributions to community and society:
- What do you consider success in your business and career?
 - Short-term:
 - Long-term:
- What are your specific goals for your personal life?
 - Family:
 - Friends and relationships:
 - Personal interests and hobbies:
 - Contributions to community and society:
- What are your goals for your business and career?
 - Income and lifestyle:
 - Wealth:
 - Free time:
 - Recognition and fame:
 - Impact on community:
 - Other:
- What do you want to be doing:
 - In one year:
 - In five years:
 - In ten years:
 - At retirement:

Core Values

- List the core personal values that you intend to bring to your business (e.g., treating people fairly, giving something back to the community).
- Where does each of these core values come from (religious faith, family, etc.)?
- Why is each of them important to you?

Personal Entrepreneurial Readiness

- What are the major reasons you want to start a business?
- How many hours are you willing and able to put into your new venture?
- How would you describe your tolerance for uncertainty and risk?
- Do you easily trust other people working with you on a common activity? Why or why not?
- How much financial risk are you willing to take with your new venture (personal assets, personal debt, etc.)?
- Assume you decide not to start your business. A short time later, you see that someone has started the same business and is doing well. How would you feel? Why?
- What are the nonfinancial risks for you in starting a new business?
- How do you react to failure? Give examples.
- How do you react in times of personal stress? How do you deal with stress in your life?
- How much income do you need to support your current lifestyle?
- How long could you survive without a paycheck?
- How much money do you have available to start your business?
- Which of your personal assets would you be willing to borrow against, or sell, to start your business?
- Whose support (nonfinancial) is important for you to have before starting your business (family, spouse, etc.)?

Developing and Testing a Business Model

In their groundbreaking study of how successful entrepreneurs develop business models, Osterwalder and Pigneur found that most entrepreneurs use a visual process, such as whiteboarding, when developing their business models.⁹ They do not start writing text; rather, they create a visual map of the key components required to make their businesses successful. A business model adds more detail to the feasibility analysis by graphically depicting the “moving parts” of the business and ensuring that they are all working together. In building a business model, an entrepreneur addresses a series of key questions that define how to create a successful business. Who is the target customer? What value does the business offer the customer? What do customers expect from the business? How do I get information to them, and how do they want to get the product? What are the key activities required to make all of the pieces come together, and what will they cost? What resources must I have to make this happen (including money)? Which key partners must I attract to be successful? In their study, Osterwalder and Pigneur found a pattern in the way that entrepreneurs used a visual representation of their business models to answer these questions. They used these findings to develop a business model canvas that is comprised of nine segments that help guide entrepreneurs through the process of developing a business model (see Figure 8.5).

Value Proposition

A compelling value proposition is at the heart of every successful business. The value proposition is the collection of products and/or services that the business offers to meet the needs of the customers. It is all the things that will set the business apart from its competitors, such as pricing, quality, service, features, product availability, and other features. Most value propositions for new businesses come from fundamental trends within the economy, such as demographics, technology, or cultural patterns. Trends lead to changes within industries. For example, the widespread use of the Internet forever changed industries such as music and newspapers. Inflation in the economy led to both soaring health care costs and rising food costs, shaking up both these industries. Entrepreneurs uncover trends such as these in the industry and market feasibility analysis. Recall from Chapter 1 that a fundamental role of entrepreneurs is finding solutions for problems and needs that customers have as a result of the changes that follow disruptive trends.

It is best to identify and focus on one or two benefits that will make the new business stand out to customers and motivate them to purchase its products or services. The best way to develop the key benefits that are at the heart of a strong value proposition is to listen to customers. Although an entrepreneur may think he or she knows what the customer wants, most of the time they will not have it quite right. In most cases, entrepreneurs must adjust their products or services to fit with what the customer actually wants or needs.

2. Identify the components of the business model canvas and explain how to use them to develop a viable business model.



FIGURE 8.5
Business Model Canvas

Source: A. Osterwalder and Y. Pigneur, *Business Model Generation* (Hoboken, NJ: Wiley, 2010).

Customer Segments

Defining the customer segments in the business model requires an entrepreneur to define the company's target market. Narrowing the target market enables a small company to focus its limited resources on serving the needs of a specific group of customers rather than attempting to satisfy the desires of the mass market. Creating a successful business depends on an entrepreneur's ability to attract real customers who are willing and able to spend real money to buy its products or services. Perhaps the worst marketing error an entrepreneur can commit is failing to define his or her target market and trying to make his or her business "everything to everybody." Small companies usually are much more successful focusing on a specific market niche or niches where they can excel at meeting customers' special needs or wants. At whose needs are the new business's products and/or services aimed? It may be a market niche, a mass market, or a segmented market based on age, gender, geography, or socioeconomic grouping.

Customer Relationships

Not every business provides the same type and same level of customer service. This is what defines the customer relationship component in the business model. For example, there are many effective business models that provide meals to consumers, ranging from a vending machine or a fast-food restaurant to a fast-casual restaurant or a fine-dining establishment. Each of these business models takes a different approach to providing customer service. The vending business offers quick, convenient, and impersonal service. The fine-dining restaurant works closely and personally with customers to ensure that they get exactly what they want. Each approach is effective and appropriate for its particular target market. When developing this segment of the business model, an entrepreneur must answer several questions: How do customers want to interact with the business? Do they want intensive personal service, or would they rather have limited engagement or even an automated interaction? There is no one best approach to customer relationships for all businesses, but there is always one best approach for a particular business model.

Channels

In the business model canvas, *channels* refer to both *communication channels* and *distribution channels*. Communication channels define how the customers seek out information about this type of product. Where do potential customers go when they want to get information about products and services? It could be Web sites, their social network, blogs, advertisements, experts, and so forth. Again, there is no one best way to communicate for all businesses, but there will be one or more ways that are most effective with the specific target market for a given business model.

The distribution channel defines the most effective way to get products to the customers for this type of business. It may be best to use in-home sales. Customers may want to order online from the comfort of their living rooms, or they may want to see the product, touch it, and feel it in an exciting new retail location. The entrepreneur must determine where the customer wants to make the purchase and then determine the most effective way to get it to the customer at that location.

Key Activities

What are the key activities that an entrepreneur must do to ensure a successful launch and to sustain the growth of the business? In the business model, the goal is to build a basic checklist of what needs to be done. The business plan expands on this list in much greater detail.

Key Resources

What are the human, capital, and intellectual resources needed for the business to be successful? Again, this will serve as an initial checklist to ensure that an entrepreneur has identified all of the key resources required. The business plan provides an opportunity to explain these resources in much greater detail and to develop the necessary cost estimates for the financial forecasts.

Key Partners

This segment of the business model includes key suppliers, key outsourcing partners, and all other external businesses or entities that are critical to making the business model work. Entrepreneurs cannot expect to become successful all by themselves. They must build a network of relationships when launching and growing their businesses.

Revenue Streams

How will the value proposition generate revenue? Will it be a one-time sale, ongoing fees, advertising, or some other sources of cash into the business? Entrepreneurs must answer these questions using the entrepreneur's definitions of the value proposition, customer segments, customer relationship, and channel components of the business model (the right side of the business model canvas). The revenue streams information serves as the framework for the more detailed revenue forecasts contained in the business plan.

Cost Structure

What are the fixed and variable costs that are necessary to make the business model work? The key activities, key resources, and key partners components of the plan (the left side of the business model canvas) help to identify the basic types of costs and provide an estimate of their scope. Just like the revenue streams, the cost structure of the business model becomes the framework to develop more detailed cost estimates that become part of the financial forecasts of the business plan.

Developing a business model is a four-phase process.¹⁰ The first phase is creating an initial business model canvas. It is best to do this on a whiteboard or on the wall using sticky notes. As the entrepreneur goes through the next three steps, the business model will change. At this point, the business model is only a series of hypotheses to be tested.

The second phase in designing the business model is to test the problem that the entrepreneur thinks the business solves for customers. The best way to do this is to use primary research data. By engaging potential customers early in developing of a new business and listening to what they have to say, entrepreneurs have a much better chance of creating a successful business model that solves a real customer need.

The third phase is testing the business model *in the market*. One technique to test the solution offered by the business model involves **business prototyping**, in which entrepreneurs test their business models on a small scale before committing serious resources to launch a business that might not work. If the test supports the hypothesis and its accompanying assumptions, the entrepreneur moves forward and develops a business plan. If the prototype flops, the entrepreneur scraps the business idea with only minimal losses and turns to the next idea.

The Internet is a valuable business prototyping tool because it gives entrepreneurs easy and inexpensive access to real live potential customers. Entrepreneurs can test their ideas by selling their products on established sites, such as eBay, or by setting up their own Web sites to gauge customers' response. Testing early, often rough, versions of a product or service is part of a **lean start-up**, a process of rapidly developing simple prototypes to test key assumptions by engaging real customers.¹¹ To launch a business using the lean start-up process, entrepreneurs begin with what is called a **minimum viable product**, the simplest version of a product or service on which to build a sustainable business.



ENTREPRENEURIAL PROFILE: Drew Houston and Arash Ferdowsi: Dropbox Dropbox, founded in 2007 by Drew Houston and Arash Ferdowsi, is a free service that lets users easily share photos, documents, and videos among any devices using their software. When developing the idea for their business, Houston and Ferdowsi knew that creating the software for Dropbox would take years and that developing a simple working prototype was not practical. To test their idea, they created a three-minute video that demonstrated how their new product would work once it was fully developed. The video drove hundreds of thousands of viewers to their Web site and created a long waiting list of people willing to use the product in its beta version. The strong interest convinced the founders and the investment community that Dropbox was a product for which there was a strong market. Dropbox now has more than 200 million users around the globe and has raised \$257 million in funding.¹²

The fourth phase of designing a business model is making changes and adjustments in the business, called **pivots** (refer to Chapter 1), based on what the entrepreneur learns from engaging customers about the business's proposed products and services. Some pivots are subtle adjustments to the business model, while others are fundamental changes to key parts of the model, including in the value proposition, markets served, or ideal revenue streams.

Building a sound business model in a start-up venture improves the chances that the business will survive the launch, gain acceptance in the market, and grow. However, there is one more



Entrepreneurship in Action

The Evolution of CoolPeopleCare's Business Model¹³

Sam Davidson and Stephen Moseley first met while working at a nonprofit in Nashville, Tennessee. The original idea for CoolPeopleCare came to Davidson after he had taken a trip to Washington, D.C., for a Save Darfur Rally in April 2006. While at the rally, he remembers seeing a man holding a cardboard sign with "Cool People Care" written on it. He remembers being struck by how powerful this phrase was. It had a really persuasive ring to it. Returning to Nashville, Davidson couldn't stop thinking about the phrase "Cool People Care." Initially, he thought it would be appealing to build a Web site and sell "Cool People Care" T-shirts and to ask people what they care about through the site. He approached Moseley to inquire about building a Web site. A 15-minute conversation turned into a three-hour planning session in which Davidson and Moseley mapped out what the first version of the Cool People Care Web site.

Davidson had observed from his experience working in nonprofits that "there are two main excuses people give for not volunteering or making a difference: one—there is not enough time; and, two—I do not know how." He believed that the CoolPeopleCare Web site could eliminate both excuses. Through the CoolPeopleCare Web site, Davidson wanted to enlighten and connect his audience. "CoolPeopleCare essentially pairs people who want to make a difference with organizations and opportunities to do so."¹⁴ He believed that the Web site would be a good way to connect young people with causes that they could help and support.

In May 2007, Davidson decided it was time to leave his full-time job and dedicate 100 percent of his time to building and growing CoolPeopleCare. The business was set up as a social for-profit venture. When asked why he did this, Davidson says, "We didn't want to compete for funds with those they wanted to help. [In addition, we] wanted to prove that a for-profit entity can have an explicit purpose of helping the community. In other words, we wanted to prove that corporations making a difference didn't have to be (and shouldn't be) an afterthought."¹⁵

The Web site initially had two main features. The first was *5 Minutes of Caring*, which highlights a single action that one can take in less than five minutes to make the world a better place and to make a difference. The second feature is customized content for more than 40 cities, which includes a community calendar and volunteer and job opportunities specific to each city and a nonprofit directory for that city.

After Davidson committed to working on CoolPeopleCare full-time, he realized that the business model would have to change for the business to be viable. Over time, Davidson has

added several new revenue streams to the business. The first was having Davidson offer speaking engagements. He soon added training sessions to help other nonprofits create revenue streams that alleviate the need for traditional fund-raising. Moseley also rolled his nonprofit consulting practice into CoolPeopleCare. Next, Moseley and Davidson wrote a book, *New Day Revolution: How to Save the World in 24 Hours*, and began to sell it through the Web site. They have sold thousands of copies of their book.

Moseley and Davidson also realized that they could offer more value to the nonprofit community. They added "Partner Pages," where nonprofits could highlight their organizations, events and volunteer listings, contact information, link to their own Web sites, donation buttons, national e-mail announcements, and job listings. Nonprofits pay \$1 a day to be listed on this page. Dozens of nonprofits soon took advantage of this new feature. The entrepreneurs also added "Cool Pages" to allow corporate sponsors to highlight their support of social causes.

The most significant change to the business model was adding merchandise to the Web site, although at the time they did not realize its eventual impact. Besides their book, the CoolPeopleCare store sells merchandise with the CoolPeopleCare logo including T-shirts, coffee mugs, and reusable shopping bags. They also sell fair-trade coffee. After Nashville was hit by a devastating flood, CoolPeopleCare began selling "We Are Nashville" T-shirts to help raise money for flood relief. Moseley and Davidson had hoped to sell 1,000 shirts, but they sold that many the very first day. Eventually, CoolPeopleCare made more than \$100,000 in profits from the T-shirt, which they donated to the Nashville Community Foundation for flood relief. They also sold "We Are Nashville" prints and bumper stickers that raised more money for this cause. In addition to the good that this new product was able to do for Nashville, it helped put CoolPeopleCare on the map on a national and even global scale, as orders came in from around the world for "We Are Nashville" products. This visibility helped take CoolPeopleCare to another level and reach a much broader audience.

1. Why did the business model of CoolPeopleCare change over time? Explain why each of the changes in the business model was successful.
2. Develop a business model canvas for the current operations of CoolPeopleCare.
3. What specific recommendations would you make to change the business model of CoolPeopleCare going forward? What is your rationale for each of these recommendations?

critical step in the business planning process. Crafting a business plan that is based on what the entrepreneur has learned through the feasibility process and developing the business model is the third step in the new business planning process. It adds necessary detail and provides the final test of the business concept.

The Benefits of Creating a Business Plan

When based on the foundation of a fully developed and tested business model, a well-conceived and factually based business plan increases a new venture's probability of success. For decades, research has proved that companies that engage in business planning outperform those that do not. A study by the Small Business Administration reports that entrepreneurs who write business plans early on are two and a half times more likely to actually start their businesses than those who do not.¹⁶ Unfortunately, many entrepreneurs never take the time to engage in the new business planning process, of which the business plan is an important element. The implications of the lack of planning are all too evident in the high failure rates that small companies experience.

A **business plan** is a written summary of an entrepreneur's proposed business venture, its operational and financial details, its marketing opportunities and strategy, and its managers' skills and abilities. There is no substitute for a well-prepared business plan, and there are no shortcuts to creating one. The plan serves as an entrepreneur's road map on the journey toward building a successful business. A business plan describes the direction the company is taking, what its goals are, where it wants to be, and how it intends to get there. The plan is written proof that an entrepreneur has performed the necessary research, has studied the business opportunity adequately, and is prepared to capitalize on it with a sound business model. Crafting a business plan is an entrepreneur's best insurance against launching a business destined to fail or mismanaging a potentially successful company.

A business plan serves two essential functions. First, it helps to guide the company's growth and development by charting its future course and devising a strategy for following it. The plan provides a battery of tools—a mission statement, goals, objectives, budgets, financial forecasts, target markets, and strategies—to help entrepreneurs lead the company successfully. A solid business plan provides managers and employees with a sense of direction when everyone is involved in creating and updating it. As more team members become committed to making the plan work, it takes on special meaning. It gives everyone targets to shoot for, and it provides a yardstick for measuring actual performance against those targets, especially in the crucial and chaotic start-up phase of the business. Creating a plan also forces entrepreneurs to, once again, subject their ideas to the test of reality. The greatest waste of a completed business plan is to let the plan go unused. When properly done, a plan becomes an integral and natural part of a company. In other words, successful entrepreneurs actually *use* their business plans to help them build strong companies.



ENTREPRENEURIAL PROFILE: Rhonda Abrams: The Planning Shop Rhonda Abrams, founder of The Planning Shop, a small publisher of books and tools for entrepreneurs, says that the business plan that she and her employees craft every year has played an important role in her company's success. "Developing a business plan is a key to long-term business survival and success," she says. Abrams credits her company's strategic plan for helping her team identify a new market opportunity that later allowed the business to survive the bankruptcy of its former distributor.¹⁷

The second function of the business plan is to attract lenders and investors. A business plan must prove to potential lenders and investors that a venture will be able to repay loans and produce an attractive rate of return. They want proof that an entrepreneur has evaluated the risk involved in the new venture realistically and has a strategy for addressing it. Unfortunately, many small business owners approach potential lenders and investors without having prepared to sell their business concepts. Given the increased challenges in funding small businesses, being thoroughly prepared to pitch a business plan to potential lenders and investors has become even more important. "We've had 3,000 entrepreneurs come to us needing money," says Tim Williamson, cofounder of The Idea Village, an incubator for entrepreneurs. "And 99 percent of them were not even ready to get the money." A collection of figures scribbled on a notepad to support a loan application or investment request is not enough. Applying for loans or attempting to attract investors without a solid business plan rarely attracts needed capital. The best way to secure the necessary capital is to prepare a sound business plan. The quality of an entrepreneur's business plan weighs heavily in the final decision to lend or

3.

Explain the benefits of building an effective business plan.

invest funds. It is also potential lenders' and investors' first impression of the company and its managers. Therefore, the finished product should be highly polished and professional in both form and content.

Three Tests That Every Business Plan Must Pass

4.

Describe the elements of a solid business plan.

Preparing a sound business plan clearly requires time and effort, but the benefits greatly exceed the costs. Building a plan forces a potential entrepreneur to look at his or her business idea in the harsh light of reality by refining the concepts developed in the business model and defining them in more detail. To get external financing, an entrepreneur's plan must pass three tests with potential lenders and investors: (1) the reality test, (2) the competitive test, and (3) the value test. Entrepreneurs develop the information used for these three tests in the feasibility analysis discussed earlier in this chapter. The first two tests, discussed in the following sections, have both an external and an internal component.

Reality Test

The external component of the reality test revolves around proving that a market for the product or service really does exist. It focuses on industry attractiveness, market niches, potential customers, market size, degree of competition, and similar factors. Entrepreneurs who pass this part of the reality test prove in the marketing portion of their business plan that there is strong demand for their business idea. Evidence they gather during the testing of the business model should be an integral part of the marketing plan to bolster the proof for the idea using real customers.

The internal component of the reality test focuses on the product or service itself. Can the company *really* build it for the cost estimates in the business plan? Is it truly different from what competitors are already selling? Does it offer customers something of value?

Competitive Test

The external part of the competitive test evaluates the company's position relative to its key competitors. How do the company's strengths and weaknesses match up with those of the competition? Do competitors' actions threaten the new company's success and survival?

The internal competitive test focuses on management's ability to create a company that will gain an edge over existing rivals. To pass this part of the competitive test, a plan must prove the quality, skill, and experience of the venture's management team. What other resources does the company have that can give it a competitive edge in the market?

Value Test

To convince lenders and investors to put their money into the venture, a business plan must prove to them that it offers a high probability of repayment or an attractive rate of return. Entrepreneurs usually see their businesses as good investments because they consider the intangibles of owning a business—gaining control over their own destinies, freedom to do what they enjoy, and others. Lenders and investors, however, look at a venture in colder terms: dollar-for-dollar returns. A plan must convince lenders that the business will repay the money they lend to the business, and it must convince investors that they will earn an attractive return on their money.

Even after completing a feasibility analysis and building a business model, entrepreneurs sometimes do not come to the realization that “this business just won't work” until they build a business plan. Have they wasted valuable time? Not at all! The time to find out that a business idea will not succeed is in the planning stages *before* committing significant money, time, and effort to the venture. It is much less expensive to make mistakes on paper than in reality. In other cases, a business plan reveals important problems to overcome before launching a company. Exposing these flaws and then addressing them enhances a venture's chances of success. Business plans help nascent entrepreneurs nail down important aspects of their concepts and prevent costly mistakes.

The real value in preparing a plan is not as much in the plan itself as it is in the *process* the entrepreneur goes through to create the plan—from the planning stages and

development and testing of the business model, and finally with the crafting of the written business plan. Although the finished product is extremely useful, the process of building the plan requires entrepreneurs to explore all areas of the business and subject their ideas to an objective, critical evaluation from many different angles. What entrepreneurs learn about their industry, target customers, financial requirements, competition, and other factors is essential to making their ventures successful. Building a business plan is one controllable factor that can reduce the risk and uncertainty of launching a company.



In the Entrepreneurial Spotlight

The Battle of the Plans

The Burton D. Morgan Center for Entrepreneurship at Purdue University runs four entrepreneurship competitions each year. Two of these competitions are for entrepreneurs to compete for prize money to support their life science or nanotechnology ventures. One of their competitions is an elevator pitch competition. The Burton D. Morgan Business Plan Competition is the oldest of these events. The 2012 competition marked the 25th anniversary of this competition. Even though it is limited to Purdue University students, its rich history and significant prize money has made it a major competitive event.

The event has two divisions. The Gold division is the open division with teams comprised undergraduate students, graduate students, or a combination of both. Staff and faculty of Purdue University may be included on the teams. The winning team of the Gold division receives a \$30,000 first prize. The Black division is only for teams wholly made up of currently enrolled undergraduate students. The winning team in the Black division receives a \$20,000 first-place prize. The goal of the competition is to provide an opportunity for Purdue students to learn about entrepreneurship by developing and presenting a business idea to a panel of judges. Participants in the competition have an opportunity to define their ideas in commercial terms and compete for substantial cash prizes that they can use to commercialize their business ideas.

The competition has three stages of judging. The first phase is based on an executive summary of the business plan. After organizers narrow that group of submissions, teams submit business plans. Competition organizers evaluate the plans and select five finalists in each division to compete in the final competition, which includes a presentation to a panel of judges. The judges evaluate the students' executive summaries, business plans, and presentations using the criteria of commercial viability, technical viability, financial viability, and strength of the management team.

In a recent competition, one of the finalists in the Black division was Azzip Pizzeria, a fast-casual restaurant concept aimed at the fastest-expanding sector of the industry. The team was led by Brad Niemeier, a senior studying hospitality and tourism management and a member of the Boilermaker football team. Niemeier came up with his idea from his experience making pizzas for his teammates. Niemeier's teammates loved his pizzas and ate all that he made for them.

Niemeier made the most of both his hospitality classes and his entrepreneurship classes. His entrepreneurship classes gave him the confidence and skills to open a restaurant at such a young age. His hospitality classes taught him the skills he needed to manage his business day-to-day.

Niemeier's team faced stiff competition in the finals. The other four finalists were Dentural (all-natural adhesive for dentures), Kyk Energy (flavor-neutral energy powder that can turn any drink into an energy drink), PlayitSafe (head impact monitoring system), and Gamers' Esc (a video gaming center).

Past finalists in this competition have had great success as entrepreneurs. In a survey of past finalists in the Burton D. Morgan Business Plan Competition, 67 percent of the respondents indicated that they currently view themselves as entrepreneurs, 35 percent indicated that they started companies as a result of participating in the business plan competition, and 67 percent of the companies launched following the competition, which began in 1987, remain in existence.

In the end, Azzip Pizza won \$20,000 as the top finisher in the Black division. Although he played in only two games during his football career at Purdue, Niemeier is proving to be a winner in game of business.

1. What benefits do entrepreneurs who compete in business plan competitions such as the one at Purdue University gain?
2. Work with a team of your classmates to brainstorm ideas for establishing a business plan competition on your campus. How would you locate judges? What criteria would you use to judge the plans? What prizes would you offer the winners, and how would you raise the money to give those prizes? Who would you allow to compete in your competition?
3. Using the ideas you generated in question 2, create a two-page proposal for establishing a business plan competition at your school.

Sources: Stacy Clardie, "Dream Realized," *Rivals.com*, May 15, 2012, <http://purdue.rivals.com/content.asp?CID=1365657&PT=4&PR=2>, www.purdue.edu/newsroom/students/2012/120222CosierBizPlan.html, and www.insideindianabusiness.com/newsitem.asp?ID=52293.

The Elements of a Business Plan

5.

Explain the three tests every business plan must pass.

Wise entrepreneurs recognize that every business plan is unique and must be tailored to the specific needs of their business. They avoid the off-the-shelf, “cookie-cutter” approach that produces a look-alike business plan. The elements of a business plan may be standard, but the way entrepreneurs tell their stories should be unique and reflect the strengths of their business models, the experience of their team, their personalities and how they will shape the culture of the business, and their enthusiasm for the new venture. In fact, the best business plans usually are those that tell a compelling story in addition to the facts. For those making a first attempt at writing a business plan, seeking the advice of individuals with experience in this process often proves helpful. Accountants, business professors, attorneys, advisers working with local chapters of the Service Corps of Retired Executives (SCORE), and consultants with Small Business Development Centers (SBDCs) are excellent sources of advice when creating and refining a plan. (For a list of SBDCs, see the Small Business Administration’s Web SBDC Web page at www.sba.gov/content/small-business-development-centers-sbdc and for a list of SCORE chapters, see their Web site at www.score.org.) Remember, however, that you should be the one to author your business plan, not someone else.

Initially, the prospect of writing a business plan may appear to be overwhelming. Many entrepreneurs would rather launch their companies and “see what happens” than invest the necessary time and energy defining and researching their target markets, defining their strategies, and mapping out their finances. After all, building a plan is hard work—it requires time, effort, and thought. However, in reality, the entrepreneur should do *both*. By getting started and seeing what happens, the entrepreneur is able to test and improve the basic business model. The plan is essential as the entrepreneur gets ready to build the business and scale its growth. The business plan is hard work that pays many dividends, and not all of these are immediately apparent. Entrepreneurs who invest their time and energy building plans are better prepared to face the hostile environment in which their companies will compete than those who do not.

Entrepreneurs can use business planning software available from several companies to create their plans. Some of the most popular programs include Business Plan Pro (Palo Alto Software*), PlanMaker (Power Solutions for Business), and Plan Write (Business Resources Software). Business Plan Pro, for example, covers every aspect of a business plan from the executive summary to the cash flow forecasts. These packages help entrepreneurs organize the material they have researched and gathered, and they provide helpful tips on plan writing with templates for creating financial statements. Business planning software may help to produce professional-looking business plans with a potential drawback: The plans they produce may look as if they came from the same mold. That can be a turnoff for professional investors who review hundreds of business plans each year.

In the past, conventional wisdom was that business plans should be 20 to 40 pages in length, depending on the complexity of the business. More recently, experts have begun to recommend that plans should be shorter, typically suggesting that they be limited to about 10 pages. There is mixed opinion on how complex the financial forecasts should be. If the forecasts are based on evidence that is substantiated by testing the business model, more detail will strengthen the entrepreneur’s case. If the numbers appear to be unsubstantiated or even fabricated, more detail can actually hurt the presentation. In many ways, having to write shorter business plans can make writing them even more of a challenge. A shorter business plan does not mean that an

Source: Scott Adams/Universal Uclick.



entrepreneur should omit any of the elements of the plan. Instead, the entrepreneur must work hard to communicate all of the key aspects of the plan as succinctly as possible. Although entrepreneurs find it difficult to communicate all of the important elements of their stories within the shorter-page-length recommendations, they run the risk of never getting used or read if their plans get too long! This section explains the most common elements of a business plan. However, entrepreneurs must recognize that, like every business venture, every business plan is unique. An entrepreneur should use the following elements as the starting point for building a plan and should modify them as needed to better tell the story of his or her new venture.

Title Page and Table of Contents

A business plan should contain a title page with the company's name, logo, and address as well as the names and contact information of the company founders. Many entrepreneurs also include the copy number of the plan and the date on which it was issued on the title page. Business plan readers appreciate a table of contents that includes page numbers so that they can locate the particular sections of the plan in which they are most interested.

The Executive Summary

To summarize the presentation to each potential financial institution or investors, the entrepreneur should write an executive summary. It should be concise—a maximum of one page—and should summarize all of the relevant points of the proposed deal. After reading the executive summary, anyone should be able to understand the entire business concept, what differentiates the company from the competition, and the amount of financing it requires. The executive summary is a synopsis of the entire plan, capturing its essence in a capsulized form. It should explain the basic business model and the problem the business will solve for customers, briefly describing the owners and key employees, target market(s), financial highlights (e.g., sales and earnings projections, the loan or investment requested, how the funds will be used, and how and when any loans will be repaid or investments cashed out), and the company's competitive advantage. Much like Abraham Lincoln's Gettysburg Address, which at 256 words lasted just two minutes and is hailed as one of the greatest speeches in history, a good executive summary provides a meaningful framework for potential lenders and investors of the essence of a company.

The executive summary is a written version of what is known as "the elevator pitch." Imagine yourself on an elevator with a potential lender or investor. Only the two of you are on the elevator, and you have that person's undivided attention for the duration of the ride, but the building is not very tall! To convince the investor that your business idea is a great investment, you must condense your message down to its essential elements—key points that you can communicate in a matter of no more than two minutes. In the Babcock Elevator Competition at Wake Forest University, students actually ride an elevator 27 floors with a judge, where they have the opportunity to make their elevator pitches in just two minutes. "The competition was designed to simulate reality," says Stan Mandel, creator of the event and director of the Angell Center for Entrepreneurship. Winners receive the chance to make 20-minute presentations of their business plans to a panel of venture capitalists, who judge the competition using criteria that range from the attractiveness of the business idea and the value proposition it offers to the quality of the plan's marketing and financial elements.¹⁸

Like a good movie trailer, an executive summary is designed to capture readers' attention and draw them into the plan. If it misses, the chances of the remainder of the plan being read are minimal. The difference between an executive summary and a movie trailer, however, is that the executive summary should give away the ending! A coherent, well-developed summary of the full plan establishes a favorable first impression of the business and the entrepreneur behind it and can go a long way toward obtaining financing. A good executive summary should allow the reader to understand the business concept and how it will make money as well as answering the ultimate question from investors or lenders: "What's in it for me?" Although the executive summary is the first part of the business plan, it should be the last section written to ensure that it truly captures all of the important points as they appear in the full plan.

Mission and Vision Statement

As you learned in Chapter 4, a mission statement expresses an entrepreneur's vision for what his or her company is and what it is to become. It is the broadest expression of a company's purpose

and defines the direction in which it will move. It anchors a company in reality and serves as the thesis statement for the entire business plan by answering the question “What business are we in?” Every good plan captures an entrepreneur’s passion and vision for the business, and the mission statement is the ideal place to express them. Entrepreneurs should avoid using too much business jargon and business clichés. It should clearly state what the business sells, its target market, and the basic nature of the business (i.e., manufacturing, consulting, service, outsourcing, and so forth).

Company History

The owner of an existing small business should prepare a brief history of the operation, highlighting the significant financial and operational events in the company’s life. This section should describe when and why the company was formed, how it has evolved over time, and what the owner envisions for the future. It should highlight the successful accomplishment of past objectives and should convey the company’s image in the marketplace.



In the Entrepreneurial Spotlight

A Business Plan: Don’t Launch Without It

A recent study by the Small Business Administration reports that entrepreneurs who create business plans in the early stages of the start-up process are more likely to actually launch companies and complete typical start-up activities such as acquiring patents, attracting capital, and assembling start-up teams more quickly than entrepreneurs who do not. “Early formal planners are doers,” write the study’s authors. “Challenging prospective entrepreneurs to accomplish a formal business plan early in the venture creation process enables them to engage in additional start-up behaviors that further the process of venture creation.”

In 1991, days before his 30th birthday, Bob Bernstein quit his job at the *Tennessee Journal* even though did not really know what he wanted to do next. However, he had been thinking about opening a coffeehouse. Nashville did not really have a true coffeehouse. The closest thing to a coffeehouse was located in a strip mall bookstore.

Bob was not prepared for the shock of the transition from employee to entrepreneur. There were mornings when it was almost unbearable to get out of bed and face the day. He had been living on his savings but soon found the \$10,000 he had set aside to fund whatever he decided was his next step in life was all that was remaining.

Bob hoped that with the \$10,000 and his great idea, he would be off and running to start up his coffeehouse. Realistically, he knew he would need more funding, so he decided to approach some local banks. They were not interested in financing his start-up. Not only was he proposing a food service business, which bankers are not generally eager to lend to, but Bob had no experience. He mentioned his idea to a friend and former colleague from his journalism days, Chuck Kane. Chuck thought he knew someone, Brad Green, who might be interested in investing in Bob’s idea.

Bob wrote an “offbeat” business plan to present to Brad Green, which mixed traditional writing with cartoons. Green liked the plan and introduced Bob to another person who would eventually become one of his investors. Bob found his next investors from his Sunday football hangout. In a casual conversation with two men from Bob’s hometown of Chicago, he shared

his vision for a coffeehouse. Both men were interested in the idea. Bob also began to find people who were willing to invest through his volunteer work in various community projects, friends he made at a sports bar where he went to watch Chicago Bears football games, and his personal network of friends in Nashville. As he talked about his idea with these people, he found that many were quite interested in the coffee business. Although they loved the idea, they were not interested in running the business. They all agreed that Nashville was in need of a “funky little coffeehouse.”

Each of Bob’s various investors contributed up to \$9,000. Although individual investments were relatively small, Bob was humbled by the trust his investors placed in him and his new venture. Through various investors and his own \$10,000, Bob raised the \$80,000 he needed to open the first store.

After 20 years in business, Bernstein now has four coffee shops in various parts of the city. Although he has had many proposals to franchise his concept, he always insists that it is “too weird to franchise.” The offbeat nature of the original business plan—cartoons and all—is apparent in the atmosphere and the culture of all of his stores. The work he put into his original business plan not only helped raise the money he needed to launch the business but also became the document that helped guide the development of the business and its culture.

1. Some entrepreneurs claim that creating a business plan is not necessary for launching a successful business venture. Do you agree? Explain.
2. What benefits do entrepreneurs who create business plans before launching their companies reap?
3. Suppose that a friend who has never taken a course in entrepreneurship tells you about a business that he or she is planning to launch. When you ask about a business plan, the response is, “Business plan? I don’t have time to write a business plan! I know this business will succeed.” Write a one-page response to your friend’s comment.

Source: Cornwall, J. “Bongo Bob,” United States Association for Small Business and Entrepreneurship, Proceedings, 2006. www.bongojava.com

Description of Firm's Product or Service

An entrepreneur should describe the company's overall product line, giving an overview of how customers use its goods or services. Drawings, diagrams, and illustrations may be required if the product is highly technical. It is best to write product and service descriptions so that laypeople can understand them. A statement of a product's position in the product life cycle might also be helpful. An entrepreneur should include a summary of any patents, trademarks, or copyrights that protect the product or service from infringement by competitors.

One danger entrepreneurs must avoid in this part of the plan is the tendency to dwell on the features of their products or services. This problem is the result of the "fall-in-love-with-your-product" syndrome, which often afflicts inventors. Customers, lenders, and investors care less about how much work, genius, and creativity went into a product or service than about what it will do for them. The emphasis of this section should be on defining the benefits customers get by purchasing the company's products or services rather than on just a "nuts-and-bolts" description of the features of those products or services. A *feature* is a descriptive fact about a product or service (e.g., "an ergonomically designed, more comfortable handle"). A *benefit* is what the customer gains from the product or service feature (e.g., "fewer problems with carpal tunnel syndrome and increased productivity"). Benefits are at the core of the value proposition of the business model. Advertising legend Leo Burnett once said, "Don't tell the people how good you make the goods; tell them how good your goods make them."¹⁹ This part of the plan must describe how a business will transform tangible product or service features into important but often intangible customer benefits—for example, lower energy bills, faster access to the Internet, less time paying monthly bills, greater flexibility in building floating structures, shorter time required to learn a foreign language, or others. Remember: *Customers buy benefits, not product or service features*. Table 8.2 offers an easy exercise designed to help entrepreneurs translate their products' or services' features into meaningful customer benefits.

 **ENTREPRENEURIAL PROFILE: Ami Kassar: Multifunding** Ami Kassar came up with the idea for his Philadelphia-based business, Multifunding, from his experience in the small business credit industry. He had seen the difficulty small businesses have finding financing, yet he knew that there was financing available for many of these businesses if they could just get connected to the right source. Although the value of the service was apparent from the beginning, it took Kassar several pivots of his business model before he offered small business customers what they wanted in

TABLE 8.2 Transforming Features into Meaningful Benefits

For many entrepreneurs, there's a big gap between what a business is selling and what its customers are buying. The following exercise is designed to eliminate that gap.

First, develop a list of the features your company's product or service offers. List as many as you can think of, which may be 25 or more. Consider features that relate to price, performance, convenience, location, customer service, delivery, reputation, reliability, quality, features, and other aspects.

The next step is to group features that have similar themes together by circling them in the same color ink. Then translate those groups of features into specific benefits to your customers by addressing the question "What's in it for me?" from the customer's perspective. (Note: It usually is a good idea to ask actual customers why they buy from you. They usually give reasons that you never thought of.) As many as six or eight product or service (or even company) features may translate into a single customer benefit, such as saving money or time or making life safer. Don't ignore intangible benefits, such as increased status; they can be more important than tangible benefits.

Finally, combine all of the benefits you identify into a single benefit statement. Use this statement as a key point in your business plan and to guide your company's marketing strategy.

Product or Service Features	Product or Service Benefits

Benefit Statement:

the way they wanted it. “There is a fundamental difference between a vision—and a business model,” says Kassir. “The core model of how we make our money has not changed from day one—we are constantly testing it and looking for ways to improve it, evolve it, and grow it. Every few months, an entrepreneur should take a cold shower and take the time to look in the rearview mirror and come up with some new things to test.” After getting a profile of a small business and an assessment of its financing needs, Multifunding puts together a report that gives the business owner various funding options. Multifunding gets paid only when the financing is completed, taking a small percentage of the approved amount of financing. Multifunding helped seven small businesses find funding in its first year and 48 in its second year. As part of the process of testing and refining his business model, Kassir began looking into new sources of revenue streams during the company’s third year.²⁰

Business and Industry Profile

If an entrepreneur intends to use the plan to raise funding, he or she should include a section that acquaints lenders and investors with the industry in which a company competes. Industry data, such as key trends or emerging developments within the industry, market size and its growth or decline, and the relative economic and competitive strength of the major firms in the industry, set the stage for a better understanding of the viability of a new business. Strategic issues, such as ease of market entry and exit, the ability to achieve economies of scale or scope, and the existence of cyclical or seasonal economic trends, further help readers evaluate the new venture. This part of the plan also should describe significant industry trends and key success factors as well as an overall outlook for its future. Information about the evolution of the industry helps the reader comprehend its competitive dynamics. A useful resource of industry and economic information is the *Summary of Commentary on Current Economic Conditions*, more commonly known as the *Beige Book*. Published eight times a year by the Federal Reserve, the *Beige Book* provides detailed statistics and trends in key business sectors and in the overall economy. It offers valuable information on topics ranging from tourism and housing starts to consumer spending and wage rates. Entrepreneurs can find this wealth of information at their fingertips on the Web at www.federalreserve.gov/monetarypolicy/beigebook/. This section should cover all of the relevant information the entrepreneur uncovered during the market and industry feasibility analysis.

Goals and Objectives

This section contains a statement of the business goals and the more specific objectives that the entrepreneur seeks to achieve. Together, goals and objectives define the targets that the company strives for. **Goals** are broad, long-range statements of what a company plans to achieve in the future that guide its overall direction. **Objectives** are short-term, specific performance targets that are measurable, attainable, and controllable. Every objective should include a technique for measuring progress toward its accomplishment. Recall from Chapter 4 that to be meaningful, an objective must have a time frame for achievement. Every objective should be tied to a business goal, which, in turn, should be tied to the company’s overall mission. In other words, accomplishing each objective should move a business closer to achieving its goals, which, in turn, should move it closer to its mission.

Business Strategy

An even more important part of the business plan is the owner’s view of the strategy needed to meet—and beat—the competition. In the previous section, an entrepreneur defined where he or she wants to take the business by establishing goals and objectives. This section addresses the question of how to get there—business strategy. Here, an entrepreneur explains how he or she plans to gain a competitive edge in the market and how his or her value proposition sets the business apart from the competition. A key component of this section is defining what makes the company unique in the eyes of its customers. One of the quickest routes to business failure is trying to sell “me-too” products or services that offer customers nothing newer, better, bigger, faster, or different. The foundation for this part of the business plan comes from the material presented in Chapter 4.

This section of the business plan should outline the methods the company will use to meet the key success factors in the industry. If, for example, making sales to repeat customers is critical to success, an entrepreneur must devise a plan of action for achieving a customer retention rate that exceeds that of existing companies in the market.

Competitor Analysis

An entrepreneur should describe the new venture's competition and how his or her chosen business strategy will allow him or her to effectively compete with key competitors. Failing to assess competitors realistically makes entrepreneurs appear to be poorly prepared, naive, or dishonest, especially to potential lenders and investors. The plan should include an analysis of each significant competitor and how well they are meeting the important criteria that target customers are currently using to make their decisions among the various companies. Entrepreneurs who believe they have no competitors are only fooling themselves and are raising a red flag to potential lenders and investors. Gathering information on competitors' market shares, products, and strategies is usually not difficult. Trade associations, customers, industry journals, marketing representatives, and sales literature are valuable sources of data. This section of the plan should focus on demonstrating that the entrepreneur's company has an advantage over its competitors and address these questions:

- Who are the company's key competitors?
- What are their strengths and weaknesses?
- What are their strategies?
- What images do they have in the marketplace?
- How successful are they?
- What distinguishes the entrepreneur's product or service from others already on the market, and how will these differences produce a competitive edge?

Firsthand competitor research is particularly valuable.

Marketing Strategy

One of the most important tasks a business plan must fulfill is proving that a viable market exists for a company's goods or services. The business modeling process identified and described a company's target customers and their characteristics and habits. Defining the target audience and its potential is one of the most important—and most challenging—parts of the business planning process.

Proving that a profitable market exists involves two steps: showing customer interest and documenting market claims, both of which were part of the business modeling process.

SHOWING CUSTOMER INTEREST An important element of any business plan is showing how a company's product or service provides a customer benefit or solves a customer problem. Entrepreneurs must be able to prove that their target customers actually need or want their goods or services and are willing to pay for them. This is why including customer feedback to validate the business model is so important. Venture capitalist Kathryn Gould, who has reviewed thousands of business plans, says that she looks for plans that focus on "target customers with a compelling reason to buy. The product must be a 'must-have.'"²¹

Proving that a viable market exists for a product or service is relatively straightforward for a company already in business but can be quite difficult for an entrepreneur with only an idea. In this case, the key is to get primary customer data. The feasibility analyses and the process of validating the value proposition during the development of the business model provide real data from real customers. Two of the most reliable techniques include building a prototype of a product so that customers can see how it works and producing a small number of products that customers can actually use. The entrepreneur could sell the product to several customers, perhaps at a discount on the condition that they provide evaluations of it. Doing so proves that there are potential customers for the product and allows customers to experience the product in operation. Getting a product into customers' hands is also an excellent way to get valuable feedback that can lead to significant design improvements and increased sales down the road. Integrating this type of primary data into a business plan demonstrates that the business has a good chance of success.



ENTREPRENEURIAL PROFILE: Charley Moore: RocketLawyer Charley Moore originally launched RocketLawyer, a Web site that targets entrepreneurs with a variety of legal documents. He first offered legal documents and corporate documents to noncompete agreements and Web site design contracts, using a fee-per-downloaded-document business model. After several months

in business, the site's analytics showed Moore that even though the site was attracting large numbers of visitors, its abandonment rate was stifling the company's revenue. "We were charging [our customers] a couple of hundred dollars less than other sites or the cost of hiring a lawyer," says Moore, "but we were asking them to pay for every document they wanted to download. It was still a lot of money for most folks." Based on feedback from customers, Moore changed the business model that he had developed in his business plan. "We decided to go with a 'first-one-free' model to accommodate customers who wanted to try our service," he explains. RocketLawyer also added a \$40 monthly membership that gives customers unlimited access to legal documents and to online document storage. The revamped business model produced results immediately. Sales increased from \$1 million to \$5 million in just one year, and the number of RocketLawyer customers climbed from 150,000 to 900,000.²²

DOCUMENTING MARKET CLAIMS Too many business plans rely on vague generalizations, such as "This market is so huge that if we get just 1 percent of it, we will break even in eight months." Statements such as these usually reflect nothing more than an entrepreneur's unbridled optimism and in most cases are quite unrealistic! In *The Art of the Start*, entrepreneur and venture capitalist Guy Kawasaki calls this the Chinese Soda Lie: "If just 1 percent of the people in China drink our soda, we will be more successful than any company in the history of mankind."²³ The problems with this reasoning are (1) few markets, especially the niche markets that small businesses often pursue, are as large as that, and (2) capturing 1 percent of a big market is extremely difficult to do, especially for a small company. Capturing a large share of a small, well-defined niche market is much more realistic for a small company than is winning a small share of a huge market.

Entrepreneurs must support claims of market size and growth rates with *facts*, and that requires market research. Results of market surveys, customer questionnaires, and demographic studies developed in the feasibility analyses and business modeling steps in the business planning process lend credibility to an entrepreneur's frequently optimistic sales projections contained within the formal business plan. (Refer to the market research techniques and resources in Chapter 9.) Quantitative market data are important because they form the basis for all of the company's financial projections in the business plan. Fortunately, entrepreneurs who follow the business planning process will already have much of this data from their feasibility analyses and from building and testing their business models.

One of the main purposes of the marketing section of the plan is to lay the foundation for the financial forecasts that follow. Sales, profit, and cash forecasts must be founded on more than wishful thinking. An effective market analysis should address the items discussed in the following sections in detail based on the framework developed in the business model.

Target Market Who are the company's target customers? How many of them are in the company's trading area? What are their characteristics (age, gender, educational level, income, and others)? What do they buy? Why do they buy? When do they buy? What expectations do they have about the product or service? Will the business focus on a niche? How does the company seek to position itself in the market(s) it will pursue? Knowing my customers' needs, wants, and habits, what should be the basis for differentiating my business in their minds?

Advertising and Promotion Only after entrepreneurs understand their companies' target markets can they design a promotion and advertising campaign to reach those customers most effectively and efficiently. Which media are most effective in reaching the target market? How will they be used? How much will the promotional campaign cost? How will the promotional campaign position the company's products or services? How can the company benefit from publicity? How large is the company's promotional budget?

Market Size and Trends Assessing the size of the market is a critical step. How large is the potential market? Is it growing or shrinking? Why? Are customers' needs changing? Are sales seasonal? Is demand tied to another product or service?



ENTREPRENEURIAL PROFILE: Ludwick Marishane: DryBath Clean water is an extremely scarce resource in many parts of the globe. Water shortages, which are common throughout much of the developing world, making bathing difficult for people who live in regions with water shortages. Ludwick Marishane of Cape Town, South Africa, a 21-year-old student, was named the 2011 Global Student Entrepreneur of the Year at the Global Student Entrepreneur Awards.

product DryBath, the only non-water-based bath substitute lotion for the whole body. “I invented it to benefit people from the poorest communities in the world and also for people in the developed world,” said Marishane. “For people with limited water supplies, DryBath provides an affordable tool to achieve lifesaving personal hygiene.”²⁴

Location For many businesses, choosing the right location is a key success factor. For retailers, wholesalers, and service companies, the best location usually is one that is most convenient to their target customers. Using census data and other market research, entrepreneurs can determine the sites with the greatest concentrations of their customers and locate there. Which sites put the company in the path of its target customers? Maps that show customer concentrations (available from census maps and other sources), traffic counts, the number of customers using a particular train station and when, and other similar types of information provide evidence that a solid and sizable customer base exists. Do zoning regulations restrict the use of a site? For manufacturers, the location issue often centers on finding a site near their key raw materials or near their primary customers. Using demographic reports and market research to screen potential sites takes the guesswork out of choosing the “right” location for a business. We will discuss the location decision in more detail in Chapter 18.

Pricing What does the product or service cost to produce or deliver? Before opening a restaurant, for example, an entrepreneur should know *exactly* what it will cost to produce each item on the menu. Failing to know the total cost (including the cost of the food as well as labor, rent, advertising, and other indirect costs) of putting a plate in front of a customer is a recipe for failure. As we will discover in Chapter 11, cost is just one part of the pricing equation. Another significant factor to consider is the image a company is trying to create in the market. “Price really is more of a marketing tool than it is a vehicle for cost recovery,” says Peter Meyer, author of *Creating and Dominating New Markets*. “People will pay more for a high value product or solution, so be sure to research your [product’s or service’s] total value.”²⁵ Pricing helps communicate and reinforce key elements of the value proposition, such as quality and value.

Other pricing issues that a plan should address include the following: What is the company’s overall pricing strategy? Will the planned price support the company’s strategy and desired image? Given the company’s cost structure, will the price produce a profit? How does the planned price compare to those of similar products or services? Are customers willing to pay it? What price tiers exist in the market? How sensitive are customers to price changes? Will the business sell to customers on credit? Will it accept credit cards? Will the company offer discounts? All of these questions help develop the revenue forecasts in the business plan. Remember that revenues are calculated with a simple formula: price times quantity. Therefore, understanding the proper pricing strategy is half the battle of developing accurate revenue forecasts.

Distribution Using the distribution channels defined in the business model, this portion of the plan should describe the specific channels of distribution that the business will use (the Internet, direct mail, in-house sales force, sales agents, retailers, or others) to distribute its products and services. Will distribution be extensive, selective, or exclusive? What is the average sale? How large will the sales staff be? How will the company compensate its sales force? What are the incentives for salespeople? How many sales calls does it take to close a sale? What can the company do to make it as easy as possible for customers to buy?

DESCRIPTION OF THE MANAGEMENT TEAM The most important factor in the success of a business venture is its management, and financial officers and investors weight heavily the ability and experience of a company’s managers in financing decisions. A plan should include the résumés of managers, key directors, and any person with at least 20 percent ownership in the company. This is the section of the plan in which entrepreneurs have the chance to sell the qualifications and the experience of their management team. Remember that *lenders and investors prefer experienced managers*. Ideally, they look for managers with at least two years of operating experience in the industry they are targeting. In a technology business, investors are looking for partners that have both management and technology expertise.

A résumé should summarize each individual’s education, work history (emphasizing management responsibilities and duties), and relevant business experience. Lenders and investors look

for the experience, talent, and integrity of the people who will breathe life into the plan. This portion of the plan should show that the company has the right people organized in the right fashion for success. One experienced private investor advises entrepreneurs to remember the following:

- Ideas and products don't succeed; people do. Show the strength of your management team. A top-notch management team with a variety of proven skills is crucial. "We're investing in people, not companies," says J. Skyler Fernandes, a New York venture capitalist at Centripetal Capital Partners. "We're not investing in ideas—people always think if you have a great idea you can always raise venture capital. In the end we are investing in people who can execute."²⁶
- Show the strengths of key employees and how you will retain them. Most small companies cannot pay salaries that match those at large businesses, but stock options and other incentives can improve employee retention.
- Enhance the strength of the management team with a capable, qualified board of advisers. A board of directors or advisers consisting of industry experts lends credibility and can complement the skills of the management team.

PLAN OF OPERATION To complete the description of the business, an entrepreneur should construct an organization chart identifying the business's key positions and the people who occupy them. Assembling a management team with the right stuff is difficult, but keeping it together until the company is established can be even harder. Thus, entrepreneurs should describe briefly the steps taken to encourage important officers to remain with the company. Employment contracts, shares of ownership, and perks are commonly used to keep and motivate key employees. A plan of operation should also begin to detail how the business operates, including space requirements, inventory management if applicable, staffing plans, and accounting processes and policies.

Finally, a description of the form of ownership (e.g., sole proprietorship, partnership, C corporation, S corporation, or limited liability company) and of any leases, contracts, and other relevant agreements pertaining to the operation is helpful.

PRO FORMA (PROJECTED) FINANCIAL STATEMENTS One of the most important sections of the business plan is an outline of the proposed company's financial statements—the "dollars and cents" of the proposed venture. In fact, one survey found that 74 percent of bankers say that financial documentation is the most important aspect of a business plan for entrepreneurs who are seeking loans.²⁷ For an existing business, lenders and investors use past financial statements to judge the health of the company and its ability to repay loans or generate adequate returns; therefore, an owner should supply copies of the company's financial statements from the past three years. Ideally, these statements should be audited by a certified public accountant because most financial institutions prefer that extra reliability, although a financial review of the statements by an accountant sometimes may be acceptable.

Whether assembling a plan for an existing business or for a start-up, an entrepreneur should carefully prepare projected (pro forma) financial statements for the operation for the next year using past operating data, published statistics, and research to derive forecasts of the income statement, balance sheet, cash forecast (always!), and a schedule of planned capital expenditures. (You will learn about creating projected financial statements in Chapter 14.) Although including only most likely forecasts in the business plan is acceptable, entrepreneurs also should develop forecasts for pessimistic and optimistic conditions that reflect the uncertainty of the future in case potential lenders and investors ask for them.

It is essential for financial forecasts to be realistic. Entrepreneurs must avoid the tendency to "fudge the numbers" just to make their businesses look good. Experienced lenders and investors can detect unrealistic forecasts easily. In fact, some venture capitalists automatically discount an entrepreneur's financial projections by as much as 50 percent. One experienced angel investor says that when looking at the financial forecasts compiled by an entrepreneur, he always "doubles the start-up costs and triples the time it will take to launch."

After completing these forecasts, an entrepreneur should perform a break-even analysis for the business. The break-even point is critical for an entrepreneurial venture because it signals

the point at which the business is able to sustain itself through cash generated by operations and should not need any additional start-up capital. It is also the point when the entrepreneur is able to get paid by the business!

It is also important to include a statement of the *assumptions* on which these financial projections are based. Potential lenders and investors want to know how an entrepreneur derived forecasts for sales, cost of goods sold, operating expenses, accounts receivable, collections, accounts payable, inventory, taxes, and other items. Spelling out realistic assumptions gives a plan more credibility and reduces the tendency to include overly optimistic estimates of sales growth and profit margins. Greg Martin, a partner in the venture capital company Redpoint Ventures, says, “I have problems with start-ups making unrealistic assumptions—how much money they need or how quickly they can ramp up revenue. Those can really kill a deal for me.”²⁸

In addition to providing valuable information to potential lenders and investors, projected financial statements help entrepreneurs run their businesses more effectively and more efficiently after start-up. They establish important targets for financial performance and make it easier for an entrepreneur to maintain control over routine expenses and capital expenditures. Entrepreneurs can use their projections to construct financial dashboards to track the progress of the business and assess how well the actual outcomes match the key assumptions made in the business plan.

THE LOAN OR INVESTMENT PROPOSAL The loan or investment proposal section of the business plan should state the purpose of the financing, the amount requested, and the plans for repayment or, in the case of investors, an attractive exit strategy. When describing the purpose of the loan or investment, an entrepreneur must specify the planned use of the funds. Entrepreneurs should state the precise amount requested and include relevant supporting data, such as vendor estimates of costs. The proposal should include all sources of funding for the business from all intended sources, including money the entrepreneur is investing in the business. Most bankers and investors want to see evidence that the entrepreneur is willing to “put skin in the game,” putting some of his or her own money at risk in the venture.

Another important element of the loan or investment proposal is the repayment schedule or exit strategy. A lender’s main consideration when granting a loan is the reassurance that the applicant will repay, whereas an investor’s major concern is earning a satisfactory rate of return. Financial projections must reflect a company’s ability to repay loans and produce adequate returns. Without this proof, a request for funding stands little chance of being approved. Entrepreneurs must provide tangible evidence that shows their ability to repay loans or to generate attractive returns. Developing an exit strategy, such as the option to cash out through an acquisition or a public offering, is important. Including examples of other firms in the same industry that have already exited proves to investors that a viable path for them to exit the business and realize a return on their investments exists.

Finally, an entrepreneur should include a realistic timetable for implementing the proposed plan. This should include a schedule showing the estimated start-up date for the project and noting all significant milestones along the way.

A business plan must present an honest assessment of the risks facing the new venture. Evaluating risk in a business plan requires an entrepreneur to walk a fine line, however. Dwelling too much on everything that can go wrong discourages potential lenders and investors from financing the venture. Ignoring the project’s risks makes those who evaluate the plan see the entrepreneur as either naive, dishonest, or unprepared. The best strategy is to identify the most significant risks the venture faces and then to describe the plans the entrepreneur has developed to avoid them altogether or to overcome the negative outcome if the event does occur. Figure 8.6 explains how two simple diagrams communicate effectively to investors both the risks and the rewards of a business venture.

Visualizing a Venture’s Risks and Rewards

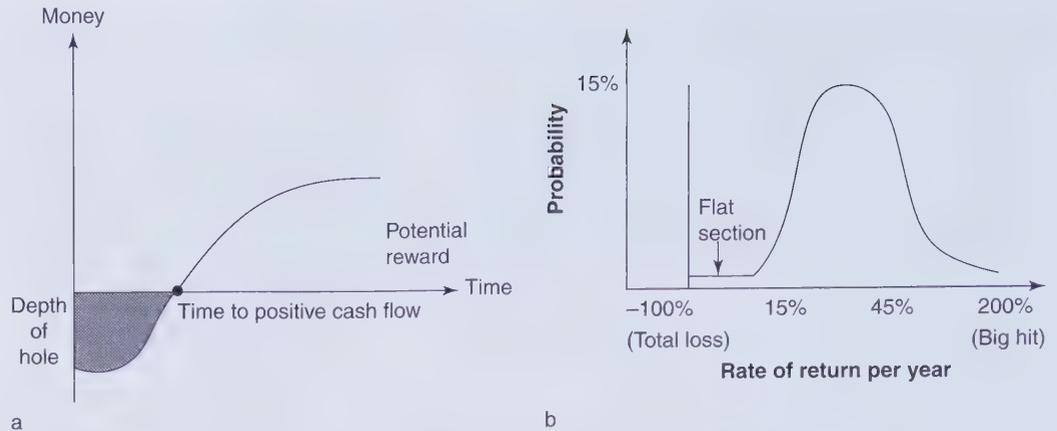
There is a difference between a *working* business plan—the one the entrepreneur is using to guide her business—and the *presentation* business plan—the one he or she is using to attract capital.

FIGURE 8.6**Visualizing a Venture's Risks and Rewards**

(a) This diagram shows the amount of money an entrepreneur needs to launch the business, the time required to reach the point of positive cash flow, and the anticipated amount of the payoff.

(b) The second diagram shows investors the range of possible returns and the probability of achieving them. This diagram portrays what investors intuitively understand: Most companies either fail big or achieve solid success.

Source: Based on William A. Sahlman, "How to Write a Great Business Plan," *Harvard Business Review*, July/August 1997, pp. 98–108.



Although coffee rings and penciled-in changes in a working plan don't matter (in fact, they're a *good* sign that the entrepreneur is actually using the plan), they have no place in a plan going to someone outside the company. A plan is usually the tool that an entrepreneur uses to make a first impression on potential lenders and investors. To make sure that impression is a favorable one, an entrepreneur should follow these tips:

- Realize that first impressions are crucial. Make sure the plan has an attractive (but not an expensive) cover.
- Make sure the plan is free of spelling and grammatical errors and "typos." It is a professional document and should look like one.
- Make it visually appealing. Use color charts, figures, and diagrams to illustrate key points. Don't get carried away, however, and end up with a "comic book" plan.
- Include a table of contents with page numbers to allow readers to navigate the plan easily. Reviewers should be able to look through a plan and quickly locate the sections they want to see.
- Make it interesting. Boring plans seldom get read; a good plan tells an interesting story.
- A plan must prove that the business will make money. In one survey of lenders, investors, and financial advisers, 81 percent said that, first and foremost, a plan should prove that a venture will earn a profit.²⁹ Start-ups do not necessarily have to be profitable immediately, but sooner or later (preferably sooner), they must make money.
- Use computer spreadsheets to generate a set of realistic financial forecasts. They allow entrepreneurs to perform valuable "what if" (sensitivity) analysis in just seconds.
- *Always* include cash flow projections. Entrepreneurs sometimes focus excessively on their proposed venture's profit forecasts and ignore cash flow projections. Although profitability is important, lenders and investors are much more interested in cash flow because they know that's where the money to pay them back or to cash them out comes from.
- The ideal plan is "crisp," long enough to say what it should but not so long that it is a chore to read.
- Tell the truth. Absolute honesty is always critical when preparing a business plan.

Business plans are forecasts about the future that an entrepreneur plans to create, something that one expert compares to "taking a picture of the unknown," which is a challenging feat! As uncertain and difficult to predict as the future may be, an entrepreneur who launches a business without a plan arguing that "trying to forecast the future is pointless" is misguided. In the *Harvard Business Review*, William Sahlman says that "the best business plans . . . are like movies of the future. They show the people, the opportunity, and the context from multiple angles. They offer a plausible, coherent story of what lies ahead. They unfold the possibilities of action and reaction."³⁰ That's the kind of "movie" an entrepreneur should strive to create in a plan.

What Lenders and Investors Look for in a Business Plan

To increase their chances of success when using their business plans to attract capital, entrepreneurs must be aware of the criteria lenders and investors use to evaluate the creditworthiness of entrepreneurs seeking financing. Lenders and investors refer to these criteria as the five Cs of credit: capital, capacity, collateral, character, and conditions.

Capital

A small business must have a stable capital base before any lender will grant a loan. Otherwise the lender would be making, in effect, a capital investment in the business. Most lenders refuse to make loans that are capital investments because the potential for return on the investment is limited strictly to the interest on the loan, and the potential loss would probably exceed the reward. In fact, the most common reasons that banks give for rejecting small business loan applications are undercapitalization or too much debt. Investors also want to make sure that entrepreneurs have invested enough of their own money into the business to survive the tenuous start-up period. Lenders and investors see capital formation as a risk-sharing strategy with entrepreneurs.

Capacity

A synonym for *capacity* is *cash flow*. Lenders and investors must be convinced of a company's ability to meet its regular financial obligations and to repay bank loan, and that takes cash. More small businesses fail from lack of cash than from lack of profit. It is possible for a company to be earning a profit and still run out of cash. Lenders expect a business to pass the test of liquidity; they study closely a small company's cash flow position to decide whether it has the capacity required to succeed. Most lenders have become extremely cautious when evaluating cash flow since the financial crisis of 2008.

Collateral

Collateral includes any assets an entrepreneur pledges to a lender as security for repayment of the loan. If an entrepreneur defaults on the loan, the bank has the right to sell the collateral and use the proceeds to satisfy the loan. Typically, lenders make very few unsecured loans (those not backed by collateral) to business start-ups. Bankers view an entrepreneur's willingness to pledge collateral (personal or business assets) as an indication of dedication to making the venture a success. Bankers will always look first at the entrepreneur's personal assets because that is the simplest way for them to get repaid on a loan if the business fails. Business assets are their last resort because selling a company's inventory, equipment, and buildings to repay loans is not an easy or an effective means of repayment for the bank.

Character

Before putting money into a small business, lenders and investors must be satisfied with the owner's character. An evaluation of character frequently is based on intangible factors such as honesty, competence, polish, determination, knowledge, experience, and ability. Although the qualities judged are abstract, this evaluation plays a critical role in a lender's or investor's decision. Banks have also begun to use the comments that potential borrowers post on social networking sites such as Facebook and Twitter to assess character. Posts and links that are not professional hurt an entrepreneur's character and reduce the likelihood of an entrepreneur securing a loan.³¹

Lenders and investors know that most small businesses fail because of poor management, and they try to avoid extending loans to high-risk entrepreneurs. Preparing a solid business plan and a polished presentation can go far in convincing potential lenders and investors of an entrepreneur's ability to manage a company successfully.

Conditions

The conditions surrounding a loan request also affect the owner's chance of receiving funds. Banks consider factors relating to the business operation, such as potential growth in the market, competition, location, form of ownership, and loan purpose. Again, the best way to provide this relevant information is in a business plan. Another important condition influencing the banker's decision is the shape of the overall economy, including interest rates, the inflation rate, and the demand for money.

Although these factors are beyond an entrepreneur's control, they still are an important component in a lender's decision. Conditions have not been as favorable for bank loans since the financial crisis in 2008, which has made getting business loans more difficult for all small businesses.

6.

Explain the "five Cs of credit" and why they are important to potential lenders and investors.



Jerell Harris, President of QuickMed Collect, pitching his company at a business plan competition.

Source: Belmont University.

7.

Understand the keys to making an effective business plan presentation.

The higher a small business scores on these five Cs, the greater its chance will be of receiving a loan or an investment.

The Pitch: Making the Business Plan Presentation

Lenders and investors are impressed by entrepreneurs who are informed and prepared when requesting a loan or investment. When entrepreneurs try to secure funding from lenders or investors, the written business plan most often precedes the opportunity to meet face-to-face. The written plan must first pass muster before an entrepreneur gets the opportunity to present the plan in person. Usually, the time for presenting a business opportunity is short, often no more than just a few minutes. (When presenting a plan to a venture capital forum, the allotted time is usually less than 20 minutes and rarely more than 30.) When the opportunity arises, an entrepreneur must be well prepared. It is important to rehearse, rehearse, and then rehearse some more. It is a mistake to begin by leading the audience into a long-winded explanation about the technology on which the product or service is based. Within minutes most of the audience will be lost, and so is any chance the entrepreneur has of obtaining the necessary financing for the new venture. A business plan presentation should cover five basic areas:

- Your company and its products and services. The presentation should answer in simple terms the first question that every potential lender and investor has: What does your company do?
- The problem to be solved, preferably told in a personal way through a compelling story. Is it eliminating the time, expense, and anxiety of waiting for the results of medical tests with a device that instantly reads blood samples or making hearing aids more effective at filtering out background noise while enhancing the dominant sound for the user?
- A description (again in simple terms) of your company's solution to the problem. Ideally, the solution your company has developed is unique and serves as the foundation of your company's competitive edge in the marketplace.
- Your company's business model. This part of the presentation explains how your company makes money and includes figures such as revenue per sale, expected gross profit and net profit margins, and other relevant statistics. This is your opportunity to show lenders and investors how your company will produce an attractive payback or payoff.
- Your company's competitive edge. Your presentation should identify clearly the factors that set your company apart from the competition.



ENTREPRENEURIAL PROFILE: NuMat Technologies NuMat Technologies recently won two of the most prestigious business plan competitions in the United States. NuMat develops new materials to enhance and make more practical the use of alternative fuels. Their team was made of two chemists (one of whom is an associate professor) and two JD/MBAs from Northwestern University. The team won the grand prizes at both the University of Texas Global Venture Labs Investment Competition and Rice University's business plan competition. "The NuMat pitch which was sensational," say Tim Berry, president and founder of Palo Alto Software. "The key was explaining the science just enough to be credible, focusing on the business, and keeping it clear and flowing from point to point."³²

No matter how good a written business plan is, entrepreneurs who stumble through the presentation will lose the deal. Entrepreneurs who are successful raising the capital their companies need to grow have solid business plans and make convincing presentations of them. Some helpful tips for making a business plan presentation to potential lenders and investors include the following:

- Prepare. Good presenters invest in preparing their presentations and knowing the points they want to get across to their audiences.
- Practice your delivery and then practice some more.
- Demonstrate enthusiasm about the business but don't be overemotional. Be genuine and be yourself.
- Focus on communicating the dynamic opportunity you see and focus on how you can capitalize on it. Fight the temptation to launch immediately into a lengthy discourse about

the details of your product or service or how much work it took to develop it. Otherwise, you'll never have the chance to describe the details to lenders and investors.

- Hook investors quickly with an up-front explanation of the new venture, its opportunities, and the anticipated benefits to them. For some businesses, a story of its impact can be a good hook to start a presentation.
- Use visual aids. They make it easier for people to follow your presentation. Don't make the mistake of making the visuals the "star" of the presentation, however. Visual aids should punctuate your spoken message and focus the audience's attention on the plan's key points.
- Follow Guy Kawasaki's 10/20/30 rule for PowerPoint presentations. Use 10 slides that you can cover in 20 minutes and use fonts no smaller than 30 points to ensure that you do not try to put too many words on each slide.³³
- Explain how your company's products or services solve some problem and emphasize the factors that make your company unique.
- Offer proof. Integrate relevant facts into your presentation to prove your plan's claims, customers' satisfaction with your company's products or services, and its profit potential.
- Hit the highlights. Specific questions will bring out the details later. Don't get caught up in too much detail in early meetings with lenders and investors.
- Keep the presentation "crisp" just like your business plan. Otherwise, says one experienced investor, "Information that might have caused an investor to bite gets lost in the endless drone."³⁴
- Avoid the use of technical terms that will likely be above most of the audience. Do at least one rehearsal before someone who has no special technical training. Tell him or her to stop you anytime he or she does not understand what you are talking about. When this occurs (and it likely will), rewrite that portion of your presentation.
- Remember that every potential lender and investor you talk to is thinking "What's in it for me?" Be sure to answer that question in your presentation.
- Close by reinforcing the potential of the opportunity. Be sure you have sold the benefits the investors will realize when the business succeeds.
- Be prepared for questions. In many cases, there is seldom time for a long question-and-answer session, but interested investors may want to get you aside to discuss the details of the plan.
- Anticipate the questions the audience is most likely to ask and prepare for them in advance.
- Be sensitive to the issues that are most important to lenders and investors by reading the pattern of their questions. Focus your answers accordingly. For instance, some investors may be interested in the quality of the management team, whereas others are more interested in marketing strategies. Be prepared to offer details on either.
- Follow up with every investor to whom you make a presentation. Don't sit back and wait; be proactive. They have what you need—investment capital. Demonstrate that you have confidence in your plan and have the initiative necessary to run a business successfully.



Ross Hill, founder of PhotoBoothCo, pitching his company at a business plan competition.

Source: Belmont University.

Conclusion

Although there is no guarantee of success when launching a business, the best way to protect against failure is to follow the business planning process that includes feasibility analysis, building and testing a business model, and crafting a strong business plan. A well-developed business model ensures that all of the working parts of a business will be in place and will mesh smoothly. The business model serves as the foundation for a good plan, which serves as a strategic compass that keeps a business on course as it travels into an uncertain future. In addition, a solid plan is essential to raising the capital needed to start a business; lenders and investors demand it. “There may be no easier way for an entrepreneur to sabotage his or her request for capital than by failing to produce a comprehensive, well-researched, and, above all, credible business plan,” says one small business expert.³⁵ Of course, following the three-phase business planning process is just one step along the path to launching a business. Creating a successful business requires entrepreneurs to put the plan into action. The remaining chapters in this book focus on putting your business model and plan to work.

Suggested Business Plan Elements

Although every company’s business plan will be unique, reflecting its individual circumstances, certain elements are universal. The following outline summarizes these components.

- I. Executive Summary (not to exceed one page)
 - A. Company name, address, and phone number
 - B. Name(s), addresses, and phone number(s) of all key people
 - C. Brief description of the business, its products and services, the customer problems they solve, and the company’s competitive advantage
 - D. Brief overview of the market for your products and services
 - E. Brief overview of the strategies that will make your company successful
 - F. Brief description of the managerial and technical experience of key people
 - G. Brief statement of the financial request and how the money will be used
 - H. Charts or tables showing highlights of financial forecasts
- II. Vision and Mission Statement
 - A. Entrepreneur’s vision for the company
 - B. “What business are we in?”
 - C. Values and principles on which the business stands
 - D. What makes the business unique? What is the source of its competitive advantage?
- III. Company History (for existing businesses only)
 - A. Company founding
 - B. Financial and operational highlights
 - C. Significant achievements
- IV. Company Products and Services
 - A. Description
 1. Product or service features
 2. Customer benefits
 3. Warranties and guarantees
 4. Unique selling proposition (USP)
 - B. Patent or trademark protection
 - C. Description of production process (if applicable)
 1. Raw materials
 2. Costs
 3. Key suppliers
 4. Lead times
 - D. Future product or service offerings

V. Industry Profile and Overview**A. Industry analysis**

1. Industry background and overview
2. Significant trends
3. Growth rate
4. Barriers to entry and exit
5. Key success factors in the industry

B. Outlook for the future**C. Stage of growth (start-up, growth, maturity)****VI. Competitor Analysis****A. Existing competitors**

1. Who are they? Create a competitive profile matrix
2. Strengths
3. Weaknesses

B. Potential competitors: Companies that might enter the market

1. Who are they?
2. Impact on your business if they enter

VII. Business Strategy**A. Desired image and position in market****B. Company goals and objectives**

1. Operational
2. Financial
3. Other

C. SWOT analysis

1. Strengths
2. Weaknesses
3. Opportunities
4. Threats

D. Competitive strategy

1. Cost leadership
2. Differentiation
3. Focus

VIII. Marketing Strategy**A. Target market**

1. Problem to be solved or benefit to be offered
2. Demographic profile
3. Other significant customer characteristics

B. Customers' motivation to buy**C. Market size and trends**

1. How large is the market?
2. Is it growing or shrinking? How fast?

D. Personal selling efforts

1. Sales force size, recruitment, and training
2. Sales force compensation
3. Number of calls per sale
4. Amount of average sale

- E. Advertising and promotion
 1. Media used—reader, viewer, listener profiles
 2. Media costs
 3. Frequency of usage
 4. Plans for generating publicity
- F. Pricing
 1. Cost structure
 - a. Fixed
 - b. Variable
 2. Desired image in market
 3. Comparison against competitors' prices
 4. Discounts
 5. Gross profit margin
- G. Distribution strategy (if applicable)
 1. Channels of distribution used
 2. Sales techniques and incentives for intermediaries
- H. Test market results
 1. Surveys
 2. Customer feedback on prototypes
 3. Focus groups
- IX. Location and Layout
 - A. Location
 1. Demographic analysis of location versus target customer profile
 2. Traffic count
 3. Lease/rental rates
 4. Labor needs and supply
 5. Wage rates
 - B. Layout
 1. Size requirements
 2. Americans with Disabilities Act compliance
 3. Ergonomic issues
 4. Layout plan (suitable for an appendix)
- X. Description of management team
 - A. Key managers and employees
 1. Their backgrounds
 2. Experience, skills, and know-how they bring to the company
 - B. Résumés of key managers and employees (suitable for an appendix)
 - C. Future additions to management team
 - D. Board of directors or advisers
- XI. Plan of Operation
 - A. Form of ownership chosen and reasoning
 - B. Company structure (organization chart)
 - C. Decision-making authority
 - D. Compensation and benefits packages
 - E. Staffing plans

- XII. Financial Forecasts** (suitable for an appendix)
- A. Key assumptions
 - B. Financial statements (year 1 by month, years 2 and 3 by quarter)
 1. Income statement
 2. Balance sheet
 3. Cash flow statement
 - C. Break-even analysis
 - D. Ratio analysis with comparison to industry standards (most applicable to existing businesses)
- XIII. Loan or Investment Proposal**
- A. Amount requested
 - B. Purpose and uses of funds
 - C. Repayment or “cash out” schedule (exit strategy)
 - D. Timetable for implementing plan and launching the business
- XIV. Appendices** (supporting documentation, including market research, financial statements, organization charts, résumés, and other items)

Chapter Review

1. Present the steps involved in conducting a feasibility analysis.
 - A feasibility analysis consists of three interrelated components: an industry and market feasibility analysis, a product or service feasibility analysis, and a financial feasibility analysis. The goal of the feasibility analysis is to determine whether an entrepreneur’s idea is a viable foundation for creating a successful business.
2. Identify the components of the business model canvas and explain how to use them to develop a viable business model.
 - The business model canvas helps entrepreneurs define their business models by defining the relationships among nine factors: value proposition, customer segments, customer relationships, channels, key activities, key resources, key partners, revenue streams, and cost structure.
3. Describe the benefits of building an effective business plan.
 - A business plan serves two essential functions. First, and more important, it guides the company’s operations by charting its future course and devising a strategy for following it. The second function of the business plan is to attract lenders and investors. Applying for loans or attempting to attract investors without a solid business plan rarely attracts needed capital. Rather, the best way to secure the necessary capital is to prepare a sound business plan.
4. Describe the elements of a solid business plan.
 - Although a business plan should be unique and tailor-made to suit the particular needs of a small company, it should cover these basic elements: an executive summary, a mission statement, a company history, a business and industry profile, a description of the company’s business strategy, a profile of its products or services, a statement explaining its marketing strategy, a competitor analysis, owners’ and officers’ résumés, a plan of operation, financial data, and the loan or investment proposal.
5. Explain the three tests every business plan should pass.
 - Reality test. The external component of the reality test revolves around proving that a market for the product or service really does exist. The internal component of the reality test focuses on the product or service itself.
 - Competitive test. The external part of the competitive test evaluates the company’s relative position to its key competitors. The internal competitive test focuses on the management team’s ability to create a company that will gain an edge over existing rivals.
 - Value test. To convince lenders and investors to put their money into the venture, a business plan must prove to them that it offers a high probability of repayment or an attractive rate of return.

6. Explain the “five Cs of credit” and why they are important to potential lenders and investors.
 - Small business owners need to be aware of the criteria bankers use in evaluating the creditworthiness of loan applicants—the five Cs of credit: capital, capacity, collateral, character, and conditions.
 - Capital: Lenders expect small businesses to have an equity base of investment by the owner(s) that will help support the venture during times of financial strain.
 - Capacity: A synonym for *capacity* is *cash flow*. The bank must be convinced of the firm’s ability to meet its regular financial obligations and to repay the bank loan, and that takes cash.
 - Collateral: Collateral includes any assets the owner pledges to the bank as security for repayment of the loan.
 - Character: Before approving a loan to a small business, the banker must be satisfied with the owner’s character.
- Conditions: The conditions—interest rates, the health of the nation’s economy, industry growth rates, and so on—surrounding a loan request also affect the owner’s chance of receiving funds.
7. Understand the keys to making an effective business plan presentation.
 - Lenders and investors are favorably impressed by entrepreneurs who are informed and prepared when requesting a loan or investment.
 - Tips include the following: Demonstrate enthusiasm about the venture but don’t be overemotional; “hook” investors quickly with an up-front explanation of the new venture, its opportunities, and the anticipated benefits to them; use visual aids; hit the highlights of your venture; don’t get caught up in too much detail in early meetings with lenders and investors; avoid the use of technological terms that will likely be above most of the audience; rehearse your presentation before giving it; close by reinforcing the nature of the opportunity; and be prepared for questions.

Discussion Questions

- 8-1. What is involved in a feasibility analysis, and what value does it provide?
- 8-2. Explain the planning process for a new business.
- 8-3. Explain the three tests that every business plan must pass.
- 8-4. Why do entrepreneurs who are not seeking external financing need to prepare business plans?
- 8-5. Describe the major components of a business plan.
- 8-6. How can an entrepreneur seeking funds to launch a business convince potential lenders and investors that a market for the product or service really does exist?
- 8-7. What are the five Cs of credit? How do lenders and investors use them when evaluating a request for financing?
- 8-8. Comment on the statement “the best business plans . . . are like movies of the future. They show the people, the opportunity, and the context from multiple angles. They offer a plausible, coherent story of what lies ahead. They unfold the possibilities of action and reaction.”

CHAPTER 9

Building a Bootstrap Marketing Plan



Learning Objectives

On completion of this chapter, you will be able to:

1. Describe the components of a bootstrap marketing plan and explain the benefits of preparing one.
2. Explain how small businesses can pinpoint their target markets.
3. Explain how to determine customer needs through market research.
4. Outline the steps in the market research process.
5. Describe the bootstrap marketing strategies on which a small business can build a competitive edge in the marketplace.
6. Discuss the “four Ps” of marketing—product, place, price, and promotion—and their role in building a successful bootstrap marketing strategy.

I am a bootstrapper. I have initiative and insight and guts, but not much money. I will succeed because my efforts and my focus will defeat bigger and better-funded competitors.

—Seth Godin

Bootstrapping is not about not spending money—it's about only spending money where it matters.

—Len Kendall

To be effective, both the business model and the business plan must be based on both a financial plan and a marketing plan. Like the financial plan, an effective marketing plan includes forecasts and analysis but from a different perspective. Rather than focus on cash flow, net income, and owner's equity, the marketing plan concentrates on a company's target customers, their needs, their buying power, and their buying behavior. Both plans should tell the same story. It is just that the financial plan tells the story in numbers, while the marketing plan tells it in words.

This chapter is devoted to creating an effective marketing plan. Before producing computer-generated spreadsheets with financial projections, entrepreneurs must determine what to sell, to whom and how often, on what terms and at what price, and how to get the product or service to the customer. In short, a marketing plan identifies a company's target customers and describes how it will attract and keep them. The process does not have to be complex. Figure 9.1 explains how to build a seven-sentence marketing strategy.

Creating a Bootstrap Marketing Plan

1.

Describe the components of a bootstrap marketing plan and explain the benefits of preparing one.

Marketing is the process of creating and delivering desired goods and services to customers and involves all of the activities associated with winning and retaining loyal customers. The secret to successful marketing is to understand the company's target customers' needs, demands, and wants; to offer them the products and services that will satisfy those needs, demands, and wants; and to provide those customers with quality, service, convenience, and value so that they will keep coming back rather than choosing a competitor. The marketing function cuts across the entire organization, affecting every aspect of its operation—from finance and production to hiring and purchasing.

Marketing strategies are not just for megacorporations competing in international markets; small companies require effective marketing strategies as much as their largest rivals do. A recent study of small businesses by research firm Hurwitz and Associates reports a positive correlation between small companies that are experiencing increases in revenue and their expenditures on marketing.¹ Because their entire marketing budgets may be nothing more than rounding errors on larger competitors' marketing budgets, however, small companies must develop creative approaches and invest their marketing dollars wisely to reach their target customers. By developing **bootstrap marketing strategies**—unconventional, low-cost, creative techniques—small companies can wring as much or more “bang” from their marketing bucks as their larger rivals. Bootstrap marketing also is sometimes known as **guerrilla marketing**.



ENTREPRENEURIAL PROFILE: Steve Lichtman: Fitness Together The importance of bootstrap marketing hit Steve Lichtman, owner of four franchised Fitness Together centers near Boston, Massachusetts, after he spent \$7,000 to send a direct-mail ad to 20,000 households in his trading area. The results were unimpressive; the campaign generated just enough new business to pay for itself. Lichtman realized that “we had to be a lot more strategic and creative” in the

FIGURE 9.1 A Seven-Sentence Marketing Strategy

Source: Based on Alan Lautenslager, “Write a Creative Marketing Plan in Seven Sentences,” *Entrepreneur*, April 24, 2006, www.entrepreneur.com/marketing/marketingideas/guerrillamarketingcolumnistallautenslager/article159486.html.

Building a successful marketing plan does not have to be a complex process. One marketing expert says that entrepreneurs can create the foundation of a marketing plan with just seven sentences:

1. What is the goal of your marketing efforts?
2. What target market are you trying to reach with your message?
3. What do you offer that is unique?
4. What is the specific need that the market? Specifically how are you addressing that need?
5. How does your business stand out from the competitors? What are you known for?
6. What are the strategies and specific steps you will use to implement your marketing plan?
7. What budget will you need to sell and promote your business?

Answering these seven questions will give you an outline of your company's marketing plan. Implementing a successful marketing plan boils down to two essentials:

1. Having a thorough understanding of your target market, including what customers want and expect from your company and its products and services.
2. Identifying the obstacles that stand in your way of satisfying customers (competitors, barriers to entry, outside influences, budgets, knowledge, and others) and eliminating them.

Source: CartoonStock.



Pretty strange term, market share, considering the whole object is not to.

company's marketing efforts. He worked with his management team to define the company's value proposition, "One client, one trainer, one goal," which involves offering customized, one-on-one personal training sessions in small, suite-like settings, before looking for the most effective ways to communicate that message to customers. As part of his bootstrap marketing strategy, Lichtman formed a partnership with a local child care provider so that parents know that their children are cared for while they are exercising. He also began building a network of contacts with local health care providers and has conducted exercise programs for rehab patients. To raise his company's visibility in the local community, Lichtman launched a "Lunch and Learn" program aimed at local businesses in which he talks with employees about health, nutrition, and exercise. Fitness Together also sends electronic newsletters with articles of interest to customers and potential customers and has a Facebook page. The company's Web site also includes testimonials (some in the form of short videos) from satisfied customers. Lichtman's most comprehensive bootstrap marketing tactic was to organize a cooperative advertising program with other Fitness Together franchisees in New England. The franchisees pool their resources to purchase advertising in traditional media such as cable television ads and billboards at discounted prices.²

A marketing plan focuses a company's attention on the customer and recognizes that satisfying the customer is the foundation of every business. Indeed, the customer is the central player in the cast of every business venture. According to marketing expert Ted Levitt, the primary purpose of a business is not to earn a profit; instead, it is "to create and keep a customer. The rest, given reasonable good sense, will take care of itself."³ Every area of the business must practice putting the customer first in planning and actions. A **bootstrap marketing plan** should accomplish four objectives:

1. It should pinpoint the target markets the small company will serve.
2. It should determine customer needs, wants, and characteristics through market research, that is, find the "pain points" in the market.
3. It should analyze a company's competitive advantages and build a strong value proposition and an effective, cost-efficient marketing strategy around them.
4. It should help create a marketing mix that meets customer needs and wants.

STUDENTS-HUB.com building a customer orientation into these four objectives of the small company's marketing plan.

Uploaded By: anonymous



In the Entrepreneurial Spotlight

Bootstrap Marketing in the New Music Industry

The music industry has undergone tremendous change over the last decade. Digital distribution of music has sent the traditional music corporation reeling. In the past, large companies in the music industry controlled everything from the creation of music through its production and its distribution. Consumers no longer have to buy an album produced and distributed by a major record company. Now music fans can buy just the songs they want by downloading them directly to their phones, tablets, and computers, often directly from their favorite artists. People's musical tastes have changed, as the long tail of marketing has created many artists will fewer but intensely loyal consumers. While the major record labels have fallen on tough times, a whole new generation of music industry entrepreneurs has emerged, including entrepreneurs who are artists, managers, software developers, and writers.

Erin O. Anderson is founder and artist manager of Olivia Management. She and the artists she works with are a part of the



Tin Cup Gypsy.

Source: Tin Cup Gypsy Entertainment Co.



entrepreneurial revolution that is changing the structure of the music industry. Anderson works with indie (independent) musicians, which means these artists aren't signed to record deals, and they don't have a big music label backing them and pushing their music into the market. The typical indie band tours the country in a van and sells merchandise in the back of a club, hoping to make enough to afford gas to the next venue and trying to scrape enough dollars together to make an album. These artists have learned to be bootstrap entrepreneurs with their music.

"As a band, it can be tough to get in front of the right audience," says Tyler Oban, CEO and drummer of the band Tin Cup Gypsy. "However, we were in a unique situation. The four of us in the band all had side gig experience. This opened doors for our band by making trades with the artists who called us to play with them. The deal was simple—let our band open for you, and we will give you a discounted rate as musicians." Although it was a lot of extra work to prepare both their own music and the music of the established bands they were playing for, this strategy allowed them to quickly get in front of big audiences and gain fans. "It also helped us to define our target market," says Oban. "Playing in different venues and in different musical genres quickly allowed us to focus on the fans we wanted to as our business gets bigger."

Producing music has also gone through significant changes. "I've had to get creative doing record promotion without a big budget," says Anderson. "Luckily, in the music world, there are a lot of technology start-ups. I do the research and find out what free and cheap tools exist to assist the artists in marketing their music."

Many other entrepreneurs have discovered that indie musicians need help and have developed an abundance of applications, programs, sites, and services to help artists reach their fans and market their music at a very low price or even sometimes for free. For example, Jamplify encourages fans of a band to share unique links to their music and earn special prizes for driving traffic to their Web sites.

"I love the idea that my bands' fans could help grow their fan base, so I volunteered to be a part of Jamplify's beta testing and got to use their service for free," says Anderson. "As a result, I have been able to drive thousands of new listeners to a music video my band had just premiered."

Another new tool for artists to bootstrap the growth of their customer bases is Noisetrade, an online music discovery site. Noisetrade enables artists to give their music away for free while collecting their fans' e-mail addresses and ZIP codes. "We have amassed great, active e-mail list of fans who enjoy the music and enjoy getting updates from my artists," says Anderson. "And they are people who are likely to buy any new albums my artists put out! My other favorite free music service is Next Big Sound, which sends a weekly dashboard that shows popularity, activity, and other metrics for musicians across social media, sales, and events. This free weekly report is sent to my in-box and contains an overview of what is happening on the Internet in regards to the artists I work with," adds Anderson. "It saves me time and money and enables me to make good decisions and get reliable feedback on the success of our marketing."

Songwriters have also had to become bootstrapping entrepreneurs in the highly competitive music industry. “After three years of writing songs professionally, I noticed an opportunity to increase my chances of getting songs cut by artists,” said Ben Cooper, songwriter and producer. Most songs that get picked up by artists are professionally produced. However, technology has developed to the point that a home studio recording can reach almost the same quality as any professional studio found in New York, Los Angeles, or Nashville. “I decided to buy a textbook on home recording techniques, and I invested a few thousand dollars in a good setup,” says Cooper. “After I spend time with another songwriter composing the song, the other songwriter goes home while I work a few extra hours polishing our demo recording. Even though I’m spending the additional time, I’m

saving hundreds of dollars per song by not paying other musicians to record. By the end of each year, I’m able to have up to 10 times as many fully recorded songs as the next songwriter.”

1. Even though the music industry has gone through tremendous change, there are still opportunities in this industry. Explain.
2. Assume that you or your friends have a band. How would you develop a plan to enter and succeed in today’s music industry?

Sources: Mark Mulligan, “Why the Music Industry Must Change Its Strategy to Reach Digital Natives,” Mashable, February 04, 2011, <http://mashable.com/2011/02/04/music-industry-digital-natives/>; “A Change of Tune,” *The Economist*, July 5, 2007, www.economist.com/node/9443082; Jeff Price, “The End of the New Music Industry Transformation; How Technology Destroyed the Traditional Music Industry,” *ArtistCore*, September 14, 2012, <http://artistcore.blogspot.com/2012/09/the-end-of-new-music-industry.html>.

Market Diversity: Pinpointing the Target Market

One of the first steps in building a marketing plan is identifying a small company’s **target market**, the group of customers at whom the company aims its products and services. The more a business learns from market research about its local markets, its customers, and their buying habits and preferences, the more precisely it can focus its marketing efforts on the group(s) of prospective and existing customers who are most likely to buy its products or services.

2.

Explain how small businesses can pinpoint their target markets.



ENTREPRENEURIAL PROFILE: Meena and Siddharath Bindra: BIBA Meena Bindra started BIBA from her home in Mumbai in 1988. Soon, it became a popular maker and seller of ethnic Indian wear. In 2004, the first exclusive brand store was launched in Inorbit Mall, Mumbai. The rise to success continued with Meena’s son, Siddharath. Now, BIBA has 135 exclusive stores in 65 cities across India, and is the largest retail chain of ethnic wear. It has adopted a number of innovative marketing policies to expand its customer reach. Siddharath has signed up designer Rohit Bal to conceptualize BIBA’s range of luxury and occasional wear. It was also a pioneer in Bollywood merchandising, starting with *Na Tum Jano Na Hum* in 2004, and continuing with 10 more projects, including blockbusters like *Devdas* and *Baghban*. BIBA aims to be the exclusive fashion destination for Indian ethnic wear by 2020.⁴

Unfortunately, most marketing experts contend that the greatest marketing mistake that small businesses make is failing to define clearly the target market to be served. Too many entrepreneurs identify a new product they would like to offer and then try to find a market for their product. Instead, it is always best to start with a target market that has a specific “pain point”—that is, a need or a want that no business is fulfilling. “It is amazing how many people assume they know what customers want without actually asking customers,” says Hunter Phillips, CEO of PRSM Healthcare in Nashville, Tennessee. “Present it as you are trying to solve a problem for them. Remember, this is about their needs rather than your idea.”

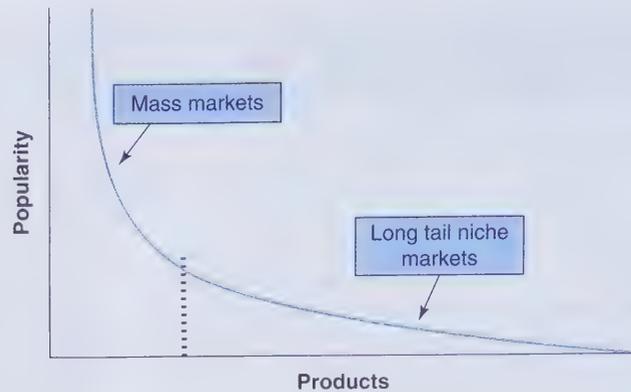
Failing to pinpoint their target markets is especially ironic because small firms are ideally suited to reaching market segments that their larger rivals overlook or consider too small to be profitable. Why, then, do so many small businesses fail to pinpoint their target markets? Because identifying, defining, and researching a target market requires market research and a marketing plan, both of which involve hard work! The result is that these companies follow a sales-driven rather than a customer-driven marketing strategy. To be customer driven, an effective marketing strategy must be based on a clear, well-defined understanding of a company’s target customers.

A “one-size-fits-all” approach to marketing no longer works because the mass market is rapidly disappearing. Much of this change is a result of how people get information about products and services. Technology is replacing the power of **mass marketing**—where companies find products and services that appeal to an entire market—with the power of online word of mouth and social media, which creates many much smaller niche markets. In his book *The Long Tail*, Chris Anderson offers evidence that suggests that this has made a fundamental shift in how businesses think about the customers to whom they market and how they provide them with goods and services. “Now, with online distribution and retail, we are entering a world of abundance,” says Anderson. “The differences are profound.”⁵ Figure 9.2 displays the **long tail of marketing**,

FIGURE 9.2

The Long Tail of Marketing

Source: Based on Chris Anderson, *The Long Tail* (New York: Hyperion, 2008).



where a few products that target the mass market are replaced by many products that are targeted at specific niche markets. There are three driving forces when marketing to niche markets in the long tail:

1. **Tools of production.** Technology has put the tools of production into the hands of everyone. For example, new tools for recording music can turn a bedroom into a recording studio with sound quality that rivals that of traditional studios with millions of dollars of equipment. Software empowers small businesses to reach and sell to a global market with Web sites and blogs that give them the means for promotion and distribution. The result has been an explosion in niche products.
2. **Internet aggregators.** Studies show that most consumers now begin their shopping by going to online aggregators to compare prices and features when making purchases. This behavior opens many niche markets to even the smallest businesses.
3. **Filtering software connects supply and demand.** Search engines and aggregators now allow consumers to search for a product, see the ads for the various businesses selling that product, and purchase that product with a “click.” Companies such as Amazon are now reaching out to specific customer segments with e-mail offers for products and services, many offered by small niche-focused businesses. These advances in technology allow small businesses to not only reach niche markets but also do business with them wherever they are through the Internet.

The most successful businesses have well-defined portraits of the customers they are seeking to attract. From market research, they know their customers’ income levels, ages, lifestyles, buying patterns, education levels, likes and dislikes, and even their psychological profiles. At successful companies, the target customer permeates the entire business—from the merchandise it purchases and the ads it uses to the layout and decor of the store. They have an advantage over their rivals because the images they have created for their companies appeal to their target customers, and that’s why they prosper. Without a clear picture of its target market, a small company will try to reach almost everyone and usually will end up appealing to almost no one.

Determining Customer Needs and Wants Through Market Research

In addition to the changes in technology that have created the long tail of marketing, the changing nature of the U.S. population is a potent force altering the landscape of business. Shifting patterns in age, income, education, race, and other population characteristics (which are the subject of demographics) have a major impact on companies, their customers, and the way they do business with those customers. Entrepreneurs who recognize demographic, social, and cultural trends as they emerge have the opportunity to differentiate their companies from the competition in meaningful ways. Those who fail to spot important trends and adjust their strategies accordingly run the risk of their companies becoming competitively obsolete as their target customers pass them by. How can entrepreneurs spot these significant trends?

- Read a variety of current publications, including those that might ordinarily be outside of your areas of interest. Reading industry-related publications also allows you to identify significant trends that affect your business directly.

3. Explain how to determine customer needs through market research.

- Watch the top 10 television shows (at least periodically). They are great indicators of customers' attitudes and values and give valuable insight into the products and services they are interested in buying. AMC's hit series *Mad Men*, a show about the advertising industry set in the early 1960s, proved to be a major influence on men's and women's fashions, home decor, eyeglasses, and other aspects of life.
- See the top 10 movies. They also influence consumer behavior. After Tommy Lee Jones and Will Smith donned Rayban sunglasses in the original *Men in Black*, sales of the company's sunglasses skyrocketed.
- Look to the past. Like clothing styles, some trends are recycled from the past. Organic food? That's what your grandparents ate! Gabriela Hernandez drew the inspiration for the line of retro makeup that her company, Bésame Cosmetics, sells from the classic colors and styles used by celebrity icons of the 1940s, such as Grace Kelly and Audrey Hepburn.⁶
- Talk to at least 100 customers each year to find out what they are buying and why. Ask them about other features they would like or other problems you could help them solve. "When in doubt, go to your customers," says veteran entrepreneur and author Norm Brodsky. "They will tell you what they want and lead you to solutions you'd never come up with on your own. Just about every successful new initiative I've taken in business has come from listening to customers."⁷
- Sensitize yourself to trend tracking. Be on the lookout for emerging trends every day by stepping outside of your normal routine and noticing what's happening around you.
- Monitor social networking sites for evidence of emerging trends. The discussions of people who gather online can reveal significant shifts in attitudes and interests.

For entrepreneurs, the key to success is to align their businesses with as many demographic, social, and cultural trends as possible. This is how successful businesses find their niche target markets. Staying on trend means staying in synchronization with the market as it shifts and changes over time. The more trends a business converges with, the more likely it is to be successful. Conversely, a business moving away from significant trends in society is in danger of losing its customer base.

By performing some basic market research, entrepreneurs can detect key demographic, social, and cultural trends and zero in on the needs, wants, preferences, and desires of its target customers. Indeed, every business can benefit from a better understanding of its market, customers, and competitors. **Market research** is the vehicle for gathering the information that serves as the foundation for the marketing plan. It involves systematically collecting, analyzing, and interpreting data pertaining to the small company's market, customers, and competitors. Businesses face the challenge of reaching the highly fragmented markets that have emerged today, and market research can help them. Market research allows entrepreneurs to answer questions such as the following: Who are my customers and potential customers? To which age-group(s) do they belong? What is their income level? Where do they live? Do they rent or own their own homes? What features are they looking for in the products or services I sell? How often do they buy these products or services? What models, styles, colors, or flavors do they prefer? What radio stations do they listen to? Which Web sites do they visit? What factors are most important to their buying decisions? How do the strengths of my product or service serve their needs and wants? What hours do they prefer to shop? How do they perceive my business? Which advertising media are most likely to reach them? How do customers perceive my business versus competitors? This information is an integral part of developing an effective marketing plan.

A small company must avoid mistakes when marketing its goods and services because there is little margin for error when funds are scarce and budgets are tight. Small businesses simply cannot afford to miss their target markets, and market research can help them zero in on the bull's-eye. Entrepreneurs should conduct market research when developing their business models and constructing their business plans, *before* launching their companies.



ENTREPRENEURIAL PROFILE: Ross Hill: PictureBoothCo Ross Hill, founder and CEO of PictureBoothCo, engaged customers to help develop his idea of a portable photo booth. His idea was to develop a photo booth that was compact enough to ship to and from events anywhere in the United States and easy enough to use that it could be set up and operated by anyone by just following a few simple instructions. "When I was in the process of creating the first photo booth prototype,

I was constantly bouncing ideas off of future customers,” says Hill. “Their feedback allowed me to avoid wasting my time on unnecessary aspects and focus all of my time on the parts of the business that were important.” What prospective customers told him was that they were more concerned about the backgrounds and image quality than they were with the look and design of the booth. This allowed him to develop a simple booth design and put most of his energy into the “user experience” aspects of the booth. “You can’t be scared to talk to future or past customers about their experience with your product,” said Hill. “If you treated them fairly, they will want to help you succeed.”

One of the worst—and most common—mistakes entrepreneurs make is *assuming* that a market exists for their products or services. The time to find out whether customers are likely to buy a product or a service is *before* investing thousands of dollars to launch it! Market research can tell entrepreneurs whether a sufficient customer base exists and how likely those customers are to buy their products and services. In addition to collecting and analyzing demographic data about their target customers, entrepreneurs can learn a great deal by actually observing, mingling with, and interviewing customers as they shop.

Market research for a small business can be informal; it does *not* have to be time consuming, complex, or expensive to be valuable. Many entrepreneurs are discovering the speed, the convenience, and the low cost of conducting market research over the Internet. Online surveys, customer opinion polls, and other research projects are easy to conduct, cost virtually nothing, produce quick responses, and help companies connect with their customers. Insight Express, an online market research firm, estimates that online surveys cost just 20 percent of what it costs to conduct a mail survey and only 10 percent of what it costs for a telephone survey.⁸ With Web-based surveys, businesses can get real-time feedback from customers, often using surveys they have designed themselves. Web sites such as Survey Monkey and Zoomerang allow entrepreneurs to conduct low-cost (in some cases free) online surveys of existing or prospective customers. One comparison study of online and mail surveys reports that response rates are higher for online surveys than for mail surveys.⁹



ENTREPRENEURIAL PROFILE: Tim Weber: GoodMusicAllDay LLC When Tim Weber, founder and CEO of GoodMusicAllDay LLC, first attempted to sell merchandise through his music blog site, he spent almost \$1,000 for one shirt design. Unfortunately, he only sold about \$200 worth of the product. “About 10 months later, I was ready to try again but not willing to put up any capital,” said Weber. Weber reached out to three start-up apparel companies and proposed that they front all costs for his next T-shirt. He would make sure that they would recoup their expenses first, and after that they would split the profits 50/50. “We created a poll on our Web site to see which kinds of clothing our audience would actually buy and were soon up and running with virtually no financial risk,” said Weber.

How to Conduct Market Research

The marketing approach that companies of all sizes strive to achieve is **individualized (or one-to-one) marketing**, a system of gathering data on individual customers and then developing a marketing plan designed specifically to appeal to their needs, tastes, and preferences. Its goal is not only to attract customers but also to keep them and to increase their purchases. In a society in which people feel so isolated and transactions are so impersonal, one-to-one marketing gives a business a competitive advantage. Companies following this approach know their customers, understand how to give them the value they want, and, perhaps most important, know how to make them feel special and important. The goal is to treat each customer as an individual. The Ritz Carlton hotel group uses a centralized computer network called Mystique that tracks its guests’ preferences and spending habits with the company and provides information to all of the hotels in the chain so that they can offer guests individual attention. When a guest checks in, the desk clerk will know, for instance, that he or she prefers a queen-size bed with foam pillows, a stock of Le Bleu bottled water in the minibar, and a glass of orange juice and a copy of the *Wall Street Journal* with breakfast. Offering these “extras” without requiring the customer to ask for them makes hotel guests feel as though the hotel is catering specifically to their unique needs and preferences.¹⁰

Individualized marketing requires business owners to gather and assimilate detailed information about their customers. Fortunately, owners of even the smallest businesses have access to affordable technology that creates and manages computerized databases, allowing them to develop

4. Outline the steps in the market research process.

close, one-to-one relationships with their customers. Much like gold nuggets waiting to be discovered, significant amounts of valuable information about customers and their buying habits is hidden *inside* many small businesses, tucked away in computerized databases. For most business owners, collecting useful information about their customers and potential new products and markets is simply a matter of sorting and organizing data that are already floating around somewhere in their companies. “Most companies are data rich and information poor,” claims one marketing expert.¹¹ The key is to mine these data and turn them into useful information that allows the company to “court” its customers with special products, services, ads, and offers that appeal most to them.

Entrepreneurs have at their disposal two basic types of market research: conducting *primary research* (data you collect and analyze yourself) and gathering *secondary research* (data that has already been compiled and is available), often at a very reasonable cost or even free. Although secondary data on customers are necessary, they are not sufficient. Entrepreneurs must get firsthand data from real customers! Primary research techniques include the following:

- **Customer surveys and questionnaires.** Keep them short. Word your questions carefully so that you do not bias the results and use a simple ranking system (e.g., a 1-to-5 scale, with 1 representing “unacceptable” and 5 representing “excellent”). Test your survey for problems on a small number of people before putting it to use. Web surveys are inexpensive and easy to conduct and provide feedback fast. Femail Creations, a mail-order company that sells clothing, accessories, and gifts to women, uses Web surveys to gather basic demographic data about its customers and to solicit new product ideas as well. Customer responses have led to profitable new product lines for the small company.¹²
- **Social media.** Small companies have discovered that social media such as Facebook, Twitter, Yelp, and others are easy, inexpensive, and effective tools for gathering feedback from their customers. The owners of Liberty Market, a popular restaurant and food store in Gilbert, Arizona, routinely send tweets to their regular customers after they visit to find out about their dining experience. Not only do the entrepreneurs receive useful feedback and suggestions for improvement, but they also stay close to their core customers.¹³
- **Focus groups.** Enlist a small number of customers to give you feedback on specific issues in your business—quality, convenience, hours of operation, service, and so on. Listen carefully for new marketing opportunities as customers or potential customers tell you what is on their minds. Once again, consider using the Web; one small bicycle company conducts 10 online focus groups each year at virtually no cost and gains valuable marketing information from them.
- **Daily transactions.** Sift as much data as possible from existing company records and daily transactions—customer warranty cards, personal checks, frequent-buyer clubs, credit applications, and others.
- **Other ideas.** Set up a suggestion system (for customers and employees) and use it. Establish a customer advisory panel to determine how well your company is meeting needs. Talk with suppliers about trends they have spotted in the industry. Contact customers who have not bought anything in a long time and find out why. Contact people who are no longer customers and find out why. Teach employees to be good listeners and then ask them what they hear.

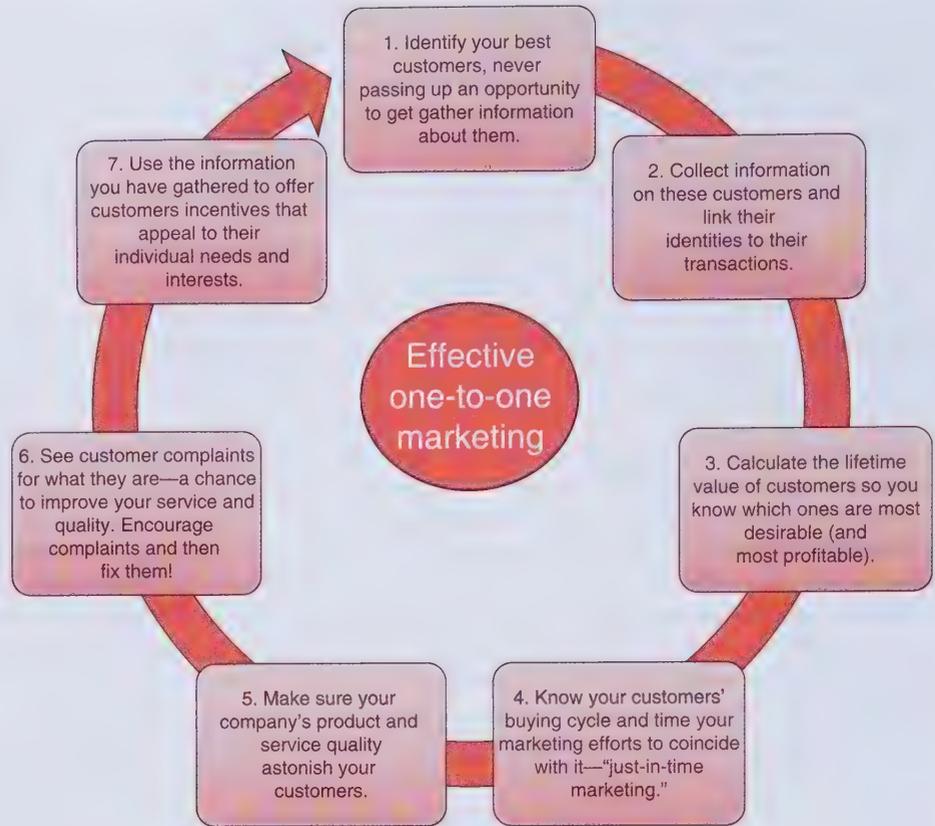
As you learned in Chapter 8, entrepreneurs have access to many useful sources of secondary research, which is usually less expensive to collect than primary data. Using secondary data, entrepreneurs can learn about their target customers’ demographic profiles, purchasing power, media preferences, and many other characteristics and gain insight into their buying habits and tendencies.

Thanks to advances in computer hardware and software, data mining, once available only to large companies with vast computer power, is now possible for even very small businesses. **Data mining** is a process in which computer software that uses statistical analysis, database technology, and artificial intelligence finds hidden patterns, trends, and connections in “big data” so that business owners can make better marketing decisions and predictions about their customers’ behavior. Finding relationships among the many components of a data set, identifying clusters of customers with similar buying habits, and predicting customers’ buying patterns, data mining gives entrepreneurs a new source of marketing power. Popular data mining software packages include Clementine, DataScope Pro, GoldMine, MineSet, and many others.

FIGURE 9.3

How to Become an Effective One-to-One Marketer

Source: Based on Susan Greco, "The Road to One-to-One Marketing," *Inc.*, October 1995, pp. 56–66.



For an effective individualized marketing campaign to be successful, business owners must collect and mine three types of information:

1. **Geographic.** Where are my customers located? Do they tend to be concentrated in one geographic region?
2. **Demographic.** What are the characteristics of my customers (age, education levels, income, gender, marital status, and many other features)?
3. **Psychographic.** What drives my customers' buying behavior? Are they receptive to new products or are they among the last to accept them? What values are most important to them?

Figure 9.3 explains how to become an effective individualized marketer.



In the Entrepreneurial Spotlight

Bootstrap Marketing Using Databases

Although social media has grown in its importance for attracting customers, a recent study shows that e-mail marketing is still the most common tool for customer acquisition (used by 86.3 percent of both B2B and B2C companies) followed by direct mail (used by 69.0 percent of businesses). Although they may seem a bit old-fashioned, e-mail and direct mail are still the workhorses of promotional channels. Businesses can purchase lists of contacts through a variety of services that can offer highly targeted lists that are specific to the type of customer, size, and geographic location. However, buying access to these services is not cheap for a small business. Many of them charge as much as several hundred dollars a month. Clever bootstrapping entrepreneurs

find ways to build a database of potential customers without subscribing to costly database services.

Jerell Harris, president of QuickMed Collect, built his own database for his company that collects medical waste from private physician practices, funeral homes, surgical centers, and other professionals who accumulate regulated waste. Rather than purchase data through a service, which Harris could not afford, he turned instead to the local library. "I found a Web site called Referenceusa.com, which is accessible, without charge, at the library. The Web site offers access to a verifiable database that has 14 million existing businesses and 4 million new businesses. In addition, one can search for businesses using NAICS codes,



Julie Zaloba, founder of Julie Zaloba Consulting, LLC.

SIC codes, city, state, and so on. Moreover, the information can be customized before it is exported." The only limitation to this service is that the user can export only 50 contacts per download. However, the download process can be repeated multiple times. "The data extracted from Referenceusa.com has allowed me to develop a list of contacts that resulted in many of them being converted into clients without incurring expenses," adds Harris.

Julie Zaloba runs a small business consulting practice and also uses free databases available through the library. She develops leads not only from these databases but also uses them as tools to work with her clients. "As a business research consultant, I need to access various industry resources that I can reference in my reports to clients. Instead of paying hundreds of dollars in subscription fees to access these online databases, I go to the university library or public library. At the library, I have free access to a wide variety of online databases in which I can research relevant information for my projects. Since I do not have to incur the cost of utilizing these resources, I can offer my consulting services at a more affordable rate."

Jake Jorgovan is the cofounder of an event design company operating in the entertainment industry that he and his partner launched while they were in college. "When we were looking to do market research and grow our sales pipeline, I was faced with the problem that I had little experience in the industry and did not know who all of the players were," said Jorgovan. "We couldn't afford a sales rep, so the only choice was to learn the industry myself." Jorgovan subscribed to variety of industry trade magazines. He carefully read through every article to identify

all the names of the key players involved in each production. He then would research these people further using Google. "I started seeing trends in the industry, who the big players were and who worked with whom," explained Jorgovan. "My document ended up growing to more than 60 pages long! It covered profiles of nearly every company and key individual in the event production industry." Jorgovan found that developing his database yielded two important outcomes. First, it gave him a contact list for the company's marketing efforts. It also helped him to be more credible when he made contacts from this list because when he talked to someone else in the industry, he knew whom they were talking about. "That created the perception that I had been in the industry for years," said Jorgovan.

In addition to actively seeking lists of contacts from free or low-cost sources, entrepreneurs can add to their database by making it easy for interested people to give them their contact information. This can be something as simple as a guest visitor book on the counter of a store or as high tech as embedding e-mail sign-up through a quick-response code. Because e-mail is fast becoming the preferred method of direct contact for many people, building an e-mail database can be a highly effective tool for attracting new customers and for retaining existing customers. Experts recommend that any direct contact with customers be as personal as possible. People tend to ignore messages that appear to be part of a large e-mail blast. Many effective marketers are using their databases to send customized messages to customers. Because social media are growing in their marketing applications, small companies can develop strategies to tie traditional e-mail and direct mail promotions into their social media marketing strategies, allowing the customers they contact to sign up for their companies' Facebook and Twitter accounts. Although direct-mail and e-mail marketing may seem a bit "old school," effective bootstrap marketers know that a list of potential customers can still be a gold mine for growing a business.

1. Are direct-mail and e-mail marketing still effective marketing tools? How can a small business owner with a limited budget develop a database when he or she is on a limited budget?
2. How can a small business owner use a database of potential and existing customers to help grow his or her business? In what ways can entrepreneurs tie e-mail marketing into their social media marketing strategies?
3. Develop a specific plan to develop a database of prospective customers for a small business you have already started or a business you hope to start in the near future. How would you go about gathering data? What type of data would you need? How would you target your data collection to ensure it is most effective for your business?

Sources: Based on Hollis Thomases, "Email Marketing Isn't Dead (Yet)," *Inc.*, August 28, 2012, www.inc.com/hollis-thomases/email-marketing-strategies.html; Brian Halligan, "Segments of One: Smarter Targeting for Your Customers," *Inc.*, January 26, 2012, www.inc.com/brian-halligan/audience-segmenting-targeting-your-customers.html.

Plotting a Bootstrap Marketing Strategy: Building a Competitive Edge

Small companies simply do not have the resources to devote to marketing that their larger rivals do. Marketing a small company effectively requires entrepreneurs to rely on bootstrap marketing strategies, those that use creative, low-cost marketing techniques that hit home with their target customers. Independent bookstores have discovered that large chains and online competitors use their buying power to get volume discounts and undercut the independents' prices. Individual shop

5. Describe the bootstrap marketing strategies on which a small business can build a competitive edge in the marketplace.

owners are finding new ways, such as special ordering, adult reading groups, educational classes, children’s story hours, author events, newsletters, autograph parties, and targeting unique niches, to retain loyal customers. These entrepreneurs are finding that the best way to gain a competitive advantage is to create value by giving customers what they really want and cannot get elsewhere.

Successful businesses often use the special advantages they have to gain a competitive edge over their larger rivals. Their close contact with the customer, personal attention, focus on service, and organizational and managerial flexibility provide a solid foundation from which to build a towering competitive edge in the market. Small companies can exploit their size to become more effective than their larger rivals at **relationship marketing** or **customer relationship management (CRM)**—developing, maintaining, and managing long-term relationships with customers so that they will want to keep coming back to make repeat purchases. CRM puts the customer at the center of a company’s thinking, planning, and action and shifts the focus from a product or service to customers and their needs and wants. CRM requires business owners to take the following steps:

- Collect meaningful information about existing customers and compile it in a database.
- Mine the database to identify the company’s best and most profitable customers, their needs, and their buying habits. In most companies, a small percentage of customers account for the majority of sales and profits. These are the customers on whom a business should focus its attention and efforts.
- Focus on developing lasting relationships with these customers. This often requires entrepreneurs to “fire” some customers that require more attention, time, and expense than they generate in revenue for the business. Failing to do so reduces a company’s return on its CRM effort.
- Attract more customers who fit the profile of the company’s best customers.

Business owners are discovering that even though they may provide their customers with satisfactory service and value, many of their customers do not remain loyal, choosing instead to buy from other companies. Businesses that provide poor customer service are in grave danger. Hepworth, a consulting firm that specializes in customer retention, measures its clients’ **revenue at risk**, which calculates the sales revenue a company stands to lose by measuring the percentage of customers who would leave because of poor service. According to Verde Group, another company that has conducted extensive research on customer satisfaction, the typical North American company is at risk of losing 21 percent of its customers because of high levels of dissatisfaction. What is more alarming is that more than 40 percent of customers who experience a customer service problem never tell the company about it; 70 percent of customers defect because of a problem that, if the company knew about it, would have been easy to fix.¹⁴ Today, earning customers’ loyalty requires businesses to take customer focus and service to unprecedented levels, and that requires building long-term relationships with customers.

To be successful bootstrap marketers, entrepreneurs must be as innovative in creating their marketing strategies as they are in developing new product and service ideas. The following bootstrap marketing principles help business owners build a competitive edge:

Find a Niche and Fill It

As we saw in Chapter 4, many successful small companies choose their niches carefully and defend them fiercely rather than compete head-to-head with larger rivals. A niche strategy allows a small company to maximize the advantages of its smallness and to compete effectively even in industries dominated by giants. It also allows them to find their place on the long tail of marketing. Focusing on niches that are too small to be attractive to large companies or in which entrepreneurs have unique expertise are common recipes for success among thriving small companies.



ENTREPRENEURIAL PROFILE: Matt Fiedler and Tyler Barstow: Vinyl Me, Please Matt Fiedler and Tyler Barstow, cofounders of Chicago-based Vinyl Me, Please, are seeking to tap into the renewed interest in vinyl records. According to Nielsen SoundScan, the demand for vinyl records has grown for the past five years. There were 4.6 million newly pressed vinyl records sold in 2012, which is a 17.7 percent increase from the previous year. Music enthusiasts love vinyl records for the warmth and depth of their sound. The niche that Vinyl Me, Please fills is bringing new and interesting music to a new generation of vinyl record enthusiasts. Each month, the subscribers to Vinyl Me,

Please receive a brand new, hand-wrapped vinyl album from an undiscovered artist. In addition to the monthly vinyl record, the company assigns subscribers a personal music consultant who gets to know their musical tastes and preferences. Every month, the consultant creates a personalized play list for each subscriber. Vinyl Me, Please brings together in one service what today's young music enthusiasts want. The company's customers love the sound of vinyl, like to interact on social media with friends about new music to try, and enjoy the surprise factor they get from services such as Pandora.¹⁵

“Small business is uniquely positioned for niche marketing,” says marketing expert Phil Kotler. “If a small business sits down and follows the principles of targeting, segmenting, and differentiating, it doesn't have to collapse to larger companies.”¹⁶

Retain Existing Customers

Keeping an existing customer is cheaper and easier than attracting a new customer. Loyal, long-term customers are the bedrock of every business. High customer retention rates translate into superior financial performance and more efficient marketing budgets. Studies by the Boston Consulting Group show that companies with high customer retention rates produce above-average profits and superior growth in market share.¹⁷ Increasing a company's retention rate by just 2 percent has the same impact as cutting expenses by 10 percent!¹⁸

Because about 20 to 30 percent of a typical companies' customers account for about 70 to 80 percent of its sales, it makes more sense to focus resources on keeping the best (and most profitable) customers than to spend them trying to chase “fair-weather” customers who will defect to any better deal that comes along. Suppose that a company increases its customer base by 20 percent each year, but it retains only 85 percent of its existing customers. Its effective growth rate is just 5 percent per year [$20\% - (100\% - 85\%) = 5\%$]. If this same company can raise its customer retention rate to 95 percent, its net growth rate *triples* to 15 percent [$20\% - (100\% - 95\%) = 15\%$].¹⁹

Shrewd entrepreneurs recognize that the greatest opportunity for new business often comes from existing customers.



ENTREPRENEURIAL PROFILE: Sharon McRill: The Betty Brigade Sharon McRill, the owner of The Betty Brigade, believes in the power of personal relationships with existing customers. Her Ann Arbor, Michigan-based personal assistance and concierge firm keeps track of important dates in its clients' lives using a low-cost online service called Benchmarkemail.com. McRill can send out automatic e-mails using templates from the site to wish her clients a happy birthday, congratulate them on an anniversary, or thank them for being loyal customers. “This keeps our company in the customers' minds in a positive way,” she says.²⁰

Although winning new customers keeps a company growing, keeping existing ones is essential to success. Research shows that repeat customers spend 67 percent more than new customers. In addition, attracting a new customer actually costs the typical business *seven to nine times* as much as keeping an existing one.²¹ Table 9.1 shows the high cost of lost customers and the steps entrepreneurs can take to improve their customer retention rates.

The formula for marketing success is simple—retain existing customers, enhance relationships with them, and attract new customers like them. However, it takes hard work and constant attention to put this simple formula into practice. Although business owners devote much attention to finding new customers, keeping existing customers coming back is the most cost-effective part of marketing efforts. Entrepreneurs are better off asking, “How can we improve customer value and service to encourage our existing customers to do more business with us?” rather than “How can we increase our market share by 10 percent?” One way that small companies can entice current customers to keep coming back is with a loyalty program (e.g., a car wash offering a punch card that gives customers one free wash after they purchase nine washes). Perhaps the most effective way for a business to build customer loyalty is to sell quality products and to offer outstanding customer service. A study by Forrester Research shows that a good customer experience correlates to customers' willingness to make repeat purchases from a company, reluctance to switch to a competing company, and likelihood of recommending the company to friends and colleagues.²²

Concentration on Innovation

Because the opportunities for most entrepreneurial ventures came from change and disruption in the business environment, innovation is key to continued success. Change has become a part of the global

TABLE 9.1 The High (Annual) Cost of Lost Customers

If you lose . . .	Spending \$5 Weekly	Spending \$10 Weekly	Spending \$50 Weekly	Spending \$100 Weekly	Spending \$200 Weekly	Spending \$300 Weekly
1 customer a day	\$94,900	\$189,800	\$949,000	\$1,898,000	\$3,796,000	\$5,694,000
2 customers a day	189,800	379,600	1,898,000	3,796,000	7,592,000	11,388,000
5 customers a day	474,500	949,000	4,745,000	9,490,000	18,980,000	28,470,000
10 customers a day	949,000	1,898,000	9,490,000	18,980,000	37,960,000	56,940,000
20 customers a day	1,898,000	3,796,000	18,980,000	37,960,000	75,920,000	113,880,000
50 customers a day	4,745,000	9,490,000	47,450,000	94,900,000	189,800,000	284,700,000
100 customers a day	9,490,000	18,980,000	94,900,000	189,800,000	379,600,000	569,400,000

When entrepreneurs understand the actual cost of losing a customer, they see their existing customers in a different way. What steps can business owners take to improve their customer retention rates?

- Contact your company's best customers regularly.** Identify the customers that account for 75 to 80 percent of your company's sales and call them (better yet, visit them) at least once every quarter.
- Keep your company's name in front of your customers.** You can accomplish this by consistently advertising, sending useful newsletters or e-mails, sponsoring workshops, seminars, or special events, or visiting customers to learn how your company can serve them better.
- Reward existing customers, especially longtime customers, with special deals exclusively for them.** It might be a special sale or a bonus discount.
- Surprise existing customers by giving them something extra.** In Louisiana, locals call it a lagniappe ("lan-yap"), a small gift that a merchant gives to a customer. Send loyal customers a special gift or include an extra "bonus" in their next order. It does not have to be expensive to be effective. For instance, when customers make a sizable purchase at Wilson Creek Outfitters, a fly-fishing shop in Morganton, North Carolina, the owner includes a dozen flies in the order for free. The cost of the lagniappe is minimal, but the goodwill and loyalty it garners are significant.
- Keep track of your customers and their needs.** Take the time to build a database of your customers, their contact information, and other relevant information about them and their needs.
- Don't take your company's customers for granted.** Your competitors are trying to lure them away; don't give them a reason to go! Avoid the tendency to become so inwardly focused that your company forgets about the importance of its customers.

Sources: Based on Customer Service Institute, 1010 Wayne Avenue, Silver Spring, MD 20910; Rhonda Abrams, "Strategies: Make Customer Retention Priority," *USA Today*, May 29, 2009, www.usatoday.com/money/smallbusiness/columnist/abrams/2009-05-29-customer-retention_N.htm.

economy. For small companies to remain competitive, they must constantly innovate. Because of their organizational and managerial flexibility, small businesses often can detect and act on new opportunities faster than large companies. As you learned in Chapter 3, innovation is one of the greatest strengths of entrepreneurs, and it shows up in the new products, unique techniques, and unusual approaches they introduce. A study by the Product Development and Management Association of the top-performing companies across more than 400 industries revealed that new products accounted for 49 percent of profits, more than twice as much as their less innovative competitors.²³ Because product life cycles are growing shorter, innovation, even incremental innovation that makes small improvements in existing products, is essential to long-term business success.

Innovation is an important source of competitive advantage for small companies in any industry, not just those in high-tech sectors.



Drew Hanlen, founder of Pure Sweat Basketball.

Source: Belmont University.

ENTREPRENEURIAL PROFILE: Drew Hanlen: Pure Sweat Basketball Drew Hanlen, National Basketball Association (NBA) skills coach and consultant and founder of Pure Sweat Basketball, built his business to bring together his passion for entrepreneurship and his love of basketball. Hanlen runs high school camps and clinics all across the country. His main focus, however, is helping NBA players improve their games and helping top collegiate players get ready for the NBA. Hanlen has developed a variety of programs and products centered on basketball training. Recently, Hanlen decided to expand into a line of clothing. "I partnered with an up-and-coming clothing company, Elevate, to launch my own clothing line. I sent them apparel that I liked from existing clothing companies, then they researched and picked fabrics, did all of the product research and developing, customized the fabrics and fit to my likings, and let me collaborate with their designer to finalize the products that they'll bring to the market. I have my own athletic apparel line, which cost me no money in product research or development. The only thing it cost me was a bit of time working with their developers, designers and marketing team."

Large corporations achieve innovation by devoting large budgets to research and development. How do small businesses manage to maintain their leadership role in innovating new products and services? They use their size to their advantage, maintaining their speed and flexibility much like a martial arts expert does against a larger opponent. And like Drew Hanlen, they bootstrap whenever possible. Their closeness to their customers enables them to read subtle shifts in the market and to anticipate trends as they unfold. Their ability to concentrate their efforts and attention in one area also gives small businesses an edge in innovation. “Small companies have an advantage: a dedicated management team focused solely on a new product or market,” says one venture capitalist.²⁴

To be an effective innovator, an entrepreneur should do the following:

- **Make innovation a strategic priority in the company by devoting management time and energy to it.** Smart entrepreneurs know that their business models are works in progress. Consistently testing the assumptions of the business model with current information from the market enhances competitiveness in a dynamic market.
- **Set goals and objectives for innovation.** Establishing targets and rewarding employees for achieving them can produce amazing results. Innovation is not just related to products. Encourage innovation in every aspect of how the company does business.
- **Encourage new product and service ideas among employees.** Workers have many incredible ideas, but they will lead to new products or services only if someone takes the time to listen to them.
- **Listen to customers.** A recent survey found that customers are eager to use social media to provide ideas on product innovation. Leading companies use social media to stay on top of the changes and improvements that customers want from their products.²⁵
- **Always be on the lookout for new product and service ideas.** They can come to you (or to anyone inside or outside the company) at any time.
- **Keep a steady stream of new products and services flowing.** Even before sales of her safety-handle children’s toothbrush took off, Millie Thomas, founder of RGT Enterprises, had developed other children’s products using the same triangular-shaped handle, including a crayon holder, paintbrushes, and fingernail brushes.²⁶

Table 9.2 describes a screening device for testing the viability of new product ideas.

TABLE 9.2 Testing the Viability of a New Product Idea

Testing the viability of new product ideas in their early stages of development can help entrepreneurs avoid expensive product failures later—after they have already invested significant amounts of cash in developing and launching them. The Chester Marketing Group, Inc., of Washington Crossing, Pennsylvania, has developed the following test to determine the viability of a new product idea at each stage in the product development process. To calculate a new product idea’s score, entrepreneurs simply multiply the score for each criterion by its weight and then add up the resulting weighted scores. For a product to advance to the next stage in the development process, its score should be at least 16.

Criterion		Score		Weight	Weighted Score
Extent of Target Market Need	Below Average	Average	Above Average	2	
	1	2	3		
Potential Profitability	Below Average	Average	Above Average	2	
	1	2	3		
Likely Emergence of Competition	Below Average	Average	Above Average	1	
	1	2	3		
Service Life Cycle	Below Average	Average	Above Average	1	
	1	2	3		
Compatibility with Company Strengths	Below Average	Average	Above Average	2	
	1	2	3		

Total Weighted
Score

5.

Discuss the “four Ps” of marketing—product, place, price, and promotion—and their role in building a successful bootstrap marketing strategy.

The Marketing Mix

Implementing a marketing strategy requires entrepreneurs to determine how they will use the “four Ps” of marketing—product, place, price, and promotion. Think of these four elements of marketing like ingredients in soup. All of them must work together to give a soup a delicious flavor. Entrepreneurs must integrate these elements into a coherent strategy to maximize the impact of their product or service on the consumer. Using the highest-priced components and promoting the highest quality in the market while pricing the product far below all competitors results in an inconsistent message in a marketing mix. All four Ps must reinforce the same image of the product or service the company presents to potential customers.

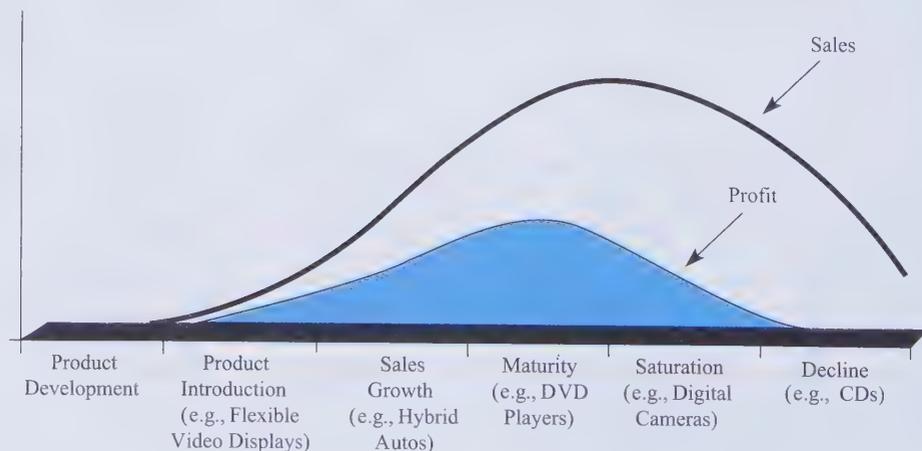
Product

The product is the foundation of the marketing mix. What makes up the product is much more than the physical item that a company sells. For example, a coffee shop sells much more than a cup of coffee. It sells a place to hang out with friends, meet with customers, or read a good book. Every element of the customer’s experience makes up the product in a marketing mix. Products can have form and shape, or they can be services with no physical form.

Products travel through various stages of development. The **product life cycle** (see Figure 9.4) measures these stages of growth, and these measurements enable the company’s management to make decisions about whether to continue selling the product, when to introduce new follow-up products, and when to introduce changes to an existing product. The length of a product’s life cycle depends on many variables, including the type of product. Fashion clothing may have a short product life cycle, lasting only four to six weeks, but a video game console’s life cycle typically lasts about four years.²⁷ Products that are more stable, such as appliances, may take years to complete a life cycle. Product life cycles are growing shorter, however. For example, the life cycle for golf equipment has shrunk over the last decade from three or four years to less than one year today.²⁸

In the *introductory stage*, marketers present their product to potential consumers. Initial high levels of acceptance are rare. Generally, new products must break into existing markets and compete with established products. Traditionally, companies use advertising and promotion to help the new product gain recognition among potential customers, who must get information about the product and the needs it can satisfy. Small businesses must intensify their marketing efforts at this level of the life cycle to overcome customer resistance and inertia—customer buying habits are hard to change. Entrepreneurs must find ways to bootstrap their marketing efforts during the entry stage of a new product because they do not have the marketing budgets of their large competitors. “Start by selling yourself and leverage your network to rise to the top,” recommends Andy Tabar, founder of Cleveland-based Bizooki. Personal selling, public relations efforts to get media stories, and creative low-cost forms of promotion can overcome the normal high cost of introducing a new product.

FIGURE 9.4
The Product Life Cycle



After the introductory stage, the product enters the *growth and acceptance stage*. In this stage, customers begin to purchase the product in large enough numbers for sales to rise and profits to increase. Products that reach this stage, however, do not necessarily become successful. If in the introductory or the growth stage the product fails to meet consumer needs, it does not generate adequate sales volume and eventually disappears from the marketplace. For successful products, sales and profit margins continue to rise through the growth stage.

In the *maturity and competition stage*, sales volume continues to rise, but profit margins peak and then begin to fall as competitors enter the market. Normally, this causes a reduction in the product's selling price to meet competitor's prices and to hold its share of the market. Sales peak in the *market saturation stage* of the product life cycle and give the marketer fair warning that it is time to introduce a new product innovation.

The final stage of the product life cycle is the *product decline stage*. Sales continue to drop, and profit margins fall drastically. However, when a product reaches this stage of the cycle, it does not mean that it is doomed to failure. Products that have remained popular are always being revised. No company can maintain its sales position without product innovation and change. Although Radio Flyer, a company started in 1917 by immigrant cabinet-maker Antonio Pasin (and managed by his grandson, Robert), still sells the classic all-metal, rubber-wheeled red wagon that made the company famous, it has introduced several models for twenty-first-century children. The Ultimate Family Wagon includes five-way flip-and-fold seats, storage compartments, cup holders (two for kids and two for adults), a tray table, and a sun canopy. Radio Flyer's latest prototype, the Cloud 9, includes enough updates to appear on *Pimp My Ride*. The high-tech wagon that features reclining upholstered seats with five-point safety harnesses; cup holders; foldout storage compartments; foot brakes; a digital handle that tracks temperature, time, distance, and speed; a slot for an MP3 player; and stereo speakers. These innovations are designed to draw new generations of children to the classic toy.²⁹

Understanding the product life cycle helps a business owner plan the introduction of new products to the company's product line. Too often, companies wait too late into the life cycle of one product to introduce another. The result is that they are totally unprepared when a competitor produces a "better mousetrap" and their sales decline. The ideal time to develop new products is early on in the life cycle of the current product (see Figure 9.5). Waiting until the current product is in the saturation or decline stages is like living on borrowed time.

There are a number of ways that a small business can enhance its product offerings.

FOCUS ON THE CUSTOMER The relationship a company forges with its customers is a crucial part of how customers perceive its products. Companies that focus on the customer experience generate 60 percent higher profits than their competitors.³⁰ A study by market research firm Genesys reports that businesses in the United States lose \$83 billion in sales each year in abandoned sales or defections to competitors because of poor customer service.³¹ The *Retail Customer*

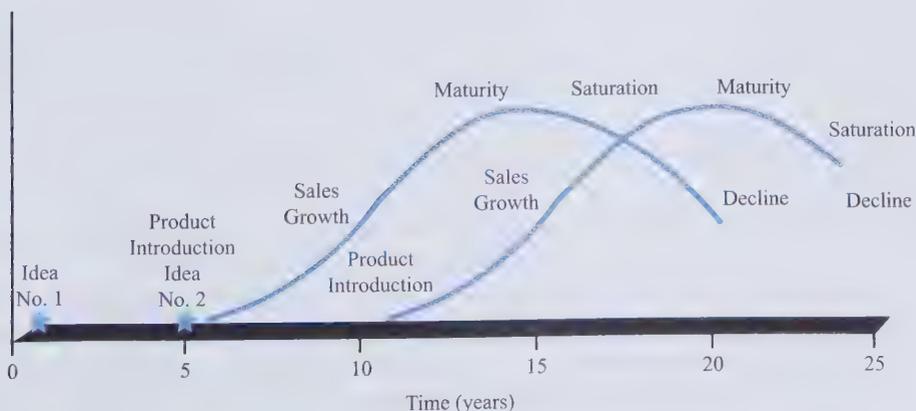


FIGURE 9.5
Time Between
Introductions of Products

Source: Based on Constant Contact 2009 Small Business Attitudes and Outlook Survey, June 18, 2009.

Dissatisfaction Study, conducted by the Jay H. Baker Retailing Initiative at the University of Pennsylvania and consulting firm Verde Group, reports the following:

- Seventy-one percent of customers in the United States have defected to a competing business because of a poor customer service experience with a company.³²
- For every complaint that a company receives from a customer, 17 other complaints exist, but the company never hears about them.
- Thirty-one percent of dissatisfied customers tell family members, friends, and colleagues about their negative experience with a company.
- Six percent of those people tell their “horror stories” to six or more people.
- Negative word-of-mouth has exponential power. For every 100 customers who have a negative experience with a business, the company stands to lose 32 to 36 current customers or potential customers.³³

Because most of a company’s sales come from existing customers, no business can afford to alienate them.

The most successful small businesses have developed a customer orientation and have instilled an attitude of customer satisfaction throughout the company. Companies with world-class customer attitudes set themselves apart by paying attention to the little things.



ENTREPRENEURIAL PROFILE: Donna Flanagin: Flanagin’s Bulk Mail When customers with children enter Flanagin’s Bulk Mail, a company in Valparaiso, Indiana, that specializes in mailing lists and bulk mail services, owner Donna Flanagin offers the children crayons and a coloring sheet so that they can create pictures that she displays on the front door. Flanagin sends children their drawings with a card on their birthdays. “It costs virtually nothing,” observes Bruce Jones, director of the Disney Institute, “yet it reminds the parents and grandparents about her business and helps make a connection with her customers.”³⁴

How do these companies focus so intently on their customers? They follow basic principles:

- When you create a dissatisfied customer, fix the problem fast. One study found that, given the chance to complain, 95 percent of customers will buy again if a business handles their complaints promptly and effectively.³⁵ The worst way to handle a complaint is to ignore it, to pass it off to a subordinate, or to let a lot of time slip by before dealing with it.
- *Encourage* customer complaints. You can’t fix something if you don’t know it’s broken, but once you know, be sure to fix it!
- Ask employees for feedback on improving customer service. A study by Technical Assistance Research Programs, a customer service research firm, found that frontline service workers can predict nearly 90 percent of the cases that produce customer complaints.³⁶ Put that expertise to work by involving frontline employees in process improvement efforts. A successful chain of medical clinics made clinic receptionists key members of their marketing teams.
- Entrepreneurs and their managers should occasionally wait on customers. It’s a great dose of reality. Dell CEO Michael Dell and his team of top managers meet periodically with the company’s major customers to get a better understanding of how to serve their needs more effectively.³⁷
- Develop a service theme as part of your culture to communicate your attitude toward customers.
- Reward employees “caught” providing exceptional service to customers. At Pitney Bowes, employees recognized by name in customer surveys receive a gift certificate.³⁸
- Carefully select and train everyone who will deal with customers. According to the Genesys study of customer satisfaction, the most important factor in providing a satisfying customer service experience is competent sales and customer service representatives.³⁹ Smart entrepreneurs view employee training for what it is: an investment rather than an expense.

DEDICATION TO SERVICE AND CUSTOMER SATISFACTION Small companies that lack the financial resources of their larger rivals have discovered that offering exceptional customer service is one of the most effective ways to differentiate their products and to attract and maintain a growing customer base. “It doesn’t take money to [provide] good customer service,” says the head of one retail company. “It takes a commitment.”⁴⁰ Unfortunately, the level of service in most companies is poor. A study by Accenture shows that 67 percent of customers globally had switched at least one service provider within the last year because of poor customer service. The study also reports that only one in four customers feels “very loyal” to current providers.⁴¹ This creates opportunities to small companies ready to earn loyalty through exceptional service.

Successful businesses recognize that superior customer service is only an intermediate step toward the goal of customer satisfaction. These companies seek to go beyond customer satisfaction, striving for *customer astonishment!* They concentrate on providing customers with quality, convenience, and service as their customers define those terms. Certainly, the least expensive—and the most effective—way to achieve customer satisfaction is through friendly, personal service. Numerous surveys of customers in a wide diversity of industries, from manufacturing and services to banking and high technology, conclude that the most important element of service is “the personal touch.” Indeed, a study conducted by market research firm NFO WorldGroup found that friendly service, not the food, is the primary reason customers return to a restaurant!⁴² Whatever the nature of the business, calling customers by name; making attentive, friendly contact; and truly caring about customers’ needs and wants are more essential than any other factor, even convenience, quality, and speed!

How can a company achieve stellar customer service and satisfaction?

Hire the Right Employees The key ingredient in the superior service equation is *people*. There is no substitute for friendly, courteous sales and service representatives. A customer service attitude requires hiring employees who believe in and embrace customer service. When it comes to the impact of customer retention on a company’s profitability, a responsive, customer-centric employee is worth many times the value of an employee who provides average (or, worse yet, below-average) customer service. “You hire people for their inherent skill,” says Gary Danko, owner of a restaurant that recently won a prestigious customer service award. “You can teach them the mechanics.”⁴³

Train Employees to Deliver Superior Service According to customers, the single most important factor in providing good customer service is having knowledgeable employees who are well informed, polite, and friendly.⁴⁴ Successful businesses train every employee who deals directly with customers; they don’t leave the art of customer service to chance.

Listen to Customers The best companies constantly listen to their customers and respond to what they hear! Social media have created a more direct channel to receive customer opinions, and successful businesses pay attention to this feedback. This allows them to keep up with customers’ changing needs and expectations. The only way to find out what customers really want and value is to ask them. In addition to social media, businesses still rely on a number of more traditional techniques, including surveys, focus groups, telephone interviews, comment cards, suggestion boxes, toll-free hot lines, and regular one-on-one conversations with customers (perhaps still the best technique). Marie Moody, founder of Stella & Chewy’s, a company that makes an all-natural line of premium frozen pet food, changed the freezing process to reduce the formation of ice crystals on the product and the company’s packaging in response to customer feedback. After making the changes, Stella & Chewy’s sales skyrocketed from \$500,000 to more than \$5 million in just two years.⁴⁵

Define Superior Service Based on what customers say, managers and employees must decide exactly what “superior service” means in the company. Such a statement should (1) be a strong statement of intent, (2) differentiate the company from others, and (3) have value to customers. Deluxe Corporation, a printer of personal checks, defines superior service quite simply: “Forty-eight hour turnaround; zero defects.”

Set Standards and Measure Performance To be able to deliver on its promise of superior service, a business must establish specific standards and measure overall performance against them. Satisfied customers should exhibit at least one of three behaviors: loyalty (increased customer retention rate), increased purchases (climbing sales and sales per customer), and resistance to rivals' attempts to lure them away with lower prices (market share and price tolerance).⁴⁶ Companies must track performance on these and other service standards and reward employees accordingly.

Examine Your Company's Service Cycle What steps must a customer go through to get your product or service? Business owners often are surprised at the complexity that has seeped into their customer service systems as they have evolved over time. One of the most effective techniques is to map each step a customer must go through to purchase a product—down to each click of the mouse—using sticky notes on a wall and identifying any steps that can be eliminated or improved. The goal is to look for steps and procedures that are unnecessary, redundant, or unreasonable and then to eliminate them.

Empower Employees to Offer Superior Service One of the most important variables in employees delivering superior service is whether they perceive that they have permission to do so. The goal is to push decision making down the organization to the employees who have contact with customers. This includes giving them the freedom to circumvent company policy if it means improving customer satisfaction. At Ritz-Carlton Hotels, every employee is authorized to spend up to \$2,000 to resolve a customer's complaint.⁴⁷ The Apple Store has benchmarked its customer service expectations to the standards set by Ritz-Carlton. When a customer walks into an Apple Store, the associate who greets that customer "owns" that relationship and is expected to do everything he or she can to make the customer experience right.⁴⁸ To be empowered, employees need knowledge and information, adequate resources, and managerial support.

Use Technology to Provide Improved Service Technological innovations provide new tools to help enhance customer service. Integrated systems that employees can access through smart phones and tablets allow employees to provide real-time solutions to customers' problems and to answer customers' questions. Chat features on Web sites turn static Web pages into live, interactive customer service tools. Even small companies can use these features by using smart phones to answer customer questions entered into the chat boxes on Web sites in real time from anywhere.

Ensure Top Management's Support The drive toward superior customer service will fall far short of its target unless the entrepreneur and the management team support it fully. Success requires more than just a verbal commitment; it calls for everyone's involvement and dedication. Periodically, the entrepreneur and all managers should spend time in customer service positions to maintain contact with customers, frontline employees, and the challenges of providing good service.

Give Customers an Unexpected (and Pleasant) Surprise Companies can make a lasting, favorable impression on their customers by providing them with an unexpected surprise periodically. The surprise does not have to be expensive to be effective.



ENTREPRENEURIAL PROFILE: Josh Gilreath: Aperture Construction, LLC Josh Gilreath, president and CEO of Aperture Construction, LLC, has discovered that an old tool still has power. Gilreath frequently sends thank-you notes to customers and key partners of his general contracting firm. "A simple box of thank-you cards can be purchased at an office supply store for less than \$20 and are a great way to show potential clients/subcontractors/suppliers that you care about what they have to say or that you value their help and opinions," says Gilreath. "In today's digital world, a handwritten thank-you stands so far out from the rest of the crowd that people can't help but notice you. In addition to being noticed and remembered, a handwritten card speaks volumes for the customer service you can offer a potential client, so in a sense you hit two birds with one stone!"

DEVOTION TO QUALITY In this intensely competitive global business environment, quality goods and services are a prerequisite for success—and even survival. According to one marketing axiom, the worst of all marketing catastrophes is to have great advertising and a poor-quality product. Customers have come to expect and demand quality goods and services, and those businesses that provide them consistently have a distinct competitive advantage.

ENTREPRENEURIAL PROFILE: John Stollenwerk: Allen Edmonds Founded in 1922, shoemaker Allen Edmonds has resisted the temptation to move its production out of the United States to offshore locations, where costs are lower, choosing instead to focus on making quality men's footwear in the United States. In factories in Wisconsin and Maine, highly skilled craftsmen continue to build Allen Edmonds shoes, which sell for \$200 to \$400 a pair, by hand using a 212-step process. "It's all about the shoes," says CEO John Stollenwerk. "I believe that Allen Edmonds can make them better and serve customers faster in the United States."⁴⁹

Today, quality is more than just a slogan posted on the company bulletin board; world-class companies treat quality as a strategic objective—an integral part of the company culture. This philosophy is called **total quality management (TQM)**—quality not just in the product or service itself but also in *every* aspect of the business and its relationship with the customer and in continuous improvement in the quality delivered to customers. Companies achieve continuous improvement by using statistical techniques to discover problems, determine their causes, and solve them; then they must incorporate what they have learned into improving the process. The ultimate goals of TQM are to *avoid* quality problems, reduce cycle time (the time between a customer's order and delivery of the finished product), reduce costs, and continuously improve the process. TQM's focus on continuous improvement is built on the "define, measure, analyze, improve, and control (DMAIC) process illustrated in Figure 9.6.

Companies on the cutting edge of the quality movement are developing new ways to measure quality. Manufacturers were the first to apply TQM techniques, but retail, wholesale, and service organizations have seen the benefits of becoming champions of quality. They are tracking customer complaints, contacting "lost" customers, and finding new ways to track the cost of quality and their return on quality (ROQ). ROQ recognizes that although any improvement in quality may improve a company's competitive ability, only those improvements that produce a reasonable rate of return are worthwhile. In essence, ROQ requires managers to ensure that the quality improvements they implement will more than pay for themselves. Using basic quality principles, Allen Edmonds invested more than \$1.5 million to redesign its Port Washington, Wisconsin, factory using principles of lean manufacturing (which focus on maximizing value for customers and minimizing waste), a move that not only improved quality but also increased worker productivity.⁵⁰

Companies that are successful in building a reputation for top-quality products and services follow certain guidelines to "get it right the first time":

- Build quality into the process; don't rely on inspection to obtain quality.
- Emphasize simplicity in the design of products and processes; it reduces the opportunity for errors to sneak in.
- Foster teamwork and dismantle the barriers that divide disparate departments.



FIGURE 9.6

The Quality DMAIC Process

Source: Adapted from Walter H. Ettinger, MD, "Six Sigma," *Trustee*, September 2001, p. 14.

- Establish long-term ties with select suppliers; don't award contracts on low price alone.
- Provide managers and employees the training needed to participate fully in the quality improvement program.
- Empower workers at all levels of the organization; give them the authority and the responsibility for making decisions that determine quality.
- Get managers' commitment to the quality philosophy. Otherwise, the program is doomed. Describing his role in his company's TQM philosophy, one CEO says, "People look to see whether you just talk about it or actually do it."⁵¹
- Rethink the processes the company uses now to get its products or services to customers. Employees at Analog Devices redesigned its production process and significantly lowered the defect rate on its silicon chips, saving \$1.2 million a year.⁵²
- Reward employees for quality work. Ideally, employees' compensation is linked clearly and directly to key measures of quality and customer satisfaction.
- Develop a company-wide strategy for constant improvement of product and service quality.

ATTENTION TO CONVENIENCE If you ask customers what they want from the businesses they deal with, one of the most common responses is "convenience," which has become an important tool for differentiating a product from those offered by the competition. In this busy, fast-paced world of dual-career couples and lengthy commutes to and from work (the average commute time is now 25.4 minutes), consumers have more disposable income but less time in which to enjoy it. Anything a business can do to enhance convenience for its customers will give it an edge. Several studies have found that customers rank easy access to goods and services at the top of their purchase criteria. Unfortunately, many businesses fail to understand that convenience has become such an important characteristic of how the customer views their products; as a result, they fail to attract and retain customers. Some companies make it a chore to do business with them, almost as if their owners have created an obstacle course for customers to negotiate. In an effort to defend themselves against a few unscrupulous customers, these businesses have created elaborate procedures for exchanges, refunds, writing checks, and other basic transactions that frustrate legitimate customers.

Successful companies go out of their way to make it easy for customers to do business with them. Many restaurants have created online tools and social networking applications that give customers the convenience and the speed of placing their meal orders online or from their mobile devices. Other restaurateurs enhance customer convenience by placing their restaurants on wheels and driving them to their customers.



ENTREPRENEURIAL PROFILE: Hayden Coleman: Moovers and Shakers Hayden Coleman

started his food truck, Moovers and Shakers, when he was a sophomore in college using funds from a business plan competition and from a Kickstarter campaign. Moovers and Shakers is an old-fashioned soda parlor on wheels that serves milk shakes and floats. Coleman uses Twitter to let his regular customers know where the food truck is heading next and Twitter and Facebook to promote his ever-changing flavor of the week. In its second season, Coleman began to set up his mobile soda shop at weddings and other private events in addition to the traditional public events where food trucks typically congregate.⁵³

Many small companies have had success by finding simple ways to make it easier for customers to do business with them. How can entrepreneurs boost the convenience levels of their businesses? By conducting a "convenience audit" from the customer's point of view to get an idea of its ETDBW ("Easy To Do Business With") index:

- Is your business located near your customers? Does it provide easy access?
- Are your business hours suitable to your customers? Should you be open evenings and weekends to serve them better?
- Would customers appreciate pickup and delivery service? John Pugh, owner of Prosperity Drug Company, a small pharmacy in tiny Prosperity, South Carolina, has built a loyal following, especially among older customers, by offering a free prescription delivery service using a classic Volkswagen Beetle affectionately known as "The Drug Bug."

- Does your business provide a sufficient number of checkout stations so that shoppers do not have to stand in long lines to make their purchases? Does your company make it easy for customers to make purchases on credit or with credit and debit cards?
- Are you using technology to enhance customer convenience? Jim Olekszy, owner of 10 North, a restaurant in Oakland, California, uses iPads and iPods to take and process orders utilizing a touch-based ordering system. “Everybody thinks it’s cool,” Olekszy says. The system is much more cost-effective than the usual computer systems used in other restaurants and speeds up customer service. An attachment for the iPads allows servers to scan credit cards tableside, speeding up the checkout process. Guests sign for their purchases on the screen and have their receipts either printed or e-mailed.⁵⁴
- Are your employees trained to handle business transactions quickly, efficiently, and politely? Waiting while rude, poorly trained employees fumble through routine transactions destroys customer goodwill.
- Do your employees use common courtesy when dealing with customers?
- Does your company offer “extras” that make customers’ lives easier? With a phone call to one small gift store, customers in need of a special gift simply tell how much they want to spend, and the owner takes care of the rest—selecting the gift, wrapping it, and shipping it. All customers have to do is pay the invoice when it arrives in the mail.
- Can you adapt existing products to make them more convenient for customers? When J.M. Smucker Company began test-marketing a premade frozen peanut butter and jelly sandwich with no crust, CEO Tim Smucker was amazed at the results. The sandwiches, called Uncrustables, generated \$20 million in sales, and Smucker added them to its product line.⁵⁵
- Does your company handle telephone calls quickly and efficiently? Long waits “on hold,” transfers from one office to another, and too many rings before answering signal customers that they are not important.

EMPHASIS ON SPEED We live in a world of instantaneous expectations. Technology that produces immediate results at the click of a mouse and that allows for real-time communication has altered our sense of time and space. Speed reigns. Customers now expect companies to serve them at the speed of light! In such a world, speed has become an important competitive weapon. With their smaller, nimbler, more flexible organizations, small companies have a natural advantage in speed over large companies, which are burdened with lumbering bureaucracies and self-absorbed cultures. World-class companies recognize that reducing the time it takes to provide a service or to develop, design, manufacture, and distribute a product reduces costs, increases quality, and increases market share. Service companies also know that they must build speed into their business systems if they are to satisfy their impatient, time-sensitive customers.

This philosophy of speed is called **time compression management (TCM)**, and it involves three aspects: (1) speeding new products to market, (2) shortening customer response time in manufacturing and delivery or providing a service, and (3) reducing the administrative time required to fill an order. In the hypercompetitive market that businesses now face, TCM has been shown to be a critical strategic tool.⁵⁶ Studies show plenty of room for improvement; most businesses waste 85 to 99 percent of the time it takes to produce products or services without ever realizing it!⁵⁷ Although speeding up the manufacturing process is a common goal, companies using TCM have learned that manufacturing takes only 5 to 10 percent of the total time between taking an order and getting the product into the customer’s hands. The rest is consumed by clerical and administrative tasks. The primary opportunity for TCM lies in its application to the administrative process.

Companies that rely on TCM to help them turn speed into a competitive edge should do the following:

- “Reengineer” the entire process rather than attempt to do the same things in the same way, only faster.
- Study every phase of the business process—whether it involves manufacturing, shipping, or any other function—looking for small improvements that speed up the entire process.

- Create cross-functional teams of workers and give them the power to attack and solve problems. In world-class companies, product teams include engineers, manufacturers, sales people, quality experts—even customers.
- Share information and ideas across the company. Easy access to meaningful information can reduce a company’s customer response time.
- Set aggressive goals for time reduction and stick to the schedule. Some companies using TCM have been able to reduce cycle time from several weeks to just a few hours!
- Instill speed in the culture. At Domino’s Pizza, kitchen workers watch videos of the fastest pizza makers in the country.
- Use technology to find shortcuts wherever possible. Rather than build costly, time-consuming prototypes, many time-sensitive businesses use computer-aided design and computer-assisted manufacturing to speed up product design and testing.

Promotion

Promotion is how a business communicates with customers using advertising, public relations, and personal selling. For an entrepreneur, bootstrapping is the key to cost effective promotion. Advertising communicates to potential customers through mass media the benefits of a good or service. Public relations involves getting media, including social media outlets such as blogs, to write stories about a business. Personal selling involves the art of persuasive sales on a one-to-one basis.

The goals of a small company’s promotional efforts are to create a brand image, to persuade customers to buy, and to develop brand loyalty. Promotion can take many forms and is put before the public through a variety of media. Entrepreneurs often must find ways to use low-cost bootstrap tactics to create promotions that get their companies noticed by both local and national media. What follows are other effective components of a bootstrap marketing strategy. Chapter 10 is devoted to more details on how to create an effective advertising and promotion campaign for a small company.

USE THE POWER OF PUBLICITY **Publicity** is any commercial news covered by the media that boosts sales but for which a small company does not pay. Publicity has power; because it is from an unbiased source, a news feature about a company or a product that appears in a newspaper or magazine has more impact on people’s buying decisions than an advertisement does. Exposure in any medium raises a company’s visibility and boosts sales, and, best of all, publicity is free! It does require some creativity and effort, however. Entrepreneurs generate publicity in a multitude of ways, ranging from sponsoring a seminar and supporting a charity to writing an article for publication on and creating an offbeat contest.



ENTREPRENEURIAL PROFILE: Joe Keeley: College Nannies and Tutors

Joe Keeley founded College Nannies and Tutors in 2000 when he was a student in business school. Keeley funded the start-up by the winnings he received from entering business plan competitions. During his initial start-up, he paid nothing for advertising. Instead, Keeley used the novelty of a former high school hockey player running a nanny business while still in college to get publicity through stories in newspapers and magazines and on radio and television. Today, College Nannies and Tutors has expanded and has franchisees in 27 states.

Don’t Just Sell—Entertain Numerous surveys have shown that consumers are bored with shopping and that they are less inclined to spend their scarce leisure time shopping than ever before. Winning customers today requires more than low prices and wide merchandise selection; increasingly, businesses are adopting strategies based on **entertailing**, the notion of drawing customers into a store by creating a kaleidoscope of sights, sounds, smells, and activities, all designed to entertain—and, of course, sell (think Disney). The primary goal of entertailing is to catch customers’ attention and engage them in some kind of entertaining experience so that they shop longer and buy more goods or services. Entertailing involves “making [shopping] more fun, more educational, more interactive,” says one retail consultant.⁵⁸ Research supports the benefits of entertailing’s hands-on, interactive, educational approach to selling; one study reports that, when making a purchase, 34 percent of consumers are driven more by emotional factors, such as fun and excitement, than by logical factors, such as price and convenience.⁵⁹

Connect with Customers on an Emotional Level Some of the most powerful marketers are those companies that have a clear sense of who they are, what they stand for, and why they exist. Defining their vision for their companies in a meaningful way is one of the most challenging tasks facing entrepreneurs. As we learned in Chapter 4, that vision stems from the beliefs and values of the entrepreneur and is reflected in a company's culture, ethics, and business strategy. Although it is intangible, this vision is a crucial ingredient in a successful bootstrap marketing campaign. Once this vision is firmly planted, bootstrap marketers can use it to connect with their customers. Harley-Davidson, the maker of classic motorcycles with that trademark throaty rumble, has established an emotional connection with its customers that many other businesses only dream of. Clint Harris of Buckeye Lake, Ohio, was such a devoted fan of the motorcycle maker that when he died, he had a replica of his motorcycle (complete with his and his wife's biker nicknames, Heavy and Ruffy, engraved on it) made to serve as a headstone.⁶⁰

Companies that establish a deeper relationship with their customers rather than one based merely on making a sale have the capacity to be exceptional bootstrap marketers. These businesses win because customers receive an emotional boost every time they buy the company's product or service. Companies connect with their customers emotionally by supporting causes that are important to their customer base, sponsoring events that are of interest to their customers, taking exceptional care of their customers, and making it fun and enjoyable to do business with them.



ENTREPRENEURIAL PROFILE: Clint Smith: Emma The e-mail marketing company Emma grew at a healthy pace in its start-up years by developing loyal customers who loved the way Emma provided personalized service. Cofounder Clint Smith intentionally built a culture that fosters strong ties among Emma, its employees, and its customers. As Emma grew, however, customers began to experience problems with the service. The volume of the several hundred small business customers was overwhelming the software's ability. However, a more functional and more scalable new version was still in development. Emma's leadership decided to switch over to the unfinished new version of the software rather than continue to battle the many shortcomings of the original software. When they switched over, the new system didn't work at all for almost a week. Once the system finally went online, employees discovered that some functions of the system were not operational and spent six months patching it so that it would run reliably. Amazingly, because of the company's strong relationship with its customers, Emma lost only one client, despite the rocky changeover in software systems.⁶¹

Build a Consistent Branding Strategy Establishing an emotional bond with customers is the first step to building a successful brand. Branding involves creating a distinct identity for a business and requires a well-coordinated effort at every touch point that a company has with its customers. A brand represents a company's "personality," and entrepreneurs should spell out their companies' brand strategy in the business plan. In an age when companies find standing out from the crowd of competitors increasingly difficult, branding strategies have taken on much greater importance. The foundation of a successful brand is providing a quality product or superior customer service that meets or, preferably, *exceeds* customers' expectations. One way to do this is by defining exactly how your company's product or service solves a problem your customers face (preferably in a unique fashion) and communicating it to your customers. Green Mountain Coffee Roasters in Waterbury, Vermont, has built a strong brand not only by creating a better cup of coffee but also by doing its part to create a better world by embracing environmental sustainability and organic growing methods and supporting local communities through charitable donations. Although entrepreneurs don't have the resources to invest in building a brand that Apple and Google do (Apple's brand alone is estimated to be worth more than \$87 billion⁶²), they can take steps to add value to their companies' images through branding. One important step is to develop consistent logos, letterheads, graphics, packaging, and decor that serve as visual ambassadors for the company, communicating its desired image, values, and personality at a glance. Caribou Coffee, the nation's second-largest chain of coffee stores, recently introduced a brand makeover built around the theme "Life is short. Stay awake for it."⁶³



ENTREPRENEURIAL PROFILE: Tim Weber: GoodMusicAllDay LLC Branding is another part of the marketing process that can benefit from bootstrapping. The original logo for the music store GoodMusicAllDay LLC was one that Tim Weber, founder and CEO, designed himself using Microsoft Word. "It was terrible," says Weber. "It was a giant lime green 'G' next to a light

purple 'M' and the words 'GoodMusicAllDay.com' with a red line under it from Word thinking it was a misspelling." Six months after founding his blog site, Weber had 40,000 views a day but knew that he needed a more professional logo. However, the site still was not generating revenues, so Weber had to find a way to bootstrap his new logo once again. "I opened a contest to our 40,000 visitors to design our new logo in return for a free shirt," said Weber. "Within two weeks I received hundreds of submissions. I let the fans vote on our Facebook page and narrow it down to five choices." From the final five, Weber selected the winning design. "This bootstrapping technique accomplished three things for the cost of one shirt," said Weber. "We got a professional logo, we increased our social media traffic, and I formed a relationship with a top-notch designer who submitted the winning logo."

EMBRACE SOCIAL MEDIA Social networking sites such as Facebook, LinkedIn, and Twitter allow companies and their customers to engage in ways that were not possible before, and smart entrepreneurs are using those sites to their advantage. Americans between the ages of 18 and 64 who use social media spend 3.2 hours *per day* on social media sites.⁶⁴ One recent study reports that companies that are highly engaged in social media significantly outperform in both revenues and profits those companies that are less engaged.⁶⁵ Yet another study finds that only 29 percent of small businesses are actively using social media but that another 23 percent want to learn how to use it.⁶⁶ Clearly, small businesses that are already successfully using social media have a clear edge!



Lessons from the Street-Smart Entrepreneur

Marketing to Millennials

Ross Chandler Hill, CEO, PictureBoothCo, has built social media into his business model. Hill rents out his proprietary picture booths to people running events. The booth's simple design means that it can be broken down and stored in a case the size of a small suitcase, and its simple operating system allows almost anyone to set it up and operate it. Therefore, Hill is able to ship his booths to people running corporate events and conferences anywhere in the country. Once they are done, they simply pack it back up and ship it back. The booth's operating system posts all of the pictures to the users' social media sites so that people can immediately share their pictures with colleagues and friends.

"When we are part of an event, the users of the photo booth create marketing content for us to use," says Hill. The pictures taken with PictureBoothCo's booths are tagged and sent out through Facebook. "One of our first customers, RedBull, found us through a past event album that we had tagged ourselves in on Facebook," says Hill. "It is amazing to think about where we would be had that not happened." Tagging their company in all of the pictures taken in the booth was a strategic decision from the outset. Social Media is not simply another sales channel for PhotoBoothCo; it is a customer referral outlet. When someone posts something about a company, they are giving their digital stamp of approval. With the Millennial Generation, recommendations sell—advertising does not.

Social media have become the main channel of communication for most Millennials. A recent study by the Pew Research Center found that 75 percent of Millennials have a social networking profile. Almost half of Millennials who use social networking sites check them at least once a day, and 88 percent of Millennials use text messaging to communicate with friends and family, sending an average of 20 text messages a day. They embrace this technology that comes along.

Because Millennials use social media platforms extensively, businesses cannot reach them using the same marketing channels that they use to reach earlier generations of customers. "These unique factors make them very savvy consumers, who pay great attention to the value of what they buy and require a different way to interact with brands," says Robert Polet, president and CEO of Gucci Group. "At Gucci Group, we recognize their transformative power in the way they engage with luxury brands. We are embracing different ways of creating dialogue through social media. Some of our brands have launched Facebook and Twitter pages and iPhone applications."

Kraft Food Group recently discovered the power of effectively marketing to Millennials when they first introduced their new zero-calorie beverage called Mio. "A lot of Kraft products traditionally target the stereotypical soccer mom," says Barry Calpino, vice president of breakthrough innovation at Kraft Foods Group. "For Mio, we decided on a Millennial target. We did things differently. For example, we launched digitally before we were even shipping product and ran a campaign with a character from The Second City (a popular comedy club based in Chicago). The campaign was viral and had high viral content before Mio was on shelf. We were on Facebook offering free samples. We also focused our resources. Mio was the biggest launch in the history of Kraft."

The Street-Smart Entrepreneur offers the following principles for effectively marketing to Millennials:

- Understand that social media is where Millennials go to get information that they trust. Millennials do not trust or respond to traditional advertising. They trust their network of friends and listen to what their friends have to say about brands through social media.

- Millennials want to interact with their brands. They want to “communicate” with their brands just like they do with their friends on social media. They want to be able to rate products, make comments about products without censorship, and talk with their friends via social media about products. Smart entrepreneurs create forums for Millennials to interact with their brands and launch conversations by posting questions and ideas on various social media platforms.
- Millennials trust their “influencers.” Popular musicians, sports stars, or other celebrities talking about your product in social media influence Millennials’ opinions faster than data travel over the Internet!
- Build trust through frequent and consistent messages sent via social media. Building a brand means building a story. Actively manage your social media reputation. If people complain, address their concerns honestly and sincerely.
- Be creative, funny, and quirky. Millennials do not trust brands that take themselves too seriously.

- Use multiple social media channels, including Facebook, Twitter, YouTube, LinkedIn, and others. Social media channels are complementary rather than competitive.
- Use the latest innovations in technology to make your content more interesting.
- Keep in mind that Millennials have a strong social conscience. The more you are able to engage in the causes they care about and show your company’s engagement via social media, the more likely they are to become loyal customers. But remember—you have to be sincere!

Sources: Based on Suzy Menkes, “Marketing to the Millennials,” *New York Times*, March 2, 2010, www.nytimes.com/2010/03/03/fashion/03iht-rmil.html?pagewanted=all&_r=0; Michal Clements, “Kraft’s Breakthrough Innovation with Mio: Marketing to Millennials,” *Chicago Now*, February 6, 2013, www.chicagonow.com/marketing-strategist/2013/02/krafts-breakthrough-innovation-with-mio-marketing-to-millennials/; “Marketing to Millennials: You’d Better Learn to Keep Up,” *Allbusiness*, April 16, 2012, smallbusiness.yahoo.com/advisor/marketing-millennials-you-d-better-learn-140000612.html; Michael Fleishner, “5 Tips for Marketing to Millennials,” www.businessknowhow.com/marketing/millennials.htm; Marc Koenig, “3 Tips for Marketing to Millennials,” *Firespring*, February 19, 2013, blog.firespring.com/2013/02/19/3-tips-for-marketing-to-millennials.

ENTREPRENEURIAL PROFILE: Cassie Schreiner: CSN Photography and Design Cassie Schreiner, owner of CSN Photography and Design, shoots weddings all over the central part of the United States. “One of the main ways I have bootstrapped is through free marketing tools,” said Schreiner. “Facebook has been a huge part of my marketing strategy.” Schreiner uses Facebook to promote word-of-mouth marketing. Her clients are excited about the images and designs she creates for their weddings. Placing them on Facebook is an easy way to have them share her work with friends and family. Some of her customers’ albums or posts go viral through tagging and commenting by fellow Facebook users. “I have been able to spread the views to over 3,000 people in less than two days,” said Schreiner, “which is huge for a small business like mine.”



Cassie Schreiner.
Source: Cassie Schreiner.

Facebook and Twitter Although sites such as Facebook and Twitter are better known for their social applications, they also can be powerful—and inexpensive—marketing tools for small companies. More than 44 percent of companies using these social networking sites report landing at least one customer from their efforts (see Figure 9.7). Because implementing an effective social marketing strategy demands a significant investment of time (50 percent of business owners who use social

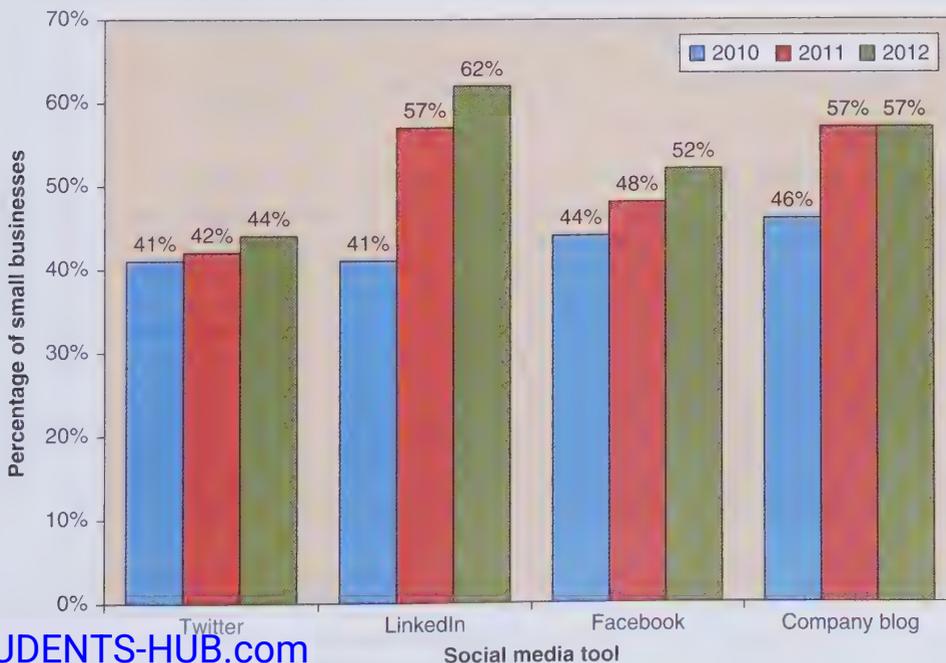


FIGURE 9.7
Percentage of Companies that Have Acquired at Least One Customer from Social Networking Sites or a Blog

Source: Based on *The State of Inbound Marketing 2011*, HubSpot, p. 10 and *The State of Inbound Marketing 2012*, Hubspot, p. 23.

media report that doing so demands more time than they had expected), some entrepreneurs outsource their social marketing efforts to companies that specialize in social media.⁶⁷

Twitter users send more than 1.2 billion tweets per week, and the average user spends 21 minutes per month on Twitter.⁶⁸ About one third of small businesses use Twitter to market their products to more than 200 million active monthly Twitter users.⁶⁹ According to research by HubSpot, businesses that use Twitter generate twice as many sales leads as companies that do not.⁷⁰ Small companies also use Twitter to listen to feedback from their customers or to update them about special events, sales, and promotions.



ENTREPRENEURIAL PROFILE: Dotti Townsend and Matt Townsend: Roots Coffee-house

Dotti Townsend and her husband Matt, owners of Roots Coffeehouse in Fort Worth, Texas, used social media to help build traffic in their first store. They use Twitter, Facebook, Four-Square, and Instagram to engage their customers and send them free mail-newsletters using programs such as MailChimp. “We’ve found that asking our customers questions via these networks draws the most attention and visibility,” says Dotti. “A question like ‘How do you brew your coffee at home?’ will get customers engaging both with us and with other customers as well as popping up on a lot of feeds.” They also feature promotions where customers get a reward if they post pictures of their Roots drink on Instagram or Twitter. “Using these outlets (without paying for their advertising programs) has enabled us to capture our digital audience and widen our customer base without costing us a penny in the marketing budget,” said Dotti.

The following tips help entrepreneurs use Twitter successfully as a bootstrap marketing tool:

- Engage in conversations. Twitter is a two-way communication tool, not an outlet for sending one-way marketing messages such as advertisements and press releases.
- Give people a reason to follow you. Reveal the “inside story” of your company, ask customers for feedback, and offer special deals to followers.
- Link Twitter to your company’s Web site. Refer followers to your company’s Web site, blog, or a video about your company and its products or services.⁷¹

Facebook now has more than 1 billion active monthly users and is available in more than 70 languages.⁷² Two-thirds of Internet users (72 percent of women and 62 percent of men) have Facebook accounts.⁷³ Because its volume of online traffic is immense, Facebook offers several business-oriented features, including a survey tool that allows business users to conduct market research and an option that lets businesses create Facebook pages (“public profiles”) and connect with potential customers, post photographs, and promote events. In addition to reaching potential customers, establishing a business presence on social networking sites increases a company’s visibility because search engines are able to locate social network pages. One key to using Facebook successfully as a marketing tool is to keep a company’s page fresh, just like the merchandise displays in a physical store. Adding photographs, announcements of upcoming events, polls and surveys, and games or contests promoting a cause the company supports are excellent ways to create buzz and keep fans coming back.



ENTREPRENEURIAL PROFILE: Peter Smith: Golden Spiral Creative

Golden Spiral Creative is a marketing company that provides branding, content creation, Web development, and online marketing services. “Our main objective as we began to market ourselves was to substantiate ourselves as not only a legitimate company but also an industry leader,” says Peter Smith, president and COO. “Social networks such as Facebook, Twitter, and LinkedIn have been a strong place for us to start.” Golden Spiral Creative first created profiles filled with relevant content. On Facebook, they created graphics to populate their time line, giving for potential clients an opportunity to see the kind of work they perform. “One push that was particularly successful was in the aftermath of an open house we held at our office,” said Smith. “We hired a photographer for under \$100 to capture the evening. After the party, we posted an album with all of the photos and tagged the people at the party. This brought us two direct leads from people who were not at the party but saw a picture of a friend at the party and were impressed by the crowd and our office environment.”

Blogging Blogs (Web logs) started out as a frequently updated online personal journal that contains a writer’s ideas on a multitude of topics with links to related sites. The proliferation of blogs has been stupendous; everyone from teenagers to giant corporations has created blogs. There are about 42 million blogs that publish about 500,000 posts a day. A recent survey of small business owners found that 55 percent have blogs.⁷⁴ However, about 65 percent of businesses with



The Team at Golden Spiral Creative.

Source: Golden Spiral Creative.

blogs have not made a post on their blog in the past year.⁷⁵ The most successful small business blogs are not just remakes of a company's Web site with thinly veiled marketing messages but instead those that tell interesting stories from the perspective of an industry (and company) insider. The key to successful business blogging is to create a blog that provides useful industry information but that also is entertaining. Web sites such as WordPress, Blogger, or LiveJournal make it easy for entrepreneurs to start blogging.

Business blogging can be an effective part of a bootstrap marketing strategy, enabling entrepreneurs to reach large numbers of potential customers economically. Blogs help establish a business owner as an expert in the field, attract the attention of potential customers, and boost a company's visibility and its sales. Companies post their blogs, promote them on their Web sites and on other blogs, and then watch as the viral nature of the Web takes over with visitors posting comments and e-mailing their friends about the blog. In fact, many small companies allow customers to contribute to their blogs, offering the potential for one of the most valuable marketing tools: unsolicited endorsements from satisfied users. Blogging's informal dialogue is an ideal match for small companies whose cultures and style tend to be informal.

Blogs can serve many business purposes, including keeping customers updated on new products, enhancing customer service, and promoting the company. Increasingly, they are becoming mainstream features on business Web sites. If monitored regularly, blogs also can give entrepreneurs keen insight into customers' viewpoints and preferences in ways that few other techniques can. One business writer says that blogs are "like never-ending focus groups."⁷⁶ Creating a blog is not risk free, however. Companies must be prepared to deal with negative feedback from some visitors.

Online Videos Video hosting sites such as YouTube give creative entrepreneurs the opportunity to promote their businesses at no cost by creating videos that feature their companies' products and services in action. Unlike television ads, uploading a video to YouTube costs nothing, and in some cases the videos reach millions of potential customers. Online videos do not have to be of professional quality to be effective; in fact, some of the most successful videos boast a distinctive "amateur" look. Eighty-five percent of Internet users watch videos online each month, and the average online viewer watches 17.4 hours of content video per month. More importantly for business, viewing of video ads has increased dramatically. More than 50 percent of Americans view 9.9 billion video ads each month.⁷⁷

ENTREPRENEURIAL PROFILE: George Livingston and Ian Raffalovich: Sweet Meat Jerky

George Livingston and Ian Raffalovich, cofounders of Sweet Meat Jerky, use videos to connect with their customers. When they were launching their fundraising campaign on Kickstarter, they filmed the steps required for two bootstrapping entrepreneurs to prepare a large order for shipment from their apartment using a time-lapse video. "When I posted it to social media, people loved it," said Livingston. "Everyone knew that shipping 400 packages of jerky was a lot of work—but when you show them the process of packing, sealing, labeling, addressing, and shipping packages over the course of an entire day, they see exactly how much work it was. People like feeling special, so creating unique video content that you share with only certain people (our Kickstarter backers in this case) can be a powerful tool." The entrepreneurs also post their videos on the company's Facebook page.

The goal of an online video is to increase awareness of a company, drive traffic to its Web site or store, and increase sales. To market their companies successfully on YouTube, entrepreneurs should do the following:

- **Develop a well-defined channel.** A "channel" on YouTube is a home page for an account. *RevZilla.com* is a motorcycle apparel, parts, and accessories online retailer whose YouTube channel has more than 2,000 videos designed to answer common customer questions about sizes and fit for many of its products by showing their employees trying on various products and discussing how to pick out the right styles and sizes.⁷⁸
- **Use the right key words.** YouTube works just like any search engine. People find content by searching key words. Tie your video to the most popular topics that people are searching on YouTube.
- **Think "edutainment."** Some of the most successful online videos combine both education and entertainment. Many businesses that sell cooking equipment and accessories have YouTube channels that give cooking lessons using their products. People who watch YouTube don't just want to see commercials—they are seeking information.

- **Be funny.** A common denominator among many successful online videos is humor. For businesses, the key is to link the humor in the video to the company's product or service and its customer benefits.



ENTREPRENEURIAL PROFILE: Dr. Robert Wagstaff: Orabrush Orabrush is a Provo, Utah, company that makes a tongue cleaner. Developed by Dr. Robert Wagstaff, the device, which is designed to eliminate bad breath, was selling only 10 tongue cleaners a month at \$3 each. Wagstaff decided to focus his marketing efforts on a YouTube video. The result was a video titled "How to Tell When Your Breath Stinks." A friend he hired to act in the video wears a white lab coat and protective goggles and educates viewers about bad breath and how the Orabrush tongue cleaner could cure it. Wagstaff posted the video on YouTube and purchased video ads using the key word "bad breath." The video was also posted on Orabrush's Facebook page and sent out via Twitter. Within the next six weeks, more than 900,000 people viewed the video, and 20 percent of them clicked on the link to the Orabrush Web site. As a result, the company sold about 10,000 tongue cleaners. Over the next two years, Orabrush sold more than 1 million products, and its video was viewed more than 15 million times. The company now posts weekly videos on its YouTube channel. The total budget for the campaign was \$1,260.⁷⁹

- **Post videos on multiple social media sites.** Customers are more likely to see a video when a company makes it available on multiple social media sites. TubeMogul is a free site that pushes video content out to multiple social media sites. However, YouTube is still by far the most watched online source for video.
- **Use other social media tools to promote new videos.** Active users of online video for promotion post many new videos each year. Some try to post a new video as often as every week. In fact, more video content is posted on YouTube each month than the three major television networks produced in the last 60 years! With so much content, finding ways to point customers to your videos using tools such as social media is essential.

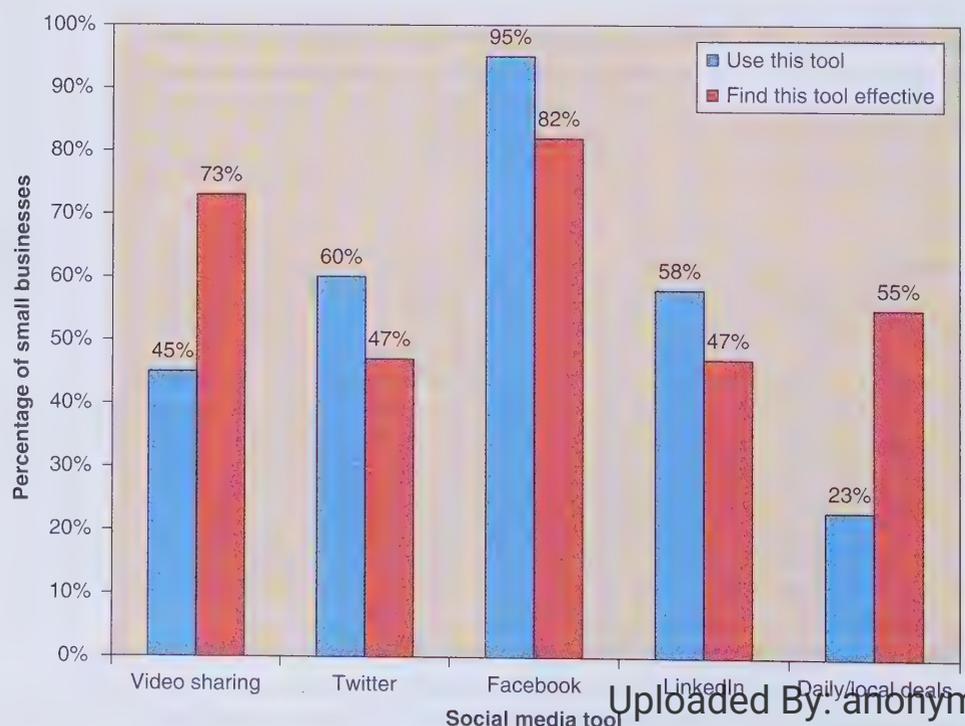
Figure 9.8 shows how owners of small companies view the use of these social media tools. Small business owners say that Facebook and online videos are their most effective social media marketing tools

Price

Almost everyone agrees that the price of the product or service is a key factor in the decision to buy. Price affects both sales volume and profits, and without the right price, both sales and profits will suffer. But pricing is also a powerful part of the marketing mix. As we will see in Chapter 11,

FIGURE 9.8
Percentage of Small Business Owners Who Say They . . .

Source: Based on *Small Business Attitudes and Outlook Survey*, Spring 2011, Constant Contact, p. 1.



the right price for a product or service depends on three factors: (1) a small company's cost structure, (2) an assessment of what the market will bear, and (3) the desired image the company wants to create in its customers' minds.

For many small businesses, nonprice competition, focusing on factors other than price, is a more effective strategy than trying to beat larger competitors in a price war. Nonprice competition, such as free trial offers, free delivery, lengthy warranties, and money-back guarantees, intends to play down the product's price and stress its durability, quality, reputation, or special features.

Place

Place (or method of distribution) has grown in importance as customers expect greater service and more convenience from businesses. Because of this trend, mail-order houses, home shopping channels, home shopping parties, and the Internet's offering the ultimate in convenience—shop at home—have experienced booming sales in recent years. In addition, many traditionally stationary businesses have added wheels, becoming mobile animal clinics, computer repair shops, and dentist offices. Any activity involving movement of goods to the point of consumer purchase provides place utility. Place utility is directly affected by the marketing channels of distribution, that is, the path that goods or services and their titles take in moving from producer to consumer.



ENTREPRENEURIAL PROFILE: Louis and Peter Tomassetti: ShaveMate

Louis and Peter Tomassetti invented a razor, ShaveMate, that contains the shaving cream in the handle. Their first customer was the military, which bought the product directly from the brothers, but they wanted to expand sales to the retail market. However, convincing retailers to give shelf space to a brand other than Gillette and Schick was difficult. They needed to build brand awareness before they could ever hope to sell their product through traditional retail channels, so they decided on a marketing plan that included both a low-cost specific public relations effort and an advertising blitz on cable television. They were able to gain local and national media exposure and were eventually invited to try selling their product through infomercials. The media attention and growing brand awareness opened the door for the Tomassettis to offer ShaveMate through national online retailers including Walgreens and Target. Because of the success of sales through the online retail distribution channel, Walgreens decided to sell ShaveMate in its retail stores.⁸⁰

Channels typically involve a number of intermediaries who perform specialized functions that add valuable utility to the goods or service. Specifically, these intermediaries provide time utility (making the product available when customers want to buy it) and place utility (making the product available where customers want to buy it).

For consumer goods, there are four common channels of distribution:

1. **Manufacturer to consumer.** In some markets, producers sell their goods or services directly to consumers. Services, by nature, follow this channel of distribution. Dental care and haircuts, for example, go directly from creator to consumer.
2. **Manufacturer to retailer to consumer.** Another common channel involves a retailer as an intermediary. Many clothing items, books, shoes, and other consumer products are distributed in this manner.
3. **Manufacturer to wholesaler to retailer to consumer.** This is the most common channel of distribution for consumer goods. Prepackaged food products, hardware, toys, and other items are commonly distributed through this channel.
4. **Manufacturer to wholesaler to wholesaler to retailer to consumer.** A few consumer goods (e.g., agricultural goods and electrical components) follow this pattern of distribution.

Two channels of distribution are common for industrial goods:

1. **Manufacturer to industrial user.** The majority of industrial goods are distributed directly from manufacturers to users. In some cases, the goods or services are designed to meet the user's specifications.
2. **Manufacturer to wholesaler to industrial user.** Most expense items (paper clips, paper, rubber bands, and cleaning fluids) that firms commonly use are distributed through wholesalers. For most small manufacturers, distributing goods through established wholesalers and agents is often the most effective route. With their limited resources, entrepreneurs sometimes have to rely on nontraditional distribution channels and use their creativity to get their products into customers' hands.

Chapter Review

1. Describe the components of a bootstrap marketing plan and explain the benefits of preparing one.
 - A major part of the entrepreneur's business plan is the marketing plan, which focuses on a company's target customers and how best to satisfy their needs and wants. A solid marketing plan should pinpoint the specific target markets the company will serve, determine customer needs and wants through market research, analyze the firm's competitive advantages and build a marketing strategy around them, and create a marketing mix that meets customer needs and wants.
2. Explain how small businesses can pinpoint their target markets.
 - Sound market research helps the owner pinpoint his or her target market. The most successful businesses have well-defined portraits of the customers they are seeking to attract.
3. Explain how to determine customer needs through market research and the steps in the market research process.
 - Market research is the vehicle for gathering the information that serves as the foundation of the marketing plan. Good research does not have to be complex and expensive to be useful. The steps in conducting market research include the following:
 - Defining the problem: "What do you want to know?"
 - Collecting the data from either primary or secondary sources
 - Analyzing and interpreting the data
 - Drawing conclusions and acting on them
4. Describe the bootstrap marketing strategies on which a small business can build competitive edge in the marketplace.
 - When plotting a marketing strategy, owners must strive to achieve a competitive advantage—some way to make their companies different from and better than the competition. Successful small businesses rely on niche picking, retaining their existing customers, and concentrating on innovation to implement a bootstrapped marketing strategy.
5. Explain the "four Ps" of marketing—product, place, price, and promotion—and their role in building a successful bootstrap marketing strategy.
 - The marketing mix consists of the "four Ps":
 - Product.** Entrepreneurs should understand their product's place in the product life cycle. Positioning the product includes focusing on the customers' needs, dedication to service and customer satisfaction, devotion to quality, dedication to service, and emphasizing speed.
 - Promotion.** Bootstrapped promotion included the use of publicity, an understanding the entertaining must be part of selling, the power of branding, and embracing social media.
 - Price.** Price is an important factor in customers' purchase decisions, but many small businesses find that non-price competition can be profitable. But, pricing must fit with the other three "Ps".
 - Place.** The focus here is on choosing the appropriate channel of distribution and using it most efficiently.

Discussion Questions

- 9-1. What is a marketing plan? What lies at its center?
- 9-2. Outline the steps of the market research process.
- 9-3. How can market research benefit a small business owner? List some possible sources of market information.
- 9-4. Explain how to determine customer needs through market research.
- 9-5. Why is it important for small business owners to define their target markets as part of their marketing strategies?
- 9-6. What is a competitive edge? How might a small company gain a competitive edge?
- 9-7. Describe how a small business owner could use the following sources of a competitive advantage: niche picking, entailing, building a consistent branding strategy, emphasizing their uniqueness, connecting with their customers, focusing on customers' needs, emphasizing convenience, concentrating on innovation, dedicating themselves to service, and emphasizing speed.
- 9-8. Explain the concept of the marketing mix. What are the four Ps? How can an entrepreneur use bootstrapping in the marketing mix?
- 9-9. Describe the bootstrap marketing strategies on which a small business can build a competitive edge in the marketplace.
- 9-10. With a 70 percent customer retention rate (average for most U.S. firms according to the American Management Association), every \$1 million of business in 2014 will grow to more than \$4 million by 2024. If you retain 80 percent of your customers, the \$1 million will grow to a little over \$6 million. If you can keep 90 percent of your customers, that \$1 million will grow to more than \$9.5 million. What can the typical small business do to increase its customer retention?

CHAPTER 10

Creative Use of Advertising and Promotion



Learning Objectives

On completion of this chapter, you will be able to:

1. Define your company's unique selling proposition.
2. Explain the differences among promotion, publicity, personal selling, and advertising.
3. Describe the advantages and disadvantages of the various advertising media.
4. Identify four basic methods for preparing an advertising budget.
5. Explain practical methods for stretching an entrepreneur's advertising budget.

Advertising is what you do when you can't go see somebody.

—Fairfax Cone

*In our factory, we make lipstick.
In our advertising, we sell hope.*

—Peter Nivio Zarlenga

Advertising is not just a business expense; it is an investment in a company's future. Without a steady advertising and promotional campaign, a small business's customer base will soon dry up. Advertising can be an effective means of increasing sales by telling customers about a business and its goods or services, by improving the image of the firm and its products, and by persuading customers to purchase its goods or services. A megabudget is not a prerequisite for building an effective advertising campaign. With a dose of creativity and ingenuity, a small company can make its voice heard above the clamor of its larger competitors—and stay within a limited budget! A company's promotional strategy, which is comprised of publicity, personal selling, and advertising, must deliver the same clear, consistent, and compelling message about the business and its products or services. Customers respond best to a positive message that is delivered consistently by each component of the strategy. One goal of a company's promotional strategy is to build **brand equity**, which is measured by customer loyalty and customers' willingness to pay a premium for its products and services.

Developing an effective advertising program has become more challenging for business owners. Because of media overflow, overwhelming ad clutter, increasingly fragmented audiences, the popularity of social media, more advertising options, and more skeptical consumers, companies have had to become more innovative and creative in their advertising campaigns. Rather than merely turning up the advertising volume on their campaigns, companies are learning to change their frequencies, trying out new approaches in different advertising media.

A company's promotional efforts must differentiate its products and services from those of competitors. Some of the most effective advertisers have enhanced their brand loyalty by emphasizing in their promotional strategies the unique customer benefits that their products or services provide. For example, Nordstrom department stores are defined by friendly customer service, Volvo is known for automotive safety, and FedEx is recognized for guaranteed overnight delivery. One of the first steps is to carefully and thoughtfully define the message that a company's promotional campaign will emphasize by defining its *unique selling proposition*.

Define Your Company's Unique Selling Proposition

1. Define your company's unique selling proposition.

Entrepreneurs should build their advertising messages on a **unique selling proposition (USP)**, a key customer benefit or a product or service that sets it apart from its competition. To be effective, a USP must actually *be* unique—something the competition does not (or cannot) provide—and compelling enough to encourage customers to buy. One technique for testing uniqueness is to replace your company's name and logo in one of your advertisements with those of your top competitor. Does the ad still make sense? If so, the ad is not based on your company's USP! Unfortunately, many business owners never define their companies' USPs, and the result is an uninspiring “me-too” message that cries out “buy from us” without offering customers any compelling reasons to do so.

A successful USP answers the critical question every customer asks: “What's in it for me?” A successful USP should express in no more than 10 words what a business can do for its customers. Can your product or service save your customers time or money, make their lives easier or more convenient, improve their self-esteem, or make them feel better? If so, you have the foundation for building a USP. The most effective ads are *not* just about a company's products and services; instead, they focus on the company's customers and how its products and services can improve *their* lives.

The most effective USPs are simple, concrete, believable, emotional, and easy to communicate to prospective customers. The best way to identify a meaningful USP is to describe the primary benefits a product or service offers customers and then to list other secondary benefits it provides. Most businesses will have no more than three primary benefits. Smart entrepreneurs look beyond the physical characteristics of their products or services, recognizing that sometimes the most powerful foundation for a USP is the *intangible or psychological* benefit a product or service offers customers, such as safety, security, acceptance, status, prestige, and others. The key is to identify a gap that customers typically experience and explain how your company's product or service can fill it. Before creating advertisements, entrepreneurs should develop a brief list of the facts that support the company's USP, such as an unconditional guarantee; 24-hour service; a fully trained, experienced staff; industry awards won; and others. The final step is to consolidate the gap-filling benefits the company offers into a single statement of USP.

The USP becomes the heart of a company's advertising message because it has the ability to cut through all of the advertising clutter. For instance, the owner of a quaint New England bed-and-breakfast came up with a four-word USP that captures the essence of the escape her business offers guests from their busy lives: "Delicious beds, delicious breakfasts." Sheila Paterson, cofounder of Marco International, a marketing consulting firm, says her company's USP is "Creative solutions for impossible marketing problems."¹ Dave Munson, founder of Saddleback Leather, a company that manufactures premium bags made from exclusive leather from the best tannery in the Western Hemisphere and featuring the finest details, stitching, and hardware, has a witty (but true) USP: "They'll fight over it when you're dead" (Munson is so confident in the superior quality of his company's bags, which carry a 100-year guarantee against all defects in workmanship and materials, that he includes links to his competitors' Web sites on the Saddleback Web site!).²

By focusing a company's advertising message on these top benefits and the facts that support them, entrepreneurs can communicate their USPs to their target audiences in meaningful, attention-getting ways. Building a firm's marketing message around a USP spells out for customers the benefits they can expect if they buy the company's product or service and why they should do business with a company rather than with its competition. However, a company must be able to *deliver* on its USP; otherwise, the advertising effort is futile!

Creating a Promotional Strategy

The terms *advertising* and *promotion* are often confused. **Promotion** is any form of persuasive communication designed to inform consumers about a product or service and to influence them to purchase these goods or services. It includes publicity, personal selling, and advertising.

Publicity

Publicity is any commercial news covered by the media that boosts sales but for which the small business does not pay. "[Publicity] is telling your story to the people you want to reach—namely the news media, potential customers, and community leaders," says the head of a public relations firm. "It is not haphazard. . . . It requires regular and steady attention."³ Because it originates from an external source, some entrepreneurs worry about losing control of the message and the medium. However, smart entrepreneurs realize that what they lose in control they gain in credibility. Publicity has power; because it is from an unbiased source, a news feature about a company or a product appearing in a newspaper or magazine has more impact on people's buying decisions than an advertisement does. Exposure in any medium raises a company's visibility and boosts sales, and, best of all, publicity is low cost!



ENTREPRENEURIAL PROFILE: Kim Nelson: Daisy Cakes Kim Nelson, owner of Daisy Cakes, a small bakery based in tiny Pauline, South Carolina, learned to bake delicious cakes from her grandmothers and was slowly building a base of loyal customers, almost all of them local. After Nelson appeared on *Shark Tank*, a television show in which entrepreneurs in search of capital pitch their business ideas to potential angel investors, and on the food segment of NBC's *Today Show*, sales skyrocketed, causing the company's Web site to crash. (Barbara Corcoran, one of the *Shark Tank* angels, invested \$50,000 in Daisy Cakes in exchange for 25 percent of the company.) Before the publicity that Nelson's television appearances generated, Daisy Cakes sold 500 cakes per year; today, Daisy Cakes sells 10,000 cakes a week, most of them through the company's Web site, www.ilovedaisycakes.com.⁴

A sound marketing plan includes strategies for both publicity and advertising; each complements the other. Arguing whether one is more important than the other "is like debating what's more important in football—offense or defense," says entrepreneur Freddy Nager.⁵ The following tactics can help entrepreneurs stimulate publicity for their companies:

Write an article that will interest your customers or potential customers. One investment adviser writes a monthly column for the local newspaper on timely topics such as "Retirement Planning," "Minimizing Your Tax Bill," and "How to Pay for College." Not only do the articles help build her credibility as an expert, but they also have attracted new customers to her business.

2. _____
Explain the differences among promotion, publicity, personal selling, and advertising.

Sponsor an event designed to attract attention. Even local events, for which sponsorships can be quite inexpensive, garner press coverage for sponsors.

Involve celebrities “on the cheap.” Few small businesses can afford to hire celebrities as spokespersons for their companies. Some companies have discovered other ways to get celebrities to promote their products, however. For instance, when Karen Neuburger, owner of Karen Neuburger’s Sleepwear, learned that Oprah Winfrey is a “pajama connoisseur,” she sent the talk show host a pair of her pajamas. The move paid off; Neuburger appeared on Oprah’s popular television show on three separate occasions, and each time, sales for her sleepwear increased.⁶

Contact local television and radio stations and offer to be interviewed. Many local news or talk shows are looking for guests to talk about topics of interest to their audiences (especially in January and February). Even local shows can reach new customers.

Publish a newsletter. With inexpensive software, any entrepreneur can publish a professional-looking newsletter. Freelancers can offer design and editing advice. The key is to make newsletters useful and interesting to existing or potential customers.



ENTREPRENEURIAL PROFILE: David Sanford: Crowne Point Historic Inn and Spa

David Sanford, owner of the Crowne Point Historic Inn and Spa in Provincetown, Massachusetts, used e-mail newsletters to increase sales during the traditionally slow off-season in New England. Sanford had tried using “traditional” advertising techniques but found the costs to be high and the results they produced to be minimal. He began sending regular e-mail newsletters with the goal of increasing the inn’s customer base and attendance at the special events the inn hosts. Analytics allow Sanford to track recipients’ responses to the newsletters and to determine which features produce the greatest results. “I’ve increased my revenue while decreasing my marketing costs,” he says. “I can stay in front of customers 12 months a year with very little expense.”⁷

Contact local business and civic organizations and offer to speak to them. A powerful, informative presentation can win new business. (Be sure your public speaking skills are up to par first! If not, consider joining Toastmasters.)

Offer or sponsor a seminar. Teaching people about a subject you know a great deal about builds confidence and goodwill among potential customers. The owner of a landscaping service and nursery offers a short course in landscape architecture and always sees sales climb afterward.

Write news releases e-mail them to media outlets. The key to having a news release picked up and printed is finding a unique angle on your business or industry that would interest an editor. Keep it short, simple, and interesting. E-mail press releases should be shorter than printed ones—typically four or five paragraphs rather than one or two pages—and they should include a link to the company’s Web site. For reasonable fees, entrepreneurs can get news releases in front of thousands of journalists around the world using services such as PR Newswire and Business Newswire.

Volunteer to serve on community and industry boards and committees. You can make your town a better place to live and work and raise your company’s visibility at the same time.

Sponsor a community project or support a nonprofit organization or charity. Not only will you be giving something back to the community, but you will also gain recognition, goodwill, and, perhaps, customers for your business.



ENTREPRENEURIAL PROFILE: Rocky and Courtney Shanower: Park Street Pizza

Every December, Rocky and Courtney Shanower, owners of Park Street Pizza in Sugarcreek, Ohio, partner with their friend Joel McKinnon, owner of a local insurance agency, in a “Pizza with a Purpose” event that supports the local United Way. The Shanowers donate 15 percent of their sales on the day of the event to the charity. Not only do the entrepreneurs take pride in giving back to the community that supports their businesses, but they also receive the equivalent of thousands of dollars worth of advertising from the publicity generated by the Pizza with a Purpose event.⁸

Support a cause. By engaging in **cause marketing**, entrepreneurs can support and promote a nonprofit cause or charity and raise the visibility of their companies in the

community at the same time. The key is choosing a cause that is important to your customers. One marketing expert offers the following formula for selecting the right cause: Mission statement + personal passion + customer demographics = ideal cause.⁹ Charity Navigator (www.charitynavigator.org) is an excellent resource for finding the right charity for your business to support.

Promote your company's publicity. When your company receives good publicity, promote it by posting the article or video on your company's Web site, posting links to the article or video on Facebook, tweeting about the coverage on Twitter, and using excerpts from it in your company's marketing materials. When Blue Ridge Log Cabins, a Spartanburg, South Carolina-based company that manufactures log homes, was featured on *Extreme Makeover Home Edition* and HGTV, owner Chip Smith placed links to the videos in a prominent place on the company's Web site and referred to the coverage in all of the company's marketing materials, including outdoor ads directing customers to the company's showroom.

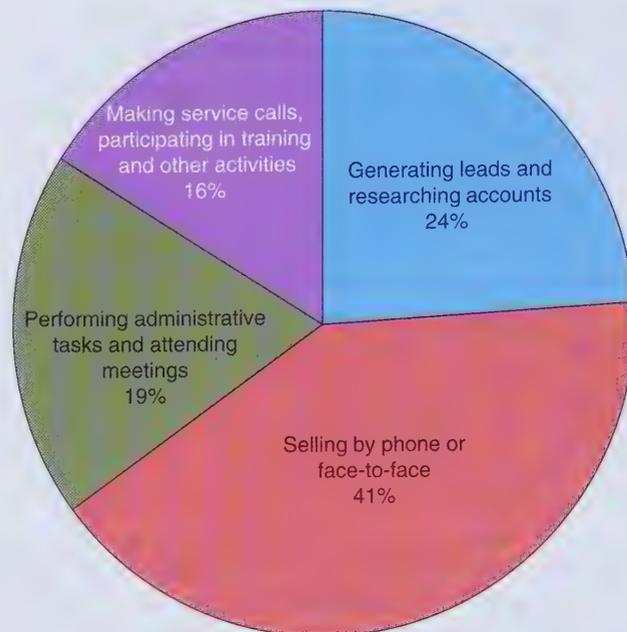
Personal Selling

Advertising often marks the beginning of a sale, but personal selling usually is required to close the sale. **Personal selling** is the personal contact between salespeople and potential customers that comes from sales efforts. Effective personal selling can give a small company a definite advantage over its larger competitors by creating a feeling of personal attention. Personal selling deals with the salesperson's ability to match customer needs to the company's goods and services. Top salespeople are characterized as follows:

- They are enthusiastic and are alert to opportunities. Star sales representatives demonstrate deep concentration, high energy, and drive.
- They are experts in the products or services they sell. They understand how their product lines or services can help their customers.
- They concentrate on their best accounts. They focus on customers with the greatest sales potential first. They understand the importance of the 80/20 rule: Approximately 80 percent of their sales comes from about 20 percent of their customers.
- They plan thoroughly. On every sales call, the best representatives act with a purpose to close the sale.
- They use a direct approach. They get right to the point with customers.
- They approach the sales call from their customers' perspectives. They have empathy for their customers and know their customers' businesses and their needs. Rather than sell the features of a product or service, they emphasize the benefits those features offer their customers.
- They offer proof of the benefits their product or service provides. The best salespeople provide tangible evidence such as statistics, facts, and testimonies from other customers about how their product or service will benefit the customer.
- They are good listeners. They ask questions and listen. By listening, sales representatives are able to identify customers' "hot buttons," key issues that drive their purchase decisions. "Questions are the key to selling," says one experienced salesperson. "Nobody ever listened themselves out of a sale!"¹⁰
- They use past success stories. They encourage customers to express their problems and then present solutions using examples of past successes.
- They leave sales material with clients. The material gives the customer the opportunity to study company and product literature in more detail.
- They see themselves as problem solvers, not just vendors. Their perspective is "How can I be a valuable resource for my customers?" In fact, smart salespeople take the time to ask their existing customers, "Is there anything I am not doing that I could be doing to serve you better?" A study by Cahners Research found that sales representatives who understand the business needs and pressures that their customers face are 69 percent more likely to close a sale.¹¹

FIGURE 10.1
How Sales Representatives Spend Their Time

Source: 2011 Sales Optimization Report, CSO Insights, 2011.



One extensive study of salespeople found that just 20 percent of all salespeople have the ability to sell and are selling the “right” product or service. That 20 percent of sales reps makes 80 percent of all sales. The study also concluded that 55 percent of sales representatives have “absolutely no ability to sell;” the remaining 25 percent have sales ability but are selling the wrong product or service.¹²

A study by Cahners Research found that it takes an average of 5.12 sales calls to close a deal.¹³ Common causes of sales rejections include the representative’s failure to determine customers’ needs, talking too much, and neglecting to ask for the order. Given the high cost of making a sales call (an average of \$412), those missed opportunities are quite costly. Figure 10.1 shows how sales representatives spend their time. (Note that they spend just 41 percent of their time engaged in active selling.)

Small business owners can improve their sales representatives’ “closing averages” by following some basic guidelines:

Hire the right people. A successful sales effort starts well before a sales representative calls on a potential customer. The first step is hiring capable salespeople who demonstrate empathy for customers and are motivated, persistent, and focused.

Train sales representatives. Too often, business owners send sales representatives out into the field with little or no training and then wonder why they cannot produce. Training starts with teaching salespeople every aspect of the products or services they will be selling before moving on to teach them how to build relationships with customers. Training must also include the two most important selling skills of all: listening to the customer and closing the sale. Many business owners find that role-playing exercises are an effective sales training technique.

Develop a selling system. To be successful, sales representatives must develop an effective selling system. To build a winning selling system, entrepreneurs can take the following steps:

1. **Prepare.** The best sales representatives know that what they do *before* they make a sales call significantly influences their success. In fact, the top complaint about sales representatives among buyers is a salesperson who is unprepared. Unfortunately, according to a study by Knowledge Anywhere, nearly 63 percent of sales representatives spend less than 20 minutes preparing for a sales call.¹⁴ Smart salespeople take the time to research their customers (most often using the Internet) and to learn about the companies where their customers work.
2. **Approach.** Establish rapport with the prospect. Customers seldom buy from salespeople they dislike or distrust.

3. **Interview.** Get the prospect to do most of the talking; the goal is to identify his or her needs, preferences, and problems. The key is to *listen* and then to ask follow-up questions that help determine exactly what the customer needs or wants before proposing a solution. Norm Brodsky, founder of six companies, including a highly successful records storage business, says, “When I call on a prospect for the first time, I don’t even talk about our company. I spend the whole visit just trying to learn all I can about the people I’m dealing with. I look to build rapport and understand how the customer likes to do business.”¹⁵
4. **Demonstrate, explain, and show.** Make clear the features and benefits of your product or service and point out how they meet the prospect’s needs or solve his or her problems.
5. **Validate.** Prove the claims about your product or service. If possible, offer the prospect names and numbers of other satisfied customers (with their permission, of course). Testimonials really work.
6. **Negotiate.** Listen for objections from the prospect. Objections can be the salesperson’s best friend; they tell him or her what must be “fixed” before the prospect will commit to an order. The key is to determine the *real* objection and confront it.
7. **Close.** Ask for a decision. Good sales representatives know when the prospect flashes the green light on a sale. They stop talking and ask for the order.

Be empathetic. The best salespeople look at the sale from the customer’s viewpoint, not their own! Doing so encourages the sales representative to stress *value* to the customer.

Set multiple objectives. Before making a sales call, salespeople should set three objectives:

1. **The primary objective** is the most reasonable outcome expected from the meeting. It may be to get an order or to learn more about a prospect’s needs.
2. **The minimum objective** is the very least the salesperson will leave with. It may be to set another meeting or to identify the prospect’s primary objections.
3. **The visionary objective** is the most optimistic outcome of the meeting. This objective forces the salesperson to be open-minded and to shoot for the top.

Monitor sales efforts and results. Selling is just like any other business activity and must be controlled. At a minimum, entrepreneurs should know the following numbers for their companies:

1. Actual sales versus projected sales
2. Sales generated per call made
3. Average cost of a sales call
4. Total sales costs
5. Sales by product, salesperson, territory, customer, and so on
6. Profit contribution by product, salesperson, territory, customer, and so on



Entrepreneurship in Action

Should an Ambulance Service Hire Its First Sales Representative?

Mike Woronka had worked at Action Ambulance Service, a small business in Wilmington, Massachusetts, that provides ambulance and transportation services for hospitals, nursing homes, rehabilitation centers, and special education programs, for 10 years before becoming the company’s CEO in 2006. Since its founding in 1977 by brothers David and Stanley Portman, Action Ambulance

has grown to employ 260 employees and to generate \$17 million in annual sales. However, the company faces intense competition from seven rivals in the greater Boston area, and rising prices and wages have driven up its cost of doing business—all while its customers are demanding faster response times. Woronka wants to differentiate Action Ambulance from its competition and believes that a more aggressive selling approach would expand the company’s territory and increase sales and profits.

Entrepreneurship in Action (continued)

Currently, Action Ambulance follows the standard model in the industry, using its account managers, who in addition to serving current customers, spend some of their time trying to develop new accounts. At conferences, the account managers meet with representatives of health care providers who are considering switching ambulance companies and with their current customers to land more of their transportation business. Currently, the account managers have no goals for landing new customers or increasing sales and are paid straight salaries with no commissions.

Woronka has considered retraining the company's existing account managers to use more aggressive direct-sales techniques. Even though doing so is the least expensive option, he is concerned that the managers may not have the skills or the motivation to become part-time salespeople. Adding to their job duties also runs the risk that they will spend less time providing quality service to existing customers.

Woronka wonders whether hiring a full-time sales representative to generate new sales would be worth the additional cost, which he estimates would include \$100,000 in salary plus a commission and 30 percent for benefits. "Many people say that you can't sell ambulance services," he says, "and that we are crazy to want to do things differently." If Woronka hires a sales representative, that person would report directly to him, which creates another potential problem because he has no sales experience.

Another option is to hire both a sales representative and a sales manager, whom he estimates would be paid \$150,000

in salary. That would add to the company's cost structure, but the sales representative and the two current account managers would report directly to the sales manager, giving Woronka more time to focus on his duties as CEO.

If Woronka decides to hire a sales representative, he wonders how he should design the job. How many sales calls should the rep make each week? How much should he expect the sales rep to generate in new sales each year? What type of base salary and commission structure should he establish? From a broader perspective, how would potential customers perceive a sales representative selling ambulance services in an industry that traditionally has not used sales reps?

1. Should Woronka retrain the company's existing account managers or hire a sales representative? Should he hire a sales manager? Explain the advantages and the disadvantages of each option.
2. If Woronka hires a sales representative and/or a sales manager, how should he design the job? What system should he put in place to make sure that the sales representative produces results?

Sources: Based on Pamela Ryckman, "When the Soft Sell Needs a Hard Look," *New York Times*, February 15, 2012, www.nytimes.com/2012/02/16/business/smallbusiness/trying-to-ramp-up-sales-in-an-industry-that-prefers-the-soft-sell.html?ref=casestudies&r=0; Pamela Ryckman, "A Reluctant CEO Hires His First Sales Rep," *New York Times*, February 22, 2012, <http://boss.blogs.nytimes.com/2012/02/22/a-reluctant-c-e-o-hires-his-first-sales-rep>; "About Action," Action Ambulance Services, 2012, www.actionambulance.com/index-2.html#whos.

Advertising

Advertising is any sales presentation that is nonpersonal in nature and is paid for by an identified sponsor. A company's target audience and the nature of its message determine the advertising media it will use. However, the process does not end with creating and broadcasting an ad. Entrepreneurs also must evaluate an ad campaign's effectiveness. Did it accomplish the objectives it was designed to accomplish? Immediate-response ads can be evaluated in a number of ways. For instance, a business owner can include coupons that customers redeem to get price reductions on products and services. Some firms use "hidden offers," statements hidden somewhere in an ad that offer customers special deals if they mention an ad or bring in a coupon from an ad. For example, Scott Fiore, owner of the Herbal Remedy, an all-natural pharmacy in Littleton, Colorado, uses a "bring this ad in for 10 percent off" message in his print ads so that he can track each ad's success rate and adjust his advertising expenditures accordingly.

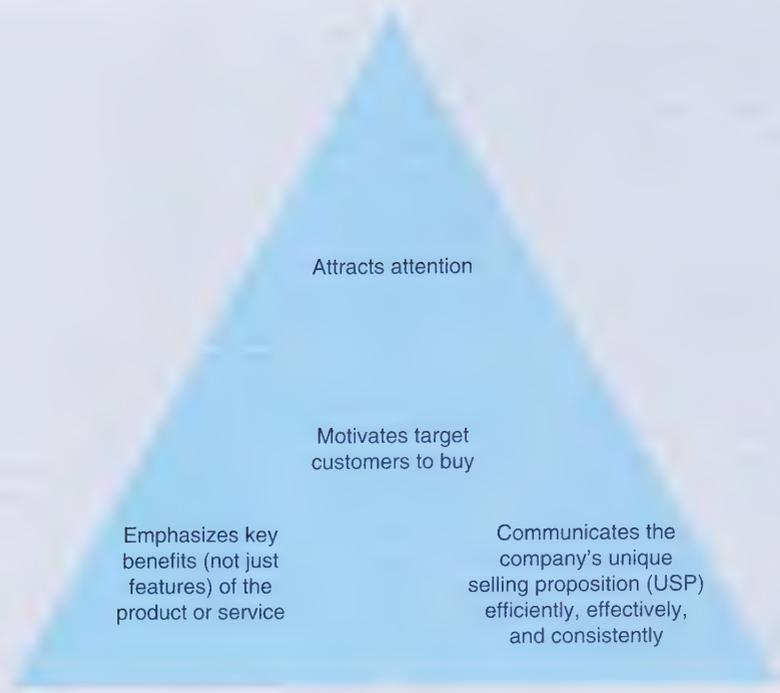
Business owners can also gauge an ad's effectiveness by measuring the volume of store traffic generated. Effective advertising should increase store traffic, which boosts sales of advertised and nonadvertised items. Of course, if an advertisement promotes a particular bargain item, the owner can judge its effectiveness by comparing sales of the items to preadvertising sales levels. Remember: The ultimate test of an ad is whether it increases sales!

Ad tests allow entrepreneurs to determine the most effective methods of reaching their target customers. An owner can design two different ads (or use two different media or broadcast times) that are coded for identification and see which one produces more responses. For example, a business owner can use a split run of two different e-mail ads, each with a different subject line. Then he or she can measure the response level to each ad to determine which one generates the greatest response. Table 10.1 offers 12 tips for creating an effective advertising campaign.

TABLE 10.1 Twelve Tips for Effective Advertising

1. **Plan more than one advertisement at a time.** An advertising campaign is likely to be more effective if you build it from a comprehensive plan for a specific time period. A piecemeal approach produces ads that lack continuity and a unified theme. One goal of advertising is to build a consistent image for your business in the minds of your customers, and that requires a comprehensive plan.
2. **Set long-run advertising objectives and measure performance against them.** One cause of inadequate planning is the failure to establish specific objectives for the advertising program. If an entrepreneur never defines what is expected from advertising, the program is likely to lack a sense of direction. Measuring an ad campaign's performance against objectives allows entrepreneurs to improve the performance of future campaigns by learning what works—and what does not.
3. **Use advertisements, themes, and media that appeal to your target customers.** Although personal judgment influences every business decision, business owners cannot afford to let bias interfere with advertising decisions. For example, you should not advertise on a particular radio station simply because you like it. What matters is whether your company's target customers listen to the station. One of the worst advertising mistakes entrepreneurs make is to create ads that attempt to make their businesses "everything to everyone." Focus instead on your company's USP and on what your company can do for its target customers.
4. **View advertising expenditures as investments, not as expenses.** From an accounting perspective, advertising is a business expense, but the money you spend on ads produces sales and profits over time that might not be possible without advertising. An effective advertising program generates more in sales than it costs. You must ask, "Can I afford *not* to advertise?"
5. **Use advertising that is different from your competitors' advertising.** Some entrepreneurs tend to "follow the advertising crowd" because they fear being different from their competitors. "Me-too" advertising frequently is ineffective because it fails to create a unique image for a business. Don't be afraid to be bold and try something different! Although entrepreneurs must adjust their advertising expenditures to coincide with the seasonal nature of their businesses, investing consistently in advertising produces better results than sporadic fits of spending.
6. **Choose the media vehicle that is best for your business even if it's not "number one."** It is not uncommon for several media within the same geographic region to claim to be "number one." Different media offer certain advantages and disadvantages. Entrepreneurs must understand who their target customers are and select the media that are best for reaching their target audiences most effectively and efficiently.
7. **Consider using someone else as the spokesperson on your television and radio commercials.** Although being your own spokesperson may lend a personal touch to your ads, the ads may be seen as nonprofessional or "homemade" and may detract from your company's image rather than improve it.
8. **Focus ads on your company's USP.** Some entrepreneurs think that to get the most for their advertising dollars, they must pack their ads full of facts and information. However, overcrowded ads only confuse customers and usually produce poor results. Simple, well-designed ads that focus on your USP and have a single call to action are much more effective.
9. **Devise ways of measuring your ads' effectiveness that don't depend on just two or three customers' responses.** Measuring the effectiveness of advertising is an elusive art at best, but the opinions of a small unrepresentative sample of customers, whose opinions may be biased, is not a reliable gauge of an ad's effectiveness. Asking new customers how they learned about your business often provides insight into the effectiveness of your advertising campaign. Online advertising media not only are low-cost but also offer the benefit of providing easily measurable analytics that tell entrepreneurs how successful their ads are. With sufficient planning, entrepreneurs can use focus groups to test the effectiveness of ads *before* they run them.
10. **Don't simply drop an ad because nothing happens immediately.** Some ads are designed to produce immediate results, but many ads require more time because of the lag effect they experience. One of advertising's rules is this: It's not the size; it's the frequency. The head of one advertising agency claims, "The biggest waste of money is stop-and-start advertising." With advertising, patience is essential, and entrepreneurs must give an advertising campaign a reasonable time to produce results. One recent study concluded that sales increases are most noticeable four to six months after an advertising campaign begins. One advertising expert claims that successful advertisers "are not capricious ad-by-ad makers; they're consistent ad campaigners."
11. **Emphasize the benefits that the product or service provides to the customer.** Too often, ads emphasize only the features of the products or services a company offers without mentioning the benefits they provide customers. Customers really don't care about a product's or service's "bells and whistles"; they are much more interested in the *benefits* those features can give them! Their primary concern is "What's in it for me?" Your ads should focus on your target customers and how your company's products or services fill their needs rather than on your company.
12. **Evaluate the cost of different advertising media.** Remember the difference between the absolute and relative cost of an ad. The medium that has a low absolute cost may actually offer a high relative cost if it does not reach your intended target audience. Evaluate the cost of different media by looking at the cost per thousand customers reached. Remember: No medium is a bargain if it fails to connect you with your intended customers.

Sources: Based on "Top 10 Tips for an Effective Advertising Campaign," *All Business*, December 2012, www.allbusiness.com/10-tips-effective-advertising/16566950-1.html#axzz2F2BbyMNM; Sue Clayton, "Advertising," *Business Start-Ups*, December 1995, pp. 6–7; *Marketing for Small Business* (Athens: University of Georgia Small Business Development Center, 1992), p. 69; "Advertising Leads to Sales," *Small Business Reports*, April 1988, p. 14; Shelly Meinhardt, "Put It in Print," *Entrepreneur*, January 1989, p. 54; Danny R. Arnold and Robert H. Solomon, "Ten 'Don'ts' in Bank Advertising," *Burroughs Clearing House* 16, no. 12 (September 1980), pp. 20–24, 43–43; Howard Dana Shaw, "Success with Ads," *In Business*, November/December 1997, p. 22; and Nimee L. Stern, "Avoid the Deadly Sins in Advertising," *Your Company*, August/September 1997, p. 22.

FIGURE 10.2**Characteristics of a Successful Ad**

The remainder of this chapter will focus on selecting advertising media, developing an advertising plan, and creating an advertising budget. Figure 10.2 illustrates the characteristics of a successful ad.

Selecting Advertising Media

Entrepreneurs quickly discover a wide array of advertising media options, including newspapers, magazines, radio, television, direct mail, and the Internet, as well as many specialty options. One of the most important decisions an entrepreneur must make is which media to use to disseminate the company's message. The medium used to transmit the message influences the customer's perception—and reception—of it. The right message broadcast in the wrong medium will miss its mark. Before selecting the vehicle for the message, entrepreneurs should consider several important questions:

- **How large is my company's trading area?** How big is the geographical region from which the firm will draw its customers? The size of this area influences the choice of advertising media.
- **Who are my target customers, and what are their characteristics?** Until they know who their target customers are, business owners cannot select the proper advertising media to reach them.
- **What budget limitations do I face?** Every business owner must direct his or her company's advertising program within the restrictions of its operating budget. The goal is to generate the greatest impact while staying within the company's budget limitations.
- **Which media do my competitors use?** Business owners should know which advertising media that their competitors use; however, they should *not* automatically assume that those media are best. Sometimes an approach that differs from the traditional one produces superior results. Figure 10.3 illustrates the results of a recent study that shows the media that adults use to get information about local small businesses.
- **How important is repetition and continuity of my advertising message?** Generally, an ad becomes effective only after it is repeated several times, and many ads must be continued for some time before they produce results. Some experts suggest that an ad must appear at least six times in most mass media before it becomes effective.
- **How does each medium compare with others in its audience, its reach, and its frequency?** Audience measures the number of paid subscribers a particular medium attracts

3.

Describe the advantages and disadvantages of the various advertising media.

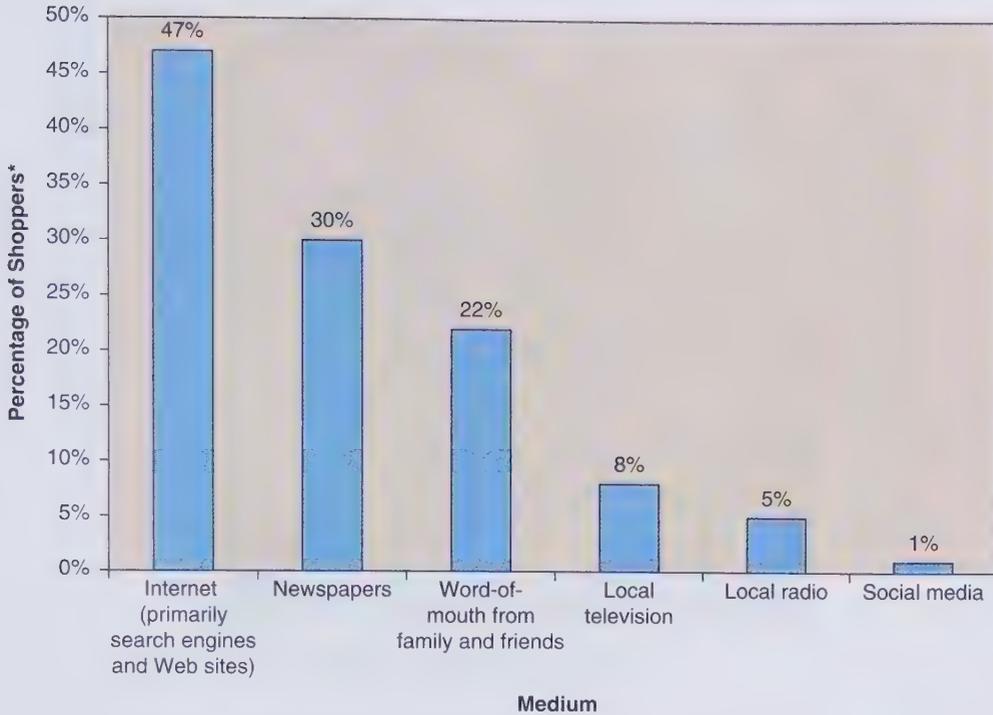


FIGURE 10.3
How Shoppers Gather Information About Local Small Businesses

Source: Based on Lee Rainie, Kristen Purcell, Amy Mitchell, and Tom Rosenstiel, “Where People Get Information About Restaurants and Other Local Businesses,” Pew Internet and American Life Project, December 14, 2011, <http://pewinternet.org/Reports/2011/Local-business-info.aspx>.

* Percentages total more than 100% because shoppers use multiple media.

and is called *circulation* in most print media, such as newspapers and magazines. **Reach** is the total number of people exposed to an ad at least once in a period of time, usually four weeks. **Frequency** is the average number of times a person is exposed to an ad in that same time period.

- **What does the advertising medium cost?** There are two types of advertising costs that entrepreneurs must consider: absolute cost and relative cost. **Absolute cost** is the actual dollar outlay a business owner must make to place an ad in a particular medium for a specific time period. An even more important measure is an ad’s **relative cost**, the ad’s cost per potential customer reached. Relative cost is most often expressed as **cost per thousand (CPM)**, the cost of the ad per 1,000 customers reached. Suppose an entrepreneur decides to advertise his product in one of two newspapers in town. The *Sentinel* has a circulation of 21,000 and charges \$1,200 for a quarter-page ad. The *Independent* has a circulation of 18,000 and charges \$1,300 for the same space. Reader profiles of the two papers suggest that 25 percent of *Sentinel* readers and 37 percent of *Independent* readers are potential customers. Using this information, the manager computes the following relative costs:

	Sentinel	Independent
Circulation	21,000	18,000
Percentage of readers who are potential customers	× 25%	× 37%
Potential customers reached	5,250	6,660
Absolute cost of ad	\$1,200	\$1,300
Relative cost of ad (CPM)	$\$1,200/5,250 = .22857$ or \$228.57 per thousand potential customers reached	$\$1,300/6,660 = .19520$ or \$195.20 per thousand potential customers reached

Although the *Sentinel* has a larger circulation and a lower absolute cost for running the ad, the *Independent* offers this entrepreneur a better advertising deal because of its lower cost per thousand potential customers (CPM) reached. It is important to note that this technique does not give a reliable comparison across media; it is a meaningful comparison only within a single

Source: CartoonStock.



Before we begin tonight's dream,
a word from our sponsor...

medium. Differences among the format, presentation, and coverage of ads in different media are so vast that cross-comparisons are not meaningful.

Media Options

The world of advertising is undergoing significant changes. The lines that once separated the various advertising media are now blurring. Features that once were unique to a specific medium now operate across multiple media. Video, once the distinctive signature of television, now appears on companies' Web sites, in e-mail ads, on YouTube, on smart phones, and through other devices. Traditional methods of advertising are not as effective as they once were because of increased advertising clutter, the growth in the time that customers spend online, and intense competition for buyers' attention. Small businesses are steadily shifting their advertising expenditures away from traditional media, such as newspapers, television, direct mail, radio, magazines, and directories, and toward digital media, such as e-mail campaigns, search engines, social media, online and mobile device ads, and others (see Figure 10.4). Entrepreneurs are looking to supplement or even replace traditional methods of advertising with inexpensive online tools and innovative, sometimes offbeat techniques that capture shoppers' attention.

Choosing advertising media is no easy task because each has particular advantages, disadvantages, and costs. Figure 10.5 shows recent trends in advertising expenditures by medium. Let's examine the features of various advertising media.

WORD-OF-MOUTH ADVERTISING Perhaps the most effective and certainly the least expensive form of advertising is **word-of-mouth advertising** in which satisfied customers recommend a business to friends, family members, and acquaintances. Unsolicited testimonials are powerful; because they are impartial, they score high on importance and credibility among potential customers. According to the Word of Mouth Marketing Association, 54 percent of U.S. consumers say that the primary factor that drives their purchasing decisions is word-of-mouth. In addition, 59 percent of consumers believe that offline (face-to-face or voice-to-voice) word-of-mouth is highly credible.¹⁶ Business owners recognize the power of word-of-mouth advertising; they rate word-of-mouth advertising as the most beneficial form of advertising to their businesses (79 percent), ahead of traditional advertising (44 percent) and social media (35 percent).¹⁷

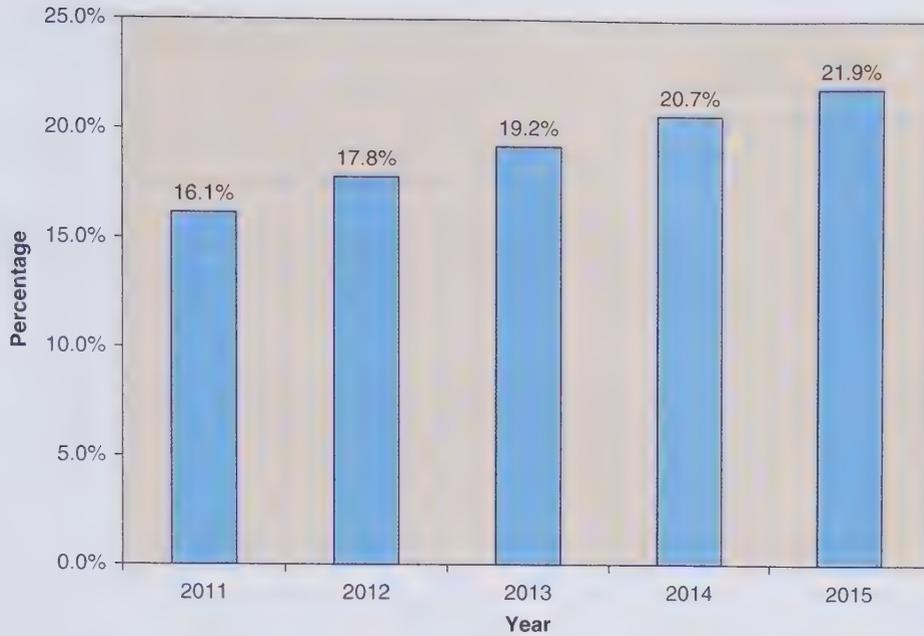


FIGURE 10.4
Global Online Advertising Expenditures as a Percentage of Total Advertising Expenditures

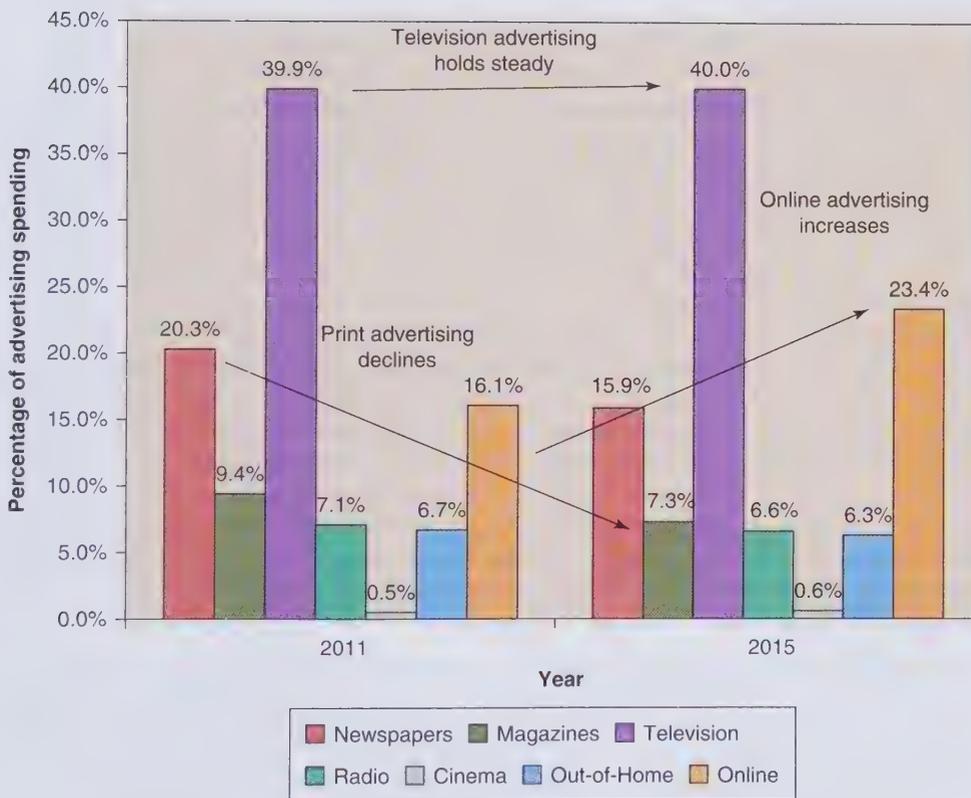


FIGURE 10.5
Advertising Expenditures by Medium Percentage of Advertising Expenditures 2011 and 2015

Source: Based on “Global Online Ad Spending Forecast to Exceed Print in 2015,” Marketing Charts, December 3, 2012, www.marketingcharts.com/wp/television/global-online-ad-spend-forecast-to-exceed-print-in-2015-25105.

Word-of-mouth advertising takes place naturally (the average American mentions specific brand names 60 times per week in online and offline conversations), but entrepreneurs can take steps to encourage customers to promote their businesses to others.¹⁸ The best ways for a company to generate positive word-of-mouth advertising are to provide superior quality, offer outstanding service, and reward customer loyalty—all of which give customers a reason to recommend the company to others. A stellar experience leads to loyal customers who become walking advertisements for the company. In an age of social networking, the quality of the experience customers have with a business has more impact than any form of advertising!

Word-of-mouth advertising can make or break a business because *dissatisfied* customers also speak out against businesses that treat them poorly. To ensure that the word-of-mouth advertising a company generates is positive, business owners must actually do what they want their customers to say they do.

Good word-of-mouth advertising is based on five characteristics: credible (a message that is honest and authentic), respectful (a company's behavior is transparent and trustworthy), social (a company that listens to, participates in, and encourages conversations with and among customers both online and offline), measurable (a company's ability to define, monitor, and evaluate success), and repeatable (a company's ability to generate consistent word-of-mouth advertising by becoming a "talkable" brand).¹⁹



ENTREPRENEURIAL PROFILE: Tom Jenkins: Big Juan's Tacos y Burros To get the word out about Big Juan's Tacos y Burros, a fast-service Mexican restaurant (now with two locations in Tucson, Arizona), to the students at the nearby University of Arizona who make up his primary target audience, Tom Jenkins hired a corps of student "brand ambassadors." The six students, most of whom are business or marketing majors at the University of Arizona, hand out free food samples, plan and coordinate special on-campus events, and chat up Big Juan's on social media. In one of their most successful campaigns, the students set up a photo backdrop featuring a big mustache, provided students with a variety of themed props, and invited them to take photos. "We posted the photos on Facebook, and the person whose photo received the most likes received a \$25 gift certificate to Big Juan's," says one student. The word-of-mouth campaign has increased sales and profits at Big Juan's, "and the costs are minimal," says Jenkins. "This is a very effective way to reach a very specific target."²⁰

A customer endorsement is an effective way of converting the power of word-of-mouth to an advertising message. Of course, unpaid and unsolicited endorsements are the most valuable. Online, these endorsements often come from customer-generated product reviews. Today, customers tend to rely more on customer reviews for information about a product or service than on the company's own descriptions.²¹ In fact, 70 percent of global customers say that they trust online customer reviews of products, services, and companies, second only to recommendations from people they know (92 percent).²² The lesson: Make sure that your Web site includes a section for customer endorsements and reviews.

The Holy Grail of word-of-mouth advertising is "buzz." Buzz occurs when a product is hot and everyone is talking about it. From the mood rings of the 1970s to Apple's iPhones, buzz drives the sales of many products. The Internet has only magnified the power of buzz to influence a product's sales. Buzz on the Web has become a powerful force in influencing the popularity of a firm's products or services. What can business owners do to start a buzz about their companies or their products or services? Sometimes buzz starts on its own, leaving a business owner struggling to keep up with the fury it creates. More often than not, however, business owners can give it a nudge by creating interest, mystique, and curiosity in a product or service. Creating buzz does not have to be expensive, but it does require being different. Consider the following tips:

- **Make your business buzz-worthy.** If your company has nothing to set it apart, customers have no incentive to create buzz about it. Does your company sell a novel product, have a unique marketing approach, offer stellar customer service, use a wacky logo, or anything else that can set it apart? If so, that can be the basis for buzz.
- **Promote your company to "influencers" in your market.** Influencers are high-profile customers who are on the front edge of every trend. They are the first to wear the hottest athletic shoe, master the coolest video game, or make the hippest restaurant their new hangout; they also are willing to tell their friends. Promoting your company's products and services to influencers increases the likelihood that your company will be the subject of buzz.
- **Make it easy for satisfied customers to spread the word about your company.** Ask customers periodically to tell a friend about your business and their positive experience with it. Put a "Tell-a-friend" link on every page of your company's Web site. Reward customers who refer other customers to your business by offering them something special in return.

- *Use e-mail and social media to encourage viral marketing and amplify your company's word-of-mouth advertising.* One of the easiest ways to accomplish this is through e-mail because it is so easy for people to pass along to their friends. Another technique is to publicize news about your company on a blog and include links to your company's Web site. Entrepreneurs also can use social media sites such as Facebook, Twitter, Pinterest, and others to engage customers and encourage buzz.



ENTREPRENEURIAL PROFILE: Luna and Larry Kaplowitz: Coconut Bliss In 2004, copreneurs Luna and Larry Kaplowitz launched Coconut Bliss, their organic frozen dessert company in Eugene, Oregon, with a hand-cranked ice cream churn they bought for \$1.50 at a Goodwill store and the idea of making premium ice cream from coconut milk. As their company has grown, the Kaplowitzes have been able to build an impressive word-of-mouth marketing program with strategic use of social media, primarily Facebook and Twitter, where they have amassed a following of 12,000 and 8,300 fans, respectively. They also raise their company's profile by posting photos on Tumblr and videos on their own YouTube channel, which enhances their ranking in search engine results. Coconut Bliss features its customers enjoying their organic frozen desserts in customer-submitted photos and videos on its Web site, Facebook page, Twitter feed, and YouTube channel. They also keep their customers engaged—and talking about the company—by sponsoring interesting contests, sharing information about organic foods, and constantly talking with them on social media.²³



Larry and Luna Kaplowitz, cofounders of Coconut Bliss.
Source: Bliss Unlimited LLC.

- *Tap into the power of YouTube.* Video-oriented Web sites such as YouTube, which has 800 million unique users and displays more than 4 billion videos per day, can be a powerful tool for creating buzz for a company's products and services.²⁴ Videos on YouTube often become viral and are an important source of buzz for small companies.

INTERNET ADVERTISING Just as the Internet has become a common tool for conducting business, it also has become a popular medium for advertisers. Internet advertising is growing rapidly because advertisers recognize that that is where their target customers are spending more of their time and because advertisers can track the effectiveness of their advertising campaigns. By 2016, U.S. companies are expected to spend \$62 billion on online advertising.²⁵

The Internet provides opportunity for small businesses to reach customers with inexpensive video ads. The Web's multimedia capabilities make it an ideal medium for companies to demonstrate their products and services with full motion, color, and sound and to involve customers in discussions about them. Businesses that traditionally used direct mail can bring the two-dimensional photos and product descriptions in their print catalogs to life in video, avoid the expense of mailings, and attract new customers that they might otherwise miss.

Online advertisements take five basic forms: banner ads, display ads, contextual ads, pay-per-click ads, and e-mail ads. **Banner ads** are small rectangular ads that reside on Web sites, much like roadside billboards, touting a company's product or service. When visitors to a site click on the banner ad, they go straight to the advertiser's home page. One measure of a banner ad's effectiveness is the number of impressions it produces. An **impression** occurs every time an ad appears on a Web page, whether or not the user clicks on the ad to explore it. Another common way of judging the effectiveness of banner ads is the **click-through rate**, which is calculated by dividing the number of times customers actually click on the banner ad by the number of impressions for that ad. For instance, if an ad is displayed 1,000 times and 12 customers actually click on the ad and go to the advertiser's Web site, the ad's click-through rate is 1.2 percent ($12 \div 1,000$). Banner ads suffer from a very low click-through rate—just 0.1 percent compared to an average click-through rate of 2.5 percent for search engines.²⁶ The cost of a banner ad to an advertiser depends on the number of prospects who actually click on it.

The primary disadvantages of banner ads is that Web users dislike them and can easily ignore them. These ads have become such a part of the landscape of the Web that users tend to ignore them. Web designers search for the best page placement for banner ads and add unique features that will catch users' attention and encourage them to click through. Another form of

interstitial ads, and contextual ads. A **pop-up ad** is a separate window in which an ad pops up spontaneously, blocking the site behind it. It is designed to grab consumers' attention for the few nanoseconds it takes them to close the window. One danger is the negative view that Internet users have of pop-up ads, which they perceive as an annoying intrusion. A slight variation on this ad is the "pop-under" ad that immediately goes behind the active screen but stays open until the browser window is closed. An **interstitial ad** is an ad page that appears for a short time before a user-requested page appears. These ads are also called transition ads, splash pages, and flash pages.

Contextual ads appear on users' screens when they download information such as news, sports, or entertainment from another site, and the ad is correlated to the user's interest or online behavior. For instance, a Web user downloading sports information might receive an ad for athletic shoes or T-shirts with the information, and one conducting a search for vitamins might receive an ad for green tea or herbal remedies. To catch the attention of Web users, many advertisers, particularly those companies who aim their products at young customers, are using video ads rather than traditional display ads. Retargeted ads are display ads that pop up after a user visits a company's Web site or types a key word into a search engine.

Pay-per-click ads require companies to bid on top-ranking search engine listings using key words that they expect Internet users to type into a search engine when they are interested in purchasing a particular product or service. The higher a company's bid is for a key word, the more prominent is the location of its ad on the results that the search engine returns. Companies pay for an ad only when a prospect actually clicks on it. Entrepreneurs who advertise on the Internet should consider making pay-per-click ads a part of their advertising strategies. According to a study by the Pew Internet and American Life Project, 73 percent of all Americans use search engines.²⁷ Google, Bing, and Yahoo!, the three leading search engines, account for about 95 percent of all searchers, and advertisers who want to increase the odds of reaching their target audiences should advertise on all three.²⁸

To calculate the maximum amount a company can afford to bid on a key word, use the following formula:

$$\text{Maximum key word bid} = \text{Conversion rate} \times \text{Profit per sale}$$

Conversion rates vary from one online industry to another, but the average conversion rate is about 3.2 percent. That means that for every 1,000 visitors to a company's site, 32 of them actually make a purchase. For a company that has a conversion rate of 3.2 percent and an average profit per order of \$12, the maximum amount the owner should bid on a key word is the following:

$$\text{Maximum key word bid} = 3.2\% \times \$12 = 38.4 \text{ cents}$$

Used properly, pay-per-click ads can drive customers to a company's Web site even before the search engines discover it and include it in their natural or organic listings. Pay-per-click ads also allow advertisers to test the effectiveness of different ads by running several variations at once (e.g., one version might include a discounted price, and another might include a free accessory). These ads are efficient because advertisers pay for an ad only when a customer actually clicks on it. **Click fraud**, which occurs when a person or a computer program generates ad clicks even though they have no interest in the advertiser's product or service, is a danger to entrepreneurs who use pay-per-click ads. The click fraud rate on search engines ranges from 13 and 18 percent, with an average of 14.7 percent.²⁹

E-MAIL ADVERTISING E-mail is the most common application on the Internet, and e-mail advertising capitalizes on that popularity. The Radicati Group estimates that Internet users have more than 3.3 billion e-mail accounts, and only 14 percent of them originate in North America!³⁰ **E-mail advertising**, in which companies broadcast their advertising messages by e-mail, is growing rapidly because it is so effective and so inexpensive. Retailers send an average of almost 15 e-mail promotions to their subscribers each month (177 per year). The busiest month for e-mail promotions, of course, is December (with 22 campaigns), and February is the slowest (with 12 campaigns). The most popular days for sending promotional e-mails are Friday and Monday, and Saturday is the least popular day.³¹

E-mail advertising takes two forms: permission e-mail and spam. As its name suggests, **permission e-mail** involves sending e-mail ads to customers with their permission; **spam** is unsolicited commercial e-mail. The Radicati Group also estimates that despite modern anti-spam technology, 15 percent of all delivered e-mail messages are spam.³² Because most e-mail users see spam as a nuisance, they often view companies that use it in a negative fashion. Smart entrepreneurs do *not* rely on spam in their marketing strategies; they know that the quality of their companies' e-mail list is more important than its quantity. Permission e-mail messages typically produce very high response rates and attractive returns on investment because recipients are more engaged. According to a global study by Silverpop, an e-mail marketing services company, the average open rate for e-mail ads is 20.1 percent, and the average click-through rate is 5.2 percent.³³ **Triggered e-mails**, those that companies send in response to a potential customer's actions, such as registering on a company's Web site or abandoning a shopping cart, have even higher open and click-through rates at 48 and 10 percent, respectively.³⁴

Forrester Research reports that 38 percent of e-mail users open their e-mail on a mobile device such as a smart phone; by 2017, 78 percent of users will access their e-mail via a mobile device. In addition, 56 percent of smart phone users in the United States who have made a purchase from their phones did so in response to an e-mail message.³⁵ As the number of smart phone users continues to grow, entrepreneurs must recognize that customers' in-boxes are moving targets and adapt their e-mail marketing strategies to accommodate smaller screen sizes. Keeping message size below 50 kilobytes so that they load quickly and optimizing them with simple designs and attention-getting call-to-action buttons so that mobile users can navigate them easily increase click-through rates. Scanning printed quick response (QR) codes allows shoppers to use their smart phones or tablets to go directly to a Web site linked to the QR code without having to type in a URL.

Building an e-mail list simply requires attention to the basics of marketing. The goal is to encourage potential buyers to share their e-mail addresses. Monument Lane, a restaurant in New York City's West Village, has been successful gathering customers' e-mail addresses by including a card with customers' bills.³⁶ Offering a reward, such as a white paper report, a one-time discount, a special offer, or an entry in drawing for a prize, increases the likelihood that customers will share their e-mail addresses. Once a small company obtains potential customers' e-mail addresses, the next step is to send messages that are useful and interesting to them. The message must be geared to their interests, highlight the product's USP, and include a link to a landing page that allows them to purchase the product easily. Entrepreneurs also must track the success and the returns that their e-mail marketing campaigns deliver with appropriate e-mail analytics.

Many companies have success with e-mail ad campaigns that produce immediate results and are very inexpensive to conduct.



ENTREPRENEURIAL PROFILE: Eric Shamban and Gilbert Johnson: The Chocolate

Bar Eric Shamban and Gilbert Johnson launched The Chocolate Bar (TCB) in 2001 in Houston, Texas, as a haven for chocolate lovers. The original store, located near Rice University, offers a variety of freshly made chocolate-themed treats, including candy, cookies, cakes, pies, ice cream, and a unique chocolate pizza. Customers also can select a specific chocolate blend and choose from a menu of nuts, fruits, and other ingredients to make their own chocolate bars. The entrepreneurs had been collecting customers' e-mail addresses as part of a weekly free dessert contest but had not engaged in any e-mail marketing until they opened their second Houston location and hired Lynne Singerman, TCB's Ambassador of Chocolate. "My goal is to create awareness of our new location and introduce the happy spirit of The Chocolate Bar to all chocolate lovers," says Singerman. She worked with e-mail marketing company Constant Contact to more than triple the size of TCB's e-mail list and to create clever e-mail marketing campaigns to make customers aware of the company's new location, special products, gift ideas, and calendar of events, including live music nights. TCB's first e-mail newsletter was a hit with customers, not only generating an open rate of nearly 50 percent but also increasing in-store traffic. Singerman enjoys the flexibility and speed of e-mail ad campaigns. "Within moments of an e-mail going out, we are getting responses from people," she says. Because of the informational reports that Singerman receives after each ad goes out, TCB constantly fine-tunes its e-mail campaign and has an impressive 62.7 percent click-through rate.³⁷



Lessons from the Street-Smart Entrepreneur

E-Mail Ads That Produce Results

Launched in 2007 as a small jewelry company selling beads on e-Bay, Ana Silver Company grew quickly, ultimately specializing in selling jewelry made from the finest sterling silver and semi-precious stones. Today, Ana Silver is the top seller of jewelry on e-Bay, stocking more than 100,000 pieces of unique silver jewelry, including bracelets, earrings, necklaces, pendants, and rings. Within two years, sales had grown to \$1 million, but co-owner George Liang believed that the company could accelerate its sales growth dramatically by connecting more closely with its customers. “We didn’t really communicate with our customers after their purchases,” he says. “E-bay sent an automatic newsletter to our customers, but we didn’t have any ongoing outreach.”

Liang wanted a low-cost, effective way to drive customers to Ana Silver’s e-Bay store and to inform them about new products and special sales. He saw e-mail marketing as the ideal solution, one that would allow the company to create efficient, personalized ad campaigns targeting its base of 50,000 customers. Not wanting to overwhelm customers with too many messages, Ana Silver settled on sending one e-mail ad to them each week, but customers can (and many do) opt in to receive more frequent messages from the company. “Every time we send out an e-mail, 60 to 80 customers make a purchase,” says Liang. “We may sell several hundred items from one e-mail.” One recent e-mail ad went out at 6 a.m., and by that afternoon, Ana Silver had received 50 orders and sold more than 200 pieces of jewelry. Just one year after launching its e-mail advertising campaign, Ana Silver’s annual sales reached \$10 million.

Businesses spend \$1.7 billion a year on e-mail marketing campaigns, and experts expect that number to grow to \$2.5 billion by 2016. What makes e-mail marketing appealing, especially to entrepreneurs such as George Liang, is that it is inexpensive, it is measurable, and it works. Studies by the Direct Marketing Association suggest that every \$1 that companies spend on e-mail marketing produces a return of \$44. In addition, according to ExactTarget’s Channel Preference Survey, 77 percent of Internet users of all ages say that their preferred method of receiving permission-based promotional messages is e-mail. (The second most preferred method is direct mail at just 9 percent.) Entrepreneurs who want to reproduce the success that Ana Silver has created using an e-mail advertising campaign should consider the following tips from the Street-Smart Entrepreneur:

Make a concerted effort to collect customers’ (and potential customers’) e-mail addresses. Every contact that anyone in your company has with a customer presents an opportunity to collect another e-mail address. Seize them! Ensure that everyone in the company understands the importance of building an accurate and reliable e-mail list because that’s where e-mail marketing success starts.

Recognize the power of simplicity. Ads that generate the highest response rates focus on a single call to action, which allows the advertiser to keep the message simple and focused. Don’t try to accomplish too much in an e-mail

in the e-mail’s second (short) paragraph; the first paragraph should explain the benefits that your company’s product or service can provide the recipient.

Make sure the e-mail’s subject line emphasizes your company’s USP. Without the right subject line, e-mail recipients may never open the e-mail. The most effective subject line messages are short; however, one study of more than 1.2 billion e-mail marketing messages by MailerMailer concludes that the highest click-through rates occur when the subject line included fewer than 40 characters, including spaces. The best subject lines suggest the product’s or service’s USP (refer to Chapter 9). For example, “Fresh lunch FAST—just \$5.99!” in the subject line of an e-mail expresses several product features to potential customers. Other subject line words that produce responses include “new,” “sale,” “save,” “you,” “instant,” “newsletter,” “news,” and “free.” Including links in the e-mail also increases a message’s click-through rate; the more links you include, the more likely the recipient is to click through on at least one of them.

Make sure your e-mails’ look and feel are consistent with your company’s overall image. Every component of a company’s advertising campaign should have a look and feel that is consistent with its brand, even though the ads may appear in many diverse media. The design of a company’s e-mail ads should rely on the same colors, themes, slogans, and look as its ads in other media.

Send e-mails when customers are most likely to make their purchases. Proper timing of e-mail ads can improve customer response rates dramatically. Messages sent on Sunday produce the highest click-through rates. January, July, August, and December are the months in which customers are *least* likely to pay attention to e-mail ads (although there are exceptions). E-mail messages sent between 4 p.m. and 8 a.m. yield the highest click-through rates, and those sent in the middle of the day produce the lowest response rates. Companies must time their e-mail ads to correspond to their customers’ demand for their products and services.

Write copy that produces the results you seek. Start by concentrating on one idea. Before writing any copy, develop a mental picture of your target customer. Give him or her a name and try to envision how your company’s product or service can benefit him or her. This will help you keep your ad copy focused on the USP you put in the subject line of the e-mail. When appropriate, consider including an endorsement from an existing customer (perhaps with a photo) to add credibility to your claims. Be sure to provide clearly visible links to your company’s Web site at several places in the e-mail ad, including at the top and the bottom of the page. Always include a prominent call to action: How do you want the customer to respond?

Incorporate social networking links and video into e-mails. Adding “Like us on Facebook” or “Follow us on Twitter” links to e-mails encourages customers to engage your company in other media and to promote it to their friends. The E-Mail Marketing Trends Survey reports that 53.8 percent of small business owners say that including video in e-mails increases their company’s click-through and open rates. Buttons that allow customers to download videos, forward them to friends, or post them on their Facebook pages encourage the viral nature of the Web to expand their advertising efforts many times over.

Use value-added items to increase your campaign’s response rate. In the typical in-box, there are dozens (if not more) of messages competing for the person’s attention. One way to boost your campaign’s response rate is to offer recipients something of value—for example, a coupon, a newsletter, or a white paper. Betsy Harper, CEO of Sales and Marketing Search, an executive search firm that specializes in sales and marketing positions, says that publishing a monthly e-mail newsletter that includes hiring trends and tips has improved her company’s visibility, reputation, and sales. Recently, says Harper, “within two minutes (literally!) of sending our e-mail newsletter, I got an e-mail from a fellow in New York. He asked me to call him right away about filling a senior sales position. We talked, signed an agreement to work together the very next day, and started the search. We finished the search in record time and received a \$22,000 fee.”

Always comply with the CAN-SPAM Act. The CAN-SPAM Act, a law that sets the rules for commercial e-mail, establishes requirements for commercial messages, gives recipients the right to opt out of e-mails, and spells out tough penalties for violators.

Never stop testing. Successful e-mail advertisers never stop experimenting with variations on their ads, testing to see which products, pitches, subject lines, timing, and other elements produce the highest response rates.

Sources: Based on “Case Study: Ana Silver Company,” Campaigner, 2012, www.campaigner.com/solutions/success-stories/ana-silver.aspx; Bob Krummert, “E-Mail Rules Social Media, Even for Fans,” Restaurant Hospitality, April 17, 2012, <http://restaurant-hospitality.com/social-media/email-rules-social-media-even-fans>; Darrell Zahorsky, “The 6 Laws of Small Business Advertising Success,” About, 2012, sbinformation.about.com/cs/advertising/a/aa022303a.htm; “The Case for Short and Sweet,” Marketing Profs, August 22, 2012, www.marketingprofs.com/short-articles/2627/the-case-for-short-and-sweet; David Schwartz, “E-Mail Marketing Earns a Staggering \$44 Return on Investment per Dollar Spent. Beats Wall Street Yields,” SOS Marketing, May 8, 2011, www.sosmarketing.com/2011/05/08/e-mail-blasts-earn-a-staggering-44-return-on-investment-per-dollar-spent; “Our Twelfth E-Mail Metrics Report,” MailerMailer, July 2012, www.mailermailer.com/resources/metrics/index.rwp; Lisa Barone, “E-Mail Marketing Success Is About Relevance,” Small Business Trends, June 18, 2009, <http://smallbiztrends.com/2009/06/email-marketing-success.html>; Peter Prestipino and Mike Phillips, “E-Mail Marketing’s Future . . . Right Now,” Website, November 2009, pp. 26–29; Michelle Keegan, “Real Life Small Business Newsletter Tips,” Constant Contact, www.constantcontact.com/learning-center/hints-tips/volume10-issue2.jsp; Gail Goodman, “Writing Compelling Promotional Copy,” Constant Contact, www.constantcontact.com/learning-center/hints-tips/hr-2006-07.jsp; Ivan Levison, “Five Common E-Mail Mistakes and How to Avoid Them,” Levison Letter 17, no. 2 (April 2002), www.levison.com/email-advertising.htm; “You’ve Got the Power,” MarketingProfs 1, no. 23 (May 22, 2008); 2010 E-Mail Marketing Trends Survey, GetResponse, 2010, p. 5.

SOCIAL MEDIA ADVERTISING Although search engine advertising (those ads that appear next to search results on search engines) account for the greatest percentage of companies’ online advertising expenditures (more on those techniques in Chapter 13), growing numbers of entrepreneurs are investing in social media advertising, placing pay-per-click ads on popular social media sites such as Facebook, Twitter, and others (see Figure 10.6).



FIGURE 10.6
Social Media Advertising Expenditures in the United States (in Billions of \$)

Facebook Ads Entrepreneurs can purchase ads on Facebook and tap into the potential customer base of more than 1 billion Facebook users worldwide. Once you decide what to advertise (e.g., a specific page on the company's Web site, a Facebook post, or a registration page for an event), you create your ad by writing a brief headline and a short description and uploading a thumbnail photograph. Then you choose your target audience (ads for narrowly defined audiences are more likely to be displayed) by defining a geographic region (country, state, city, or ZIP code), age, gender, and broad categories (e.g., parents or people interested in country music or cooking) or specific interests, such as the products or services that you sell. For instance, a wedding planner in Fort Worth, Texas, could target her ads to women within the city whose relationship status is "engaged." Facebook also gives you the ability to bid on pay-per-click ads (you pay for the ad only when a user actually clicks on it) and to limit the total amount you spend on the campaign (either a daily budget or the maximum amount for the entire campaign). Finally, Facebook gives advertisers useful feedback on their ads' performances and allows them to generate useful reports that make comparing different advertisements simple.



ENTREPRENEURIAL PROFILE: Stuart Weitzman: Legendary shoe designer Stuart Weitzman expanded the reach of his business with the help of Facebook. Weitzman learned about the popularity of his shoes in different markets on Facebook, and then expanded the presence of his company in countries where the Facebook metrics were positive. After studying click-through rates, Weitzman ran targeted Facebook advertisements appealing to a potential young customer base. Success of the Facebook campaign enabled the company to increase its in-store presence in Dubai and in other Asian markets.³⁸

Twitter Ads On Twitter, small businesses can advertise their businesses through promoted accounts and promoted tweets. By signing up for a promoted account, Twitter identifies people who have interests that are similar to a company's current followers and promotes the company in these prospects' "Who to follow" sections, allowing the business to gain new followers who can spread the word about the company. With promoted tweets, Twitter constantly monitors a company's best, most engaging tweets and promotes them to people both on the Web and on mobile devices, which allows business to reach customers on the go. Like Facebook, you pay only when someone follows your account or engages in your promoted tweet. Twitter allows entrepreneurs to focus their ads within a specific geographic location and to limit the amount they spend per campaign.

*Bonobos, the online clothing retailer, also has had great success with Twitter ads. "On short notice, we can launch campaigns on Twitter with minimal effort and low costs compared to traditional media channels," says David Fudge, the company's head of social media. "Twitter gives us quick access to an engaged audience and drives customers directly to our Web site for purchases." When Bonobos advertised a "Twixclusive" (only on Twitter) 24-hour sale, the campaign landed 100 first-time customers and produced an impressive 1,200 percent return on investment.*³⁹

SPONSORSHIPS AND SPECIAL EVENTS Although sponsorships and special events are a relatively new advertising medium for small companies, a growing number of small businesses are finding that sponsoring special events attracts a great deal of interest and provides a lasting impression of the company in customers' minds. As customers become increasingly harder to reach through any single advertising medium, companies of all sizes are finding that sponsoring special events—from wine tastings and beach volleyball tournaments to fitness walks and barbecue festivals—is an excellent way to reach their target audiences. Businesses in the United States spend \$13.6 billion a year event sponsorships.⁴⁰



ENTREPRENEURIAL PROFILE: Bobby Harris: BlueGrace Logistics Bobby Harris, founder of BlueGrace Logistics, a company that manages freight hauling and shipping for businesses, discovered that many of his company's customers (shipping managers) are fans of mixed martial arts events. To promote his company, Harris has sponsored more than 20 Ultimate Fighting Championship (UCF) competitors at rates that are far below those that most professional sports charge their sponsors. Several of the athletes that BlueGrace has sponsored have appeared in national magazines and on network television sporting the company's logo. In addition to the company's logo appearing on competitors' clothing, the company benefits from UCF athletes promoting BlueGrace on their social media posts.⁴¹

A wide range of sponsorships exists. Sponsoring a hole at a charitable golf outing may cost as little as \$100, but landing the name of your business or product on the hood of a car driven by a NASCAR racer can cost \$8 million or more. Sponsorships and participation in special events can be very cost-effective if an entrepreneur selects events whose attendees are potential customers. For instance, a company whose target audience is women between the ages of 35 and 54 with household incomes that exceed \$150,000 might consider sponsoring equestrian events because they draw that demographic. Local festivals and events gain a sponsor a great deal of positive publicity for a modest sponsorship fee. Support for charity functions enhances the sponsor's community image, increases sales, and often attracts new customers.

Small companies do not have to rely on other organizations' events to generate advertising opportunities; they can create their own special events. The owner of *Quadrille Quilting* in North Haven, Connecticut, partnered with the owners of two other quilting shops to create *Shop Hops*, an event in which customers buy "passports" to all three stores that entitle them to refreshments and special prizes. The first *Shop Hop*, which took place on a *Super Bowl* weekend, generated an entire month's sales in just one day for *Quadrille Quilting*.⁴²

Creativity and uniqueness are essential ingredients in any special event promotion, and entrepreneurs excel at those. The following tips help entrepreneurs get the greatest promotional impact from event sponsorships:

- Do not count on sponsorships for your entire advertising campaign. Sponsorships are most effective when they are part of a coordinated advertising effort. Most sponsors spend no more than 10 percent on their advertising budgets or sponsorships.
- Look for an event that is appropriate for your company and its products and services. The owner of a small music store in an upscale mountain resort sponsors a local jazz festival every summer during the busy tourist season and generates lots of business among both residents and tourists. Ideally, an event's audience should match the sponsoring company's target audience. Otherwise, the sponsorship will be a waste of money.
- Research the event and the organization hosting it *before* agreeing to become a sponsor. How well attended is the event? What is the demographic profile of the event's visitors? Is it well organized?
- Try to become a dominant (or, ideally, the only) sponsor of the event. A small company can be easily lost in a crowd of much larger companies sponsoring the same event. If sole sponsorship is too expensive, make sure that your company is the only one from its industry sponsoring the event.
- Clarify the costs and level of participation required for sponsorship up front.
- Get involved. Do not simply write a check for the sponsorship fee and then walk away. Find an event that is meaningful to you, your company, and its employees and take an active role in it. Your sponsorship dollars will produce a higher return if you do.

TELEVISION In advertising dollars spent, television ranks first in popularity of all media. Although the cost of national television ads precludes their use by most small businesses, local spots on cable television can be an extremely effective means of broadcasting a small company's message. A 30-second commercial on network television may cost more than \$500,000 (a 30-second spot during the *Super Bowl* sells for \$3.5 million, up from \$600,000 in 1987), but a 30-second spot on local cable television, which is in 60.4 percent of U.S. homes, may go for as little as \$10 in small markets.⁴³



ENTREPRENEURIAL PROFILE: Bill Geiger: Oregon Mint Company Bill Geiger, founder of

Oregon Mint Company, a company that makes Mint Snuff, a chewable mint designed to help people stop using chewing tobacco, sells his products through select retail stores nationwide and through the company's Web site. Geiger knows that his target customers are the wives, girlfriends, and mothers of chewing tobacco users and for years had used cable television ads that promoted the benefits of Mint Snuff. Geiger used an application called *SpotMixer* to create a television commercial from his computer. "It was incredibly easy," he says. "I built my ad at 1:30 in the morning in just 25 minutes." He also used Google TV Ads to decide which cable networks across the nation to use and to target while placing caps on costs. Geiger continues to test the effectiveness of his ads on different networks and television programs to determine which ones generate the

greatest response. Since Geiger began running his television ads with the help of Google TV Ads, sales of Mint Snuff have increased fivefold. “Google TV Ads and SpotMixer have allowed me to reach my audience affordably,” he says.⁴⁴

Television advertising offers a number of distinct *advantages*:

Broad coverage. Television ads provide extensive coverage of a sizable region, and they reach a significant portion of the population. Television reaches 88.3 percent of adults every day, exceeding the reach of all other major advertising media.⁴⁵ In fact, the average household spends 8 hours and 21 minutes each day tuned in to television.⁴⁶ The typical adult sees 26 commercial breaks a day, for a total of 73 minutes of advertisements.⁴⁷

Ability to focus on a target audience. Because many cable channels focus their broadcasting in topical areas—from home and garden or food to science or cartoons—cable television offers advertisers the ability to reach specific target markets much as radio ads do. Because an inverse relationship exists between time spent in television viewing and education level, television ads overall are more likely to reach people with lower educational levels.

Visual advantage. The primary benefit of television is its capacity to present the advertiser’s product or service visually. With television ads, entrepreneurs are not limited to mere descriptions of a product or service; instead, they can demonstrate their uses and show firsthand their advantages. For instance, a small retail store selling a hydraulic log splitter can design a television commercial to show how easily the machine works. The ability to use sight, sound, and motion makes television ads a powerful selling tool.

Flexibility. Television ads can be modified quickly to meet the rapidly changing conditions in the marketplace. Advertising on television is a close substitute for personal selling. Like a sales representative’s call, television commercials can use “hard-sell” techniques, attempt to convince through logic, appeal to viewers’ emotions, persuade through subtle influence, or use any number of other strategies. In addition, advertisers can choose the length of the spot, its time slot, and even the program during which to broadcast the ad.

Design assistance. Few entrepreneurs have the skills to prepare an effective television commercial. Although professional production firms might easily charge \$50,000 to produce a commercial, the television station from which an entrepreneur purchases airtime often will help design and produce an ad very inexpensively.

Television advertising also has several *disadvantages*:

Brief exposure. Most television ads are on the screen for only a short time (30-second spots are most common) and require substantial repetition to achieve the desired effect. One of the realities is that television viewers often avoid or ignore the commercial messages.

Clutter. By the age of 65, the average person has seen more than 2 million television commercials, and more ads are on the way!⁴⁸ With so many television ads beaming across the airwaves, a small company’s advertising message easily could become lost in the shuffle.

Zapping and zipping. **Zappers**, television viewers who flash from one channel to another during commercials, and **zippers**, those who use digital video recording devices such as TiVo to fast-forward through commercials, pose a real threat to television advertisers. Zapping and zipping can cut deeply into an ad’s reach, preventing television advertisers from reaching the audiences they hope to reach. Zipping poses a significant threat because 43 percent of U.S. households now own a DVR device (compared to just 12.3 percent in 2007).⁴⁹

Fragmented audience. As the number of channels that cable and satellite providers offer proliferates, the question of where to advertise becomes more difficult to answer. The typical television viewer now has about 145 channels from which to choose. The dramatic increase in the number of channels available has fragmented the audience that an ad run on a single channel will reach.

Costs. Television commercials can be expensive to create. A professionally done 30-second ad can cost several thousand dollars to develop, even before an entrepreneur purchases

TABLE 10.2 Guidelines for Creative Television Ads

- **Keep it simple.** Avoid confusing the viewer by sticking to a simple concept.
- **Have one basic idea.** The message should focus on a single, important benefit to the customer. Why should people buy from your business?
- **Make your point clear.** The customer benefit should be obvious and easy to understand.
- **Make it unique.** To be effective, a television ad must reach out and grab the viewer's attention. Take advantage of television's visual experience.
- **Get viewers' attention.** Unless viewers watch the ad, its effect is lost.
- **Involve the viewer.** To be most effective, an ad should portray a situation to which the viewer can relate. Common, everyday experiences are easiest for people to identify with.
- **Use emotion.** The most effective ads evoke an emotion from the viewer—a laugh, a tear, or a pleasant memory. A recent study by Adobe reports that 73 percent of consumers say that an advertisement should tell a unique story rather than merely attempt to sell.
- **Consider production values.** Television offers vivid sights, colors, motions, and sounds. Use them to your advantage!
- **Prove the benefit.** Television allows an advertiser to prove a product's or service's customer benefit by actually demonstrating it.
- **Identify your company well and often.** Make sure your store's name, location, Web site, and product line stand out. The ad should portray your company's image.

Source: Based on Television Bureau of Advertising, *How to Make a Creative Television Commercial*, New York, NY; Adobe, *Click Here: The State of Online Advertising* (San Jose, CA: October 2012), p. 14.

airtime. The cost per thousand households reached for network ads is \$14.50, and for cable ads it is \$6.⁵⁰ Advertising agencies and professional design firms offer design assistance—sometimes at hefty prices—leading many small business owners hire less expensive freelance ad designers or turn to the stations on which they buy airtime for help with their ads. Table 10.2 offers some suggestions for developing creative television commercials.

USING TELEVISION CREATIVELY Although television ads are not affordable for every small business, many entrepreneurs have found creative ways to use the power of television advertising without spending a fortune. Two popular methods include creating infomercials and using home shopping networks. **Infomercials** (also called **direct-response television**) come in two lengths: short-form, two- to three-minute pitches and long-form, 30-minute television full-length commercials packed with information, testimonials, and a sales pitch asking for an immediate response. The length of these ads allows entrepreneurs to demonstrate and explain their products in detail and to show customers the benefits of using them, a particularly important consideration for a new or complex product. Producing and airing a half-hour infomercial can be expensive, often costing \$300,000 to \$1 million, depending on its production quality, format, content, celebrity involvement, and broadcast schedule. Short-form infomercials cost about \$15,000 to \$20,000 to produce. Because most infomercials ask for an immediate response from viewers, entrepreneurs can gauge their success at landing customers, sometimes within minutes of airing them and almost always within one week. Products such as the Shamwow, Snuggie, PedEgg, and Total Gym have reached millions of units in sales with the help of infomercials.

 **ENTREPRENEURIAL PROFILE: Tom Campanaro: Total Gym Inc.** Tom Campanaro, a former bodybuilder, launched Total Gym Inc. in 1974 to sell the pulley-based home workout system that he had developed. Campanaro created a 30-minute infomercial starring Total Gym user and celebrity Chuck Norris and Christie Brinkley. The infomercial, which at 15 years and counting holds the record for the longest-running infomercial in history, has proved to be highly successful, leading to sales of more than \$1 billion of the Total Gym, which retails for between \$600 and \$900.⁵¹

Only one in 10 products that rely on infomercials succeeds.⁵² To become an infomercial star, a product should meet the following criteria:

- Be unique and of good quality.
- Solve a common problem.

- Be easy to use and easy to demonstrate.
- Appeal to a mass audience.
- Have an “aha! factor” that makes customers think “What a great idea!”

Shopping networks such as QVC, HSN, and ShopNBC, which reach about 100 million homes in the United States, offer entrepreneurs another route to television. Although time on these networks is free, getting a product accepted is difficult; networks accept only about 3 to 4 percent of the items they review. Shopping networks look for items that have “demonstration appeal” and offer viewers attractive benefits. Entrepreneurs must exercise caution, however, because sales are on consignment (the network pays only for the items it actually sells), and returns may pose problems because most networks offer 100-percent-satisfaction guarantees. In addition, the networks pay for the items that sell 30 to 60 days after the sale, which sometimes causes cash flow problems for small businesses. The upside is that entrepreneurs have the potential sell thousands of products in just a matter of minutes.

RADIO With 11,000 on-air stations, 7,000 streaming stations, and 1,800 digital stations, radio permits advertisers to reach specific audiences over large geographic areas. By choosing the appropriate station, program, and time for an ad, a small company can reach virtually any target audience.

Radio advertising offers several *advantages*:

Extensive reach. Radio’s nearly universal presence gives advertisements in this medium a major advantage. Nearly every home and car in the United States is equipped with a radio, which means that radio ads receive a tremendous amount of exposure in the target market. Although the myriad entertainment options available has reduced the time that customers spend with any particular advertising media, the average adult spends nearly 15 hours each week listening to the radio. According to the Radio Advertising Bureau, radio reaches 92.5 percent of adults each week.⁵³

Audience delivery. Radio commercial breaks retain on average 92 percent of the lead-in listening audience, which means fewer commercial zappers than television ads experience.⁵⁴

Market segmentation. Radio advertising is flexible and efficient because advertisers can choose stations aimed at a specific market within a broad geographic region. Radio stations design their formats to appeal to specific types of audiences. (Ever notice how the stations you listen to are not the same ones your parents listen to?) AM stations, which once ruled the airways, now specialize mainly in “talk formats,” such as call-in, news, religion, sports, and automotive shows. On the FM dial, country, urban contemporary, classical, classic rock, rhythm and blues, Hispanic, and “oldies” stations have listener profiles that give entrepreneurs the ability to pinpoint practically any advertising target.

Flexibility and timeliness. Radio commercials have short closing times and can be changed quickly. Small firms that sell seasonal merchandise or advertise special sales or events can change their ads on short notice to match changing market conditions.

Friendliness. Radio ads are more “active” than ads in printed media because they use the spoken word to influence customers. Vocal subtleties used in radio ads are impossible to convey through printed media. Spoken ads can suggest emotions and urgency, and they lend a personalized tone to the message.

Radio advertisements also have some *disadvantages*:

Poor listening. Radio’s intrusiveness into the public life almost guarantees that customers will hear ads, but they may not listen to them. Listeners are often engaged in other activities while the radio is on and may ignore the message.

Need for repetition. Listeners usually do not respond to radio ads after a single exposure to them. Radio ads must be broadcast repeatedly to be effective. Consistency in radio ads is the key to success.

Limited message. Radio ads are limited to one minute or less, which requires that business owners keep their messages simple, covering only one or two points. In addition, radio spots do not allow advertisers to demonstrate their products or services. Although listeners can hear the engine purr, they can’t see the car; spoken messages can only describe the product or service.

TABLE 10.3 Guidelines for Effective Radio Copy

- **Mention the business often.** This is the single most important and inflexible rule in radio advertising. Also make sure listeners know how to find your business. If the address is complicated, use landmarks.
- **Stress the benefit to the listener.** Don't say "Dixon's has new fall fashions." Say "Dixon's fall fashions make you look fabulous."
- **Use attention-getters.** One key to a successful radio ad is grabbing listeners' attention from the start and holding it. Radio gives the options of music, sound effects, and unusual voices. Crack the barrier with sound.
- **Zero in on your audience.** Know to whom you're selling. Radio's selectivity attracts the right audience. It's up to you to communicate in the right language.
- **Keep the copy simple and to the point.** Don't try to impress listeners with vocabulary. "To be or not to be" may be the best-known phrase in the language—and the longest word has just three letters.
- **Sell early and often.** Don't back into the selling message. At most, you've got 60 seconds. Make the most of them. Don't be subtle.
- **Write for the ear.** Forget the rules of grammar; write conversationally.
- **Prepare your copy.** Underline words you want to emphasize so that the announcer knows how the ad should read.
- **Triple space.** Type clean, legible copy. Make sure the announcer rehearses the ad.
- **Use positive action words.** Use words such as *now* and *today*, particularly when you're writing copy for a sale. Radio has qualities of urgency and immediacy. Take advantage of them by including a time limit or the date the sale ends.
- **Put the listener in the picture.** Radio's theater of the mind means you don't have to talk about a new car. With sounds and music, you can put the listener behind the wheel.
- **Focus the spot on getting a response.** Make it clear what you want the listener to do. Don't try to get a mail response. Use phone numbers or a Web site address only and repeat the number at least three times. End the spot with the phone number or the Web address.
- **Don't stay with a loser.** Direct-response ads produce results right way—or not at all. Don't stick with a radio spot that is not generating sales. Change it.

Sources: Kim T. Gordon, "Turn It Up," *Entrepreneur*, January 2004, pp. 80–81; Radio Advertising Bureau, New York, NY, *Radio Basics*.

BUYING RADIO TIME A small business owner can zero in on a specific advertising target by using the appropriate radio station. Stations following various formats—from rap to rhapsodies—appeal to specific audiences. Radio advertising time usually sells in 15-second, 30-second, and 60-second increments. Many radio stations now offer five-second spots called "adlets" and even super-short one- or two-second "blinks" that are designed to increase the awareness of a brand among listeners. Fixed spots are guaranteed to be broadcast at the times specified in the owner's contract with the station. Preemptible spots are cheaper than fixed spots, but the advertiser risks being preempted by an advertiser willing to pay the fixed rate for a time slot. Floating spots are the least expensive, but the advertiser has no control over broadcast times. Many stations offer package plans, using flexible combinations of fixed, preemptible, and floating spots. Table 10.3 offers a guide to producing effective radio copy.

Radio rates vary depending on the time of day they are broadcast, and, like television, there are prime-time slots known as drive-time spots. Although exact hours may differ from station to station, the following classifications are common (listed in descending order of cost):

Class AA: Morning drive time—6 A.M. to 10 A.M.

Class A: Evening drive time—4 P.M. to 7 P.M.

Class B: Home worker time—10 A.M. to 4 P.M.

Class C: Evening time—7 P.M. to midnight

Class D: Nighttime—midnight to 6 A.M.

Some stations may have different rates for weekend time slots.



ENTREPRENEURIAL PROFILE: Robin and Chris Sorensen: Firehouse Subs

Robin and Chris Sorensen, former firefighters and cofounders of Firehouse Subs, a chain of sandwich shops with nearly 600 locations, watched as a recession caused sales to decline. "In our entire history, we had never had a period when our entire system was running negative sales," says CEO Don Fox. Research showed that customers were still buying from lower-priced restaurants such as Firehouse Subs and indicated that the company's declining sales problem stemmed from a lack of brand differentiation. Firehouse Subs launched a brand-building radio campaign that emphasized the company's USP and included the Sorensens as spokesmen. "Our way beats their way," the ad

said. "If you don't agree, it's free." The ads "turned things around on a dime," says Fox, pointing out that sales increased by more than 10 percent. "We immediately went to positive sales for the entire system."⁵⁵

NEWSPAPERS For decades, local print newspapers were the medium that most small businesses relied on to get their advertising messages out to customers. Online media have reduced significantly the money that businesses of all sizes spend on newspaper ads. Both the circulation and the number of newspapers in the United States have declined, as has the share of total advertising dollars the medium attracts. The circulation of nation's 1,382 daily newspapers has declined from 62.2 million in 1980 to 44.4 million today, and many papers have added online versions of their content in an attempt to offset the decline.⁵⁶ Newspapers provide several *advantages* to small business advertisers:

Selected geographical coverage. Newspapers are geared to a specific geographic region, and they reach potential customers across all demographic classes. Local newspapers, in particular, provide extensive coverage of a company's immediate trading area.

Flexibility. A business can change its newspaper advertisements on very short notice. Entrepreneurs can select the size of the ad, its location in the paper, and the days on which it runs. For instance, auto repair shops often advertise their tune-up specials in the sports section on weekends, and party shops display their ads in the entertainment section as the weekend approaches.

Timeliness. Newspapers almost always have very short closing times, the publication deadline prior to which the advertising copy must be submitted. Many newspapers allow advertisers to submit their copy as late as 24 hours before the ad runs.

Communication potential. Newspaper ads can convey a great deal of information by employing attractive graphics and copy. Properly designed, they can be very effective in attracting attention and persuading readers to buy.

Low costs. Newspapers normally offer advertising space at low absolute cost and, because of their blanket coverage of a geographic area, at low relative cost as well.

Prompt responses. Newspaper ads typically produce relatively quick customer response. A newspaper ad is likely to generate sales the very next day, and advertisers who use coupons can track the response to an ad. This advantage makes newspapers an ideal medium for promoting special events, such as sales, grand openings, or the arrival of a new product.

Attractive target audience. Adults who read newspapers are an attractive target market for many small businesses. Newspaper readers tend to be well-educated, older people with high household incomes.

Newspaper advertisements also have *disadvantages*:

Wasted readership. Because newspapers reach a wide variety of people, at least a portion of an ad's coverage will be wasted on readers who are not potential customers. This non-selective coverage makes it more difficult for newspapers to reach specific target markets than ads in other media.

Reproduction limitations. The quality of reproduction in newspapers is limited, especially when it is compared with that of magazines and direct mail. Recent technological advances, however, are improving the quality of reproduction in newspaper ads.

Lack of prominence. One frequently cited drawback of newspapers is that they carry so many ads that a small company's message might be lost in the crowd. The typical newspaper is 63 percent advertising.⁵⁷ This disadvantage can be overcome by increasing the size of the ad or by adding color to it. Color can increase the reading of ads by as much as 80 percent over black-and-white ads. Studies show that two-color ads do "pull" better than black-and-white ones but only by a small margin. The *real* increase in ad recall and response comes from using full four-color ads. Bold headlines, illustrations, and photographs also increase an ad's prominence. Proper ad placement in the newspaper can increase an ad's effectiveness. The best locations are on a right-hand page, near the right margin, above the half-page mark, or next to editorial articles. The most read sections in a newspaper are the front page, the local news section, and the sports section.

Less effective in reaching young adults. Newspaper circulation as a percentage of U.S. households has declined from 98 percent in 1970 to 40 percent today as readers have migrated to the Internet.⁵⁹ Print newspaper ads are less effective in reaching young adults; just 24 percent of 18- to 34-year-old adults read a daily newspaper.⁶⁰ Young people, in particular, read news online rather than from a printed newspaper.

Short ad life. The typical newspaper is soon discarded, and as a result, an ad's life is extremely short. Business owners can increase the effectiveness of their ads by giving them greater continuity. Spot ads can produce results, but maintaining a steady flow of business requires some degree of continuity in advertising.

BUYING NEWSPAPER ADS Print newspapers typically sell ad space by lines and columns or inches and columns. For instance, a 4-column \times 100-line ad occupies four columns and 100 lines of space (14 lines = 1 column inch). For this ad, the small business owner would pay the rate for 400 lines. If the newspaper's line rate is \$3.50, this ad would cost \$1,400 (400 lines \times \$3.50 per line). Most papers offer discounts for bulk, long-term and frequency contracts, and full-page ads. Advertising rates vary from one paper to another, depending on factors such as circulation and focus. Entrepreneurs should investigate the circulation statements, advertising rates, and reader profiles of a newspaper to see how well it matches the company's target audience before selecting one as an advertising medium.

MAGAZINES Another advertising medium available to the small business owner is magazines. Today, customers have nearly 7,200 magazine titles from which to choose, many of them in electronic form. With a total circulation of more than 312 million adults in the United States, magazines have a wide reach, and their readers tend to be more educated and have higher incomes than consumers of other advertising media such as television.⁶¹

Magazines offer several *advantages* for advertisers:

Long life spans. Magazines have a long reading life because readers tend to keep them longer than other printed media. Few people read an entire magazine at one sitting. Instead, most pick it up, read it at intervals, and come back to it later. The result is that each magazine ad has a good chance of being seen several times.

Multiple channels of engagement. Growing numbers of magazine ads include action codes, such as QR codes, that take users to a company's Web site, Facebook page, or online video, giving advertisers the ability to engage customers across multiple channels. Some online magazines include apps that allow readers to click on an ad to purchase the advertised product. In addition, 69 percent of magazine readers say that they have posted a magazine article on Facebook, and 75 percent have followed a magazine on Twitter and Pinterest.⁶²

Reader engagement. The average magazine reader spends 41 minutes with a magazine.⁶³ Print magazines have a high "pass-along" rate, being handed down front reader to reader.

Target marketing. Within the last 25 years, magazines have become increasingly focused. Advertisers can select magazines aimed at customers with specific interests—from wooden boats and black-and-white photography to container gardening and bodybuilding. By selecting the appropriate special-interest periodical, small business owners can reach those customers with a high degree of interest in their goods or service. Once business owners define their target markets, they can select magazines whose readers most closely match their customer profiles. For instance, *House and Garden* magazine reaches a very different audience than *Rolling Stone*.

Ad quality. Magazine ads tend to be of high quality. Consumers rank magazine ads ahead of ads in all other media on capturing readers' attention and in trustworthiness.⁶⁴ Advertisers can choose the location of their ads in a magazine. The most effective locations for magazine ads are the back cover, the inside front cover, and the inside back cover. Multiple page spreads also increase ad recall among readers.⁶⁵

Magazines also have several *disadvantages*:

Costs. Magazine advertising rates vary according to their circulation rates; the higher the circulation, the higher the rate. Thus, local magazines, whose rates are often comparable to newspaper rates, may be the best bargains for small businesses.

Long closing times. Another disadvantage of magazines is the relatively long closing times they require. For a weekly print magazine, the closing date for an ad may be several weeks before the actual publication date, making it difficult for advertisers to respond quickly to changing market conditions.

Lack of prominence. Another disadvantage of magazine ads arises from their popularity as an advertising vehicle. The effectiveness of a single ad may be reduced because of a lack of prominence; 46.2 percent of the typical magazine content is devoted to advertising.⁶⁶ Proper ad positioning, therefore, is critical to an ad's success. Research shows that readers "tune out" right-hand pages and look mainly at left-hand pages.

Declining circulation rates. Circulation rates for most magazines have declined over the last decade, prompting many of them to launch digital versions of their content. According to the Pew Research Center, only 17 percent of adults say they read a print magazine yesterday, down from 23 percent in 2002.⁶⁷

SPECIALTY ADVERTISING As advertisers have shifted their focus to "narrowcasting" their messages to target audiences and away from "broadcasting," specialty advertising has grown in popularity. Businesses spend more than \$20 billion annually on promotional gift items such as pens, shirts, caps, memory sticks, umbrellas, and calendars that are imprinted with a company's name, address, telephone number, Web address, logo, and slogan.⁶⁸ The most popular promotional items are apparel, writing instruments, bags, and calendars.⁶⁹ Specialty items are best used as reminder ads to supplement other forms of advertising and help to create goodwill among existing and potential customers.

Specialty advertising offers several *advantages*:

Reaching select audiences. Advertisers have the ability to reach specific audiences with well-planned specialty items. Lindner, one of Europe's leading makers of coffins, made a memorable splash with its customers by giving away calendars featuring photographs of models sporting nothing but body paint posing with the company's coffins! The calendar was such a hit that the family-owned company was inundated with requests and has made the calendar an annual tradition.⁷⁰

Personalized nature. By carefully choosing a specialty item, business owners can "personalize" their advertisements. When choosing advertising specialties, business owners should use items that are unusual, related to the nature of the business, and meaningful to customers. In addition, the item should be something that customers will keep and use (preferably in the environment in which they make decisions about using the company's products and services) and reinforce the company's USP.

Versatility. The rich versatility of specialty advertising is limited only by the business owner's imagination. Advertisers print their logos on everything from pens and golf balls to key chains and caps.

They work. Specialty advertising cuts through ad clutter because people enjoy receiving promotional products. One study found that 76.2 percent of people who had received a promotional product within the last two years were able to recall the specific product, the advertiser, and the message.⁷¹

There are *disadvantages* to specialty advertising:

Potential for waste. Unless entrepreneurs choose the appropriate specialty item for their businesses and their target audiences, they will be wasting time and money.

Cost. Some specialty items can be quite expensive. In addition, some owners have a tendency to give advertising materials to anyone—even to those people who are not potential customers. Proper distribution of giveaway items is an important aspect of enhancing the effectiveness of and controlling the cost of specialty advertising.

POINT-OF-PURCHASE ADS In-store advertising has become popular as a way of reaching the customer at a crucial moment—the point of purchase. Smart entrepreneurs "plan the in-store experience to win over shoppers where it matters most—the point of purchase," says Richard Winter, president of Point of Purchase Advertising International. "Research shows that consumers make 76 percent of all buying decisions at the point of sale and that end-cap (those displays

at the end of aisles) and freestanding displays of items are most effective.⁷² Self-service stores are especially well suited for point-of-purchase ads because they remind people of the products as they walk the aisles. These in-store ads are not just simple signs or glossy photographs of the product in use. Some businesses use in-store music interspersed with household hints and, of course, ads. Another technique involves shelves that contain tiny devices that sense when a customer passes by and triggers a prerecorded sales message. Some self-service stores use floor graphics, point-of-purchase ads that transform their floors into advertising space.

OUTDOOR ADVERTISING Outdoor (or out-of-home) advertising is one of the oldest forms of advertising in existence. Archaeological evidence shows that merchants in ancient Egypt chiseled advertising messages on stone tablets and placed them along major thoroughfares. Outdoor advertising remains popular today; advertisers spend \$6.4 billion on this medium annually.⁷³ The United States is a highly mobile society, and outdoor advertising takes advantage of this mobility. Outdoor advertising is popular among small companies, especially retailers, because well-placed ads serve as reminders to shoppers that the small business is nearby and ready to serve their needs. In addition, the brevity required for an effective outdoor ad is ideal for directing viewers to a company's Web site. Very few small businesses rely solely on outdoor advertising; instead, they supplement other advertising media with outdoor ads such as billboards and transit ads. With a creative out-of-home ad campaign, a small company can make a big impact with only a small budget.

 **ENTREPRENEURIAL PROFILE: Wade and Betty Lindsey: Wade's Southern Cooking**

Wade's Southern Cooking, a restaurant that Wade and Betty Lindsey founded in 1947 in Spartanburg, South Carolina, and that specializes in fresh meats and vegetables, created an outdoor ad in 1995 that depicted a green bean, the pun "Bean me up, Scottie," and the restaurant logo and address. The ad was an instant hit, and the company has since created more than 70 billboards that use puns and comical themes based on vegetables and other items on its menu. (One ad featured a stalk of broccoli reclining on a couch wearing a Snuggie and the phrase "Comfort food.") The outdoor campaign has played a significant role in the second-generation family business's growth and success.⁷⁴



One of Wade's Southern Cooking's outdoor advertisements.
Source: Wade's Restaurant Inc.

Outdoor advertising offers certain *advantages* to a small business:

High exposure. Outdoor advertising offers high-frequency exposure, especially among people who commute to work. The average one-way commute to work in the United States is more than 25 minutes.⁷⁵ Most people tend to follow the same routes in their daily traveling, and billboards are there waiting for them when they pass by.

Broad reach. The typical outdoor ad reaches an adult 29 to 31 times each month. The nature of outdoor ads makes them effective devices for reaching a large number of potential customers within a specific area. Not only has the number of cars on the road increased, but the number of daily vehicle trips people take has also climbed. In addition, the people outdoor ads reach tend to be younger, wealthier, and better educated than the average person.

Attention-getting. The introduction of new technology such as 3-D, fiber optics, and other creative special effects to outdoor advertising has transformed billboards from flat, passive signs to innovative, attention-grabbing promotions that passersby cannot help but notice.

Flexibility. Advertisers can buy outdoor advertising units separately or in a number of packages. Through its variety of graphics, design, unique features, and choice of location, outdoor advertising enables the small advertiser to match his or her message to the particular audience.

Cost efficiency. Outdoor advertising offers one of the lowest costs per thousand customers reached of all advertising media. The cost per thousand customers (CPM) for out-of-home ads is \$2.26, compared to \$4.54 for radio, \$5.50 for newspaper ads, \$6.98 for magazine ads, and \$6.00 to \$14.50 for television commercials.⁷⁶

Out-of-home ads also have several *disadvantages*:

Brief exposure. Because billboards are immobile, the reader is exposed to the advertiser's message for only a short time—typically only one or two seconds. As a result, the message must be short and to the point.

Limited ad recall. Because customers often are zooming past outdoor ads at high speed, they are exposed to an advertising message very briefly, which limits their ability to retain the message.

Legal restrictions. In many cities, outdoor ads are subject to strict regulations; some cities place limitations on the number, size, content, and type of billboards allowed along roadsides. Some cities have banned digital billboards altogether in the name of traffic safety and beautification.

Lack of prominence. Some heavily traveled routes are so cluttered with out-of-home ads that the effectiveness of any single ad is reduced.

USING OUTDOOR ADS Consumers are spending more time in their cars than ever before (18.5 hours per week), and outdoor advertising is an effective way to reach them.⁷⁷ Technology has changed the face of outdoor advertising dramatically in recent years. Computerized printing techniques that render truer, crisper, and brighter colors, billboard extensions, and three-dimensional effects have improved significantly the quality of standard billboards (known as posters or bulletins in the industry). New vinyl surfaces display print-quality images and are extremely durable. Digital billboards, giant computer screens that rotate messages every 6 to 10 seconds, allow companies to create vibrant, high-resolution, eye-catching ads that capture viewers' attention at reasonable cost.

Because the outdoor ad is stationary and the viewer is in motion, a small business owner must pay special attention to its design. An outdoor ad should do the following:

- Allow viewers to identify the product and the company clearly and quickly.
- Use a simple background. The background should not compete with the message.
- Rely on large illustrations that jump out at the viewer.
- Include clear, legible fonts. All lowercase or a combination of uppercase and lowercase letters works best. Very bold or very thin typefaces become illegible at a distance. Select simple fonts that are easy to read from a distance.
- Use black-and-white designs. Research shows that black-and-white outdoor ads are more effective than color ads. If color is important to the message, pick color combinations that contrast both hue and brightness, such as black on yellow.
- Emphasize simplicity. Short copy and short words are best. Don't try to cram too much onto a billboard. Because of their brief window of exposure, ads with just three to five words are most effective, and ads containing more than 10 words are ineffective.
- Use illumination so that passersby can read them at night. By using illuminated billboards, advertisers can increase the reach of outdoor ads by 16 percent.⁷⁸
- Be located on the right-hand side of the highway.

Two of the latest trends in outdoor advertising are Internet-connected digital boards and billboards that send messages to customers' cell phones. With digital billboards, ad content is virtually unlimited; advertisers can include eye-catching graphics and streaming media in their ads. (Giant digital billboards, called spectaculars, are common in New York's Times Square, where large auto-free plazas cater to pedestrians, whose travel speeds are slower than cars.) Digital billboard ads, which cost as little as \$600 to more than \$15,000 per month, offer advertisers great flexibility. For instance, a restaurant could change the messages it displays to advertise its breakfast offerings in the morning, lunch specials at midday, and dinner menu in the afternoon and evening.

The latest outdoor ads include a computer chip that interacts with a Web browser that is common to many cell phones, which enables advertisers to send messages to the cell phones of passersby. For instance, a movie theater's smart billboard could send show times to customers' cell phones for the feature films it is running.

Many entrepreneurs use company vehicles as rolling outdoor ads, posting business signs on them or transforming the entire car into a rolling advertisement with vinyl wrap. These rolling ads should be consistent with a company's advertising strategy, tasteful, and include ways for people who see them to contact the company, including its Web site and telephone number. Outdoor gear retailer L.L.Bean generated buzz with its promotion of a vehicle wrap to celebrate the company's one-hundredth anniversary featuring a larger-than-life (13 feet



L.L.Bean's Bootmobile, a rolling advertisement.

Source: L.L.Bean Bootmobile.

tall and 20 feet long) replica of L.L.Bean's first and most iconic product, the Maine hunting boot, which L.L.Bean began selling in 1912. The Bootmobile travels to various stores to host special events, which its drivers promote through various social media such as Twitter (@Bootmobile).⁷⁹

TRANSIT ADVERTISING A variation of outdoor advertising is transit advertising, which includes advertising signs on the inside and outside of the public transportation vehicles such as trains, buses, and subways throughout the country's urban areas. The medium is poised for growth as more cities look to public transit systems to relieve traffic congestion.

Transit ads offer a number of *advantages*:

Wide coverage. Transit advertising offers advertisers mass exposure to a variety of customers. The message literally goes to where the people are.

Repeat exposure. Transit ads provide lengthy and repeated exposure to a message, particularly for inside cards, the ads that appear inside the vehicle.

Low cost. Even small business owners with limited budgets can afford transit advertising.

Flexibility. Transit ads come in a wide range of sizes, numbers, and duration. With transit ads, an owner can select an individual market or any combination of markets across the country.

Transit ads also have several *disadvantages*:

Generality. Although entrepreneurs can choose the specific transit routes on which to advertise, they cannot target a particular segment of the market through transit advertising as effectively as they can with other media. The effectiveness of transit ads depends on the routes that public vehicles travel and on the people they reach, which, unfortunately, the advertiser cannot control. Overall, transit riders tend to be young, affluent, and culturally diverse.

Limited appeal. Unlike many media, transit ads are not beamed into the potential customer's residence or business. The result is that customers cannot keep them for future reference.

Brief message. Transit ads do not permit advertisers to present a detailed description or a demonstration of the product or service for sale. Although inside ads have a relatively long exposure (the average ride lasts 22.5 minutes), outside ads must be brief and to the point.

DIRECT MAIL Direct mail has long been a popular method of direct marketing and includes tools such as letters, postcards, catalogs, discount coupons, brochures, and other items that businesses mail to customers' or potential customers' homes or businesses. The earliest known catalogs were printed by fifteenth-century printers. Although online sales long ago surpassed direct-mail catalog sales, companies spend \$21 billion annually on direct-mail ads, selling virtually every kind of product imaginable, from Christmas trees and lobsters

to furniture and clothing (the most popular mail-order purchase).⁸⁰ Direct mail offers some distinct *advantages* to entrepreneurs:

Flexibility. Direct mail gives advertisers the capacity to tailor a message to target customers using variable data printing. Rather than send a blanket mail blast to 100,000 addresses, advertisers can target 5,000 high-potential customers with a mailing. An advertiser's presentation to customers can be as simple or as elaborate as necessary. One custom tailor shop achieved a great deal of success with fliers it mailed to customers and included a swatch of material from the fabrics for the upcoming season's line of suits. With direct mail, the tone of the message can be personal, creating a positive psychological effect. In addition, advertisers control the timing of their campaigns, sending ads when they are most appropriate.

Reader attention. With direct mail, an advertiser's message does not have to compete with other ads for the reader's attention. Most people enjoy getting mail, and studies show that 80 percent of people read some or all of their advertising mail.⁸¹ Unlike many e-mail messages, direct mail gets a recipient's undivided attention at least for a moment. If the message is on the mark and sent to the right audience, direct-mail ads can be a powerful advertising tool. Catalogs are particularly effective at capturing recipients' attention. The average household receives three catalogs per week, and recipients typically look at two of them. In addition, 92 percent of people who receive catalogs say that they have purchased something from at least one of them.⁸²

Rapid feedback. Direct-mail advertisements produce quick results. In most cases, an ad will generate sales within three or four days after customers receive it. Business owners should know whether a mailing has produced results within a relatively short time period.

Measurable results and testable strategies. Because they control their mailing lists, direct marketers can readily measure the results their ads produce. Also, direct mail allows advertisers to test different ad layouts, designs, and strategies (often within the same "run") to see which one pulls the greatest response. The best direct marketers are always fine-tuning their ads to make them more effective. Table 10.4 offers guidelines for creating direct mail ads that really work.

Effectiveness. The right message targeted at the right mailing list can make direct mail one of the most efficient forms of advertising. Direct mail to the right people produces results.

Direct-mail ads also suffer from several *disadvantages*:

Inaccurate mailing lists. The key to the success of the entire mailing is the accuracy of the customer list. Using direct-mail ads with a poor mailing list is a guaranteed waste of money. Experienced direct mail marketers cite the 60-30-10 rule, which says that 60 percent of a campaign's success depends on the quality of the list, 30 percent on the offer, and 10 percent on the creativity of the ad.⁸³ Make sure the mailing list you use is accurate and up to date.

Clutter. The typical household receives on average 624 pieces of direct mail annually.⁸⁴ With that volume of direct mail, it can be difficult for an advertisement to get customers' attention.

High relative costs. Relative to the size of the audience reached, the cost of designing, producing, and mailing an advertisement via direct mail is high. Rising paper and postage costs pose real threats to companies that use direct mail. However, if a mailing is well planned and properly executed, it can produce a high percentage of responses, making direct mail one of the least expensive advertising methods in terms of return on investment.

High throwaway rate. Often called junk mail, direct-mail ads become "junk" when an advertiser selects the wrong audience or broadcasts the wrong message. According to the Direct Mail Association, the average response rate for a direct-mail campaign is 4.4 percent.⁸⁵ By supplementing traditional direct-mail pieces with toll-free (800) numbers and carefully timed follow-up phone calls, companies have been able to increase their response rates.

HOW TO USE DIRECT MAIL The key to a direct mailing's success is the right mailing list. Even the best direct-mail ad will fail if sent to the "wrong" customers. Owners can develop lists themselves, using customer accounts, telephone books, city and trade directories, and other sources, including companies selling complementary but noncompeting products, and organizations' membership lists, business or professional magazines' subscription lists, and

TABLE 10.4 Guidelines for Creating Direct-Mail Ads That Really Work

In many industries, the average direct-mail campaign is one that produces a response rate of at least 4.4 percent, which means that 95.6 percent of the customers who received the ad did *not* respond to it! What steps can entrepreneurs take to improve the results of their direct mail campaigns?

Realize that repetition is one key to success.

Experts estimate that customers must receive at least three direct-mail pieces per month from a business before they really notice the ad.

Provide meaningful incentives.

Direct mail succeeds by getting prospects to respond to a written offer. To do that, a direct-mail ad must offer potential customers something of value—a free sample, a special price, a bonus gift, or anything that a company’s target customers value. Twenty percent of prospects who do not open the direct-mail ads they receive say that they have no reason to open them. Make sure your offer gives them a reason!

Write copy that will get results.

Try the following proven techniques:

- Write catchy headlines and openers. Promise readers your most important benefit in the headline or first paragraph.
- Use short “action” words and paragraphs and get to the point quickly.
- Make the copy look easy to read with lots of “white space.”
- Use eye-catching words such as *free, you, save, guarantee, new, profit, benefit, improve*, and others.
- Consider using computerized “handwriting” somewhere on the page or envelope; it attracts attention.
- Forget grammatical rules; write as if you were speaking to the reader.
- Repeat the offer three or more times in various ways.
- Back up claims and statements with proof and endorsements whenever possible.
- Always include a clear call to action—ask for the order or a specific response. “People are more likely to respond when you specifically tell them what to do,” says marketing expert Dean Rieck.
- Ask attention-getting questions such as “Would you like to lower your home’s energy costs?” in the copy.
- Use high-quality copy paper and envelopes (those with windows are best) because they stand a better chance of being opened and read. Brown envelopes that resemble government correspondence work well.
- Envelopes that resemble bills almost always get opened.
- Address the envelope to an individual, not “Occupant.”
- Avoid mailing labels, which shout “direct-mail ad piece.” The best campaigns print addresses directly on the envelopes.
- Use stamps if possible. They get more letters opened than metered postage.
- Use a postscript (P.S.)—always; they are the most often read part of a printed page. Make sure the P.S. contains a “hook” that will encourage the recipient to read on. This is the perfect place to restate offer’s USP.
- Include a separate order form that passes the following “easy” test:
 - **Easy to find.** Consider using brightly colored paper or a unique shape.
 - **Easy to understand.** Make sure the offer is easy for readers to understand. Marketing expert Paul Goldberg says, “Confuse ‘em and you lose ‘em.”
 - **Easy to complete.** Keep the order form simple and unconfusing.
 - **Easy to pay.** Direct-mail ads should give customers the option to pay by whatever means is most convenient.
 - **Easy to return.** Including a postage-paid return envelope (or at a minimum a return envelope) will increase the response rate.

Build and maintain a quality mailing list over time.

The right mailing list is the key to a successful direct-mail campaign. You may have to rent lists to get started, but once you are in business, use every opportunity to capture information about your customers. Constantly focus on improving the quality of your mailing list.

Integrate direct-mail campaigns with other advertising media.

Use direct mail to direct customers to your company’s Web site, Facebook page, or blog (perhaps by including a QR code in the mailing).

Test your campaigns and track their results.

Successful direct-mail marketers constantly tweak their ads and test the results. “Testing is everything,” says the founder of a company that used direct-mail ads as part of a marketing strategy that led his company to \$10 million in annual sales. Monitoring the response rate from each mailing is essential for knowing which ads and which lists actually produce results.

Sources: Based on Dean Rieck, “How to Use Direct Mail to Drive Targeted Web Site Traffic,” MarketingProfs, August 3, 2010, www.marketingprofs.com/articles/2010/3796/how-to-use-direct-mail-to-drive-targeted-website-traffic; Chrisanne Sternal, “23 Great Direct Mail Tips for Entrepreneurs,” *Understanding Marketing*, March 23, 2010, <http://understandingmarketing.com/2010/03/23/23-great-direct-mail-tips-for-entrepreneurs>; *What’s in the Mailbox? The Impact of One-to-One Marketing on Consumer Response*, Winterberry Group, January 2007, p. 7; “Direct Mail Tips for Manufacturers’ Letters,” Koch Group, www.kochgroup.com/directmail.html; Kim T. Gordon, “Copy Right,” *Business Start-Ups*, June 1998, pp. 18–19; Paul Hughes, “Profits Due,” *Entrepreneur*, February 1994, pp. 74–78; “Why They Open Direct Mail,” *Communications Briefings*, December 1993, p. 5; Ted Lammers, “The Elements of Perfect Pitch,” *Inc.*, March 1992, pp. 53–55; “Special Delivery,” *Small Business Reports*, February 1993, p. 6; Gloria Green and Jennifer Green, “How to Develop a Direct Mail Program,” *Small Business Forum*, Winter 1993/1994, pp. 30–45; Susan Headden, “The Junk Mail Deluge,” *U.S. News & World Report*, December 8, 1997, pp. 40–48; Joanna L. Krotz, “Direct-Mail Tips for Sophisticated Marketers,” Microsoft Small Business Center, www.microsoft.com/smallbusiness/resources/marketing/customer_service_acquisition/direct_mail_tips_for_sophisticated_marketers.mspcx.

mailing list brokers who sell lists for practically any need. Advertisers can locate list brokers through *The Direct Marketing List Source* from the Standard Rate and Data Service found in most public libraries. The key to success with a direct mail campaign is to get your ad noticed, and the right mailing list is the ideal starting point.



ENTREPRENEURIAL PROFILE: Clare Meehan: AlphaGraphics in the Cultural District

Clare Meehan, CEO of AlphaGraphics in the Cultural District, a print and marketing communications company in Pittsburgh, Pennsylvania, and her team created an unusual direct-mail ad campaign that involved mailing a coconut (“Did you know you could mail a coconut?” said the hangtag), material on the power of direct mail, and a link to a personalized Web site to 200 carefully selected high-level marketing executives in local businesses. The goal was to direct the prospects to the Web site, invite them to a marketing workshop hosted by AlphaGraphics, and build a list of potential clients. The direct-mail campaign was a huge success, generating a 300 percent return on investment, drawing 41 prospects to the marketing workshop, and producing a 20 percent increase in sales for the company.⁸⁶

TRADE SHOWS Trade shows provide manufacturers and distributors with a unique opportunity to advertise to a preselected audience of potential customers who are inclined to buy. Thousands of trade shows take place each year, and carefully evaluating and selecting the right shows can produce profitable results for a business owner. Companies spend \$24.5 billion on trade shows annually, but trade show success does *not* depend on how much an exhibitor spends; instead, success is a function of planning, preparation, and follow-up.⁸⁷

Trade shows offer the following *advantages*:

A natural market. Trade shows bring together buyers and sellers in a setting in which exhibitors can explain and demonstrate their products. Converting a prospective customer at a trade show into an actual sale costs 38 percent less than converting a prospect on a sales call.⁸⁸

Preselected audience. Trade exhibits attract potential customers with a genuine interest in the goods or services on display. There is a high probability that trade show attendees will make a purchase. According to one survey, 83 percent of trade show attendees have the authority to make purchasing decisions, and 91 percent of attendees say they get the most useful buying information from trade shows.⁸⁹

New customer market. Trade shows offer exhibitors a prime opportunity to reach new customers and to contact people who are not accessible to sales representatives.

Cost advantage. As the cost of making a field sales call continues to escalate, companies are realizing that trade shows are an economical method of generating leads and making sales presentations.

There are, however, certain *disadvantages* associated with trade shows:

Increasing costs. The cost of exhibiting at trade shows is rising. Registration fees, travel and setup costs, sales salaries, and other expenditures may be a barrier to some small firms.

Wasted effort. A poorly planned exhibit ultimately costs the small business more than its benefits are worth. Too many firms enter exhibits in trade shows without proper preparation, and they end up wasting their time, energy, and money on unproductive activities.

To avoid these disadvantages, entrepreneurs should do the following:

- Verify that the audience is a good fit for your company’s products or services. Research trade shows to find the ones that will put you in front of the best prospects for your company.
- Establish objectives for every trade show. Do you want to generate 100 new sales leads, make new product presentations to 500 potential customers, or generate \$5,000 in sales?
- Communicate with key potential customers *before* the show; send them invitations or invite them to stop by your booth for a special gift.
- Plan your display with your target audience in mind and make it memorable. Be sure your exhibit shows your company and its products or services in the best light. Do everything to maximize the visibility of your exhibit and keep the display neat.

- Staff your booth with knowledgeable salespeople. Attendees appreciate meeting face-to-face with knowledgeable and friendly staff. Every staff member should have an elevator pitch and questions with which to engage prospects in conversation.
- Do something to attract a crowd to your booth. Demonstrate your product or service so that customers can see it in action, sponsor a drawing for a prize, or set up an interactive display. Drawing a crowd creates “buzz” for your company among attendees.
- Learn to distinguish between serious customers and “tire kickers.”
- Make it easy for potential customers to get information about your company and its products and services. Distribute literature that clearly communicates the benefits of your products or services.
- Project a professional image at all times. Salespeople who man the booth should engage prospects in conversation and should ask qualifying questions.
- Capture prospective customers’ contact information, including e-mail addresses, and follow up with prompt “welcome” e-mails.
- Follow up promptly on every sales lead. The most common mistake trade show participants make is failing to follow up on the sales leads the show generated. If you are not going to follow up leads, why bother to attend the show in the first place?

Few small businesses rely on a single advertising medium to communicate their advertising messages to potential customers, choosing instead to employ **cross-channel advertising strategies** in which they communicate with potential customers using a variety of media. For instance, Gary Lindsey, head of marketing at The Parent Company, a consumer product business that targets young parents, says that although the company is primarily Web based, it relies heavily on direct-mail catalogs and e-mail marketing to drive sales. “There’s real return on investment from those catalogs,” says Lindsey. “People love shopping on the Internet, but there is something powerful when you combine print and Internet.”⁹⁰

How to Prepare an Advertising Budget

One of the most challenging decisions confronting a small business owner is how much to spend on advertising. The amount entrepreneurs want to spend and the amount they can afford to spend usually differ significantly. There are four methods of creating an advertising budget: *what is affordable*, *matching competitors*, *percentage of sales*, and *objective and task*.

Under the what-is-affordable method, business owners see advertising as a luxury. They view it completely as an expense rather than as an investment that generates sales and profits in the future. As the name implies, entrepreneurs who use this method spend on advertising whatever their companies can afford. Too often, business owners determine their advertising budgets after they have funded all of the other budget items. The result is an advertising budget that is inadequate for getting the job done. This method also fails to relate the marketing communications budget to the marketing communications objective.

Another approach is to match the advertising budget of the company’s competitors, either in a flat dollar amount or as a percentage of sales. This method assumes that a company’s advertising needs and strategies are the same as those of its competitors, which is rarely the case. Although competitors’ actions can be helpful in establishing a floor for marketing communications expenditures, relying on this technique can lead to blind imitation instead of a budget suited to a small company’s circumstances.

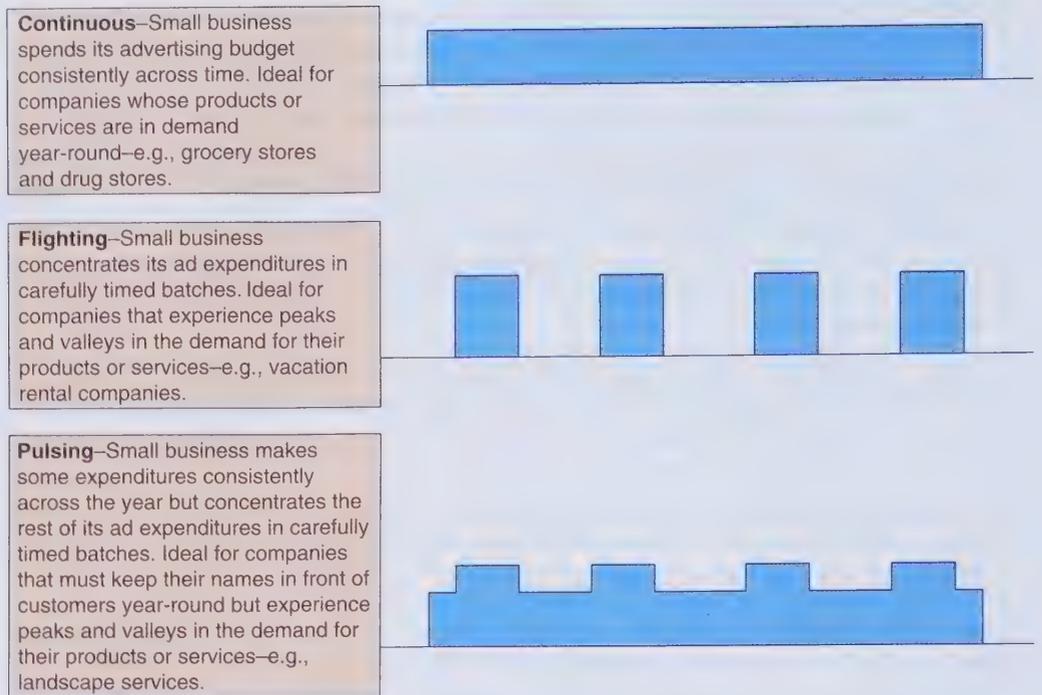
The most commonly used method of establishing an advertising budget is the simple percentage-of-sales approach. This method relates advertising expenditures to actual sales results. Tying advertising expenditure to sales rather than to profits creates greater consistency in advertising because most companies’ sales tend to fluctuate less than profits. One rule of thumb for establishing an advertising budget is spending 10 percent of projected sales the first year of business, 7 percent the second year, and at least 5 percent in each successive year. Relying totally on broad rules like these can be dangerous, however. They may not be representative of a small company’s advertising needs.

The objective-and-task method is the most difficult and least used technique for establishing an advertising budget. It also is the method most often recommended by advertising experts.

4.

Identify four basic methods for preparing an advertising budget.

FIGURE 10.7
Advertising Scheduling Strategies



With this method, an entrepreneur links advertising expenditures to specific business objectives. The objective-and-task method builds up an advertising budget from the bottom up by analyzing what it will cost to accomplish an entrepreneur's business objectives. For example, suppose that an entrepreneur wants to boost sales of a particular product 10 percent by attracting local college students. He may determine that a nearby rock radio station would be the best advertising medium to use. Then he must decide on the number and frequency of the ads and estimate their costs. Entrepreneurs follow this process for each advertising objective.

Once they establish their advertising objectives and budgets, many entrepreneurs find it useful to use a calendar to plan the timing of their advertising campaigns and expenditures across the year. An advertising calendar helps entrepreneurs ensure that they create a continuous presence in customers' minds throughout the year by creating a steady flow of interesting and useful information flowing their way. Figure 10.7 illustrates three common advertising scheduling strategies.

How to Advertise Big on a Small Budget

The typical small business does not have the luxury of an unlimited advertising budget. Most cannot afford to hire a professional ad agency. This does not mean, however, that a small company should assume a second-class advertising posture. Most advertising experts say that, unless a small company spends more than \$10,000 to \$15,000 a year on advertising, it probably doesn't need an ad agency. For most, hiring freelance copywriters and artists on a per-project basis is a much better bargain. With a little creativity and a dose of ingenuity, small business owners can stretch their advertising dollars and make the most of what they spend. Three useful techniques are cooperative advertising, shared advertising, and stealth advertising.

Cooperative Advertising

In **cooperative advertising**, a manufacturing company shares the cost of advertising with a retailer if the retailer features its products in those ads. Both the manufacturer and the retailer get more advertising per dollar by sharing expenses. Cooperative advertising not only helps small businesses stretch their advertising budgets but also offers another source of savings: the free advertising packages that many manufacturers supply to retailers. These packages usually include photographs and illustrations of the product as well as a copy of the ad copy, and they are available in different media.

5.

Explain practical methods for stretching an entrepreneur's advertising budget.

Shared Advertising

In **shared advertising**, a group of similar businesses forms a syndicate to produce generic ads that allow the individual businesses to dub in local information. The technique is especially useful for small businesses that sell relatively standardized products or services such as legal assistance, autos, and furniture. Because the small firms in the syndicate pool their funds, the result usually is higher-quality ads and significantly lower production costs.

Stealth Advertising

In Chapter 9, you learned about bootstrap marketing principles, offbeat, low-cost techniques for marketing a small company's goods and services. In advertising, these techniques are called **stealth advertising**, which includes innovative ads that do not necessarily look like traditional ads and often are located in unexpected places. Ads now appear on electrical outlets in airport terminals, on eggs (gently printed directly onto the shells with lasers), on clothes hangers from laundries, in urinals in public restrooms (using a device called Wizmark that plays sounds and pictures when a guest arrives), and in other unusual places.⁹¹ One consumer products company achieved success with a campaign that involved painting manhole covers in New York City to look like steaming hot cups of coffee. Bamboo Lingerie attracted a great deal of attention for its brand by stenciling on New York City sidewalks the message "From here it looks like you could use some new underwear" and its name and logo.⁹² Some cities, including New York, Chicago, Los Angeles, San Diego, San Francisco, and others, have outlawed stealth advertising, calling it logo graffiti.⁹³

Other Ways to Save

Other cost-saving suggestions for advertising expenditures include the following:

- **Repeat ads that have been successful.** In addition to reducing the cost of ad preparation, repetition may create a consistent image in a small firm's advertising program.
- **Use identical ads in different media.** If a billboard has been an effective advertising tool, an owner should consider converting it to a newspaper or magazine ad or a direct-mail flier.
- **Hire independent copywriters, graphic designers, photographers, and other media specialists.** Many small businesses that cannot afford a full-time advertising staff buy their advertising services à la carte. They work directly with independent specialists and usually receive high-quality work that compares favorably with that of advertising agencies without paying a fee for overhead.
- **Concentrate advertising during times when customers are most likely to buy.** Some small business owners make the mistake of spreading an already small advertising budget evenly—and thinly—over a 12-month period. A better strategy is to match advertising expenditures to customers' buying habits.

Chapter Review

1. Define your company's unique selling proposition (USP).
 - Branding a company's products or services depends on communicating the correct USP.
 - Answers the customer's ultimate question: What's in it for me?
2. Explain the differences among promotion, publicity, personal selling, and advertising.
 - Promotion is any form of persuasive communication designed to inform consumers about a product or service and to influence them to purchase these goods or services.
 - Publicity is any commercial news covered by the media that boosts sales but for which the small business does not pay.
 - Personal selling is the personal contact between salespeople and potential customers that comes from sales efforts.
 - Advertising is any sales presentation that is nonpersonal in nature and is paid for by an identified sponsor. A company's target audience and the nature of its message determine the advertising media it will use.
3. Describe the advantages and disadvantages of various advertising media.
 - The medium used to transmit an advertising message influences customers' perception—and reception—of it.

- Media options include word-of-mouth, the Internet, e-mail, social media, newspapers, radio, television, magazines, direct mail, the Internet, outdoor advertising, transit advertising, directories, trade shows, special events and promotions, and point-of-purchase ads.
4. Discuss the four basic methods for preparing an advertising budget.
 - Establishing an advertising budget presents a real challenge to the small business owner.
 5. Explain practical methods for stretching a business owner's advertising budget.
 - There are four basic methods: what is affordable, matching competitors, percentage of sales, and objective and task.
 - Despite their limited advertising budgets, small businesses do not have to take a second-class approach to advertising. Three techniques that can stretch a small company's advertising dollars are cooperative advertising, shared advertising, and stealth advertising.

Discussion Questions

- 10-1. What are the three elements of promotion? How do they support one another?
- 10-2. What factors should an entrepreneur consider when selecting advertising media?
- 10-3. What is a unique selling proposition (USP)? What role should it play in a company's advertising strategy?
- 10-4. One writer describes the unique selling proposition of a company from which she received an e-mail: "Combining the strategy, business processes, implementation, and technical support skills of a CRM systems integrator with the data management, analytic, and marketing skills of a database marketing service provider to deliver and operate a close-looped marketing and sales environment." How do you rate the effectiveness of this USP? Explain. What are the characteristics of an effective USP?
- 10-5. Summarize the advantages and disadvantages of the following advertising media:
 - Word-of-mouth
 - Social media
 - Sponsorships
 - Television
 - Radio
 - Newspapers
 - Internet advertising
 - Magazines
 - Specialty advertising
 - Direct mail
 - Out-of-home advertising
 - Transit advertising
 - Directories
 - Trade shows
- 10-6. Assume you are a small business owner who has an advertising budget of \$1,500 to invest in a campaign promoting a big July Fourth "Blowout" sale. Where would you be most likely to invest your advertising budget if you were trying to reach customers in the 25- to 45-year-old age range with higher-than-average disposable income who are likely to be involved in boating activities in a local resort town? Explain. How would you generate free publicity to extend your advertising budget?
- 10-7. How are promotion, publicity, personal selling, and advertising different from each other?
- 10-8. Describe the characteristics of an effective outdoor advertisement.
- 10-9. Explain the characteristics of a successful advertising campaign.
- 10-10. Describe the common methods of establishing an advertising budget. Which method is most often used? Which technique is most often recommended? Why?
- 10-11. What techniques can small business owners use to stretch their advertising budgets?
- 10-12. Use a search engine to locate the most recent "E-Mail Marketing Trends Survey." Using the information in it, work with a team of your classmates to select a local small business with which you are familiar to design an effective e-mail advertising campaign. What are the advantages and the disadvantages of using e-mail as an advertising medium?

CHAPTER 11

Pricing and Credit Strategies



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain why pricing is both an art and a science.
2. Discuss the relationships among pricing, image, competition, and value.
3. Describe effective pricing strategies for both new and existing products and services.
4. Explain the pricing techniques used by retailers.
5. Explain the pricing techniques used by manufacturers.
6. Explain the pricing techniques used by service firms.
7. Describe the impact of credit on pricing.

*Price is what you pay.
Value is what you get.*

—Warren Buffett

The moment you make a mistake in pricing, you're eating into your reputation or your profits.

—Katharine Paine

Pricing: A Creative Blend of Art and Science

1.

Explain why pricing is both an art and a science.

One of the most challenging yet most important decisions entrepreneurs must make involves pricing their products and services. Studies by consulting firm Accenture show that increasing prices by just 1 percent can produce an 11 percent increase in a company's profit, a result that is much greater than that produced by a comparable 1 percent decrease in costs.¹ "There's nothing you can do as quickly to improve profitability—and nothing you can do as quickly to destroy profitability—as change your pricing," says one consultant who specializes in pricing.² Prices that are too high can drive customers away and hurt a small company's sales. Pricing products and services too low, a common tendency among first-time entrepreneurs, robs a business's ability to earn a profit, leaves customers with the impression that its goods and services are of inferior quality, and threatens its long-term success. Improper pricing has created serious problems for many business owners who mistakenly believed that their prices were high enough to generate a reasonable profit when, in reality, they were not.



ENTREPRENEURIAL PROFILE: Jill Caren: *OutdoorPlayToys.com* When Jill Caren started *OutdoorPlayToys.com*, an online retailer of toys designed to allow children to have a fun day of play outside, she set her prices based on each toy's cost and an estimate of shipping charges. However, shipping charges, particularly on heavy items such as pedal cars and playhouses, were higher than she had anticipated, and her company lost money on sales of those items. Caren conducted an analysis of her company's total costs of operation (including shipping costs), raised her prices accordingly, and turned her company around.³

Another complicating factor is a holdover from the Great Recession: Customers have become more price sensitive. "The recession changed people's perceptions and expectations about value significantly," says Kurt Kane, chief marketing officer for Pizza Hut, a company that has reformulated its pricing strategy to emphasize value to its customer base. "A generation of consumers has been born under a new value mindset, and I don't see that changing anytime soon."⁴ A recent survey of shoppers' behavior by Parago reports that 70 percent of shoppers say that they are more price sensitive than they were just 12 months before. Reflecting this sensitivity, 95 percent of shoppers look for sales, deals, rebates, or lowest advertised prices at least some of the time before they buy.⁵ Shoppers are using technology such as smart phones and tablet PCs with price comparison apps to shop for the best deals—often right in the middle of a store's aisles. In a recent survey by Perception Research Services International, 76 percent of smart phone owners use their phones while shopping, 53 percent of these mobile shoppers use their phones to compare product prices, and 48 percent use them to look for discount coupons or sales.⁶ The result is a new age of price transparency that entrepreneurs have never before experienced and an environment that makes setting the right prices all the more important—and difficult (see Figure 11.1).

Price is the monetary value of a good or service; it is a measure of what a customer must give up to obtain a good or service. For shoppers, price is a reflection of value. Customers often look to a product's or service's price for clues about its value. Consider the following examples, which illustrate the sometimes puzzling connection between price and perceived value:

- After a stint in the advertising industry, Brent Black launched The Panama Hat Company of the Pacific, a small shop in Kailua, Hawaii, from which he sells some of the world's finest Panama hats. Made by skilled artisans in Ecuador, the hats sport weaves of exceptionally thin straw that range from 19 to 60 rows per inch. Black's basic line of hats require 150 hours of work by a talented team of craftsmen, and his ultrapremium hats can take up to 1,000 hours to make. Black purchases the hats directly from Ecuadorian weavers and then blocks them by hand into dozens of styles using another labor-intensive process in his shop. Prices for Black's hats range from \$650 for a basic panama hat with 19 rows per inch to \$25,000 for one made by premier hatmaker Simón Espinal.⁷
- Shoppers know that they can find a smart phone for as little as \$99 (sometimes for free) if they sign a contract with a wireless carrier. Yet Swiss watchmaker Ulysse Nardin, founded in 1846, cannot keep up with demand for its Chairman smart phone, which carries the official title of the most expensive smart phone in the world. The company's base model sells for \$14,000, and its premier model, which features 3,000 hand-cut diamonds on the faceplate, goes for a lofty \$130,000! When Ulysse Nardin introduced its ultra-luxurious phone, it expected to receive at most 400 orders; instead, customers placed more than 8,000

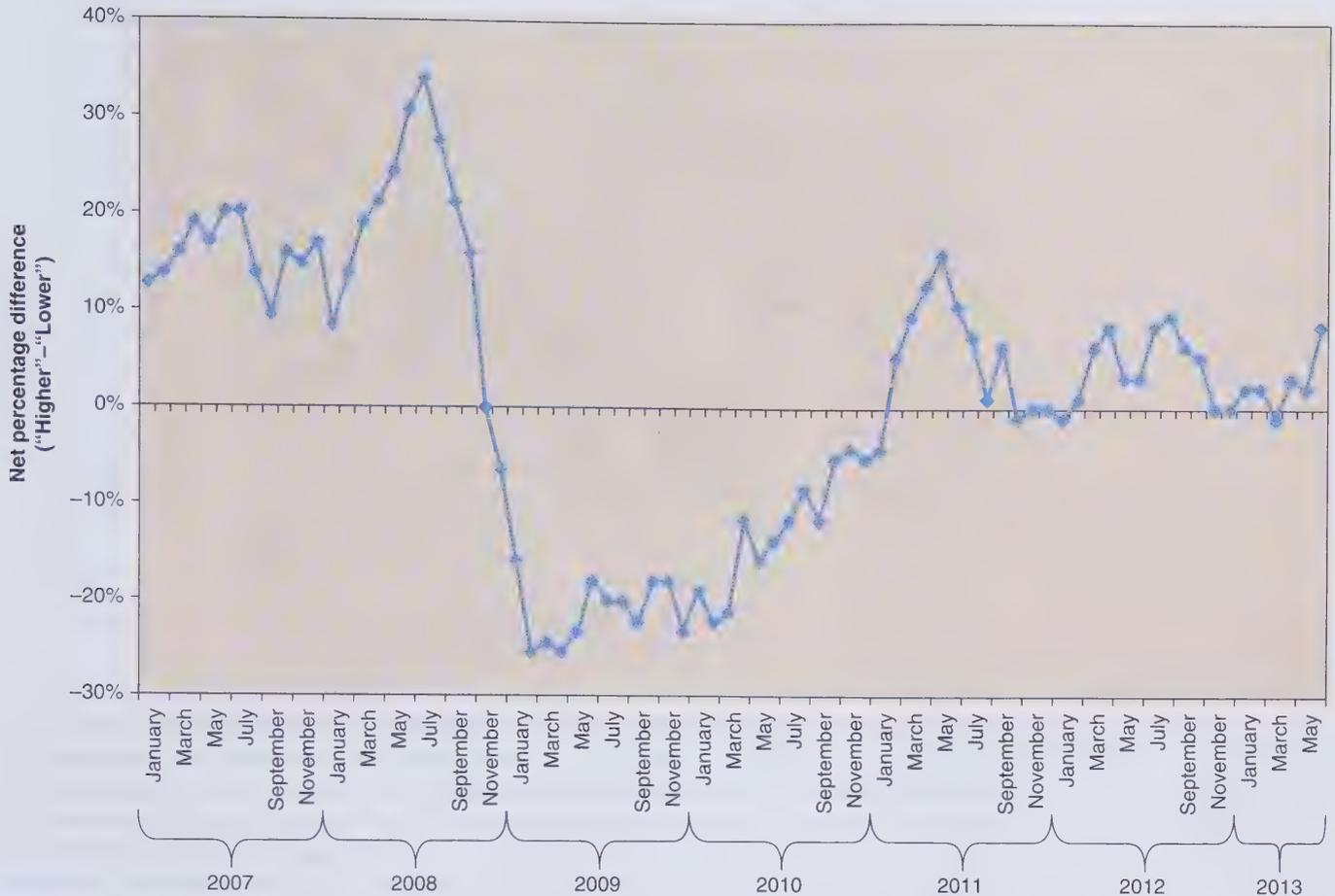


FIGURE 11.1

The Reality of Pricing Decisions—Net Difference in the Percentage of Small Business Owners Who Set Prices *Higher* and Those Who Set Prices *Lower* Than in the Previous 3 Months

Source: Based on William Dunkelberg and Holly Wade, “NFIB Small Business Economic Trends,” National Federation of Independent Businesses, July 2013, p. 8.

orders. In addition to its touch screen, the feature-packed Chairman boasts a rose gold case, a thumbprint reader (for unlocking the phone), a physical numeric keypad, and a winding stem on the side (a throwback to the company’s watchmaking heritage) that supplies it with backup power.⁸

- 3×1 , a shop in Manhattan’s SoHo District started by fashion entrepreneur Scott Morrison, sells bespoke, custom-made, and limited-edition jeans to upscale clients. 3×1 ’s limited-edition jeans, which are already made and ready to wear, range from \$295 to \$495 per pair. 3×1 ’s custom process allows customers to select the denim fabric and the hardware that go into their jeans that sell for between \$535 and \$750 per pair. Customers who choose the bespoke option get to work with Morrison and his pattern maker to create a pair of jeans made to their measurements and specifications. The shop offers more than 135 different denim fabrics, and the most expensive denim that Morrison uses costs more than \$100 per meter. Making a typical pair of jeans requires at least 3 meters of fabric. Morrison, his pattern makers, and tailors produce 22 to 30 pairs of jeans per day on site in full view of customers using old-fashioned single-needle sewing machines and years of cutting and sewing experience and skill. Every pair of jeans is numbered. Sales have exceeded Morrison’s expectations, and he is considering opening a second store in Japan.

As you can see, setting higher prices sometimes can *increase* the appeal of a product or service (“If you charge more, you must be worth it”).

Source: Cartoonstock.



“What are they worth? Well, it’s difficult to put a price on such extraordinary works of art. How much you got?”

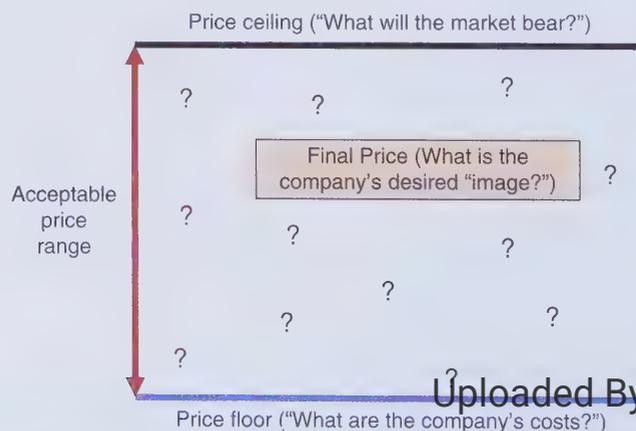
it, and it must be compatible with customers’ perceptions of value. “Pricing is not just a math problem,” says one business writer. “It’s a psychology test.”⁹ The psychology of pricing is an art much more than it is a science. It focuses on creating value in the customer’s mind but recognizes that value is what the customer perceives it to be. At the outset, the goal is not necessarily to determine *the* ideal price but rather an ideal price *range*. This **price range** is the area between the **price floor** that is established by a company’s total cost to produce the product or provide the service and the **price ceiling**, which is the most the target customers are willing to pay (see Figure 11.2). The final price within this range depends on the image the company wants to create in the minds of its customers.

The price floor depends on a company’s cost structure, which can vary considerably from one business to another, even though they may be in the same industry. Although their cost structures may be different from those of their competitors, many entrepreneurs play follow the leader with their prices, simply charging what their competitors do on similar or identical products or services. Although this strategy simplifies the pricing decision, it can be very dangerous. Determining the price floor for a product or service requires entrepreneurs to have access to timely, accurate information about the cost of producing or selling a product or providing a service.

The price ceiling depends on entrepreneurs’ ability to understand their customers’ characteristics and buying behavior, the benefits that the product or service offers customers, and the prices of competing products. The best way to learn about customers’ buying behavior is to conduct ongoing market research and to spend time with customers, listening to the feedback they

FIGURE 11.2

What Determines Price?



offer. Small companies with effective pricing strategies tend to have a clear picture of their target customers and how their companies' products and services fit into their customers' perception of value. A company that begins losing valued customers who complain that its prices are too high has bumped into the price ceiling, and the owner should consider cutting prices.

An entrepreneur's goal is to position the company's prices within this acceptable price range that falls between the price floor and the price ceiling. The final price that entrepreneurs set depends on the desired image they want to create for their products or services: discount (bargain), middle of the road (value), or prestige (luxury). A prestige pricing strategy is not necessarily better or more effective than a no-frills, value pricing strategy. What matters most is that the company's pricing strategy matches the image the owner wants to create for it and the prices its target customers are willing and able to pay. Surveying potential customers, either in person or online, about the price they expect to pay for a particular product or service can be helpful. Serial entrepreneur Bryan Janeczko, cofounder of Nu-Kitchen, an online food retailer, surveyed customers using Survey Monkey about the price they would expect to pay for a day's worth of healthy meals. Responses ranged from \$20 to \$40 per day, leading Janeczko to set a price of \$30.¹⁰

Entrepreneurs often find themselves squeezed by rising operating and raw material costs but are hesitant to raise prices because they fear losing customers. Businesses faced with rising operating and raw material costs should consider the following strategies:

- **Communicate with customers.** Let your customers know what's happening. Danny O'Neill, owner of The Roasterie, a wholesale coffee business that sells to upscale restaurants, coffeehouses, and supermarkets, operates in a market in which the cost of raw material and supplies can fluctuate wildly due to forces beyond his control. When coffee prices nearly doubled in just three months, O'Neill was able to pass along the rising costs of his company's raw material to customers without losing a single one. He sent his customers a six-page letter and copies of newspaper articles about the increases in coffee prices. The approach gave the Roasterie credibility and showed customers that the necessary price increases were beyond his control.¹¹
- **Rather than raise the price of the good or service, include a surcharge.** Price increases tend to be permanent, but if higher costs are the result of a particular event (e.g., a hurricane that disrupted the nation's ability to process oil and resulted in rapidly rising fuel costs), a company can include a temporary surcharge. If the pressure on its costs subsides, the company can eliminate the surcharge. Before gasoline prices climbed rapidly, Ricky Eisen, who owns Between the Bread, a catering business in New York City, and uses two trucks and a van to make deliveries, paid \$40 to \$60 for gas for each vehicle; now she pays \$75 to fill up each one. "It's enough to put a dent in our profit," she says. Eisen recently added a 5 percent fuel surcharge to offset the increased cost of doing business.¹²
- **Rather than raise prices, consider eliminating customer discounts, coupons, and "freebies."** Over time, discounts, coupons, and other freebies add up and can cut into a company's profits, sometimes significantly. Eliminating them is an invisible way of raising prices that can add significantly to a small company's profit margin.
- **Offer products in smaller sizes or quantities.** As food costs soared, many restaurants introduced "small plates," reduced portion items that enabled them to keep their prices in check. In the quick-service sector, mini-burgers billed as "fun food" and offered in bundles became a popular item on many menus.
- **Focus on improving efficiency everywhere in the company.** Although raw materials costs may be beyond a business owner's control, other costs within the company are not. One way to cope with the effects of a rapid increase in costs is to find ways to cut costs and to improve efficiency in other areas. These improvements may not totally offset higher raw materials costs, but they can dampen their impact. Rather than raise prices, the owners of Jen-Mor Florists, a family-run flower shop in Dover, Delaware, decided to cut the number of deliveries to the edge of their territory to just one per day to reduce the company's delivery expenses.¹³
- **Consider absorbing raw material cost increases to keep customers with long-term importance to the company.** Saving a large account might be more important than keeping pace with rising costs. Companies that absorb the rising cost of raw materials often find ways to cut costs in other areas and to operate more efficiently.

- **Emphasize the value your company provides to customers.** Unless a company reminds them, customers can forget the benefits and value its products offer. “If you provide great value to your customers, a little price increase isn’t going to scare them away,” says Elizabeth Gordon, a small business consultant.
- **Raise prices incrementally and consistently rather than rely on large periodic increases.** Companies that do so are less likely to experience resistance due to customers’ sticker shock. In the restaurant business, about 33 cents of each \$1 of sales goes to cover food and beverage costs. Recent increases in food costs have had a direct (and negative) impact on a restaurant’s profits, which average between 3 and 5 percent of sales. When the cost of chicken wings increased by 70 percent in just one year, Buffalo Wild Wings, a chain of more than 850 restaurants that specializes in wings, gradually raised the price of its wings from 45 to 50 cents and then to 60 cents. “We have not seen any resistance to that price increase at all,” says CEO Sally Smith.¹⁴
- **Shift to less expensive raw materials if possible.** When seafood and beef prices increased, many restaurants added more chicken dishes to their menus. When gold prices tripled within a four-year period, jeweler John Christian, based in Austin, Texas, began creating more designs in silver and gold, all-silver, and even steel to keep costs and prices under control. The company also launched a separate line of products called Carved Creations priced well below the average \$750 price for the John Christian line. Within two years, Carved Creations accounted for 30 percent of the company’s sales.¹⁵
- **Modify the product or service to lower its cost.** At quick-service restaurants, value menu items priced at \$1 account for about 10 percent of sales. However, rapidly rising food and energy costs have squeezed or eliminated franchisees’ profits on these items, forcing chains to modify the items by eliminating a slice of cheese (which saves six cents) or shaving two ounces of beef from the patty to maintain the \$1 price.¹⁶ Companies using this strategy must exercise caution, taking care not to reduce the quality of their products and services so much that they damage their reputations.
- **Anticipate rising materials costs and try to lock in prices early.** It pays to keep tabs on raw materials prices and be able to predict cycles of inflation. Entrepreneurs who can anticipate rising prices may be able to make purchases early or lock in long-term contracts before prices take off.

Three Powerful Pricing Forces: Image, Competition, and Value

Price Conveys Image

A company’s pricing policy can be a powerful tool for establishing a brand and for creating a desired image among its target customers. Whether they are seeking an image of exclusivity or one that reflects bargain basement deals, companies use price to enhance the image of their brands. Some companies emphasize low prices, but others establish high prices to convey an image of quality, exclusivity, and prestige, all of which appeal to a particular market segment.

2.

Discuss the relationships among pricing, image, competition, and value.



Oyster Fine Bamboo Fly Rods.
Source: Oyster Fine Bamboo Fly Rods.



ENTREPRENEURIAL PROFILE: Bill Oyster: Oyster Fine Bamboo Fly Rods While recovering from serious injuries incurred while training as a cyclist for the 1996 Olympic Games, Bill Oyster studied and then began building classic bamboo fly rods (Modern fly rods are mass-produced from high-tech graphite and carbon-fiber materials and typically sell for as little as \$50 to as much as \$900) that are handmade and require as much as 200 hours of work to complete. Although Oyster originally began building bamboo rods as a hobby, he soon “had more orders than I could keep up with,” he says. Today, his business, Oyster Fine Bamboo Fly Rods, located in tiny Blue Ridge, Georgia, has a waiting list of customers that is two years long despite the fact that the average price of a rod is \$8,000 (a basic Oyster bamboo fly rod costs \$1,840). Each rod is made from six strips of bamboo, which Oyster cuts in triangular shapes and tapers to less than the width of a toothpick. The pieces are glued together, flame tempered for strength, and dipped in varnish. Oyster then adds hardware, which he engraves himself to customers’ specifications. Customers from around the world, including former presidents, have ordered fly rods from Oyster for prices of up to \$17,000.¹⁷

resulting image (“wow” factor) they create for the buyer. Although entrepreneurs must recognize the extremely limited market for ultraluxury items such as these, the ego-satisfying ownership of limited-edition fly rods, watches, shoes, handbags, cars, jewelry, and other items is a potent psychological force that supports a premium price strategy.

Too often, small companies underprice their products and services, believing that low prices are the only way they can gain an advantage in the marketplace. According to management consulting firm McKinsey and Company, 80 to 90 percent of the pricing mistakes that companies make involve setting prices that are too low.¹⁸ Companies that fall into this trap fail to recognize the extra value, convenience, service, and attention that they give their customers—things that many customers are willing to pay extra for. These entrepreneurs forget that price is just *one* element of the marketing mix and for many customers is not the most important factor. A global study by Accenture reports that 67 percent of customers are not willing to compromise on quality just to get a lower price, and 54 percent of customers are not willing to compromise on the level of customer service they receive in exchange for a lower price.¹⁹

The secret to setting prices properly is understanding a company’s target market: the customer groups at which the it aims its goods or services. Target market, business image, and price are interwoven.



ENTREPRENEURIAL PROFILE: Mark Kronenberg: Math 1-2-3 Mark Kronenberg, founder of Math 1-2-3, an in-home math tutoring and test preparation company in 21 cities across the United States, targets upscale customers who are interested more in results than in price. Some clients have balked at the rates (up to \$200 per hour) that Math 1-2-3 charges for its highly qualified, carefully selected tutors, but Kronenberg says that attracting and retaining high-end clients has been more profitable for his company. “It’s a misconception that if you raise prices too much, you’ll have no business,” he says. “There are many customers who shop based on quality, not lowest price. I think it’s best to avoid a race to the bottom. It’s an easy race to win, but you won’t have a lot of profit to show for it.”²⁰

Competition and Prices

An important part of setting appropriate prices is tracking competitors’ prices regularly; however, the prices that competitors are charging is just *one* variable in the pricing mix (and often not the most important one at that). When setting prices, entrepreneurs should take into account their competitors’ prices, but they should *not* automatically match or beat them. Businesses that offer customers extra quality, value, service, or convenience can charge higher prices as long as customers recognize the “extras” they are getting. In other words, companies that implement a successful differentiation strategy (refer to Chapter 3) can charge higher prices for their products and services.



ENTREPRENEURIAL PROFILE: Naomi Poe: Better Batter Gluten Free Flour Naomi Poe, founder of Better Batter Gluten Free Flour (BBGFF) in Altoona, Pennsylvania, initially tried to match competitors’ prices, but because her flour and baking mixes contain no gluten, they cost more to produce than traditional products that contain gluten. As a result, BBGFF was losing money. Poe knew that she had to raise prices but feared that her company’s sales would plummet—until she realized that her products offered customers extra value that she could promote. Not only were they gluten free, a significant benefit for the 2.4 million Americans who suffer from celiac disease, but they also tasted good! “In blind taste tests on people, not just those who are gluten intolerant, we heard consistently that our products were superior,” she says. “We also offer an unconditional guarantee as well as education and counseling services.” Over the course of the next three years, Poe raised prices on BBGFF’s products by one-third and actually saw sales increase. Her company is now profitable.²¹

Two factors are vital to studying the effects of competition on a small firm’s pricing policies: the location of the competitors and the nature of the competing goods. In most cases, unless a company can differentiate the quality and the quantity of extras it provides, it must match the prices charged by nearby competitors for identical items. For example, if a self-service station charges a nickel more for a gallon of gasoline than the self-service station across the street charges, customers will simply go across the street to buy. Without the advantage of a unique business image, quality of goods sold, value of service provided, convenient location, favorable credit terms, and others—a small company must match local competitors’ prices or else lose

sales. Before matching any competitor's price change, however, entrepreneurs should consider the rivals' strategies. The competition may be establishing its prices using a unique set of criteria and a totally different strategy.

The nature of competitors' goods also influences a small company's pricing policies. Entrepreneurs must recognize those products that are direct substitutes for those they sell and strive to keep prices in line with them. For example, the local sandwich shop should consider the hamburger restaurant, the taco shop, and the roast beef shop as competitors because they all serve fast foods. Although none of them offers the identical menu of the sandwich shop, they are all competing for the same quick-meal dollar.

Whenever possible, entrepreneurs should avoid head-to-head price competition with other firms that can more easily offer lower prices because of their lower cost structures. Most locally owned drugstores cannot compete with the prices of large national drug chains. However, many local drugstores operate successfully by using nonprice competition by offering personal service, free delivery, credit sales, and other extras that the chains have eliminated. Nonprice competition can be an effective strategy for a small business in the face of larger, more powerful enterprises because there are many dangers in experimenting with prices. For instance, price shifts cause fluctuations in sales volume that the small firm may not be able to tolerate. In addition, frequent price changes may muddle a company's image and damage customer relations.

One of the deadliest games a small business can get into with competitors is a price war. Price wars can eradicate profit margins, force companies out of business, and scar an entire industry for years. The tablet computer market has been characterized by price wars. Apple, which relies on a premium pricing strategy for its leading edge products, quickly became the dominant player in the market when it introduced its iPad in 2010 at a starting price of \$499. In 2011, as the tablet market became more crowded, online giant Amazon decided to grab market share by offering a lower-priced tablet and introduced its Kindle Fire at just \$199. Within a year, Amazon had reduced the price of an entry-level Kindle to \$159 and introduced updated versions of a high-definition Kindle Fire at prices that ranged from \$199 to \$599, prices that were \$230 to \$349 less than a comparable iPad. "Amazon did what it had to do to compete with Apple, Google, and other tablet makers, putting some pressure on them, particularly on price," says an industry analyst. Other companies, including Google and Microsoft entered the fray, introducing their own tablets at prices similar to Amazon's. Although Apple's iPad remains the dominant tablet with 55 percent market share, Amazon managed to capture 21 percent of the market with its low-price strategy but had to rely on sales of apps and other services, such as its Prime membership for profits. "We want to make money when people use our devices, not when they buy our devices," says Amazon CEO Jeff Bezos.²²

Price wars usually begin when one competitor believes that it can achieve a higher volume through lower price or that it can exert enough pressure on competitors' profits to drive them out of business. In most cases, entrepreneurs overestimate the power of price cuts to increase sales sufficiently to improve their profitability. In a price war, a company may cut its prices so severely that it is impossible to achieve the volume necessary to offset the lower profit margins. If a company that has a 25 percent gross profit margin cuts prices by 10 percent, it would have to *triple* its sales volume just to break even. Even when price cuts work, their effects are often temporary. Customers lured by the lowest price usually have almost no loyalty to a business. The lesson: The best way to survive a price war is to stay out of it by emphasizing the unique features, benefits, advantages, and value your company offers its customers!

Focus on Value

Ultimately, the "right" price for a product or service depends on one factor: the value that it provides for customers. There are two aspects of value, however. Entrepreneurs may recognize the *objective* value of their products and services, which is the price customers would be willing to pay if they understood perfectly the benefits that a product or service delivers for them. Unfortunately, few if any customers can see a product's or a service's true objective value; instead, they see only its *perceived* value, which determines the price they are willing to pay for it. "Customers see value in more than product and price," says Jim Barnes, a business owner, consultant, and author. "They spend where they believe they get the best total value, and that does not mean always opting for the lowest price." Small companies that find creative ways to add value to their products and services—for instance, by making it easy for customers to buy from them (Barnes calls these "I'll-look-after-that-for-you" moments), impressing them with stellar service, and providing unexpected extras (such as

an electronics retailer consolidating a customer's various remote controls into one when installing a new television)—do not have to resort to price cuts as often as companies that fail to do these things. By offering extra value, these companies encourage their customers to look beyond mere price to determine value. “We must offer the customer something that allows us to earn the prices we charge,” concludes Barnes. “We must go above and beyond, creating new and different forms of value that will compensate for the pressure on customers to obtain more for less.”²³

Businesses that underprice their products and services or run constant sales and discount price promotions may be short-circuiting the value proposition they are trying to communicate to their customers. Customers may respond to price cuts, but companies that rely on them to boost sales risk undermining the perceived value of their products and services. In addition, once customers grow accustomed to buying products and services during special promotions, the habit can be difficult to break. They simply wait for the next sale. Many retailers now face this problem as customers accustomed to buying items on sale postpone buying them until the next special sale arrives. The result has been fluctuating sales and a diminished value of those stores' brands.

In some economic conditions, companies have little choice but to offer lower-priced products. Techniques that companies can use to increase customers' perception of value and essentially lower their prices with less risk of diminishing their brands include offering coupons and rebates that are not as closely connected to the product as direct price cuts. **Limited-time-only (LTO) discounts** used sparingly also increase short-term sales without causing long-term damage to a brand. Another strategy that some companies have used successfully is to launch a **fighter brand**, a less expensive, no-frills version of a company's flagship product that is designed to confront lower-priced competitors head-on, satisfy the appetites of value-conscious customers, and preserve the image of the company's premium product. Rather than lower the price of its Pentium computer chip, Intel introduced the lower-cost Celeron chip to stave off rival AMD's line of value-priced chips.

The good news is that companies can influence through marketing and other efforts customers' perception of value. “The price you get for a product is a function of what it's truly worth—and how good a job you do communicating that value to the end user,” says one entrepreneur.²⁴ Indeed, setting a product's or a service's price is another way a company can communicate value to its customers. For most shoppers, three reference points define a fair price: the price that they have paid for the product or service in the past, the prices that competitors charge for the same or similar product or service, and the costs that a company incurs to provide the product or service. The price that customers have paid in the past for an item serves as a baseline reference point, but people often forget that inflation causes a company's costs to rise from year to year. Therefore, it is important for business owners to remind customers periodically that they must raise prices to offset the increased cost of doing business. “Over time, costs always go up,” says Norm Brodsky, owner of a successful document storage company. “I'd rather raise prices a little every year or with every new contract than be forced to demand a big increase down the road.”²⁵

As we have seen already, companies often find it necessary to match competitors' prices on the same or similar items unless they can establish a distinctive image in customers' minds. One of the most successful strategies for companies facing direct competition is to differentiate their products or services by adding value for customers and then charging for it. For instance, a company might offer faster delivery, a longer product warranty, extra service, or something else that adds value to an item for its customers and allows the business to charge a higher price.

Perhaps the least understood of the three reference points is a company's cost structure. Customers often underestimate the costs businesses incur to provide products and services, whether it is a simple cotton T-shirt on a shelf in a beachfront shop or a lifesaving drug that may have cost hundreds of millions of dollars and many years to develop. They forget that business owners must make or buy the products they sell, market them, pay their employees, and cover a host of other operating expenses, ranging from health care to legal fees.

Pricing Strategies and Tactics

There is no limit to the number of variations in pricing strategies and tactics. The wide variety of options is exactly what allows entrepreneurs to be so creative with their pricing. This section examines some of the most commonly used tactics under a variety of conditions. Pricing always plays a critical role in a firm's overall strategy; pricing policies must be compatible with a com-

3.

Describe effective pricing strategies for both new and existing products and services.

New Product Pricing: Penetration, Skimming, or Sliding

Most entrepreneurs approach setting the price of a new product with a great deal of apprehension because they have no precedent on which to base their decisions. As a result, they often look at the prices their competitors charge and set prices that are slightly lower. If a new product's price is too high, it is in danger of failing because of low sales volume. However, if its price is too low, the product's sales revenue might not cover costs. *Establishing a price that is too low is far more dangerous than setting one that is too high.* Not only does the company forgo revenues and profits, but it also limits the product's perceived value in the eyes of its target customers. "When you build a business around the lowest price, you soon find that there's always someone else who can offer an even lower one," says serial entrepreneur Norm Brodsky. "As a result, you are under constant pressure to keep reducing your price. At best, you end up with an unsustainable commodity business that's no fun to run and an obstacle to achieving the goal of becoming economically self-sufficient."²⁶ To avoid the trap of setting their prices too low, entrepreneurs should consider the total value that they provide their customers, including intangibles such as additional service, convenience, speed, and others, and set a price that reflects that value.



ENTREPRENEURIAL PROFILE: Karsanbhai Patel: Nirma Ltd Karsanbhai Patel started selling a detergent power to add to his income but rewrote sales strategies. In 1969, Patel, a chemist at the department of Mining and Geology in the government of the Indian state of Gujarat, manufactured a phosphate-free synthetic detergent power. Aimed at middle- and lower-income groups, the product was priced at Rs 3.50 per kilogram. The market leader at that time—Surf of Hindustan Unilever Ltd—was priced at Rs 15 per kilogram. Patel's company Nirma, which began as a one-man operation, revised the rules of the game by offering quality products at affordable prices.

When pricing any new product, an entrepreneur must satisfy three objectives:

1. **Get the product accepted.** No matter how unique a product is, its price must be acceptable to a company's potential customers. The price a company can charge depends, in part, on the type of product it introduces:
 - **Revolutionary products** are so new that they transform an industry. Companies that introduce these innovative products usually have the ability to charge prices that are close to the price ceiling although they may have to educate customers about the product's benefits.
 - **Evolutionary products** involve making enhancements and improvements to products that are already on the market. Companies that introduce these products do not have the ability to charge premium prices unless they can use the enhancements they have made to differentiate their products from those of competitors. Establishing a price that is too low for an evolutionary product can lead to a price war.
 - **Me-too products** are products that companies introduce just to keep up with competitors. Because they offer customers nothing new or unique, me-too products offer companies the least amount of pricing flexibility. Achieving success with these products means focusing on cost control and targeting the right market segments.
2. **Maintain market share as competition grows.** If a new product is successful, competitors will enter the market, and a small company must work to expand or at least maintain its market share. Continuously reappraising a product's price in conjunction with special advertising and promotion techniques helps the company maintain market share.
3. **Earn a profit.** A small company must establish a price for the new product that is higher than its cost. Entrepreneurs should not introduce a new product at a price below cost because it is much easier to lower the price than to increase it once the product is on the market. Pricing their products too low is a common and often fatal mistake for new businesses; entrepreneurs are tempted to underprice their products and services when they enter a new market to ensure its acceptance.

Entrepreneurs have three basic strategies to choose from in establishing a new product's price: penetration, skimming, and life cycle pricing.

PENETRATION If a small company introduces a new product in a highly competitive market in which a large number of competitors are competing for acceptance, the product must penetrate

the market to be successful. To gain quick acceptance and build market share quickly, some entrepreneurs use a penetration pricing strategy, introducing the product at a low price. Setting the price just above total unit cost allows the business to develop a wedge in the market and quickly achieve a high volume of sales. The resulting low profit margins may discourage other competitors from entering the market with similar products.

A penetration pricing strategy is ideal when introducing relatively low-priced goods into a market in which no elite segment and little opportunity for differentiation exist. This strategy works best when customers' switching costs (the cost of switching to a lower priced competitor's product) is high (e.g., video game consoles). Penetration pricing also works when a company's competitors are locked into high cost structures that result from the channels of distribution they use, labor agreements, or other factors. For instance, since its inception, Southwest Airlines has relied on its lower cost structure to compete with older, "legacy" carriers by emphasizing low prices. For a penetration pricing strategy to be successful, a company should have a cost advantage over its rivals; otherwise, it risks starting a no-win price war.

Entrepreneurs must recognize that a penetration pricing may take time to be effective; until a company achieves customer acceptance for the product, profits are likely to be small. When a young college student launched a carpet cleaning business to help pay for his education, he decided to be the low-cost provider in his area. Although he landed plenty of work for his part-time business, he found that his company generated very little profit after deducting the expenses of doing business. Realizing that his customers would be willing to pay more for quality work, he raised his prices and began earning a reasonable profit.²⁷

A danger of a penetration pricing strategy is that it attracts customers who know no brand loyalty. Companies that garner customers by offering low introductory prices must wonder what will become of their customer bases if they increase their prices or if a competitor undercuts their prices. If a penetration pricing strategy succeeds and the product achieves mass-market penetration, sales volume increases, economies of scale result in lower unit cost, and the company earns attractive profits. The objectives of the penetration strategy are to achieve quick acceptance among customers and to generate high sales volume as soon as possible.

SKIMMING Companies often use a skimming pricing strategy to introduce a new product or service into a market with little or no competition or to establish a product or service as unique and superior to those of its competitors. Sometimes a company uses this tactic when introducing a product into a competitive market that contains an elite group that is willing and able to pay a premium price or when introducing a revolutionary product. A company sets a higher-than-normal price in an effort to quickly recover its initial developmental and promotional costs of the product. The idea is to set a price well above the product's total unit cost and to promote the product heavily to appeal to the segment of the market that is not sensitive to price. This pricing tactic often reinforces the unique, prestigious image of a company and projects a high-quality image of the product. If a product's price proves to be too low under a penetration strategy, raising the price can be very difficult. If a company using a skimming strategy sets a price that is too high to generate sufficient volume, it can easily lower the price. Successful skimming strategies require a company to differentiate its products or services from those of competitor to justify the above-average price.

 **ENTREPRENEURIAL PROFILE: Billy Lowe** Billy Lowe, who owns a hair salon in Hollywood, California, has developed an "A-list" clientele of celebrities and has a reputation for treating his not-so-famous clients like celebrities as well. Lowe reinforces his salon's high-quality image ("Every day is a good hair day!") with a premium pricing strategy for his styling services that include a cut and style starting at \$125 and full highlights starting at \$175. "Clients are glad to pay your prices when there is perceived value and excellence," he says. "The spirit in which you offer your products and services also can help determine their attitudes toward your premium prices."²⁸

LIFE CYCLE PRICING A variation of the skimming pricing strategy is called life cycle pricing. Using this technique, a small company introduces a product at a high price. Then technological advances, the learning curve effect, and economies of scale enable the company to lower its costs and reduce the product's price faster than its competitors can. By beating other businesses in a price decline, the company discourages competitors and, over time, becomes a high-volume producer. Blu-Ray players are a prime example of a product introduced at a high price that quickly cascaded downward as companies forged important technological advances and took

TABLE 11.1 Tips for Avoiding Pricing Mistakes

- Tip 1. Be careful with cost-plus pricing.** When companies base their prices on costs rather than on customers' perception of value, the result is almost always prices that are either too low or too high.
- Tip 2. Recognize that "me-too" pricing gives a company no pricing power.** A much better strategy is to differentiate your company's products or services by creating additional value for customers or by targeting market niches.
- Tip 3. Realize that you cannot achieve the same profit margin across every product line your company sells.** The profit margin for paper clips is likely to be quite different from the profit margin for printers.
- Tip 4. Recognize that your customer base is made up of different customer segments and that some of them are more sensitive to price than others.** Even if a company sells a single product or service, its value proposition differs among its different customer segments. That means that by adding extra value to its offerings aimed at customers who are willing to pay for it, a company can charge higher prices.
- Tip 5. Do not put off raising prices out of fear of a customer backlash.** If your costs of providing a product or service go up and you never raise prices, your profit margins shrink until you can no longer stay in business. Perpetually absorbing cost increases by holding prices the same is the pricing equivalent of sticking your head in the sand. The outcome is certain: business failure.
- Tip 6. Do not compensate sales representatives solely on sales volume.** Doing so encourages them to sell at any price, particularly low prices that destroy the company's profitability. Create profit-based incentives for your sales force.
- Tip 7. Avoid launching a price war.** As you learned in this chapter, no one "wins" a price war, and they can devastate an industry's profits for years.
- Tip 8. Realize that although discounts have their place in a company's pricing strategy, they can be as addictive as drugs.** "Companies that get hooked on discounts do little more than drive down their value proposition, sometimes past the point of no return," says one pricing consultant. If you decide to use discounts, use them sparingly, briefly, and creatively.
- Tip 9. Recognize that some customers are more valuable to your business than others.** Customers who always demand the lowest prices and the highest level of service often are a company's least profitable customers. Do not waste a disproportionate amount of time and energy catering to them; instead, identify your company's most profitable customers, focus on serving them well, and attract more customers like them.
- Tip 10. Remember that price is just one variable in the sales equation.** Costs, customers' perception of value, and image are important factors as well. Use them!

Sources: Based on "Eradicate Pricing Errors," *Sales & Marketing Management*, August 5, 2009, p. 1; Steve McKee, "How to Discount (If You Insist)," *Business Week*, August 14, 2009, www.businessweek.com/smallbiz/content/aug2009/sb20090814_425078.htm.

advantage of economies of scale. When Blu-Ray players were first introduced in 2006, they sold for \$800; three years later, they were selling for just \$220. Today, shoppers can purchase Blu-Ray players that have more features for less than \$100. Life cycle pricing assumes that competition will emerge over time. Even if no competition arises, companies almost always lower the product's price to attract a larger segment of the market. In a life cycle pricing strategy, the initial high price contributes to the rapid return of start-up or development costs and generates a pool of funds to finance expansion and technological advances.

Table 11.1 offers useful tips for avoiding common pricing mistakes.

Pricing Techniques for Established Products and Services

Entrepreneurs have a variety of pricing techniques or tactics available to them to apply to established products and services. Entrepreneurs must examine each of these techniques or tactics to determine their effectiveness under different circumstances and situations.

ODD PRICING Although studies of consumer reactions to prices are mixed and generally inconclusive, many entrepreneurs use the technique known as **odd pricing**. They set prices that end in odd numbers (frequently 5, 7, or 9) because they believe that an item selling for \$12.69 appears to be much cheaper than an item selling for \$13.00. Odd pricing, such as odd pricing are designed to appeal to certain customer interests, but research on their

effectiveness is mixed. Some studies show no benefits from using odd pricing, but others have concluded that the technique can produce significant increases in sales. Omitting the “\$” symbol from prices may help, too. Researchers at Cornell University have discovered that restaurants that list menu prices without the “\$” symbol (“12”) achieved higher sales on average than those whose menu prices were written in script (“twelve dollars”) or included the “\$” symbol (“\$12”).²⁹

PRICE LINING Price lining or tiered pricing is a technique that greatly simplifies the pricing decision. Under this system, an entrepreneur sells a product in several different price tiers or price lines. Each category of merchandise contains items that are similar in appearance, quality, cost, performance, or other features. Many lined products appear in sets of three—good, better, and best—at prices designed to satisfy different market segments’ needs and incomes. Apple uses price lining for many of its products, including the iPad Mini, which it introduced at prices of \$329 (16 GB), \$429 (32 GB), and \$529 (64 GB). Price lining can boost a store’s sales because it makes goods available to a wide range of shoppers, simplifies the purchase decision for customers, and allows them to keep their purchases within their budgets.



In the Entrepreneurial Spotlight

How to Compete with Cheap Knockoffs of Your Successful Product



Sarah and Jenifer Kaplan, cofounders of Footzyrollupz.

Source: Rollashoe LLC.

Sisters Jenifer and Sarah Kaplan admit that the designer high heels and stilettos that they wear often end up hurting their feet and causing them to quietly slip off their shoes whenever they can. They, like many women, were willing to put up with some degree of discomfort to be able to sport the latest “must-have” shoe. Little did they know that their fashion persistence would lead them to become entrepreneurs. After graduating from college, the sisters realized that many women suffered from the same uncomfortable shoe problem and launched Footzyrollupz, a company based in Miami Beach that sells comfortable flat shoes that women can roll up and discreetly slip into a small purse, clutch, or handbag, car glove box, or desk drawer.

As growing numbers of women discovered the simplicity and usefulness of Footzyrollupz, the company’s sales increased quickly, which attracted competitors. Large retail stores began selling cheap knockoffs of their rollable yet comfortable and stylish shoes at much lower prices. “We had to differentiate ourselves from the \$10 version at Target,” says Sarah, “so we went with tiered pricing.” The sisters decided to introduce a lower-priced Ever-

called Lux that sold for \$30 per pair. The strategy was successful, and the impact was immediate. “We had a 100 percent increase in revenue,” says Sarah. “We actually have had the most interest in our higher-priced shoes,” says Sarah. Buoyed by the success of their initial pricing strategy, the Kaplans now offer Footrollupz shoes at three general price levels: basic models that start at just \$22, mid-range shoes that are priced around \$36, and a luxury collection that sell at prices from \$55 to \$69.

By refusing to engage in a price war with competitors and using tiered pricing, the Kaplans were able to generate additional sales without portraying their company as a bargain-basement discount seller. When their company’s sales began to decline due to a weak economy and competition from cheap knockoffs, the Kaplans knew that they had to reevaluate the pricing strategy of Footrollupz but refused to be drawn into a price war. What are the signs that mean it is time to consider changing your company’s pricing strategy?

1. **Unit sales growth slows or declines.** When sales volume stalls or declines, the market may be saturated, the economy may be struggling, competitors could be stealing away your customers, or your prices are out of line with customers’ perceived value of your products and services.
2. **Discounts fail to increase sales.** The reason that companies offer price discounts is to increase sales, ideally by a greater percentage than the discount. If a discount fails to produce results, continuing to offer it is a recipe for disaster. “Price cutting usually is not the best strategy for a small business—especially a business that serves a target market that cares more about value and service than paying the lowest possible price,” explains one business writer. “Not only does discounting generally fail to help you acquire new customers, but it may also result in your making less money from the customers you already have.”

3. **Competitors introduce new products or services.**

Innovations by competitors can change—sometimes

In the Entrepreneurial Spotlight *(continued)*

dramatically—the price–value equation in the market. “If the competition has leapfrogged you on value, you may not be able to maintain your current pricing strategy,” explains one pricing expert.

4. **Low-cost competitors enter the market.** When a market is experiencing high growth, it often attracts new entrants. If those new competitors have lower cost structures and utilize penetration pricing strategies, their entry can muddle the entire industry’s pricing structure. When faced with this situation, some companies engage in a price war, but others take different approaches, such as introducing fighter brands or moving into less-price-sensitive niche markets.
5. **Gross profit margin declines.** As you will learn in Chapter 14, that a company’s gross profit margin = $(\text{Sales} - \text{Cost of good sold}) \div \text{Sales}$. The only ways to repair a gross profit margin that is too low is to either reduce the company’s cost of goods sold or increase its prices.

1. Explain the dangers of discounting as a pricing strategy for increasing sales.
2. Use the Internet to research price wars. What conditions usually prompt price wars? What impact do price wars have on an industry and the companies in it? What outcomes are typical in a price war?
3. Many small companies compete successfully without focusing on providing the lowest prices, even in industries in which customers view product or service prices as important purchasing criteria. What tactics do these companies use to compete successfully without relying on the lowest prices?

Sources: Based on Eilene Zimmerman, “Real-Life Lessons in the Delicate Art of Setting Prices,” *New York Times*, April 20, 2011, www.nytimes.com/2011/04/21/business/smallbusiness/21sbiz.html?pagewanted=all&_r=0; Ryan McCarthy, “Pricing: How Low Can You Really Go?,” *Inc.*, March 2009, pp. 91–92; Vincent Ryan, “The Price Is Wrong,” *CFO*, December 2009, p. 52; Rosalind Resnick, “Hold the Line on Price,” *Washington Post*, March 9, 2009, www.washingtonpost.com/wp-dyn/content/article/2009/03/11/AR2009031103668.html; “About Us,” ePromos, www.epromos.com/AboutPromos/AboutUs.jsp.

FREEMIUM PRICING Companies that use **freemium pricing** provide a basic product or service to customers for free but charge a premium for expanded or upgraded versions of the product or service. Products or services that customers must use or experience to appreciate their value, such as software, are ideal candidates for a freemium pricing strategy. The goals of a freemium pricing strategy are to gain rapid and extensive adoption of a product or service and to give potential customers a chance to discover the value that it offers, particularly in its upgraded versions. The key to a successful freemium strategy is to expose users to enough free product or service features while reserving the most valuable benefits for customers who are willing to pay for the expanded versions. Typically, only about 2 to 4 percent of customers who use the free version of a product actually purchase its upgraded versions; therefore, for a freemium strategy to be successful, the potential market must be sizable.³⁰ Suppose, for example, that a company’s revenue target is \$10 million and that its average annual revenue per *paying* customer is \$120. The company would need 83,333 paying customers ($\$10 \text{ million} \div \120 per customer) to reach its target. Assuming a conversion rate of 3 percent, the company would have to attract 2,777,778 free users ($83,333 \text{ customers} \div 3 \text{ percent}$) to generate \$10 million in annual sales.

One of the greatest dangers of a freemium pricing strategy is underestimating the cost of providing service and support for free users.



ENTREPRENEURIAL PROFILE: Drew Houston and Arash Ferdowsi: Dropbox “The big lesson [with] a freemium business model is that your marketing cost is the free users,” says Drew Houston, who with Arash Ferdowsi cofounded Dropbox, a company that provides cloud storage and universal access to and sharing of files. Houston and Ferdowsi decided to use a freemium pricing strategy because “Dropbox was offering a product that people didn’t know they needed until they tried it,” explains Houston. Dropbox allows users to store up to 2 gigabytes of data for free (with incentives of up to 18 gigabytes of space for referring other users). Customers who need more storage space can purchase plans that start at just \$9.99 per month for 100 gigabytes of space and go up to \$6,420 per year for larger corporate users.³¹

DYNAMIC PRICING For many businesses, the pricing decision has become more challenging because the Internet gives customers access to incredible amounts of information about the prices of items ranging from cars to computers. Increasingly, customers are using the Internet to find the lowest prices available. To maintain their profitability, companies have developed pricing

dynamic (or customized) pricing, in which they set different prices on the same products and services for different customers using the information they have collected about their customers. Rather than sell their products at fixed prices, companies using dynamic pricing rely on fluid prices that may change based on supply and demand, the prices that competitors are charging, and which customer is buying or when a customer makes a purchase. For instance, a first-time customer making a purchase at an online store may pay a higher price for an item than a regular customer who shops there frequently pays for that same item.

Online retailers, especially those that operate stores through eBay or Amazon, are heavy users of dynamic pricing, often updating the prices of the products they sell minute by minute. Their goal is to establish the lowest price on an item, sometimes by just a penny, so that they can achieve the top spot in search engine results for shoppers who are searching for the lowest prices. The software they use allows retailers, even small ones, to define how often to update their prices, which competitors' prices to monitor, how much to beat competitors prices by, and how low the total price can go.

Dynamic pricing is not a new concept. The standard practice in ancient bazaars involved merchants and customers haggling until they came to a mutually agreeable price, which meant that different customers paid different prices for the same goods. Although the modern version of dynamic pricing often involves sophisticated market research and powerful computer software that can change millions of products in just minutes, the goal is the same: to charge the right customer the right price at the right time. The products for which price changes occur most frequently are consumer electronics, clothing, shoes, jewelry, and household staples. Research shows that prices actually go down about as often as they go up.



ENTREPRENEURIAL PROFILE: Al Falack: Cookie's Cookie's, an online children's clothing store that Al Falack operates through Amazon, uses dynamic pricing software from Mercent Corporation to update its prices every 15 minutes in an attempt to make it into Amazon's recommended "buy box," which shoppers who purchase select 95 percent of the time. Falack says that even with the software, monitoring prices requires a commitment, but the payoff is dramatically higher sales. Falack sets the software's parameters to beat the prices of certain competitors (only those with at least two stars out of Amazon's five-star rating) by a specific percentage and to establish a minimum price floor. The almost constant adjustments mean that Falack often sells clothing at lower prices in his Amazon store than he does in his physical store in Brooklyn, New York. "The long-term implication is that a price is no longer a price," says Mercent's CEO.³²

LEADER PRICING Leader pricing is a technique in which a retailer marks down the customary price (i.e., the price consumers are accustomed to paying) of a popular item in an attempt to attract more customers. The company earns a much smaller profit on each unit because the markup is lower, but purchases of other merchandise by customers seeking the leader item often boost sales and profits. In other words, the incidental purchases that consumers make when shopping for the leader item boosts sales revenue enough to offset a lower profit margin on the leader. Grocery stores often use leader pricing. For instance, during the holiday season, stores often use turkeys as a price leader, knowing that they will earn higher margins on the other items that shoppers purchase with their turkeys.

GEOGRAPHIC PRICING Small businesses whose pricing decisions are greatly affected by the costs of shipping merchandise to customers across a wide range of geographic regions frequently employ one of the **geographic pricing** techniques. For these companies, freight expenses constitute a substantial portion of the cost of doing business and often cut deeply into already narrow profit margins. One type of geographic pricing is **zone pricing**, in which a company sells its merchandise at different prices to customers located in different territories. For example, a manufacturer might sell at one price to customers east of the Mississippi and at another to those west of the Mississippi. A small business must be able to show a legitimate basis (e.g., difference in selling or transportation costs) for the price discrimination or risk violating Section 2 of the Clayton Act.

Another variation of geographic pricing is the **uniform delivered pricing**, a technique in which a company charges all of its customers the same price regardless of their location, even though the cost of selling or transporting merchandise varies. The company calculates the freight costs for each region in which it sells and combines them into a uniform fee. The

result is that local customers subsidize the firm's charge for shipping merchandise to distant customers.

A final variation of geographic pricing is **F.O.B. factory**, in which a small company sells its merchandise to customers on the condition that they pay all shipping costs. Using this technique, a company can set a uniform price for its product and let each customer cover the freight cost.

DISCOUNTS Many small businesses use **discounts**, or **markdowns**, reductions from normal list prices, to move stale, outdated, damaged, or slow-moving merchandise. A seasonal discount is a price reduction designed to encourage shoppers to purchase merchandise before an upcoming season. For instance, many retail clothiers offer special sales on winter coats in late summer. Some companies grant discounts to special groups of customers, such as senior citizens or college students, to establish a faithful clientele and to generate repeat business. One study suggests that for items other than luxury goods, placing discount signs close to merchandise displays and promoting dollar discounts rather than percentage discounts increases the probability of making a sale.³³

As tempting as discounts are to businesses when sales are slow, they also carry risks. Because price is an important signal of quality and image to customers, businesses that turn to discounts too often create the impression that they may be lowering their quality standards, thereby diluting the value of their brand and image in the marketplace. "For the sake of a short-term increase in sales, you can wreck the long-term value of your brand," says Rafi Mohammed, author of *The Art of Pricing*.³⁴ Many restaurants, from quick-service chains to fast-casual outlets, relied heavily on price discounts in an attempt to attract customers during a recent recession. For many, however, the traffic that the discounts offered failed to offset the price cuts, resulting in the same lower total revenues they were trying to avoid. In addition, when the economy improved, many restaurants faced difficulty weaning customers from their discount price expectations. "They've trained customers to eat \$5 foot-long sandwiches," says one industry analyst about a popular chain's discounts.³⁵ As the economy improved, restaurants reduced their use of discount coupons and introduced new, higher-priced menu items.³⁶ One less visible way to offer discounts is to enroll customers in a loyalty program that entitles them to **earned discounts**, discounts that customers receive when their purchases reach a minimum threshold.

Limited-time offers (LTOs) are discounts that retailers run for a limited amount of time ("Regular price: \$150. Sale price \$120 for three days only.") with the goal of creating a sense of urgency and excitement among customers. Although limited-time offers are a common pricing tool for many retailers, quick-service restaurants are perhaps the most frequent users of limited-time offers. To create a successful limited-time offer, retailers should emphasize the end date of the offer and include a distinct call to action in their advertising, promote the offer on social media as well as in traditional advertising channels, and end the offer on the advertised date. Toppers Pizza, a pizza chain with 41 locations in the Midwest and South, has had great success running periodic, aggressively priced limited-time offers (such as a one-topping large pizza for just \$5) by promoting them among its 50,000 Facebook fans. "We do double the volume of transactions during the LTO compared to a normal week," says Scott Iversen, the company's vice president of marketing. "The volume we do in ancillary sales of drinks and sides makes up for the lower [profit] margin on the LTO."³⁷

Recent research suggests that using a **steadily decreasing discount (SDD)**, a limited-duration discount that declines over time, is superior to a standard (hi-lo) discount, a common tactic in which a company offers frequent discounts off of its standard prices. When one company used a hi-lo discount of 20 percent for three days before returning to the items to full price, sales increased by 75 percent. For the same items, a steadily decreasing discount of 30 percent the first day, 20 percent the second day, and 10 percent the third day (which yielded the same average discount of 20 percent) produced an increase in sales of 200 percent. The researchers conclude that the steadily decreasing discount is more effective because it creates a sense of urgency, especially among wary or indecisive customers.³⁸

Multiple unit pricing is a promotional technique that offers customers discounts if they purchase in quantity. Many products, especially those with a relatively low unit value, are sold using multiple pricing. For example, instead of selling an item for 50 cents, a small company might offer five for \$2.



Entrepreneurship in Action

Social Coupons: Beneficial—or Just Plain Bad—for Business?

Lisa Bridge bought a successful yoga studio in New York City and relocated it to a new, less expensive location; completing the renovation and the move took longer than expected, however, and sales fell precipitously. In an attempt to generate sales quickly, Bridge began offering discount coupons on Groupon, LivingSocial, and other daily deal sites. Some of the coupons offered discounts of more than 50 percent off the regular price of a yoga session. Although Bridge was concerned about offering such large discounts, she needed customers; her goal was to use the coupons to entice first-time customers to join her studio. Unfortunately, she was offering so many deals through so many sites that shoppers could become regular customers without having to pay full price.

The discount coupons worked. New customers, almost all of whom were paying significantly reduced rates, began signing up, but Bridge could not afford to hire new instructors to accommodate the demand for classes that the discount coupons had created. Existing customers were crowded out, and confusion reigned at the front desk: How much is your discount? Did the Groupon deal include a free yoga mat, or was that the LivingSocial deal? “Rather than focus on members, management catered to the ‘deals’ people,” says one former employee. “But people who bought deals rarely stayed on as customers. If they did, they bought an offer from a different [daily deal] site and never paid full price.” Several months later, the yoga studio closed.

When sales are slow, business owners are tempted to reduce prices to get customers in the front door and move merchandise, and daily deal sites such as Groupon, Living Social, Amazon Local, Google Offers, and others that offer shoppers coupons that yield significant discounts at local businesses are ready to promote the deal (think social media meets coupons). To promote a small company’s special, Groupon, which claims to have 33 million active users worldwide, collects 50 percent of the discounted price (which usually at least 50 percent of the normal price) for each coupon it sells, which means that business owners get only 25 percent of a product’s or service’s full price. In addition, Groupon does not pay merchants their portion of the coupons’ sales immediately; businesses receive three equal payments spread across 60 days. Mark Grohman, owner of Meridian Restaurant in Winston-Salem, North Carolina, says that he does not plan to offer daily discounts through Groupon again because the slow payments put too much pressure on his restaurant’s cash flow. “The payment timing is so erratic you can’t count on any of that money to pay your bills,” he says. “With small margins in restaurants, you need that cash in the bank as fast as possible.” To protect their cash flow and profits, business owners must be extremely careful concerning the deals and discounts they offer.

Daily deal sites have the power to drive significant volumes of traffic to a business, but making a profit on the increased volume can be a challenge. A study by the Jesse H. Jones Graduate School of Business at Rice University reports that 27 percent of businesses lose money on Groupon discount deals. The study also reports that although 80 percent of coupon users are first-time customers, only 20 percent of them become repeat customers.

Given the nature of daily discount sites such as Groupon, the customers that companies attract with the discount coupons tend to be bargain shoppers and deal seekers who are looking for low prices. “In their current form, social coupons are not ideally suited to ensure customer acquisition and yield business profits,” conclude two professors at the Massachusetts Institute of Technology who studied the impact of social coupons on small businesses.

What steps can business owners take to ensure that they reap the benefits of promotions on daily deal sites and avoid the pitfalls?

- **Use daily deal to build relationships with new customers.** Use the deals as a way to find new customers, then stay connected with them through social media channels and other marketing avenues. The goal is to convert them into long-term, loyal customers.
- **Emphasize customer service.** The best way to create repeat customers is to provide them with excellent service and make sure that their first experience with your company is a positive one.
- **Be ready for a surge in business.** Coupon offers through daily deal sites can create significant increases in the volume of business for companies in a short period of time. Make sure that you have the staff, cash, and raw materials ready to handle it. “If people come in the door and get frustrated by long lines, it’s a total backfire,” says Brendan Shapiro, owner of outdoor store Potomac River Running and a regular Groupon user.
- **Limit your promotion.** To avoid nasty surprises, smart daily deal site users place time and quantity limits and blackout dates on their offers.
- **Run specials on overstocked merchandise or underutilized services.** A daily deal special can be a useful tool for selling slow-moving merchandise.
- **Use the new customer contact opportunity to cross-sell.** For example, a yoga studio might cross-sell yoga clothing and accessories to new customers who purchase discount coupons.
- **Know your costs and the revenue that each coupon will generate.** The typical Groupon sale generates only 25 percent of the normal revenue that a company earns, which makes earning a profit on a deal challenging. Nearly three-fourths of companies make money on their Groupon offers; your goal is to be one of them.
- **Limit offers to new customers only.** Providing social coupons only to new customers avoids the problem of cannibalizing a company’s existing revenue.
- **View your daily deal offer as a marketing expense.** Heather Speizman, owner of Bottles and Brushes, an art studio in Mount Pleasant, South Carolina, offered a \$15 Groupon for an art class normally priced at \$35 to

Entrepreneurship in Action *(continued)*

generate buzz about a new location she was opening in nearby Summerville. The promotion worked, generating lots of buzz for her new store. “It was a great experiment in social media at its best,” she says.

- **Track the results.** The only way to determine whether a Groupon deal was successful is to monitor the results it produces. How many coupons did customers purchase? How many did they redeem? What is the average sale for customers who used the coupons? What proportion of them bought additional products or services? How many of them become repeat customers?
1. Use the Internet to find examples of companies that have experienced great success with and great failure with daily

deal sites such as Groupon and LivingSocial. What lessons can you draw from them?

2. Work with a group of your classmates to brainstorm local businesses that could benefit from an offer on a daily deal site. What deal do you suggest the business offer?

Sources: Based on Dan Slater, “Are Daily Deals Done?,” *Fast Company*, April 2012, pp. 43–44; “Beware the Cost of Social Coupons,” *Build*, Fall 2012, Section D.13; Sarah E. Needleman and Shayndi Raice, “Groupon Holds Cash Tight,” *Wall Street Journal*, November 10, 2011, pp. B1, B4; Tim Gray, “How to Find Success Using Groupon,” *The ROI Factor*, August 3, 2012, www.bluefountainmedia.com/blog/how-to-find-success-using-groupon/; Tim Donnelly, “How Groupon Can Boost Your Company’s Exposure,” *Inc.*, January 24, 2011, www.inc.com/guides/201101/how-groupon-works-for-small-businesses.html; Duff McDonald, “The High Value of Discount Prices,” *Wall Street Journal*, June 23–24, 2012, p. C9; Gwen Moran, “Sealing the Deal-Seekers,” *Entrepreneur*, June 2012, p. 77.

BUNDLING Many small businesses have discovered the marketing benefits of **bundling**, grouping together several products or services (or both) into a package that offers customers extra value at a special price. Rather than cut into their already thin profit margins with price discounts during a recent recession, some restaurants used a bundling strategy, offering customers value-priced groupings of items. Pizza Hut has had great success with its “\$10 Dinner Box,” a limited-time offer that includes one medium one-topping pizza, five breadsticks with marinara dipping sauce, and 10 cinnamon sticks with icing. The items in the dinner box would cost \$16 if customers purchased them separately. “Our brand has come to recognize that there is a much higher standard for value than there was just a few years ago,” says Kurt Kane, the company’s chief marketing officer. “[Customers] are looking to spend their money wisely.”³⁹

OPTIONAL-PRODUCT PRICING **Optional-product pricing** involves selling the base product for one price but selling the options or accessories at a much higher percentage markup. Automobiles are often sold at a base price with a multitude of options available at separate prices. In many cases, automakers bundle together the most popular options in specially priced packages. Apple relies on optional-product pricing, offering an extensive selection of accessories for its smart phones, tablets, and computers. For instance, smart phone accessories include cases and armbands, speakers, car chargers and adapters, headsets, docking stations, credit card readers, and others and together can cost as much or more as the phone itself.

CAPTIVE-PRODUCT PRICING **Captive-product pricing** is the granddaddy of all pricing tactics in which the basic product is useless without the appropriate accessories. King Gillette, the founder of the company that manufactures Gillette razors, taught the business world that the *real* money is not in the razor (the product) itself but in the blades (the accessory). Today, we see the same pricing strategy used by Nintendo and other electronic game manufacturers that have a very small profit margin on the product but substantially higher margins on the game cartridges. When Nintendo launched its popular Wii game station, the company’s strategy was to sell a simpler game station with games that players could enjoy without having to invest dozens of hours to learn them. This strategy enabled Nintendo to introduce its game station at a price of just \$249, well below the \$500 price tag on Sony’s PlayStation 3 and Microsoft’s \$400 Xbox 360. Nintendo’s real moneymaker, however, is the games that it sells to Wii owners that are priced at \$50 each (still below the \$60 price tag on most PlayStation games). Nintendo’s pricing strategy worked, and sales of Wii stations and games outstripped those of Sony’s and Microsoft’s products.⁴⁰

BY-PRODUCT PRICING **By-product pricing** is a technique in which the revenues from the sale of by-products allow a firm to be more competitive in its pricing of the main product. For years, owners of sawmills considered bark chips to be a nuisance. Today, they package them and sell them as ground cover to home owners, gardeners, and landscapers. One of the most creative examples of by-product pricing, packaging once-worthless exotic animal droppings and marketing it as fertilizer under the clever name “Zoo Doo.”

SUGGESTED RETAIL PRICES Many manufacturers print suggested retail prices on their products or include them on invoices or in wholesale catalogs. Small business owners frequently follow these suggested retail prices because doing so eliminates the need to make a pricing decision. Nonetheless, following prices established by a distant manufacturer may create problems for a small business. For example, a clothing retailer may try to create a high-quality, exclusive image through a prestige pricing policy, but manufacturers may suggest discount outlet prices that are incompatible with the small firm's image. Another danger of accepting the manufacturer's suggested price is that it does not take into consideration a small company's cost structure or competitive situation. A controversial U.S. Supreme Court decision in 2007 overturned a nearly 100-year-old ruling and allows manufacturers to set and enforce minimum prices that retailers can charge for the manufacturer's products as long as doing so does not reduce competition. In its decision, the Court upheld the right of Leegin Creative Leather Products to refuse to sell its Brighton brand belts to Kays Kloset, a small company in Lewisville, Texas, that was selling the belts discount prices that were 20 percent below the suggested retail price. However, more than 30 states are considering passing new antitrust laws that explicitly ban all minimum price agreements in an attempt to preempt the court's decision.⁴¹

FOLLOW-THE-LEADER PRICING Some small businesses make no effort to be price leaders in their immediate geographic areas and simply follow the prices that their competitors establish. Maintaining a follow-the-leader pricing policy may not be healthy for a small business because it robs the company of the opportunity to create a distinctive image in its customers' eyes.

A small company's pricing strategy must be compatible with its marketing objectives, its marketing mix, and its cost structure. In addition, the pricing strategy must be consistent with the competitive realities of the marketplace and the shifting forces of supply and demand. The forces that shape the pricing decision can change rapidly, and therefore a company's pricing strategy is never completely fixed. Pricing decisions must take into account a company's cost, the special value the product or service creates for buyers, and the pricing tactics of competitors.

The underlying forces that dictate how a business prices its goods or services vary greatly among industries. The next three sections investigate pricing techniques used in retailing, manufacturing, and service firms.



Lessons from the Street-Smart Entrepreneur

Enhancing Your Company's Pricing Power

As the economy slowed in a recent recession, businesses of all sizes and across myriad industries began offering price discounts to encourage customers to buy their goods and services. Fast-casual restaurants such as Applebee's and Ruby Tuesday offered a selection of dinner specials priced at two for \$20. Quick-service restaurants expanded their value menus and introduced bundled items at rock-bottom prices. Subway's \$5 foot-long sandwiches were a hit, appealing to a broad base of customers.

Then many of these companies realized that they had created a challenging problem: How do we raise prices when the economy improves? Once customers become accustomed to value deals, how does a business change their perceptions of the relationship between price and value? The following pricing power matrix can help:

The horizontal axis of the matrix measures the extent to which customers view a product or service as a necessity or a discretionary purchase. The vertical axis describes a product's or service's level of uniqueness, which ranges from an undifferentiated commodity to a completely unique item. Where on the matrix does your company's product or service fall?

The best quadrant for a company to operate in is the upper left corner, or uniqueness, a situation in which customers

have a high need for a product or service that is unique and highly differentiated from competing products and services. An individual's brand of shampoo or razor blades that fit his or her razor offer good examples. These products have the greatest degree of pricing power, even during economic downturns.

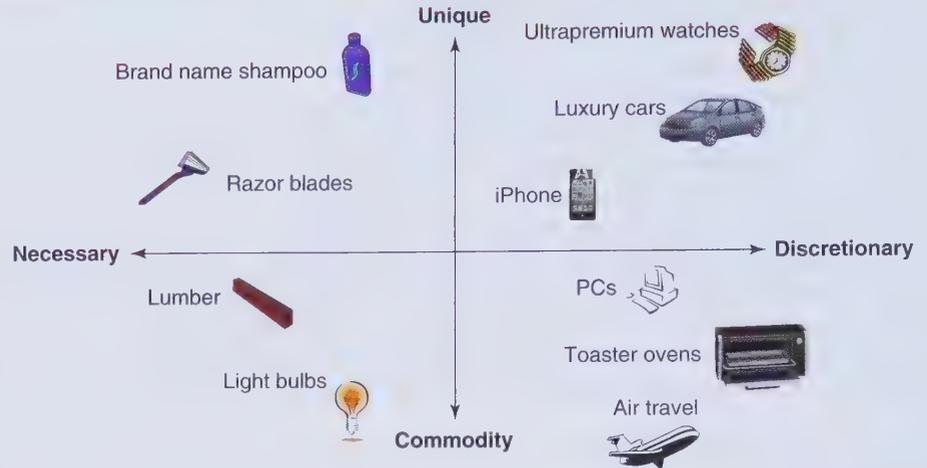
The lower-right quadrant is discretionary commodities. With a discretionary commodity, a company's products or services are very similar to those of competitors, and customers do not have to have them or can postpone their purchases of them at least for a while. The airline industry finds itself in this unenviable position because many customers can choose alternative methods of travel, postpone their trips, or choose a less expensive flight on a competing airline.

The remaining two quadrants offer in-between positions of pricing power. In the lower left corner are products and services that, although necessary, offer little opportunity for differentiation. Lightbulbs and lumber provide good examples, and companies that produce them often end up matching competitors' prices because customers see them as the same.

The upper right corner contains products and services that are quite unique but are highly discretionary; customers simply do not have to have them, which means that companies that operate in this sector do not have maximum pricing power.

Lessons from the Street-Smart Entrepreneur (continued)

Pricing power matrix.



that sell for as much as \$650,000 and cars such as Rolls Royce are good examples. During a recent economic downturn, for instance, Rolls Royce introduced the \$245,000 Ghost, a smaller, more “affordable” car (at least compared to the rest of its line, including the \$380,000 Phantom) that is, in the Rolls Royce tradition, hand built and offers amenities such as night-vision cameras, inch-thick lamb’s wool carpet, and a cashmere head liner. Located in the same quadrant, Apple recently cut the price of its entry-level iPhone in half and introduced a next-generation model to maintain its sales in the face of competing smart phones and more frugal customers.

Companies have the ability to move from one quadrant to a more desirable one by executing the proper strategy. The following questions help entrepreneurs consider their strategic options to increase their pricing power:

1. Can you offer a product or service that your customers consider a necessity? Doing so enhances a small company’s pricing power.
2. Can you offer an “affordable luxury”? Even in austere economic conditions, customers are willing to splurge on small

luxuries such as gourmet chocolates, premium ice cream, and luxury muffins. These affordable luxuries give companies a great deal of pricing power.

3. What steps can you take to differentiate your company’s products or services from those of your competitors? The greater the degree of differentiation of a company’s products and services, the less price sensitive customers tend to be and the more pricing power a company has.
4. Can you offer customers something that will save your customers money? If so, your company has the ability to increase its pricing power.
5. Can you reduce the role of price in customers’ buying decisions by, for example, offering superior customer service? Most small companies have the ability to deemphasize the role that price plays in customers’ buying decisions.

Sources: Based on Geoff Colvin, “Yes, You Can Raise Prices,” *Fortune*, March 2, 2009, p. 20; Sara Wilson, “When to Lower Your Price Point,” *Entrepreneur*, April 2009, pp. 28–29; Hannah Elliott, “Stealth Wealth,” *Forbes*, January 18, 2010, p. 62; Dan Neil, “Rolls Royce Builds a Real Car,” *Wall Street Journal*, April 10–11, 2010, p. W6; Yukari Iwatani Kane, “To Sustain iPhone, Apple Halves Price,” *Wall Street Journal*, June 9, 2009, p. B1.

Pricing Techniques for Retailers

4. Explain the pricing techniques used by retailers.

Because retail customers have become more price conscious and the Internet has made prices more transparent, many retailers have changed their pricing strategies to emphasize value. This value–price relationship allows for a wide variety of highly creative pricing and marketing practices. Delivering high levels of perceived value in products and services is one key to retail customer loyalty. To justify paying a higher price than those charged by competitors, customers must perceive a company’s products or services as giving them greater value.

Markup

The basic premise of a successful business operation is selling a good or service for more than it costs to produce or purchase it. The difference between the cost of a product or service and its selling price is called **markup** (or **markon**). Markup can be expressed in dollars or as a percentage of either cost or selling price:

$$\text{Dollar markup} = \text{Retail price} - \text{Cost of the merchandise}$$

$$\text{Percentage (of retail price) markup} = \frac{\text{Dollar markup}}{\text{Retail price}}$$

$$\text{Percentage (of cost) markup} = \frac{\text{Dollar markup}}{\text{Cost of unit}}$$

For example, if a man's shirt costs \$14 and the manager plans to sell it for \$30, the markup is as follows:

$$\begin{aligned} \text{Dollar markup} &= \$30 - \$14 = \$16 \\ \text{Percentage (of retail price) markup} &= \frac{\$16}{\$30} \\ &= 53.3\% \\ \text{Percentage (of cost) markup} &= \frac{\$16}{\$14} \\ &= 114.3\% \end{aligned}$$

The cost of merchandise used in computing markup includes not only the wholesale price of the merchandise but also all other costs (such as shipping and transportation charges) that the retailer incurs minus any discounts (such as quantity or cash discounts) that the wholesaler or manufacturer offers. Markups vary across industries and product lines. Tobacco products typically carry a markup (of cost) of 18 percent, jeans have a markup of 115 percent (although the markup on some designer jeans is 350 percent or more), and popcorn in a movie theater has a markup of 1,275 percent.⁴² Table 11.2 shows markup calculations for Apple's iPhone 5 and Nokia's Lumia 900 smart phone.

Once entrepreneurs have a financial plan in place, including sales estimates and anticipated expenses, they can compute their companies' **average markup**, the average markup required on all merchandise to cover the cost of the items, all incidental expenses, and a reasonable profit:

$$\text{Initial markup} = \frac{\text{Operating expenses} + \text{Reductions} + \text{Profits}}{\text{Net sales} + \text{Reductions}}$$

Operating expenses are the cost of doing business, such as rent, utilities, and depreciation; reductions include markdowns, special sales, employee discounts, and the cost of stockouts. For

TABLE 11.2 Markup Calculations for Apple's 16 GB iPhone 5 and Nokia's Lumia 900 Smartphone

Component	iPhone 5	Lumia 900
Memory	\$20.85	\$27.00
Display and touch screen	\$44.00	\$58.00
Processor	\$17.50	\$17.00
Cameras	\$18.00	\$18.00
Wireless hardware	\$39.00	\$38.00
User interface and sensors	\$6.50	\$14.00
Power management device	\$8.50	\$9.00
Battery	\$4.50	\$4.50
Mechanical/electromechanical components	\$33.00	\$18.00
Box contents	\$7.00	\$5.50
Assembly cost	\$8.00	\$8.00
Total cost	\$206.85	\$217.00
Price without a contract*	\$649.00	\$449.99
\$ Markup = Price - cost	\$442.15	\$232.99
Percentage (of cost) markup =	213.8%	107.4%
*Price with a contract (Carriers typically subsidize the full price of phones for their customers.)	\$199.00	\$99.99

Sources: HIS iSuppli Research, September 2012; Arik Hesseldahl, "iPhone 5 Costs Stay in Check," *Wall Street Journal*, September 20, 2012, p. B4; Adrian Kingsley-Hughes, "iPhone 5 16GB Cost an Estimated \$207 to Build," *ZDNet*, September 19, 2012, www.zdnet.com/iphone-5-16gb-costs-an-estimated-207-to-build-7000004476.

example, if a small retailer forecasts sales of \$980,000, operating expenses of \$540,000, and \$24,000 in reductions and expects a profit of \$58,000, the initial markup percentage is as follows:

$$\begin{aligned}\text{Initial markup percentage} &= \frac{\$540,000 + \$24,000 + \$58,000}{\$980,000 + \$24,000} \\ &= 62\%\end{aligned}$$

Any item in the store that carries a markup of at least 62 percent covers costs and meets the owner's profit objective. Any item that carries a markup less than 62 percent reduces the company's net profit.

Once an entrepreneur determines the average markup percentage, he or she can compute the appropriate retail price to achieve that markup using the following formula:

$$\text{Retail price} = \frac{\text{Dollar cost}}{(1 - \text{Average markup percentage})}$$

For instance, applying the markup of 62 percent to an item that cost the retailer \$17.00 gives the following retail price:

$$\text{Retail price} = \frac{\$17.00}{(1 - 62\%)} = \$44.74$$

The owner establishes a retail price of \$44.74 for the item using a 62 percent markup.

Finally, a retailer must verify that the computed retail price is consistent with the company's overall image. Is the final price congruent with the company's strategy? Is it within an acceptable price range? How does it compare with the prices charged by competitors? Perhaps most important, are the customers willing and able to pay this price?

Pricing Techniques for Manufacturers

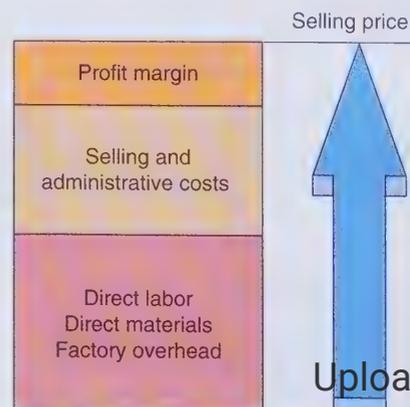
For manufacturers, the pricing decision requires the support of accurate, timely accounting records. The most commonly used pricing technique for manufacturers is **cost-plus pricing**. Using this method, manufacturers establish a price composed of direct materials, direct labor, factory overhead, selling and administrative costs, plus the desired profit margin. Figure 11.3 illustrates the components of cost-plus pricing.

The main advantage of the cost-plus pricing method is its simplicity. Given the proper cost accounting data, computing a product's final selling price is relatively easy. In addition, because this technique adds a profit onto the top of the firm's costs, a manufacturer is likely to achieve the desired profit margin. This strategy does not encourage manufacturers to use their resources efficiently, however. Because manufacturers' cost structures vary so greatly, cost-plus pricing also fails to consider the competition adequately. Finally, cost-plus pricing fails to recognize the important links among price, value, and image. "The price that consumers are willing to pay has little to do with manufacturing costs," says pricing expert Rafi Mohammed. He says that a better pricing strategy is to capture "the value of a product, not simply mark up its costs."⁴³ Despite its

5.

Explain the pricing techniques used by manufacturers.

FIGURE 11.3
Components of Cost-Plus Pricing



drawbacks, the cost-plus method of establishing prices remains prominent in many industries, such as construction and printing.

Direct Costing and Pricing

One requisite for a successful pricing policy in manufacturing is a reliable cost accounting system that can generate timely reports to determine the costs of processing raw materials into finished goods. The traditional method of product costing is called **absorption costing** because all manufacturing and overhead costs are absorbed into the finished product's total cost. Absorption costing includes direct materials and direct labor, plus a portion of fixed and variable factory overhead costs, in each unit manufactured. Full-absorption financial statements are used in published annual reports and in tax reports and are very helpful in performing financial analysis. However, full-absorption statements are of little help to a manufacturer when determining prices or the impact of price changes.

A more useful technique for managerial decision making is **variable (or direct) costing**, in which the cost of the products manufactured includes only those costs that vary directly with the quantity produced. In other words, variable costing encompasses direct materials, direct labor, and factory overhead costs that vary with the level of the company's output of finished goods. Factory overhead costs that are fixed (such as rent, depreciation, and insurance) are *not* included in the costs of finished items. Instead, they are considered to be expenses of the period.

A manufacturer's goal when establishing prices is to discover the cost combination of selling price and sales volume that exceeds the variable costs of producing a product and contributes enough to cover fixed costs and earn a profit. Full-absorption costing clouds the true relationships among price, volume, and costs by including fixed expenses when calculating unit cost. Direct costing, however, yields a constant unit cost of the product no matter what the volume of production is. The result is a clearer picture of the price–volume–costs relationship.

The starting point for establishing product prices is the direct-cost income statement. As Table 11.3 indicates, the direct-cost statement yields the same net income as does the full-absorption income statement. The only difference between the two statements is the format. The full-absorption statement allocates costs such as advertising, rent, and utilities according to the activity that caused them, but the direct-cost income statement separates expenses into fixed and variable costs. Fixed expenses remain constant regardless of the production level, but variable expenses fluctuate according to production volume.

When variable costs are subtracted from total revenues, the result is the manufacturer's **contribution margin**, the amount remaining that contributes to covering fixed expenses and earning a profit. Expressing this contribution margin as a percentage of total revenue yields the company's contribution percentage. Computing the contribution percentage is a critical step in establishing prices through the direct-costing method. This manufacturer's contribution percentage is 36.5 percent, which is calculated as follows:

$$\begin{aligned} \text{Contribution percentage} &= 1 - \frac{\text{Variable expenses}}{\text{Revenues}} \\ &= 1 - \frac{\$502,000}{\$790,000} = 36.5\% \end{aligned}$$

Computing a Break-Even Selling Price

A manufacturer's contribution percentage tells what portion of total revenue remains after covering variable costs to contribute toward meeting fixed expenses and earning a profit. This manufacturer's contribution percentage is 36.5 percent, which means that variable costs absorb 63.5 percent of total revenues. In other words, variable costs represent 63.5 percent ($1.00 - 0.365 = 0.635$) of the product's selling price. If this manufacturer plans to produce 50,000 units, its variable costs include the following:

Material	\$5.01/unit
Direct labor	\$3.80/unit
Variable factory overhead and selling expenses	\$1.23/unit
Total variable cost	\$10.04/unit

TABLE 11.3 Full-Absorption Versus Direct-Cost Income Statement

Full-Absorption Income Statement			
Sales revenue			\$790,000
Cost of goods sold			
Materials	250,500		
Direct labor	190,200		
Factory overhead	120,200	<u>560,900</u>	
Gross profit			\$229,100
Operating expenses			
General and administrative	66,100		
Selling	112,000		
Other	11,000	<u>189,100</u>	
Total operating expenses			<u>189,100</u>
Net income (before taxes)			<u>\$40,000</u>
Direct-Cost Income Statement			
Sales revenue (100%)			\$790,000
Variable costs			
Materials	250,500		
Direct labor	190,200		
Variable factory overhead	13,200		
Variable selling expenses	48,100	<u>502,000</u>	
Total variable costs (63.5%)			502,000
Contribution margin (36.5%)			288,000
Fixed costs			
Fixed factory overhead	107,000		
Fixed selling expenses	63,900		
General and administrative	66,100		
Other fixed expenses	11,000	<u>248,000</u>	
Total fixed expenses (31.4%)			<u>248,000</u>
Net income (before taxes) (5.1%)			<u>\$40,000</u>

The minimum price at which the manufacturer would sell the item is \$10.04. Any price below that does not cover variable costs. To compute the break-even selling price for his product, find the selling price using the following equation:

$$\text{Profit} = \frac{\left(\text{Selling price} \times \text{Quantity produced} \right) + \left(\text{Variable cost per unit} \times \text{Quantity produced} \right) + \text{Total fixed cost}}{\text{Quantity produced}}$$

which becomes:

$$\text{Break-even selling price} = \frac{\text{Profit} + \left(\text{Variable cost per unit} \times \text{Quantity produced} \right) + \text{Total fixed cost}}{\text{Quantity produced}}$$

To break even, the manufacturer assumes \$0 profit. Given that its plans are to produce 50,000 units of the product and that fixed costs will be \$248,000, the break-even selling price is as follows:

$$\begin{aligned} \text{Break-even selling price} &= \frac{\$0 + (\$10.04/\text{unit} \times 50,000 \text{ units}) + \$248,000}{50,000 \text{ units}} \\ &= \frac{\$750,000}{50,000 \text{ units}} \\ &= \$15.00 \text{ per unit} \end{aligned}$$

Thus, \$4.96 (\$15.00/unit – \$10.04/unit) of the \$15.00 break-even price goes toward meeting fixed production costs. But suppose the manufacturer wants to earn a \$75,000 profit. Then the required selling price is calculated as follows:

$$\begin{aligned}\text{Selling price} &= \frac{\$75,000 + (10.04/\text{unit} \times 50,000 \text{ units}) + \$248,000}{50,000 \text{ units}} \\ &= \frac{\$825,000}{50,000 \text{ units}} \\ &= \$16.50/\text{unit}\end{aligned}$$

Now the manufacturer must determine whether customers will purchase 50,000 units at \$16.50. If the manufacturer thinks they won't, managers must decide to either produce a different, more profitable product or lower the selling price by lowering either its cost or its profit target. Any price above \$15.00 will generate some profit although less than that desired. In the short run, the manufacturer could sell the product for less than \$15.00 if competitive factors dictate but *not* below \$10.04 because a price below \$10.04 would not cover the variable costs of production.

Because the manufacturer's capacity in the short run is fixed, pricing decisions should be aimed at using resources most efficiently. The fixed cost of operating the plant cannot be avoided, and the variable costs can be eliminated only if the firm ceases to offer the product. Therefore, the selling price must be at least equal to the variable costs (per unit) of making the product. Any price above that amount contributes to covering fixed costs and providing a reasonable profit.

Of course, over the long run, the manufacturer cannot sell below total costs and continue to survive. A product's selling price must cover total product costs—both fixed and variable—and generate a reasonable profit.

Pricing Techniques for Service Businesses

Service businesses must establish their prices on the basis of the materials used to provide the service, the labor employed, an allowance for overhead, and a profit. As in a manufacturing operation, a service firm must have a reliable and accurate accounting system to track the total costs of providing the service. Most service firms base their prices on an hourly rate, usually the actual number of hours required to perform the service. Some companies, however, base their fees on a standard number of hours, determined by the average number of hours needed to perform the service. For most businesses, labor and materials constitute the largest portion of the cost of providing a service. To establish a reasonable and profitable price for service, entrepreneurs must know the cost of materials, direct labor, and overhead for each unit of service they provide. Using these basic cost data and a desired profit margin, an owner of a small service firm can determine the appropriate price for the service.

Consider a simple example for pricing a common service—computer repair. Ned's Computer Repair Shop uses the direct-costing method to prepare an income statement for exercising managerial control (see Table 11.4). Ned estimates that he and his employees spend about 9,250 hours in the actual production of computer repair service. The total cost per productive hour for Ned's TV Repair Shop is as follows:

$$\text{Total cost per hour} = \frac{\$104,000 + 68,000}{9,250 \text{ hours}} = \$18.59/\text{hour}$$

Now Ned must add in an amount for his desired profit. He expects a net operating profit margin of 18 percent of sales. To compute the final price, he uses the following equation:

$$\begin{aligned}\text{Price per hour} &= \text{Total cost per productive hour} \div (1 - \text{net profit target as \% of sales}) \\ &= \$18.59 \div (1 - .18)\end{aligned}$$

$$= \$22.08/\text{hour}$$

6.

Explain the pricing techniques used by service firms.

TABLE 11.4 Direct-Cost Income Statement, Ned's Computer Repair Shop

Sales revenue		\$199,000
Variable expenses		
Labor	52,000	
Materials	40,500	
Variable factory overhead	<u>11,500</u>	
Total variable expenses		104,000
Fixed expenses		
Rent	2,500	
Salaries	38,500	
Fixed overhead	<u>27,000</u>	
Total fixed expenses		68,000
Net income		<u>\$27,000</u>

A price of \$22.68 per hour will cover Ned's costs and generate the desired profit. Smart service shop owners compute the cost per production hour at regular intervals throughout the year because they know that rising costs can eat into their profit margins very quickly. Rapidly rising labor costs and materials prices dictate that service company owners compute the price per hour even more frequently. As in the case of the retailer and the manufacturer, Ned must evaluate the pricing policies of competitors and decide whether his price is consistent with the firm's image.

Of course, the price of \$22.68 per hour assumes that all jobs require the same amount of materials. If this is not a valid assumption (and it probably is not), Ned must recalculate the price per hour without including the cost of materials:

$$\begin{aligned}\text{Cost per productive hour} &= \frac{\$172,000 - \$40,500}{9,250 \text{ hours}} \\ &= \$14.22/\text{hour}\end{aligned}$$

Adding in the desired 18 percent net operating profit on sales yields the following:

$$\begin{aligned}\text{Price per hour} &= \$14.22/\text{hour} \times \frac{1.00}{(1 - 0.18)} \\ &= \$14.22/\text{hour} \times 1.219 \\ &= \$17.34/\text{hour}\end{aligned}$$

Under these conditions, Ned would charge \$17.34 per hour plus the actual cost of materials used and a markup on the cost of materials. For instance, a repair job that takes four hours to complete would have the following price:

Cost of service (4 hours × \$17.34/hour)	\$69.36
Cost of materials	\$41.00
Markup on materials (60%)	\$24.60
Total price	\$134.96

Because services are intangible, their pricing offers more flexibility than do tangible products. One danger that entrepreneurs face is pricing their services too low because prospective customers' perceptions of a service are influenced heavily by its price. In other words, establishing a low price for a service actually may harm a service company's sales!



ENTREPRENEURIAL PROFILE: Reid Carr: Red Door Interactive To avoid this problem,

Reid Carr, founder of Red Door Interactive, a San Diego-based company that specializes in Web services, prices each project that his company takes on by estimating the number of hours it will

take to complete and multiplying that number by an hourly rate and then including some “wobble room” for unforeseen cost overruns. If the flow of work slows, Carr allows his employees to work on pro bono projects to raise the visibility of his company and to show the quality of work his employees create. “Pro bono work is free advertising,” explains Carr.⁴⁴

The Impact of Credit on Pricing

In today’s business environment, linking a company’s pricing strategy with its credit strategy has become essential. Consumers crave convenience when they shop, and one of the most common conveniences they demand is the ability to purchase goods and services on credit. Small businesses have three options for selling to customers on credit: credit cards, installment credit, and trade credit.

7.

Describe the impact of credit on pricing.



Entrepreneurship in Action

To Accept Credit Cards or Not: That Is the Question

In 2008, when Miki Mishihata opened his unique bike shop, Hello Bicycle, in the Beacon Hill neighborhood in Seattle, Washington, he faced a difficult decision: whether to accept credit card payments. He wanted to provide potential customers with as many convenient ways as possible to pay for the bikes and accessories that they purchased from his small shop, but he worried about the “exorbitant” fees he would pay on each credit card transaction, the flat monthly charges, and the cost of the equipment he would have to lease or purchase. Ultimately, he decided to forgo the added cost of accepting credit card payments, but he often wondered just how many sales Hello Bicycle missed because he did not accept credit cards.

Mishihata’s dilemma is one that is all too familiar to millions of small business owners across the United States. In fact, a recent survey by Intuit Inc. reports that 55 percent of the country’s 27 million small businesses do not accept credit card payments. The survey also estimates that by not accepting credit card payments, the average small business misses out on \$7,000 in sales annually. That means that these small businesses give up the potential to generate a total of \$189 billion more in sales annually!

Three years after starting his bicycle shop, Mishihata signed up with Square, a company that provides a digital credit card system that charges merchants a 2.75 percent swipe fee (or a flat rate of \$275 per month) and supplies them with a free card reader. Once he began accepting credit card payments, Mishihata began to notice a difference in his business almost immediately. In just one year, the number of transactions at Hello Bicycle doubled, and sales revenue nearly tripled. In addition, Mishihata is pleased with the Square’s environmentally friendly paperless system and his ability to track the shop’s transactions online from almost anywhere. “Small businesses shouldn’t be asking how much new credit card processing technology costs but how it’s going to make them more money,” says Merrell Sheehan, a top manager at a merchant services firm. Omar

Green, Intuit’s director of strategic mobile initiatives, was surprised when he discovered that a savvy group of Girl Scouts was using his company’s GoPayment mobile payment services and smart phones to process customers’ credit card purchases of Girl Scout cookies. “It became obvious to me that there was a sea change in the world of payments when the Girl Scouts started using GoPayment,” he says. “It was crazy how much these little girls were bringing in.”

The benefits of accepting credit card payments are significant. Studies show that credit card users spend more (up to 50 percent more) than people who make purchases only with cash. Small business owners who accept credit card payments say that they not only generate more sales but also benefit from faster cash receipts and reduced losses to bad debts resulting from customers who fail to pay their invoices. Customers also appreciate the convenience of mobile payments and are adopting the technology rapidly. Globally, more than 212 million people make mobile payment purchases totaling nearly \$172 billion annually; by 2016, Gartner estimates that 416 million people will purchase \$617 billion in goods in services with mobile payments. In the United States, mobile commerce sales generate \$5.3 billion in sales but are expected to reach \$31 billion by 2016.

Many companies now offer simple mobile payment services that accept credit and debit cards through smart phones or tablet computers. Rather than apply for a merchant account to be able to accept credit card payments through a bank or independent sales organization (which sometimes takes months), these companies allow merchants to begin processing credit card transactions almost instantly, and the money from the transactions is deposited into the small company’s account the day after the transaction takes place. Pay Anywhere, a service provided by payment processing company North American Bancard, is growing fast, says company founder Marc Gardner. The company is signing up thousands of small businesses

Entrepreneurship in Action *(continued)*

each month, charging them a transaction fee of 2.69 percent and providing them with free card readers and software that analyzes transactions.



Lance Boyd, founder of Bucking Bull pro.
Source: Ursula O'Hara.

For years, Lance Boyd, founder of Bucking Bull Pro, a small business that sells products to bull riders both online and at bull-riding events, accepted only checks and cash but realized that he was missing out on many sales. He recently began accepting mobile credit card payments through AppNinjas' Swipe service, which charges him \$24.95 per month plus 24 cents and 1.74 percent per swipe. Not only have sales increased, but Boyd also experiences fewer write-offs due to uncollectible debts. "I use it 10 to 20 times a day during an event," he says.

1. Why do 55 percent of small businesses not accept credit card payments? What are the disadvantages of forcing customers to pay with cash or checks?
2. Have you ever decided not to make a purchase because a small business did not accept credit or debit card payments? Describe the event.
3. What benefits can small companies reap by accepting credit card payments?

Sources: Based on Jennifer Wang, "Power Pay," *Entrepreneur*, January 2012, pp. 25–32; Steven Henn, "What's in Your Wallet? Wait, You Don't Need One," *National Public Radio*, August 16, 2012, www.npr.org/blogs/alltechconsidered/2012/08/16/158928044/whats-in-your-wallet-wait-you-dont-need-one; Kathy Ames Carr, "Small Businesses Weigh Fee or Free When Accepting Credit Cards," *Crain's Cleveland Business*, September 24, 2012, www.crainscleveland.com/article/20120924/SUB1/309249991; "GoPayment Survey Estimates \$100 Billion in Missed Sales for Small Businesses That Deny Plastic," Intuit Corporation, May 22, 2012, http://about.intuit.com/about_intuit/press_room/press_release/articles/2012/GetBusinessGrowing.html.

Credit Cards

Since 1992, the share of purchases made with cash or checks has declined from 85 percent to just 39 percent; shoppers today prefer using credit and debit cards to make purchases.⁴⁵ Consumers around the globe hold more than 2 billion credit cards and use them to purchase nearly \$6.1 trillion in goods and services annually—more than \$11.5 million in purchases per minute.⁴⁶ The message is clear: Customers expect to make purchases with credit cards, and small companies that fail to accept credit cards run the risk of losing sales to competitors who do. Research shows that customers who use credit cards make purchases that are 112 percent higher than if they had used cash.⁴⁷ Accepting credit cards broadens a small company's customer base and closes sales that it would lose if customers had to pay in cash.

Before a business can accept credit cards, it must obtain authorization and merchant status from either a bank or an independent sales organization. Companies that accept credit cards incur additional expenses for offering this convenience, however. Businesses must pay to use the system—typically 1.5 to 3 percent of each transaction, which they in turn must factor into the prices of their products or services. They also pay a transaction fee of 5 to 50 cents per charge (the average fee is 10 cents per transaction) and must purchase or lease equipment to process transactions. Credit card processing fees average about 2 percent of each transaction and operate on a multistep process.⁴⁸ On a \$100 Visa or MasterCard purchase at a typical business, the bank that issued the customer's credit card collects \$1.80, an amount that consists of a 1.70 percent processing fee called the **interchange fee**, the fee that banks collect from retailers whenever customers use a credit or debit card to make a purchase, and a 10-cent flat transaction fee. The retailer's bank, called the processing bank, receives a processing fee of 0.4 percent of the purchase amount (40 cents in this example), leaving the retailer with \$97.80. The prices entrepreneurs charge must reflect the higher costs associated with credit card transactions.

Credit and debit card processing fees, known as “swipe fees,” costs businesses \$50 billion per year, and small businesses typically pay higher credit card processing fees than their larger counterparts.⁴⁹ These fees, especially on small purchases, can eradicate any profit that a small company might have earned. To minimize the fees associated with credit card transactions, some entrepreneurs offer incentives to customers to pay with cash. For Luan Schooler, owner of Forster & Dobbs, a specialty food store in Portland, Oregon, annual interchange fees total \$10,000, an amount she considers part of her company’s overhead cost. “People will pay for a \$1.50 soda with a credit card,” she says. “In those circumstances, we are losing money—or making so little that it wasn’t worth selling it in the first place.”⁵⁰

Credit card readers that attach to tablets and smart phones allow entrepreneurs to accept debit and credit card payments on the go. Square, a start-up company cofounded by Twitter cofounder Jack Dorsey, offers merchants a credit card reader that plugs into a smart phone, giving businesses the convenience of a mobile cash register. Square provides its reader to merchants at no cost and charges a flat 2.75 percent transaction fee (which includes banks’ interchange fees). Mobile payments made with smart phones or tablets are common in Europe and Asia and are growing rapidly in the United States. Start-up companies such as Square as well as established companies such as PayPal, Google, and Microsoft also offer “digital wallet” apps that allow shoppers to pay for purchases (either debit or credit) with their phones or tablets rather than by swiping a credit card.⁵¹

E-COMMERCE AND CREDIT CARDS When it comes to online business transactions, the most common method of payment is the credit card. Internet vendors are constantly challenged by the need to provide secure methods of transacting business in a safe environment. As you will learn in Chapter 13, many shoppers remain suspicious of online transactions for reasons of security and privacy. Therefore, online merchants must ensure their customers’ privacy and the security of their credit card transactions by using computer encryption software.

Online merchants also face another obstacle: credit card fraud. Because they lack the face-to-face contact with their customers, online merchants face special challenges to avoid credit card fraud. According to a study by the CyberSource, online merchants lose 1.0 percent of their annual revenue, about \$3.4 billion, to fraud each year.⁵² Because small and midsize companies are less likely than large businesses to use high-tech online fraud detection tools, they are more likely to be victims of e-commerce fraud. The following steps can help online merchants reduce the probability that they will become victims of credit card fraud:

- Use an address verification system to compare every customer’s billing information on the order form with the billing information in the bank or credit card company’s records.
- Require customers to provide the CVV2 number from the back of the credit card. Although crooks can get access to this number, it can help screen out some fraudulent orders.
- Check customers’ Internet Protocol (IP) addresses. If an order contains a billing address in California, but the IP address from which the order is placed is in China, chances are that the order is fraudulent.
- Monitor activity on your Web site with the help of a Web analytics software package. Many packages are available, and analyzing log files can help online entrepreneurs pinpoint the sources of fraud.
- Verify large orders. Large orders are a cause for celebration but only if they are legitimate. Check the authenticity of large orders, especially if the order is from a first-time customer.
- Post notices on your Web site that your company uses antifraud technology to screen orders. These notices make legitimate customers feel more confident about placing their orders and crooks trying to commit fraud tentative about running their scams.
- Contact the credit card company or the bank that issued the card. If you suspect that an order may be fraudulent, contact the company *before* processing it. Taking this step could save a small company thousands of dollars in losses.⁵³

DEBIT CARDS Consumers around the world carry more than 4.5 billion debit cards that act as electronic checks, automatically deducting the purchase amount immediately from a customer's checking account. Globally, shoppers conduct nearly 98 billion debit card transactions, totaling almost \$5.1 trillion each year.⁵⁴ As customers' use of debit cards continues to grow, more small businesses are equipping their stores to handle debit card transactions. The equipment is easy to install and to set up, and the cost to the company is negligible. The payoff can be big, however, in the form of increased sales, improved cash flow, and decreased losses from bad checks. In addition, interchange fees on debit cards are lower than those on credit cards.

INSTALLMENT CREDIT Small companies that sell big-ticket consumer durables—major appliances, cars, and boats—frequently rely on installment credit. Because very few customers can purchase these items in a single lump-sum payment, small businesses finance them over time. The time horizon may range from just a few months up to 25 or more years. Most companies require the customer to make an initial down payment for the merchandise and then finance the balance for the life of the loan. The customer repays the loan principal plus interest on the loan. One advantage of installment loans for a small business is that the owner retains a security interest as collateral on the loan. If the customer defaults on the loan, the owner still holds the title to the merchandise. Because installment credit absorbs a small company's cash, many entrepreneurs rely on financial institutions such as banks and credit unions to provide the installment credit. When a business has the financial strength to “carry its own paper,” the interest income from the installment loan contract often yields more than the initial profit on the sale of the product. For some businesses, such as auto dealerships and furniture stores, financing is an important source of revenue and profit.

TRADE CREDIT Many small companies, especially those that sell to other businesses, offer their customers trade credit; that is, they create customer charge accounts. The typical small business invoices its credit customers monthly. To speed collections, some offer cash discounts if customers pay their balances early; others impose penalties on late payers. Before deciding to use credit as a competitive weapon, a small business owner must make sure that the company's cash position is strong enough to support that additional pressure. Trade credit can be a double-edged sword. Small businesses must be willing to grant credit to purchasers to get and keep their business, but they must manage credit accounts carefully to make sure that their customers pay in full and on time.

LAYAWAY Although technically not a form of credit, layaway plans, like trade credit, enable customers to purchase goods over time. In the typical layaway plan, a customer selects an item, pays a deposit on it, and makes regular payments on the item until it is paid in full. Unlike trade credit, the retailer keeps the item until the customer has finished paying. Most stores establish minimum payments and maximum payoff dates, and some charge a service fee. Created during the Great Depression as a way to help shoppers purchase goods, layaway has become popular once again, especially around the holiday season, as stubborn unemployment and slow economic growth have posed challenges for both merchants and shoppers.

Chapter Review

1. Explain why pricing is both an art and a science.
 - Pricing requires a knowledge of accounting to determine the firm's cost, strategy to understand the behavior of competitors, and psychology to understand the behaviors of customers.
2. Discuss the relationships among pricing, image, and competition.
 - Company pricing policies offer potential customers important information about the firm's overall image. Accordingly, when developing a marketing approach

- to pricing, business owners must establish prices that are compatible with what their customers expect and are willing to pay. Too often, small business owners *underprice* their goods and services, believing that low prices are the only way they can achieve a competitive advantage. They fail to identify the extra value, convenience, service, and quality they give their customers—all things many customers are willing to pay for.
- An important part of setting appropriate prices is tracking competitors' prices regularly; however, what the competition is charging is just one variable in the pricing mix. When setting prices, business owners should take into account their competitors' prices, but they should not automatically match or beat them. Businesses that offer customers extra quality, value, service, or convenience can charge higher prices as long as customers recognize the "extras" they are getting. Two factors are vital to studying the effects of competition on the small firm's pricing policies: the location of the competitors and the nature of the competing goods.
3. Discuss effective pricing strategies for both new and existing products and services.
 - Pricing a new product is often difficult for the small business manager, but it should accomplish three objectives: getting the product accepted, maintaining market share as the competition grows, and earning a profit.
 - There are three major pricing strategies generally used to introduce new products into the market: penetration, skimming, and sliding down the demand curve.
 - Pricing techniques for existing products and services include odd pricing, price lining, leader pricing, geographic pricing, opportunistic pricing, discounts, multiple pricing, bundling, and suggested retail pricing.
 4. Explain the pricing techniques used by retailers.
 - Pricing for the retailer means pricing to move merchandise. Markup is the difference between the cost of a product or service and its selling price.
 - Some retailers use retail price, but others put a standard markup on all their merchandise; more frequently, they use a flexible markup.
 5. Explain the pricing techniques used by manufacturers.
 - A manufacturer's pricing decision depends on the support of accurate cost accounting records. The most common technique is cost-plus pricing, in which the manufacturer charges a price that covers the cost of producing a product plus a reasonable profit. Every manufacturer should calculate a product's break-even price, the price that produces neither a profit nor a loss.
 6. Explain the pricing techniques used by service firms.
 - Service firms often suffer from the effects of vague, unfounded pricing procedures and frequently charge the going rate without any idea of their costs. A service firm must set a price based on the cost of materials used, labor involved, overhead, and a profit. The proper price reflects the total cost of providing a unit of service.
 7. Describe the impact of credit on pricing.
 - Offering customer credit enhances a small company's reputation and increases the probability, speed, and magnitude of customers' purchases. Small firms offer three types of customer credit: credit cards, installment credit, and trade credit (charge accounts).

Discussion Questions

- 11-1. Stuart Frankel, a Subway franchisee, came up with the idea for Subway's \$5 foot-long sandwich to combat slow weekend sales at his restaurants. It was such a hit that Subway introduced the idea to all of its 33,000 outlets, and in one year it generated \$3.8 billion in sales. One marketing consultant asks, "Is the \$5 foot-long just a flash in the pan, or is it a function of consumer price points and price elasticity that affect all markets?" What do you think?
- 11-2. Explain why pricing is both an art and a science.
- 11-3. How does pricing affect a small firm's image?
- 11-4. Discuss the relation between pricing, image, competition, and value.
- 11-5. Describe the strategies a small business could use in setting the price of a new product. What objectives should the strategy seek to achieve?
- 11-6. Explain three objectives an entrepreneur must keep in mind while deciding on the price for a new product.
- 11-7. Explain the pricing techniques used by retailers.
- 11-8. What is markup? How is it used to determine prices?
- 11-9. What is follow-the-leader pricing? Why is it risky?
- 11-10. Explain the pricing techniques used by manufacturers.

- 11-11. Explain the difference between full-absorption costing and direct costing. How does absorption costing help a manufacturer determine a reasonable price?
- 11-12. Explain the techniques for a small service firm setting an hourly price.
- 11-13. What is the relevant price range for a product or service?
- 11-14. What advantages and disadvantages does offering trade credit provide to a small business?
- 11-15. What are the most commonly used methods to purchase online using credit?
- 11-16. What advantages does accepting credit cards provide a small business? What costs are involved?

CHAPTER 12

Global Marketing Strategies



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain why “going global” has become an integral part of many small companies’ strategies.
2. Describe the nine principal strategies small businesses can use to go global.
3. Explain how to build a successful export program.
4. Discuss the major barriers to international trade and their impact on the global economy.
5. Describe the trade agreements that have the greatest influence on foreign trade.

American small businesses that don't go global today will be playing catch-up tomorrow.

—Dan Brutto

There's been a fundamental shift. Years ago, the competition for business was across the street, across the town, and sometimes across the state. Now it's across the world.

—Michael Masserman

Until recently, the world of international business was much like the world of astronomy before Copernicus, who revolutionized the study of the planets and the stars with his theory of planetary motion. In the sixteenth century, his Copernican system replaced the Ptolemaic system, which held that the earth was the center of the universe with the sun and all the other planets revolving around it. The Copernican system, however, placed the sun at the center of the solar system with all of the planets, including the earth, revolving around it. Astronomy would never be the same.

In the same sense, business owners across the globe were guilty of having Ptolemaic tunnel vision when it came to viewing international business opportunities. Like their pre-Copernican counterparts, owners saw an economy that revolved around the nations that served as their home bases. Market opportunities stopped at their homeland's borders. Global trade was only for giant corporations that had the money and the management to tap foreign markets and enough resources to survive if the venture flopped. That scenario no longer holds true in the twenty-first century. Managers must focus on expanding their companies internationally "because that's the only way their businesses can survive," says Mona Pearl, author of *Grow Globally: Opportunities for Your Middle-Market Company Around the World*. "They're playing in a global field no matter what they think. Instead of feeling panic and fear, they should look at the global market as an opportunity."¹

Twenty-five years ago, if a company was considered to be multinational, everyone knew that it was a giant corporation; today, that is no longer the case. The global marketplace is as much the territory of small, upstart companies as it is that of giant multinational corporations. Powerful, affordable technology, the Internet, increased access to information on conducting global business, and the growing interdependence of the world's economies have made it easier for companies of all sizes, many of which had never before considered going global, to engage in international trade. Only 24 percent of U.S. small businesses are engaged in global commerce, but those that have made the transition often reap significant benefits.²



ENTREPRENEURIAL PROFILE: Alexis Maybank and Alexandra Wilkis Wilson: Gilt Groupe

In 2007, Alexis Maybank and Alexandra Wilkis Wilson, who had become best friends at Harvard Business School, started Gilt Groupe, a Web site that sponsors flash sales, brief sales that sometimes last only a few hours, of top designer labels at prices that are up to 60 percent off of regular retail prices. Their business model caught on, and sales grew quickly. Within 16 months, Gilt Group, which is based in New York City, went global when Maybank and Wilson launched a Gilt Groupe Web site for Japan, where they faced "an untapped market, no competitors, and access to the biggest luxury spenders in the world," says Wilson. "The biggest challenge in Japan was learning that what worked in the United States wouldn't work there for cultural reasons." To support its e-commerce platform, the company soon opened a technology headquarters in Dublin, Ireland, a popular destination for many Internet-based companies because of its sizable population of talented

Source: CartoonStock.



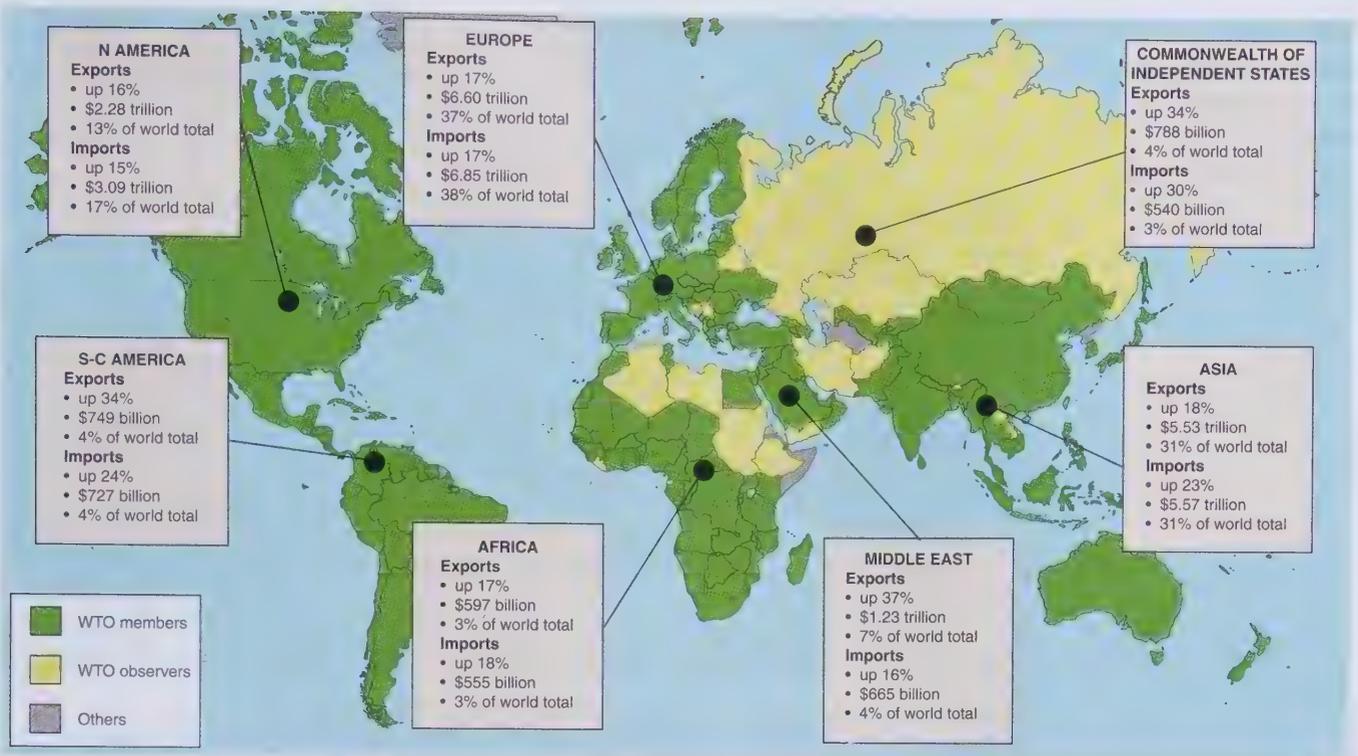


FIGURE 12.1
Merchandise Exports and Imports by Region of the World, 2011

Source: World Trade Organization, 2012, http://www.wto.org/english/news_e/pres12_e/pr658_e.htm.

high-tech employees. In 2011, Wilson, Maybank, and Susan Lyne, the company's CEO, expanded the company's global presence significantly when they began offering Gilt Groupe Web sites that are customized to appeal to shoppers in each of 90 countries. Wilson and Maybank expect international sales to accelerate their company's growth and have created mobile apps for various platforms that allow global shoppers to make purchases from their smart phones, tablets, and other mobile devices. Now with 5 million members, Gilt Groupe conducts 156 flash sales each week of products that range from clothing and home décor to food and wine.³

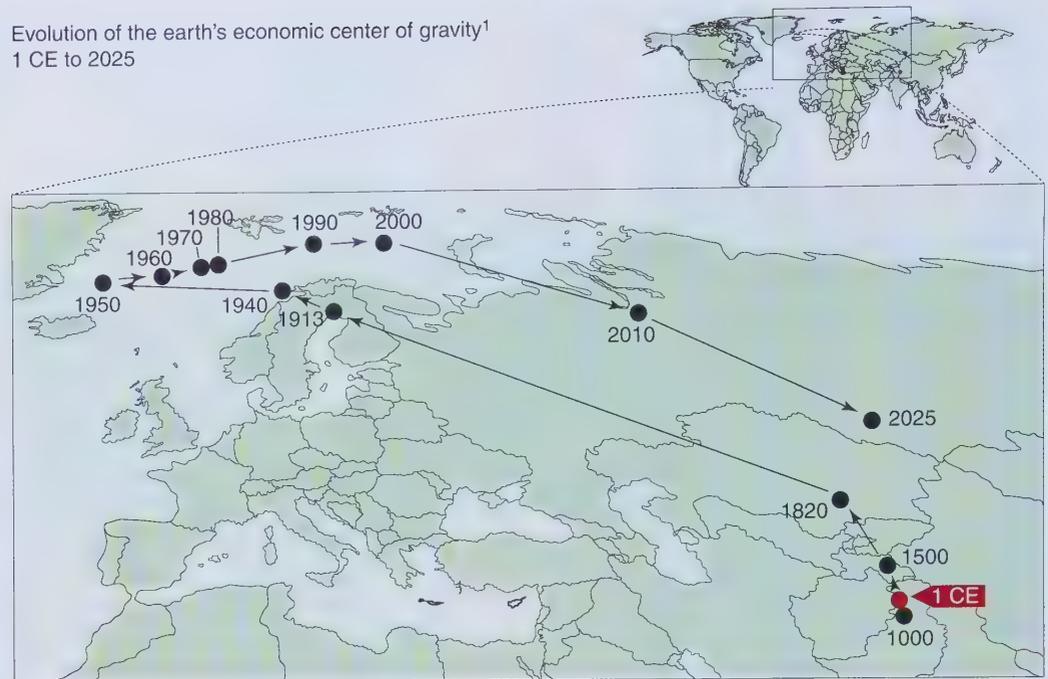
Just a few decades ago, military might governed world relationships; today, commercial trade and economic benefit have become the forces that drive global interaction. Since 1948, the value of world merchandise exports has risen from \$58.0 billion to \$18.4 trillion (see Figure 12.1).⁴ Countries at every stage of development are reaping the benefits of increased global trade. The economies of emerging markets such as China and India are growing faster than those of mature markets such as the United States and Germany. The International Monetary Fund (IMF) predicts that the countries whose economies will grow the fastest over the next several years are China, India, and the ASEAN 5, which includes the Philippines, Indonesia, Malaysia, Thailand, and Vietnam.⁵ The IMF estimates that China, where economic growth has been among the fastest in the world, will boast the largest gross domestic product (GDP) in the world by 2016.⁶ China also will become one of the world's largest consumer markets by 2025.⁷ Indeed, the world economic center of gravity, which is calculated adjusting each country's geographic center by its global economic influence (measured by its GDP), has shifted from the mid-Atlantic in 1970 to a point between Bucharest, Romania, and Helsinki, Finland because of Asia's rapid economic growth. By 2050, the world economic center of gravity will be located on the border between China and India (see Figure 12.2).⁸ The message is clear: Global markets present a tremendous opportunity for entrepreneurs who are prepared to tap into them.

Advances in technology have cut the cost of long-distance communications and transactions so much that conducting business globally often costs no more than doing business locally. Even the smallest companies are using their Web sites to sell in foreign markets at minimal costs. Small businesses are buying raw materials and services from all over the globe, wherever the deals are made. They are also selling their products and services to domestic and international customers. Jack Stack, CEO of Springfield Remanufacturing Corporation, a Springfield, Missouri-based company that refurbishes automotive engines and parts, was surprised when he learned that the company was

FIGURE 12.2 The World's Shifting Economic Center of Gravity

Source: McKinsey Global Institute,
June 2012.

Evolution of the earth's economic center of gravity¹
1 CE to 2025



¹Calculated by weighting national GDP by each nation's geographic center of gravity; a line drawn from the center of the earth through the economic center of gravity locates it on the earth's surface. For detailed analysis, see the appendix in the McKinsey Global Institute (MGI) report *Urban world: Cities and the rise of the consuming class*.

purchasing parts from suppliers in 56 different countries! “Here we were, minding our business in Springfield, Missouri,” says Stack, “and suddenly we discover that we’ve gone global.”⁹

Entrepreneurs are seeing new markets emerge around the world as the ranks of the middle class surge. These business owners realize that the size of these fast-growing markets is small today compared to their potential in the near future. Changes such as these are creating instability for businesses of *any* size going global, but they also are creating tremendous opportunities for those small companies ready to capitalize on them.



ENTREPRENEURIAL PROFILE: Tim Link: Skirts Plus Tim Link, the second-generation owner of Skirts Plus, a small company based in Shakopee, Minnesota, that markets rubber skirts used in fishing lures, conducts business globally. Skirts Plus creates its skirt designs in Minnesota, works with a company in Vietnam to manufacture them, and sells about 250,000 rubber skirts per week to wholesale customers around the world. The company benefits from the quality rubber skirts and lower prices its Vietnamese supplier provides. Link says that “building trust” with international suppliers and customers is essential to his company’s success. “When we first started manufacturing in Vietnam, I traveled there every other month for two to three weeks at a time,” he says. “Today, I visit about once a year, and that’s really important. We’ve had the same [manufacturing] partner for 10 years, and the trust and understanding we have established makes all the difference.”¹⁰

Why Go Global?

1.

Explain why “going global” has become an integral part of many small companies’ strategies.

Small companies can no longer consider themselves to be strictly domestic businesses in this hotly competitive global environment. Approximately 95 percent of the world’s population lives outside the United States, and more than 70 percent of the world’s purchasing power lies beyond the borders of the United States. In addition, 80 percent of economic growth through 2016 will take place outside the United States.¹¹ Companies also face stiff foreign competition. “In the global economy, the competitor six time zones away is potentially as serious a threat as the competitor six blocks away,” says one expert.¹² For companies across the world, going global is a matter of survival, not preference. No matter where a company’s home base is, competitors are forcing it to think globally. “There are an awful lot of people in the rest of the world who think they are pretty good at doing your business,” warns Lester Thurow.¹³ Companies that fail to see the world as a global marketplace risk being blindsided in their markets both at home and abroad. “Just being part of the domestic market and depending on that source of revenue isn’t cutting

it anymore,” says Maryann Stein, director of a development agency in Erie, Pennsylvania, that helps small companies break into global markets. “We haven’t really had to explore other markets because U.S. companies have been OK just selling domestically. That’s not the case anymore.”¹⁴

Failure to cultivate global markets can be a lethal mistake for modern businesses—whatever their size. In short, to thrive in today’s economy, small businesses must take their place in the world market. Today, the potential for doing business globally for businesses of all sizes means that where a company’s goods and services originate or where its headquarters is located is insignificant. To be successful, companies must consider themselves to be businesses without borders.

Going global can put a tremendous strain on a small company, but entrepreneurs who take the plunge into global business can reap many benefits, including the ability to offset sales declines in the domestic market and the opportunity to increase sales and profits. “When a small business owner expands internationally, it becomes less dependent on the ebb and flow of one particular country’s economic cycle,” says Shan Nair, an international business consultant. “This helps the owner build a profitable alternative revenue stream.” Other benefits include the ability to improve the quality of their products to meet the stringent demands of foreign customers, lower the manufacturing cost of their products by spreading fixed costs over a larger number of units, and enhance their competitive positions to become stronger businesses. Expanding a business beyond its domestic borders actually enhances a small company’s overall performance, particularly when the owner transfers the lessons learned from competing in international markets to the entire business. Several studies have concluded that small companies that export are 20 percent more productive, produce 20 percent more job growth, earn more money, grow faster, create higher paying jobs, and are more likely to survive than their purely domestic counterparts. One study shows that 64 percent of small and medium companies saw a positive financial return within two years of launching an export initiative; 34 percent of them generated positive financial returns within six months.¹⁵ Another study conducted by CompTIA of small and medium-size businesses that export reports that 64 percent of owners say that doing business globally has made their companies significantly more competitive. In addition, 86 percent of these business owners say that their companies’ export sales are growing faster than their domestic sales.¹⁶

Unfortunately, many entrepreneurs have not learned to view their companies from a global perspective. Indeed, learning to *think globally* may be the first—and most threatening—obstacle an entrepreneur must overcome on the way to creating a truly global business. One British manager explains,

If you are operating in South America, you’d better know how to operate in conditions of hyperinflation. If you’re operating in Africa, you’d better know a lot about government relations and the use of local partners. If you’re operating in Germany, you’d better understand the mechanics of codetermination and some of the special tax systems that one finds in that country. If you’re operating in China, it’s quite useful in trademark matters to know how the People’s Court of Shanghai works. . . . If you’re operating in Japan, you’d better understand the different trade structure.¹⁷

Gaining a foothold in newly opened foreign markets or maintaining a position in an existing one is no easy task, however. Until an entrepreneur develops the attitude of operating a truly global company rather than a domestic company that happens to be doing business abroad, achieving success in international business is difficult. That attitude starts at the top in the executive’s office. Success in the global economy also requires constant innovation; staying nimble enough to use speed as a competitive weapon; maintaining a high level of quality and constantly improving it; being sensitive to foreign customers’ unique requirements; adopting a more respectful attitude toward foreign habits and customs; hiring motivated, multilingual employees; and retaining a desire to learn constantly about global markets. In short, the path to success requires businesses to become “insiders” who see the world as their market rather than mere “exporters.”

Before venturing into the global marketplace, an entrepreneur should consider six questions:

1. Is there a profitable market in which our company has the potential to be successful over the long run? Table 12.1 shows a country screening matrix designed to help entrepreneurs decide which countries offer the best opportunities for their products.

2. Do we have adequate resources of time, people, and capital to commit to a global campaign?

TABLE 12.1 A Country Screening Matrix

For an entrepreneur considering launching a global business venture, getting started often is the hardest step. “The world is such a big place! Where do I start?” is a typical comment from entrepreneurs considering global business. The following matrix will help you narrow down your options. Based on preliminary research, select three to five countries that you believe have the greatest market potential for your products. Then, use the following factors to guide you as you conduct more detailed research into these countries and their markets. Rate each factor on a scale of 1 (lowest) to 5 (highest). Based on your ratings, which country has the highest score?

Market Factor	Country 1 Rating	Country 2 Rating	Country 3 Rating
Demographic/physical environment			
<ul style="list-style-type: none"> • Population size, growth, density • Urban and rural distribution • Climate and weather variations • Shipping distance • Product-significant demographics • Physical distribution and communication network • Natural resources 			
Political environment			
<ul style="list-style-type: none"> • System of government • Political stability and continuity • Ideological orientation • Government involvement in business • Attitudes toward foreign business (trade restrictions, tariffs, nontariff barriers, bilateral trade agreements) • National economic and developmental priorities 			
Economic environment			
<ul style="list-style-type: none"> • Overall level of development • Economic growth: gross domestic product, industrial sector • Role of foreign trade in the economy • Currency: inflation rate, availability, controls, stability of exchange rate • Balance of payments • Per capita income and distribution • Disposable income and expenditure patterns 			
Social/cultural environment			
<ul style="list-style-type: none"> • Literacy rate, educational level • Existence of middle class • Similarities and differences in relation to home market • Language and other cultural considerations 			
Market access			
<ul style="list-style-type: none"> • Limitations on trade: high tariff levels, quotas • Documentation and import regulations • Local standards, practices, and other nontariff barriers • Patents and trademark protection • Preferential treaties • Legal considerations for investment, taxation, repatriation, employment, code of laws 			
Product potential			
<ul style="list-style-type: none"> • Customer needs and desires • Local production, imports, consumption • Exposure to and acceptance of product • Availability of linking products • Industry-specific key indicators of demand • Attitudes toward products of foreign origin • Competitive offerings 			
Local distribution and production			
<ul style="list-style-type: none"> • Availability of intermediaries • Regional and local transportation facilities • Availability of manpower • Conditions for local manufacture 			
Total score			

3. Are we considering going global for the right reasons? Are domestic pressures forcing our company to consider global opportunities? Will going global make our company stronger and enhance our competitive advantage?
4. Do we understand the cultural differences, history, economics, values, opportunities, and risks of conducting business in the country(s) we are considering?
5. Do we have a viable exit strategy for our company if conditions change or the new venture does not succeed?
6. Can we afford *not* to go global?

Going Global: Strategies for Small Businesses

The globalization of business actually *favors* small businesses because it creates an abundance of niche markets that are ideal for small companies to serve. “In this global economy, the competitive edge is swiftness to market and innovation,” says John Naisbitt, trend-spotting author of *The Global Paradox*, and those are characteristics that are hallmarks of entrepreneurs.¹⁸ Their agility and adaptability gives small firms the edge in today’s highly interactive, fast-paced global economy. “The bigger the world economy, the more powerful its smallest players,” concludes Naisbitt.¹⁹

Becoming a global business depends on instilling a global culture throughout the organization that permeates *everything* the company does. Entrepreneurs who conduct international business successfully have developed a global mind-set for themselves and their companies. As one business writer explains,

The global [business] looks at the whole world as *one market*. It manufactures, conducts research, raises capital, and buys supplies wherever it can do the job best. It keeps in touch with technology and market trends around the world. National boundaries and regulations tend to be irrelevant, or a mere hindrance. [Company] headquarters might be anywhere.²⁰

As cultures across the globe become increasingly interwoven, companies’ ability to go global will determine their degree of success. Small companies pursuing a global presence have nine principal strategies available: creating a presence on the Web, relying on trade intermediaries, establishing joint ventures, engaging in foreign licensing arrangements, franchising, using countertrading and bartering, exporting products or services, establishing international locations, and importing and outsourcing (see Figure 12.3).

Creating a Presence on the Web

The simplest and least expensive way for a small business to reach the 95 percent of the world’s consumers who live outside the United States is to establish a Web site. The Internet gives small businesses tremendous marketing potential all across the globe without having to incur the expense of opening international locations. With a well-designed Web site, a small company can extend its reach to customers anywhere in the world—without breaking the budget! A Web site is available to anyone, anywhere in the world and provides 24-hour-a-day exposure to a company’s products or services, making global time differences meaningless. “You don’t have to go out the door to be global,” says Susan Anthony, a patent attorney. “If you have a Web site, you’re global.”²¹

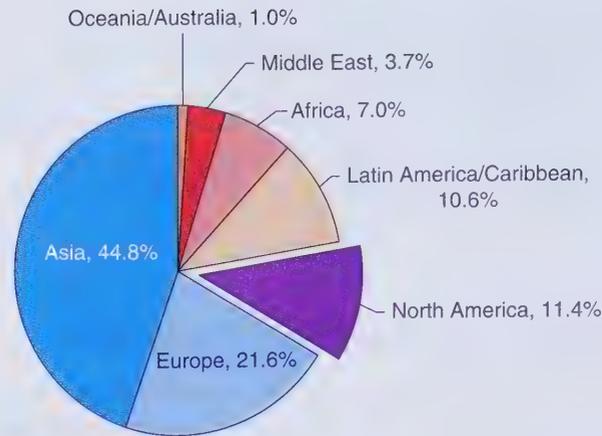


2. Describe the nine principal strategies small businesses can use to go global.

FIGURE 12.3
Nine Strategies
for Going Global

FIGURE 12.4**World Internet Users by Region**

Source: "Internet Usage Statistics: The Big Picture," Internet World Stats 2012, <http://www.internetworldstats.com/stats.htm>.



Establishing a presence on the Web is an essential ingredient in the strategies of small companies trying to reach customers outside the borders of the United States. Although Internet usage varies greatly by region of the world (see Figure 12.4), the number of Internet users is growing extremely fast—nearly 570 percent worldwide since 2000. Other important factors for U.S. entrepreneurs to note are that almost 89 percent of the estimated 2.4 billion Internet users worldwide live *outside* of North America and that less than 27 percent of Internet users speak English.²²

Before the advent of the Internet, small businesses usually took incremental steps toward becoming global businesses. They began selling locally, and, then, after establishing a reputation, expanded regionally and perhaps nationally. Only after establishing their businesses domestically did entrepreneurs begin to think about selling their products or services internationally. The Internet makes that business model obsolete because it provides small companies with a low-cost global distribution channel that they can utilize from the day they are launched. Designed properly, a Web site can be a powerful and engaging global marketing tool. "Thanks to the Internet and mobile technologies, an entire world of entrepreneurs can participate in global trade and bring products to world markets," says a senior manager at eBay. "For the first time in history, global trade is open to every business, regardless of its size."²³



ENTREPRENEURIAL PROFILE: David Greenberg: Parliament Tutors After graduating from New York University in 2008 with a degree in economics, David Greenberg could not find a job in the financial industry, which was in the midst of a severe crisis. Greenberg borrowed \$5,000 from his mother to launch Parliament Tutors, a Web-based company that matches in-home tutors with students who need private tutoring and preparation for standardized tests. In its first month of operation, Parliament Tutors generated \$8,000 in revenue. Today, the company has four full-time employees who coordinate more than 600 tutors and generates revenues of \$50,000 per month. Greenberg now offers online tutoring as well as in-home tutoring in 27 states and recently decided to expand internationally, targeting students in London, Paris, Montreal, Shanghai, and Tel Aviv whose goal is to attend schools in the United States. The global expansion has been successful, but Greenberg says that he should have "made a Web site for each country instead of just one Web site for our whole international operation."²⁴

Entrepreneurs who do not want to take the time to set up their own Web sites can still sell to international customers through the Internet giant eBay, which has a wide global reach of 116 million active users. eBay handles an average of \$2,100 worth of transactions every second, and 57 percent of all eBay transactions take place outside the United States.²⁵ eBay's international sales are growing twice as fast as its domestic sales. In fact, a recent study reports that 97 percent of eBay commercial sellers, most of which are small businesses, sell their products internationally. More than 80 percent of eBay sellers export to five or more foreign countries.



ENTREPRENEURIAL PROFILE: Elizabeth Bennett and Sara Luther: AfricaDirect In 1997, Elizabeth Bennett and Sara Luther started AfricaDirect, a company that specializes in selling unique items such as clay pots, textiles, jewelry, bead work, carvings, and other items created by crafters in Africa. Bennett heard about a business owner selling beads on eBay and decided to see whether AfricaDirect's products would sell on an eBay store. "At first, I was like, "Wow! We made \$50 this week [on eBay]," she recalls. Today, AfricaDirect has seven drop shipping partners who ship products into the economies of small African villages, and provides a valuable marketplace for

the hand-crafted products produced by local artisans. The company generates the majority of its \$1.2 million in annual sales through eBay, Etsy, and the AfricaDirect Web site. "I never would have guessed that we could grow our business into what it is today," says Bennett.²⁶

Rather than merely counting on international customers to stumble onto their Web sites, small companies can take a proactive approach by creating sites that are customized for specific countries. Business owners can determine which countries to target by using Web analytics to identify the countries in which their existing online customers live. Hiring someone who understands the nuances of the language, culture, and business practices of the target countries to create the site is the safest strategy and avoids embarrassing cultural blunders. An entrepreneur won't have much luck listing "tennis shoes" for sale on a Web site aimed at customers in the United Kingdom; customers there would search for "plimsolls" or "daps." Google Global Market Finder is a free market research tool that shows entrepreneurs how many times people around the world use particular key words in online searches in 56 different languages. Business owners can use the Global Market Finder to test the international appeal of key words on their Web sites and to isolate the key words that are likely to produce the best results in their search engine optimization strategies.



In the Entrepreneurial Spotlight

Going Global One Step at a Time

Like most small businesses, Couch Guitar Straps, a company based in Signal Hill, California, that makes high-quality guitar straps used by famous and not-so-famous guitarists, received its first international order through its Web site from a customer in Japan. "I had no idea how much it was going to cost to ship or whether the customer would really pay," recalls Dan Perkins, the company's owner. Perkins, who started Couch Guitar Straps in his garage in 1999, filled that first international order in 2004. Today, international sales account for 35 percent of the company's sales, and that percentage is growing. "Technology erases boundaries and makes it convenient to conduct business globally," says Laurel Delaney, an international business expert and consultant. For Couch Guitar Straps, selling to international customers came naturally as growing numbers of them found the company's Web site and placed orders. "Having a Web site flattens the globe," says Perkins, who also discovered the importance of a sound search engine optimization (SEO) strategy. "SEO is like the new Yellow Pages," he says. "If you can get listed high in search results, you're in the world's phone book."

Delaney encourages her small business clients with global aspirations to use social media to attract and connect with international customers. "Market via every imaginable platform—blogs, Facebook, YouTube, Twitter, and LinkedIn," she says. "Keep a conversation going worldwide about what's great about your company." That strategy proved to be quite successful for Couch Guitar Straps, whose Web site, blog, and e-mail newsletters profile the uniqueness of its products (which include a vegan guitar strap) and the musicians who use them, including Beck, The White Stripes, and Keith Urban. One of Couch's four employees always includes a hand-written thank you note in every order. Couch also keeps shipping as simple as possible, relying on the U.S. Postal Service and postage software from DYMO Endicia to keep shipping costs low and to allow customers to track their packages.

Ensuring that international customers pay is a common concern among small companies that sell globally because they cannot afford to incur the burdensome costs of writing off bad debts. Selling on open account to international customers is the most risky option, and collecting cash in advance is the least risky but can severely limit the pool of international customers. On small orders, companies can accept payments through PayPal or credit cards. Larger orders may require a company to work with its bank's international department on a letter of credit or to purchase credit insurance from a private insurer or the Export-Import Bank.

A decade after making its first international sale, Couch Guitar Straps has developed a sizable pool of global customers. The company continues to sell guitar straps to individual customers around the world through its Web site, to 70 retail outlets in the United States and around the world, and to distributors in Japan, Austria, and Germany. When working with international distributors, Perkins says, "just like in the United States, we start out with a small order and see how it goes."

Small companies such as Couch Guitar Straps prove that even really small businesses can go global. "It's like getting the first olive out of the jar, and then the rest tumble out," says Delaney. "Once you get that first [international] market or customer, you'll want to do more. There's never been a better time to go global," she says. "You have nothing to lose and everything to gain."

1. How does the Internet enable entrepreneurs to create global businesses at start-up? Has this always been the case?
2. What lessons can you draw from Dan Perkins's experience with international sales at Couch Guitar Straps?

Sources: Based on Rieva Lesonsky, "Taking Your Business Global," *Success*, October 2012, www.success.com/articles/1053-taking-your-business-global; "About Us," Couch Guitar Straps, www.couchguitarstraps.com/about_us.html.

Relying on Trade Intermediaries

Another alternative for low-cost and low-risk entry into international markets is to use a trade intermediary. Trade intermediaries are domestic agencies that serve as distributors in foreign countries for domestic companies of all sizes. They rely on their networks of contacts, their extensive knowledge of local customs and markets, and their experience in international trade to market products effectively and efficiently all across the globe. Trade intermediaries serve as export departments for small businesses. Although a broad array of trade intermediaries is available, the following are ideally suited for small businesses:

EXPORT MANAGEMENT COMPANIES Export management companies (EMCs) are an important channel of foreign distribution for small companies just getting started in international trade or for those lacking the resources to assign their own people to foreign markets. Most EMCs are merchant intermediaries, working on a buy-and-sell arrangement with domestic small companies. They provide small businesses with a low-cost, efficient, independent international marketing department, offering services ranging from market research on foreign countries and advice on patent protection to arranging financing and handling shipping. More than 1,000 EMCs of all sizes operate across the United States, and many of them specialize in particular products or product lines. The chief advantage of using an export management company is that a small business's products get international exposure without having to tie up its own resources excessively.



ENTREPRENEURIAL PROFILE: Martha Montoya: Los Kitos Entertainment

Martha Montoya owns a unique media enterprise, Los Kitos Entertainment. It is a privately held company founded in 1997 in Santa Ana, CA. The core business is the syndication of the inspirational Los Kitos bilingual cartoon strip to over 320 newspapers in the United States and overseas. Montoya started exporting her colorful cartoon characters for use on snack packages in China, Ecuador, Colombia, and other countries. She estimates that revenues of her company have grown between 30% and 40% since she started exporting.²⁷

The greatest benefits that EMCs offer small companies are ready access to global markets and an extensive knowledge base on foreign trade, both of which are vital for entrepreneurs who are inexperienced in conducting global business. In return for their services, EMCs usually earn an extra discount on the goods they buy from their clients or, if they operate on a commission rate, a higher commission than domestic distributors earn on what they sell. EMCs charge commission rates of about 10 percent on consumer goods and 15 percent on industrial products. Although EMCs rarely advertise their services, finding one is not difficult. The Federation of International Trade Associations provides useful information for small companies about global business and trade intermediaries on its Web site (<http://fita.org>), including a *Directory of Export Management Companies*. Industry trade associations and publications and the U.S. Department of Commerce's Export Assistance Centers* also can help entrepreneurs to locate EMCs and other trade intermediaries.

EXPORT TRADING COMPANIES Another tactic for getting into international markets with a minimum of cost and effort is through export trading companies, which have been important vehicles in international trade throughout history. The Hudson's Bay Company and the East India Company were dominant powers in world trade in the sixteenth, seventeenth, and eighteenth centuries.

Export trading companies (ETCs) are businesses that buy and sell products in a number of countries, and they typically offer a wide range of services such as exporting, importing, shipping, storing, distributing, and others to their clients. Unlike EMCs, which tend to focus on exporting, ETCs usually perform both import and export trades across many countries' borders. However, like EMCs, ETCs lower the risk of exporting for small businesses. Some of the largest trading companies in the world are based in the United States and Japan. In fact, many businesses that have navigated successfully Japan's complex system of distribution have done so with the help of ETCs.

In 1982, Congress passed the Export Trading Company Act to allow producers of similar products to form ETC cooperatives without the fear of violating antitrust laws. The goal was to encourage U.S. companies to export more goods by allowing businesses in the same industry to band together to form export trading companies to increase their export efficiency.

*A searchable list of the Export Assistance Centers is available at the *Export.gov* Web site www.export.gov/eac/index.asp.

MANUFACTURER'S EXPORT AGENTS **Manufacturer's export agents** (MEAs) act as international sales representatives in a limited number of markets for various noncompeting domestic companies. Unlike the close, partnering relationship formed with most EMCs, the relationship between an MEA and a small company is a short-term one in which the MEA typically operates on a commission basis.

EXPORT MERCHANTS **Export merchants** are domestic wholesalers who do business in foreign markets. They buy goods from many domestic manufacturers and then market them in foreign markets. Unlike MEAs, export merchants often carry competing lines, which means they have little loyalty to suppliers. Most export merchants specialize in particular industries—office equipment, computers, industrial supplies, and others.

RESIDENT BUYING OFFICES Another approach to exporting is to sell to a **resident buying office**, a government-owned or privately-owned operation established in a country for the purpose of buying goods made there. Many foreign governments and businesses have set up buying offices in the United States. Selling to them is just like selling to domestic customers because the buying office handles all the details of exporting.

FOREIGN DISTRIBUTORS Some small businesses work through foreign distributors to reach international markets. Domestic small companies export their products to these distributors who handle all of the marketing, distribution, and service functions in the foreign country.



ENTREPRENEURIAL PROFILE: Peter Cole: Gamblin Artists Colors In 2007, when Peter Cole took over Gamblin Artists Colors, a company that makes hand-crafted oil paints, varnishes, and other artists' supplies, international sales accounted for less than 5 percent of the company's revenue. Cole realized that foreign markets represented a significant opportunity for the company's high-quality products and traveled to several countries that basic market research helped managers select as prime targets. Logging more than 80,000 miles in less than one year, Cole established relationships with foreign distributors in Israel, Australia, Mexico, Great Britain, and Spain. Gamblin Artists Colors now generates more than \$5 million in annual sales, and international sales account for 10 percent (and growing) of the total.²⁸

The Value of Using Trade Intermediaries

Trade intermediaries such as these are becoming increasingly popular among businesses attempting to branch out into world markets because they make that transition much faster and easier. Most small business owners simply do not have the knowledge, resources, or confidence to go global alone. Intermediaries' global networks of buyers and sellers allow their small business customers to build their international sales much faster and with fewer hassles and mistakes. Entrepreneurs who are inexperienced in global sales and attempt to crack certain foreign markets quickly discover just how difficult the challenge can be. However, with their know-how, experience, and contacts, trade intermediaries can get small companies' products into foreign markets quickly and efficiently. The primary disadvantage of using trade intermediaries is that doing so requires entrepreneurs to surrender control over their foreign sales. Maintaining close contact with intermediaries and evaluating their performance regularly help to avoid major problems, however.

The key to establishing a successful relationship with a trade intermediary is conducting a thorough screening to determine which type of intermediary—and which one in particular—will serve a small company's needs best. An entrepreneur looking for an intermediary should compile a list of potential candidates using some of the sources listed in Table 12.2. In addition, entrepreneurs can find reliable intermediaries by using their network of contacts in foreign countries and by attending international trade shows while keeping an eye out for potential candidates. After compiling the list, entrepreneurs should evaluate each one using a list of criteria to narrow the field to the most promising ones. Interviewing a principal from each intermediary on the final list should tell entrepreneurs which ones are best able to meet their companies' needs. Finally, before signing any agreement with a trade intermediary, it is wise to conduct thorough background and credit checks. Entrepreneurs with experience in global trade also suggest entering short-term agreements of about a year with new trade intermediaries to allow time to test their ability and willingness to live up to their promises. Many entrepreneurs begin their global business initiatives with trade intermediaries and then venture into international business on their own as their

TABLE 12.2 Resources for Locating a Trade Intermediary

Trade intermediaries make doing business around the world much easier for small companies, but finding the right one can be a challenge. Fortunately, several government agencies offer a wealth of information to businesses interested in reaching into global markets with the help of trade intermediaries. Entrepreneurs looking for help in breaking into global markets should contact the International Trade Administration, the U.S. Commerce Department, and the Small Business Administration first to take advantage of the following services:

- **Agent/Distributor Service.** Provides customized searches to locate interested and qualified foreign distributors for a product or service. (Search cost, \$250 per country)
- **Commercial Service International Contacts List.** Provides contact and product information for more than 82,000 foreign agents, distributors, and importers interested in doing business with U.S. companies.
- **Country Directories of International Contacts List.** Provides the same kind of information as the CSIC List but is organized by country.
- **Industry Sector Analyses.** Offer in-depth reports on industries in foreign countries, including information on distribution practices, end users, and top sales prospects.
- **International Market Insights.** Include reports on specific foreign market conditions, upcoming opportunities for U.S. companies, trade contacts, trade show schedules, and other information.
- **Trade Opportunity Program.** Provides up-to-the-minute, prescreened sales leads around the world for U.S. businesses, including joint venture and licensing partners, direct sales leads, and representation offers.
- **International Company Profiles.** Commercial specialists will investigate potential partners, agents, distributors, or customers for U.S. companies and will issue profiles on them.
- **Commercial News USA.** A government-published magazine that promotes U.S. companies' products and services to 400,000 business readers in 176 countries at a fraction of the cost of commercial advertising. Small companies can use *Commercial News USA* to reach new customers around the world for as little as \$499.
- **Gold Key Service.** For a small fee, business owners wanting to target a specific country can use the Department of Commerce's Gold Key Service, in which experienced trade professionals arrange meetings with prescreened contacts whose interests match their own.
- **Platinum Key Service.** The U.S. Commercial Service's Platinum Key Service is more comprehensive than its Gold Key Service, offering business owners long-term consulting services on topics such as building a global marketing strategy, deciding which countries to target, and how to reach customers in foreign markets.
- **Matchmaker Trade Delegations Program.** This program helps small U.S. companies establish business relationships in major markets abroad by introducing them to the right contacts.
- **Multi-State/Catalog Exhibition Program.** The Department of Commerce presents companies' product and sales literature to hundreds of interested business prospects in foreign countries for as little as \$450.
- **Trade Fair Certification Program.** This service promotes U.S. companies' participation in foreign trade shows that represent the best marketing opportunities for them.
- **Economic Bulletin Board.** Provides online trade leads and valuable market research on foreign countries compiled from a variety of federal agencies.
- **U.S. Export Assistance Centers.** The Department of Commerce has established 19 export centers in major metropolitan cities around the country to serve as one-stop shops for entrepreneurs who need export help. (www.sba.gov/aboutsba/sbaprograms/internationaltrade/useac/index.html)
- **Trade Information Center.** The center helps locate federal export assistance, provides export assistance, and offers a 24-hour automated fax retrieval system that gives entrepreneurs free information on export promotion programs, regional market information, and international trade agreements. Call USA-TRADE.
- **Office of International Trade.** Through the Office of International Trade, the Small Business Administration works with other government and private agencies to provide a variety of export development assistance, how-to publications, online courses, and information on foreign markets.
- **Export-U.com.** This Web site (www.export-u.com) offers free export webinars to business owners on topics that range from the basics, "Exporting 101," to more advanced topics such as export financing arrangements. The site also provides links to many useful international trade Web sites.
- **U.S. Commercial Service.** The U.S. Commercial service, a division of the International Trade Administration (www.trade.gov), provides many of the services listed in this table. Its Web site (www.buyusa.gov) is an excellent starting point for entrepreneurs who are interested in exporting.
- **Export.gov.** This Web site from the U.S. Commercial Service is an excellent gateway to myriad sources for entrepreneurs who are interested in learning more about exporting. This site includes market research, trade events, trade leads, and much more.
- **Federation of International Trade Associations.** The FITA Global Trade Portal (www.fita.org) is an excellent source for international import and export trade leads and events and provides links to about 8,000 Web sites related to international trade.

Joint Ventures

Joint ventures, both domestic and foreign, lower the risk of entering global markets for small businesses. They also give small companies more clout in foreign lands. In a **domestic joint venture**, two or more U.S. small businesses form an alliance for the purpose of exporting their goods and services abroad. For export ventures, participating companies get antitrust immunity, allowing them to cooperate freely. The businesses share the responsibility and the costs of getting export licenses and permits, and they split the venture's profits. Establishing a joint venture with the right partner has become an essential part of maintaining a competitive position in global markets for a growing number of industries.

In a **foreign joint venture**, a domestic small business forms an alliance with a company in the target nation. The host partner brings to the joint venture valuable knowledge of the local market and the customs and the tastes of local customers, making it much easier to conduct business in the foreign country. "For a small business, a far less risky approach to selling goods or services in a distant market is to work through local partners who understand the market and often have built-in distribution channels," says Edward Wes, a partner in a law firm that specializes in international business.²⁹ Forming a joint venture with a local company also is the best way for a business to negotiate the maze of government regulations in some countries. Some foreign countries place limitations on how joint ventures operate. Some nations, for example, require domestic (host) companies to own at least 51 percent of the venture. Sometimes, says one international manager, "the only way to be German in Germany, Canadian in Canada, and Japanese in Japan is through alliances."³⁰ When Subway, one of the leading franchises in the world, enters foreign markets with one of its sandwich shops, it often looks for a local company with which to form a joint venture. "Nobody knows an area like a local partner," says Don Fertman, a director of international development at Subway.³¹

The most important ingredient in the recipe for a successful joint venture is choosing the right partner. A productive joint venture is much like a marriage, requiring commitment, trust, and understanding. In addition to picking the right partner(s), a second key to creating a successful alliance is to establish common objectives. Defining *exactly* what each party in the joint venture hopes to accomplish at the outset minimizes the opportunity for misunderstandings and disagreements later on. One important objective should always be to use the joint venture as a learning experience, which requires a long-term view of the business relationship. Issues to address *before* entering into a joint venture include the following:

- What contributions will each party make?
- Who will be responsible for making which decisions?
- How much control will each party have over the joint venture's direction?
- How will the earnings from the joint venture be allocated?
- How long will the joint venture last? Under what circumstances can the parties terminate the relationship?

 **ENTREPRENEURIAL PROFILE: Wolverine Worldwide and Tata International** Wolverine Worldwide, a company based in Rockford, Michigan, that markets many famous shoe brands, including Hush Puppies, Merrell, Sebago, Caterpillar, Chaco, and others, recently entered into a joint venture to expand its presence in the shoe market in India. Wolverine saw a sizable market opportunity in India and found the ideal partner in Tata International, a large, diversified company with a significant global presence that will manage the joint venture's wholesale distribution process in India. Tata International brings to the joint venture 30 years of experience in manufacturing footwear for the Indian market, a sound understanding of what Indian customers want in footwear, and access to important retail outlets through its TRENT division, which operates more than 50 department stores in India.³²

Unfortunately, most joint ventures fail. That makes it essential for the companies in an alliance to establish a contingency plan for getting out in case the joint venture doesn't work. Common problems leading to failure include improper selection of partners, incompatible management styles, failure to establish common goals, inability to be flexible, and failure to trust one another. What can entrepreneurs do to avoid these pitfalls in joint ventures?

Defining at the outset important issues such as each party's contributions and responsibilities, the distribution of earnings, the expected life of the relationship, and the circumstances under which the parties can terminate the relationship.

- Understand their partner's reasons and objectives for joining the venture.
- Select a partner that shares their company's values and standards of conduct but whose skill set complements those that reside in their own companies.
- Spell out in writing exactly how the venture will work, what each partner's responsibilities are, and where decision-making authority lies.
- Prepare a "prenuptial agreement" that spells out what happens in case of a "business divorce."

Foreign Licensing

Rather than sell their products or services directly to customers overseas, some small companies enter foreign markets by licensing businesses in other nations to use their patents, trademarks, copyrights, technology, processes, or products. In return for licensing its assets, a small company collects royalties from the sales of its foreign licenses. Licensing is a relatively simple way for even the most inexperienced business owners to extend their reach into global markets. Licensing is ideal for companies whose value lies in its intellectual property, unique products or services, recognized name, or proprietary technology. Although many businesses consider licensing only their products to foreign companies, the licensing potential for intangibles such as processes, technology, copyrights, and trademarks often is greater. Some entrepreneurs earn more money from licensing their know-how for product design, manufacturing, or quality control than they do from actually selling their finished goods in a highly competitive foreign market with which they are not familiar. Foreign licensing enables a small business to enter foreign markets quickly, easily, and with virtually no capital investment. Risks to the company include the potential loss of control over its manufacturing and marketing processes and creating a competitor if the licensee gains too much knowledge and control. Securing proper patent, trademark, and copyright protection beforehand can minimize those risks, however.



ENTREPRENEURIAL PROFILE: ObjectVideo ObjectVideo, a privately held company based in Reston, Virginia, that develops sophisticated software that enhances the effectiveness and capabilities of video surveillance systems, has forged licensing agreements with seven of the world's top 10 manufacturers of video surveillance devices. Launched in 1998 by former scientists and managers from the Defense Advanced Research Projects Agency, ObjectVideo has amassed an impressive collection of intellectual property, including patented algorithms that give surveillance systems the ability to differentiate between humans, vehicles, and other objects and to track in real time every object within a video field. The company recently signed a global licensing arrangement with Panasonic System Networks of Japan that gives Panasonic access to ObjectVideo's extensive intellectual property portfolio.³³

International Franchising

Franchising has become a major export industry for the United States. A recent survey by the International Franchise Association reports that 61 percent of its members currently have international locations and that 75 percent of U.S.-based franchisors plan to start or accelerate their expansion abroad.³⁴ Franchises are attracted to international markets, where they find it easier to increase sales and profits because the domestic market has become increasingly saturated with outlets and is much tougher to wring growth from than in the past. As a growth strategy, international franchising works best for experienced franchisors. Both the cost and the complexity of franchising increase as the distance between franchisor and franchisees increases. Before committing to global expansion, franchisors should meet the following criteria:

- Sufficient financial and managerial resources to devote to globalization.
- A solid track record of success in the United States.
- Adequate trademark protection for the franchise's brand.
- Time-tested training, support, and reporting procedures that help franchisees succeed.³⁵

International franchisors sell virtually every kind of product or service imaginable—from fast food to child day care—in global markets. In some cases, the products and services sold in international markets are identical to those sold in the United States. However, most franchisors have learned that they must adapt their products and services—and sometimes their names—to

suit local culture, tastes, and customs. When Naked Pizza, a franchise based in New Orleans, Louisiana, with more than 450 locations selling low-calorie, all-natural ingredients and enriched crusts, opened its first international location in Dubai, United Arab Emirates, cofounders Jeff Leach and Randy Crochet changed the name to N_K_D Pizza out of respect for the nation's conservative culture.³⁶ Fast-food chains operating in other countries often must make adjustments to their menus to please locals' palates.

ENTREPRENEURIAL PROFILE: Dunkin' Donuts and McDonald's Dunkin' Donuts, with more than 10,000 total outlets—more than 3,000 of which are international locations—has learned to adapt its menu and its business model to fit the culture and customs of the countries in which it operates. In China, where the company already has more than 150 stores with more to come, Dunkin' Donuts is focusing more on the afternoon snack market than the breakfast market because eating sweet items such as traditional doughnuts for breakfast is foreign to most Chinese people. The company also has modified its menu in China to include doughnuts that would be unrecognizable in the United States, including one made of dried pork and seaweed and another made with dried fish.³⁷ In Japan, McDonald's (known as "Makudonarudo") outlets sell koroke burgers (made of mashed potatoes and cabbage), rice burgers, and katsu burgers (cheese wrapped in a roast pork cutlet topped with katsu sauce and shredded cabbage) in addition to their traditional American fare. At McDonald's locations in India, where 80 percent of the population is Hindu and does not eat beef, Maharaja Macs made of chicken share the menu with Vegetable McNuggets and the McAloo Tikki, a vegetarian sandwich, and in Japan, the Koroke Burger (which is made of mashed potatoes and cabbage), a shrimp burger (the Ebi Filet-O), and a green tea-flavored milkshake appear on the menu.³⁸ In Germany, McDonald's restaurants sell McBeer, and in Great Britain they offer British Cadbury chocolate sticks. Some McDonald's outlets in Canada sell poutine, French fries topped with cheese curds and gravy, and the McHomard, a sandwich made of chunks of lobster meat on a roll.

Because they are the most populous nations on earth, China and India are becoming franchising "hot spots." These markets are most attractive to franchisors because they offer large middle-class populations, rising personal incomes, significant numbers of young consumers with purchasing power and a fascination with Western products, growing service economies, and spreading urbanization. Because the franchise industry is nascent in both China and India, the potential for growth is tremendous, and U.S. franchisors are taking note. Other nations that are attracting franchisors' attention include Brazil, the nations of the Middle East and North Africa, and Russia. Establishing franchises in these countries can be challenging, but the potential payoff is significant. McDonald's, with more than 18,700 locations outside the United States, was the first franchise to enter Russia in 1990 with a company-owned store (after 14 years of negotiations with the then Soviet government). The fast-food giant, which continues to open 40 to 50 company-owned stores in Russia each year, recently announced that it has partnered with Rosinter, Russia's largest restaurant holding company, to sell franchises there. Also attracted by Russia's rising wages and consumer spending, Subway, the sandwich chain that operates more than 10,100 foreign outlets, plans to open 1,000 restaurants in Russia by 2015.³⁹

Growth potential is the primary attraction of international markets. Franchisors that decide to expand internationally should take these steps:

- 1. Identify the country or countries that are best suited to the franchisor's business concept.** Factors to consider include a country's business climate, demographic profile, level of economic development, rate of economic growth, degree of legal protection, language and cultural barriers, and market potential. Franchisors making their first forays into global markets should consider focusing on a single nation where cultural barriers are minimal (such as Canada or the United Kingdom) or a small group of nations with similar cultures. Figure 12.5 shows how various nations rank on their attractiveness as markets for franchises.
- 2. Generate leads for potential franchisees.** Franchisors looking for prospective franchisees in foreign markets have many tools available to them, including international franchise trade shows, their own Web sites, trade missions, and brokers. Many franchisors have had success with trade missions such as those sponsored by trade groups such as the International Franchise Association, the U.S. Department of Commerce's Gold and Platinum Key Programs, or various state programs. These trade missions are designed to introduce franchisors to qualified franchise candidates in target countries.



Dunkin' Donuts in Shanghai.
Source: © James Leynse/Corbis.



McDonald's in India.
Source: Jens Kalaene/Newscom.

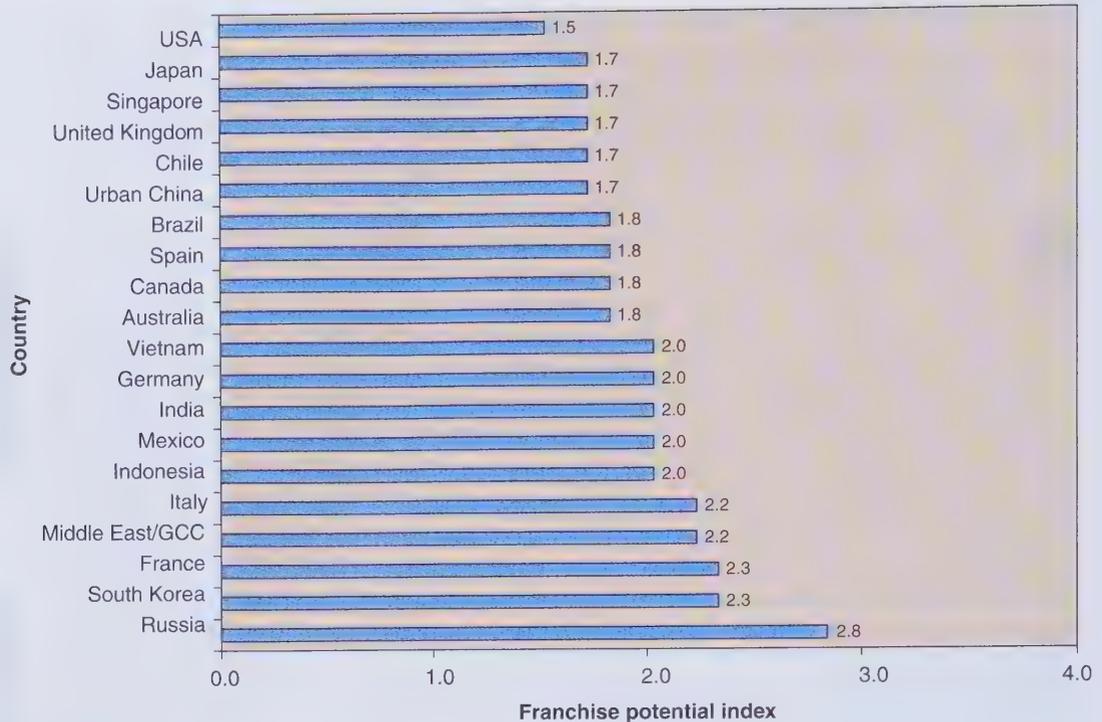


FIGURE 12.5

Franchise Potential by Country (1 = Highest Potential; 4 = Lowest Potential)

Source: Based on GlobalVue and the International Franchise Association, 2012.



ENTREPRENEURIAL PROFILE: Mauricio Acevedo: BannaStrow BannaStrow, a Miami, Florida-based franchise that sells made-to-order crepes, coffee, and smoothies, had only four units when Mauricio Acevedo, the company's CEO, went on trade missions sponsored by the U.S. Commerce Department to the United Kingdom, Panama, and India with the goal of identifying potential area developers and master franchisees to spur the company's growth. "When I come back, I will have a master franchisee or area developer in each of the cities I'm visiting," says Acevedo. "It's not the same for a franchisor to go by yourself and try to get partners as it is to go with the hand of the U.S. Commercial Service helping you set up the right meetings with the right people."⁴⁰

Other franchisors rely on brokers who have extensive business contacts in specific countries.

3. **Select quality candidates.** Just as in any franchise relationship, the real key to success is choosing the right franchisee. Because of the complexity and cost of international franchising, selecting quality franchisees is essential to success.
4. **Structure the franchise deal.** Franchisors can structure international franchise arrangements in a variety of ways, but three techniques are most popular: direct franchising, area development, and master franchising:
 - **Direct franchising**, common in domestic franchise deals, involves selling single-unit franchises to individual operators in foreign countries. Although dealing with individual franchisees makes it easier for the franchisor to maintain control, it also requires more of the franchisor's time and resources.
 - **Area development** is similar to direct franchising except that the franchisor allows a franchisee to develop multiple units in a particular territory, perhaps a province, a county, or even an entire nation. A successful area development strategy depends on a franchisor selecting and then supporting qualified franchisees. Krispy Kreme, which has nearly 700 doughnut shops in 21 countries, recently entered into an area development agreement with LLC Doughnuts Café, a restaurant company owned by Andrey Novikov and based in Moscow, Russia, in which Novikov will build 40 Krispy Kreme

shops in Moscow by 2017. The franchisor was drawn to Novikov because of his extensive experience in food service and his deep knowledge of the local market, culture, and customs.⁴¹

- **Master franchising** is the most popular strategy for companies entering international markets. In a master franchising deal, a franchisor sells to a franchisee the right to develop subfranchises within a broad geographic area or, sometimes, an entire foreign country. In short, master franchising turbocharges a franchisor's growth. Many franchisors use this method to open outlets in international markets more quickly and efficiently because their master franchisees understand local laws and the nuances of selling in local markets. Although master franchising simplifies a franchisor's expansion into global markets, it gives franchisors the least amount of control over their international franchisees. Started in 1987, Tasti D-Lite, a company that sells tasty, low-calorie, frozen desserts made from natural ingredients, began franchising in 2008 and has grown rapidly. Tasti D-Lite used master franchising to enter Australia and Central America and recently created a master franchise agreement with Al-Himmah International Limited to open locations in six Middle Eastern countries, including Saudi Arabia, Bahrain, Kuwait, Qatar, Lebanon, and Jordan.⁴²



Entrepreneurship In Action

Growing Beyond the Borders

Johnny Rockets

Ronn Teitelbaum started Johnny Rockets, a restaurant with a retro 1950s theme that serves classic American fare such as burgers, hot dogs, fries, onion rings, milkshakes, and floats, on Melrose Avenue in Los Angeles in 1986. Today, the company operates 300 company-owned or franchised restaurants, 223 of which are located in the United States and the remainder in 16 countries. Like many franchises, Johnny Rockets is expanding rapidly in international markets; the company recently opened its first outlets in the Dominican Republic, Indonesia, Nigeria, Russia, Brazil, Pakistan, and Morocco. John Fuller, the company's CEO, says that Johnny Rockets's American theme resonates well with customers in international markets. "Internationally, we sell Americana," he says. "The currency we use is burgers, shakes, and fries."

Fuller wants to open more international franchises but says that finding the right franchisees poses a significant challenge. The company has identified China and India as markets with tremendous growth potential for its products but has been stymied by the inability to find qualified franchisees to operate its restaurants.

Wing Zone

In 1991, University of Florida students Matt Friedman and Adam Scott grew weary of ordering pizza to fuel their late-night study sessions and decided that chicken wings would provide a tasty alternative. Late at night, they would take over the kitchen of the fraternity house where they lived and experiment until they had perfected their special sauces and the process of cooking wings. They began selling their delectable wings to other students and knew that they had a hit when they sold out their first two nights in business. Friedman and Scott soon opened their first Wing Zone store in Gainesville, Florida, to target the population of hungry students. In 1999, the company began franchising its restaurants in

1999, is now based in Atlanta, Georgia, and has 100 units, most of which are located in college towns, in 20 states.

A few years ago, Friedman, the company's CEO, evaluated the U.S. franchise market and saw that it was crowded with competition and was not likely to provide significant growth opportunities. "We realized that, although our stores were performing well, our domestic expansion was going to be limited," he says. "We started considering other growth avenues we could follow." That led Wing Zone to investigate establishing international franchises, something that Friedman and his management team did not take lightly. They knew that international expansion would test the integrity of their franchise system, would require a significant investment of capital and time, and would require many months of research to determine which international markets offer the greatest promise for the Wing Zone concept. In addition, they realized that finding the right franchisees was one key to success. Friedman and his management team realized that international expansion would require a significant financial investment, one that would not likely produce a return for at least two or three years.

Friedman and his management team established the criteria for the ideal international market: a culture that had a taste for the company's spicy wings, an acceptance of home delivery (one of Wing Zone's core concepts), a high level of poultry consumption, and a growing middle class with adequate purchasing power. They settled on Panama as the location of their first international outlet. The team's research paid off, enabling the company to adapt its first international location to the local culture. They expanded the size of the restaurant to include seating for up to 60 customers (the chain's domestic stores are take-out and delivery only) and modified the menu slightly to please local palates. The adaptations were successful, and the store set a new company sales record in its first week. Wing Zone has since opened locations in the Bahamas, the Dominican Republic,

Entrepreneurship in Action *(continued)*

Malaysia, the United Arab Emirates, and Saudi Arabia. Friedman also is negotiating with potential franchisees in England, Ireland, Scotland, and Japan.

1. Why are franchises such as Johnny Rockets and Wing Zone expanding into international markets? What are the risks and the rewards of doing so?
2. John Fuller says that finding the right franchisees to operate Johnny Rockets restaurants in foreign countries is a challenge. How do you recommend that the company locate qualified franchisees?
3. Use the Internet to research other countries that would be good target markets for Johnny Rockets and Wing Zone. Explain your reasoning.
4. Develop at least three suggestions for a small franchisor that is interested in opening its first international outlet.

Sources: Based on Lisa Jennings, "Johnny Rockets Expands Overseas," *Nation's Restaurant News*, June 20, 2012, <http://nrn.com/latest-headlines/johnny-rockets-expands-overseas>; "About Us," Johnny Rockets, www.johnnyrockets.com/about-us/our-company.html; Jason Daley, "Despite the Slowdown at Home, U.S. Franchises Expand Abroad," *Entrepreneur*, April 26, 2011, www.entrepreneur.com/article/219493; "Company Information," Wing Zone, www.wingzone.com/company.html.

Countertrading and Bartering

As business becomes increasingly global, companies are discovering that attracting customers is just one part of the battle. Another problem global businesses face when selling to some countries is that their currencies are virtually worthless outside their borders, so getting paid in a valuable currency is a real challenge! Companies wanting to reach these markets must countertrade or barter. A **countertrade** is a transaction in which a company selling goods and services in a foreign country agrees to help promote investment and trade in that country. The goal of the transaction is to help offset the capital drain from the foreign country's purchases. As entrepreneurs enter more developing nations, they will discover the need to develop skill at implementing this global trading strategy.

Countertrading does suffer from numerous drawbacks. Countertrade transactions can be complicated, cumbersome, and time consuming. They also increase the chances that a company will get stuck with useless merchandise that it cannot move. They can lead to unpleasant surprises concerning the quantity and quality of products required in the countertrade. Still, countertrading offers one major advantage: Sometimes it's the only way to make a sale!

Entrepreneurs must weigh the advantages against the disadvantages for their companies before committing to a countertrade deal. Because of its complexity and the risks involved, countertrading is not the best choice for a novice entrepreneur looking to break into the global marketplace.

Bartering, the exchange of goods and services for other goods and services, is another way of trading with countries lacking convertible currency. In a barter exchange, a company that manufactures electronics components might trade its products for the coffee that a business in a foreign country processes, which it then sells to a third company for cash. Barter transactions require finding a business with complementary needs, but they are much simpler than countertrade transactions.

Exporting

For years, small businesses in the United States could afford the luxury of conducting business at home in the world's largest market, never having to venture outside its borders. However, a growing number of small companies, realizing the profit potential that exporting offers, are making exporting part of their business models. A recent study by CompTIA reports that small and medium-size companies that export generate on average 12 percent of their revenues from exports.⁴³

Large companies continue to dominate export sales, however. Only about 1 percent of the 27 million businesses in the United States export their goods and services, a percentage that is significantly lower than that in other developed nations. Although small and medium-size companies account for 98 percent of the 293,000 U.S. businesses that export goods and services, they generate less than one-third of the nation's export sales. In addition, 58 percent of small businesses that sell internationally export to just one country.⁴⁴ Their impact is significant, however; small companies generate \$1.8 billion each day in export sales. Small businesses that export are bigger, more productive, and more profitable than their strictly domestic counterparts.⁴⁵ Other studies show that exporters grow faster, are less likely to fail, and produce higher employment growth.⁴⁶

Many more small companies are capable of exporting but are not doing so. One of the biggest barriers facing companies that have never exported is not knowing where or how to start

3.

Explain how to build a successful export program.

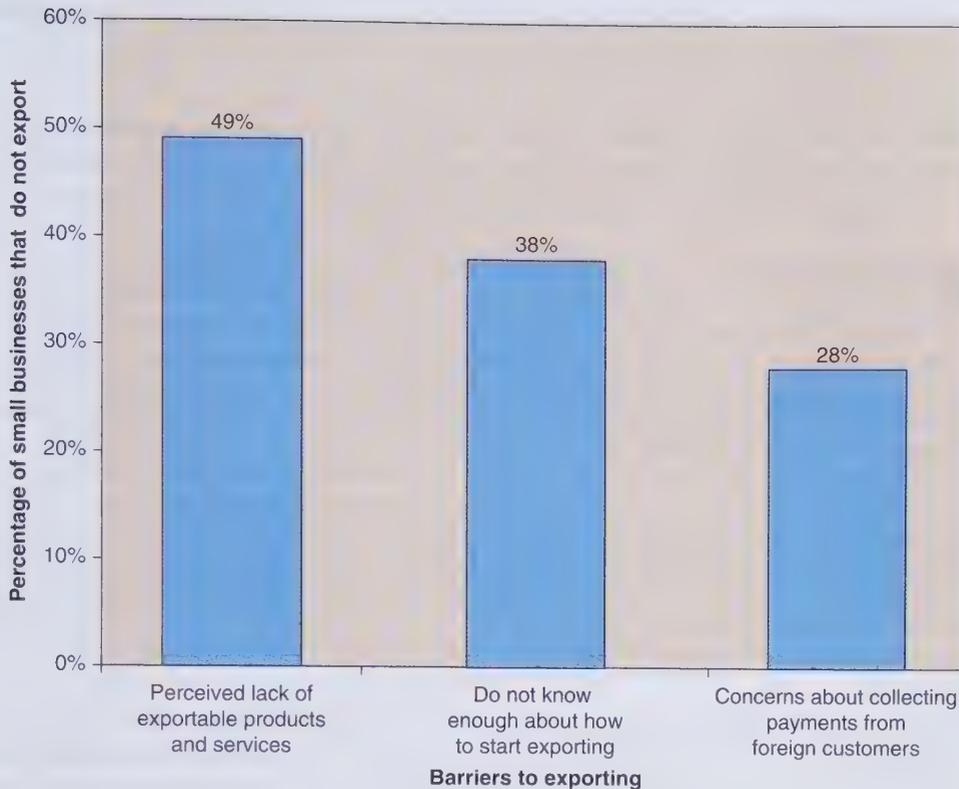


FIGURE 12.6
Barriers to Exporting—
Among Small Companies
That Do Not Export

Source: Based on NSBA/SBEA Small Business Exporting Survey, 2010.

(see Figure 12.6). Paul Hsu, whose company sells ginseng across the globe, explains, “Exporting starts with a global mind-set, which unfortunately, is not all that common among owners of small- and medium-sized businesses in the United States. Most entrepreneurs in the United States envision markets only within domestic and sometimes even state borders, while foreign entrepreneurs look at export markets first.”⁴⁷

Breaking the psychological barrier to exporting is the first—and most difficult—step in setting up a successful program. The U.S. Commercial Service’s *Export Programs Guide* provides entrepreneurs with a comprehensive list of federal programs designed to help U.S. exporters. The U.S. Commercial Service Web site (www.buyusa.gov) is an excellent starting point for entrepreneurs who are looking for international business partners to help their companies expand into global markets. Another valuable source of information are the U.S. Export Assistance Centers (<http://www.export.gov/eac/>), which serve as single contact points for information on the multitude of federal export programs that are designed to help entrepreneurs who want to start exporting. Entrepreneurs who want to learn more about exporting should investigate *A Basic Guide to Exporting* (<http://export.gov/basicguide>). The U.S. Small Business Administration (SBA) publishes the *Export Business Planner*, a comprehensive set of worksheets that guides users through the process of building an export business plan and is available to download for free (www.sba.gov/exportbusinessplanner). The SBA’s Web site (www.sba.gov) also includes a section that is dedicated to exporting and importing. The U.S. government export portal, www.export.gov, gives entrepreneurs access to valuable information about exporting in general (finance, shipping, documentation, and others) as well as details on individual nations (market research, trade agreements, statistics, and more). Export-U (www.export-u.com/exportu4), a Web site created by the Export Assistance Center in Atlanta and the Georgia Small Business Development Center’s International Trade Center, offers a series of Webinars ranging from “Are You Ready to Export?” to “Managing Global Risk.” The Census Bureau (www.census.gov/foreign-trade/aes/exporttraining/videos/index.html) provides several short videos on export-related topics. *The Trade Finance Guide*, a publication from the International Trade Administration (<http://export.gov/tradefinanceguide/index.asp>), helps entrepreneurs learn the basics of trade finance, including the various methods of payments that exporters use and the source of export financing that are available. Shipping giant UPS International offers a Web site (www.international.ups.com) for U.S. exporters who want to take part in global trade, including both exporting and importing. Learning more about exporting and realizing that it is within the realm of

possibility for small companies—even *very* small companies—is the first and often most difficult step in breaking the psychological barrier to exporting.

The next challenge is to create a sound export strategy.

1. Recognize that even the smallest companies and least experienced entrepreneurs have the potential to export; help is available. Size and experience are not prerequisites for a successful export program; all that is required is a willingness to learn and to utilize available resources.



Al Youngwerth, founder of Rekluse Motor Sports.

Source: Rekluse Motorsports.



ENTREPRENEURIAL PROFILE: Al Youngwerth: Rekluse Motor Sports Al Youngwerth, who began riding dirt bikes at age eight, recognized the problems with existing motorcycle clutches and set out to design a better one. He kept his job in information technology while he built the first prototype of his automatic clutch in his garage in Boise, Idaho, and posted it on online motorcycle forums to get customer feedback. A business owner in Italy discovered Youngwerth's design and ordered one of the company's first clutches. In 2002, Youngwerth launched Rekluse Motor Sports and began filling orders, including the first order from the customer in Italy. International sales through foreign distributors have been a significant part of Rekluse Motor Sports's sales ever since. Youngwerth used export resources from the SBA, the Department of Commerce, and other government entities, including the U.S. Commercial Services Gold Key Matching Service, to find distributors. In 2010, export sales were growing so fast that he hired a full-time export manager. Export sales to markets that include Canada, South Africa, Brazil, and Europe now account for 26 percent of the company's revenue, and Rekluse Motor Sports, now with 40 employees, was recently named the National Exporter of the Year by the SBA.⁴⁸

2. Analyze your product or service. Is it special? New? Unique? High quality? Priced favorably due to lower costs or exchange rates? Does it appeal to a particular niche? In which countries would there be sufficient demand for it? In many foreign countries, products from the United States are in demand because they have an air of mystery about them. Exporters also quickly learn the value that foreign customers place on quality. In some cases, entrepreneurs must modify their existing products and services slightly to suit foreign customers' lifestyles, housing needs, body sizes, traditions, and cultures. When Peter Cole, CEO of Gamblin Artists Colors, the company that makes hand-crafted oil paints, varnishes, and other artists' supplies, began exporting to Australia, he quickly realized the importance of modifying the size of the products. "In Australia, they want larger sizes of paints—sizes we had not contemplated for the U.S. market," says Cole. "People tend to paint bigger and thicker."⁴⁹ Making modifications such as these often spells the difference between success and failure in the global market. In other cases, products destined for export need little or no modification. Experts estimate that one-half of exported products require little modification, one-third require moderate modification, and only a few require major changes.

3. Analyze your commitment. Are you willing to devote the time and the energy to develop export markets? Does your company have the necessary resources to capitalize on market opportunities? In any international venture, patience is essential. Laying the groundwork for an export operation can take from six to eight months (or longer), but entering foreign markets isn't as tough as most entrepreneurs think. "One of the biggest misconceptions people have is that they can't market overseas unless they have a big team of lawyers and specialists," says one export specialist. "That just isn't true."⁵⁰ Table 12.3 summarizes key issues managers must address in making the "export or not" decision.

4. Research markets and pick your target market. Before investing in a costly sales trip abroad, entrepreneurs should use the vast resources available for exporters online to research potential markets that are most promising for their products. Armed with research, small business owners can avoid wasting time and money pursuing markets with limited potential for their products and can concentrate on those with the greatest promise. Entrepreneurs usually are most comfortable starting their export efforts in nations with which the United States has trade agreements and where English is the accepted language of business. A study by UPS International reports that small exporters have had the most success selling their products in Canada, the United Kingdom, Australia, and Mexico.⁵¹ Figure 12.7 shows the top five countries to which small and medium-size businesses plan to export within the next two years. Table 12.4 offers questions to guide entrepreneurs as they conduct international market research.

TABLE 12.3 Management Issues in the Export Decision**I. Experience**

1. With what countries has your company already conducted business (or from what countries have you received inquiries about your product or service)?
2. Which product lines do foreign customers ask about most often?
3. Have you prepared a list of sales inquiries for each buyer by product and by country?
4. Is the trend of inquiries or sales increasing or decreasing?
5. Who are your primary domestic and foreign competitors?
6. What lessons has your company learned from past export experience?

II. Management and Personnel

1. Who will be responsible for the export entity's organization and staff? (Do you have an export "champion"?)
2. How much top management time
 - a. should you allocate to exporting?
 - b. can you afford to allocate to exporting?
3. What does management expect from its exporting efforts? What are your company's export goals and objectives?
4. What organizational structure will your company require to ensure that it can service export sales properly? (Note the political implications, if any.)
5. Who will implement the plan?

III. Production Capacity

1. To what extent is your company using its existing production capacity? Is there any excess? If so, how much?
2. Will filling export orders hurt your company's ability to make and service domestic sales?
3. What will additional production for export markets cost your company?
4. Are there seasonal or cyclical fluctuations in your company's workload? When? Why?
5. Is there a minimum quantity foreign customers must order for a sale to be profitable?
6. To what extent must your company modify its products, packaging, and design specifically for its export targets? Is your product quality adequate for foreign customers?
7. What pricing structure will your company use? Will your prices be competitive?
8. How will your company collect payment on its export sales?

IV. Financial Capacity

1. How much capital will your company need to begin exporting? Where will it come from?
2. How will you allocate the initial costs of your company's export effort?
3. Does your company have other expansion plans that would compete with an exporting effort?
4. By what date do you expect your company's export program to pay for itself?
5. How important is establishing a global presence to your company's future success?

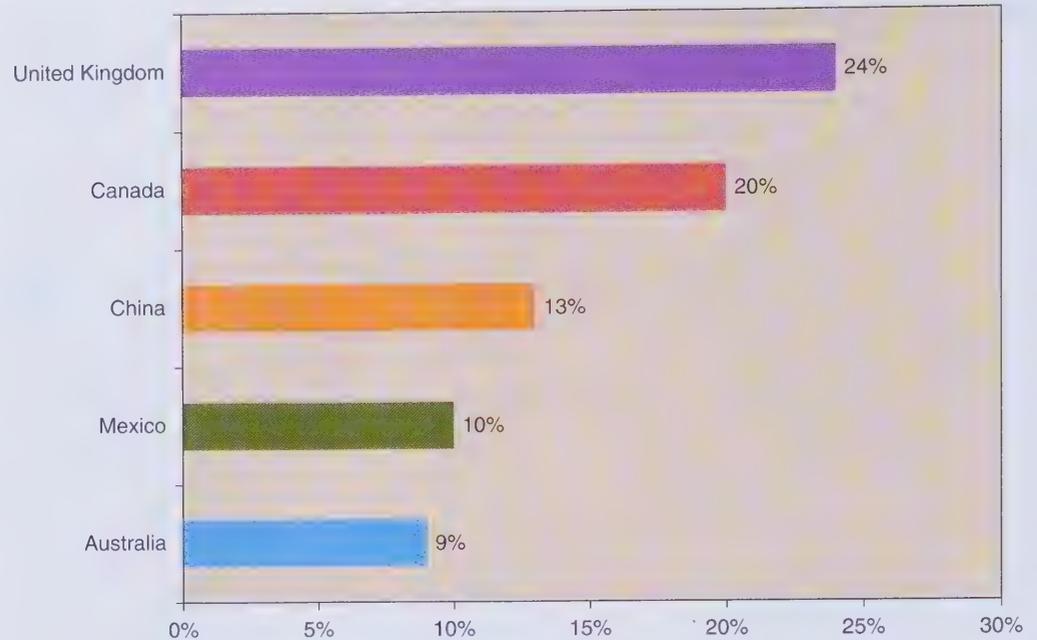
Source: Based on *A Basic Guide to Exporting* (Washington, DC: U.S. Department of Commerce, 1986), p. 3.

family business in Palatine, Illinois, that makes the famous Weber grill that is a mainstay in millions of backyards in the United States (where 70 percent of the population owns a grill), has achieved success exporting its iconic grills to other parts of the world, including Europe, New Zealand, Australia, and South Africa. Weber-Stephen discovered that the smallest version of its grill, the 14½-inch Smokey Joe, appeals to customers in China and India, where living quarters and available outdoor spaces are much smaller than in the United States.⁵²

5. Develop a distribution strategy. Should you use an export intermediary or sell directly to foreign customers? As you learned earlier in this chapter, many small companies just entering international markets prefer to rely on trade intermediaries or a joint venture partner to break new ground. Using intermediaries or joint ventures often makes sense until an entrepreneur has the chance to gain experience in exporting and to learn the ground rules of selling in foreign

FIGURE 12.7**Countries to Which Small Businesses Intend to Export Within the Next Two Years**

Source: Based on *Perceptions of Global Trade*, UPS International, 2011, p. 21.

**TABLE 12.4 Questions to Guide International Market Research**

- Is there an overseas market for your company's products or services?
- Are there specific target markets that look most promising?
- Which new markets abroad are most likely to open up or expand?
- How big is the market your company is targeting, and how fast is it growing?
- What are the major economic, political, legal, social, technological, and other environmental factors affecting this market?
- What are the demographic and cultural factors affecting this market, such as disposable income, occupation, age, gender, opinions, activities, interests, tastes, and values?
- Who are your company's present and potential customers abroad?
- What are their needs and desires? What factors influence their buying decisions: price, credit terms, delivery terms, quality, brand name, and so on?
- How would they use your company's product or service? What modifications, if any, would be necessary to sell to your target customers?
- Who are your primary competitors in the foreign market?
- How do competitors distribute, sell, and promote their products? What are their prices?
- What are the best channels of distribution for your product?
- What is the best way for your company to gain exposure in this market?
- Are there any barriers such as tariffs, quotas, duties, or regulations to selling your product in this market? Are there any incentives?
- Are there any potential licensing or joint venture partners already in this market?

Source: Based on *A Basic Guide to Exporting* (Washington, DC: U.S. Department of Commerce, 1986), p. 11.

with less than \$1 million in annual sales) and small companies (those with annual sales between \$1 million and \$20 million) use to export their products and services.

6. Find your customer. Small businesses can rely on a host of export specialists to help them track down foreign customers. (Refer to Table 12.1 for a list of some of the resources available from the government.) The U.S. Department of Commerce and the International Trade Administration should be the first stops on any entrepreneur's agenda for going global. These agencies have the market research available for locating the best target markets for a particular company and specific customers in those markets. Industry Sector Analyses, International Market Insights, and Customized Market Analyses (CMAs) are just some of the reports and services global entrepreneurs

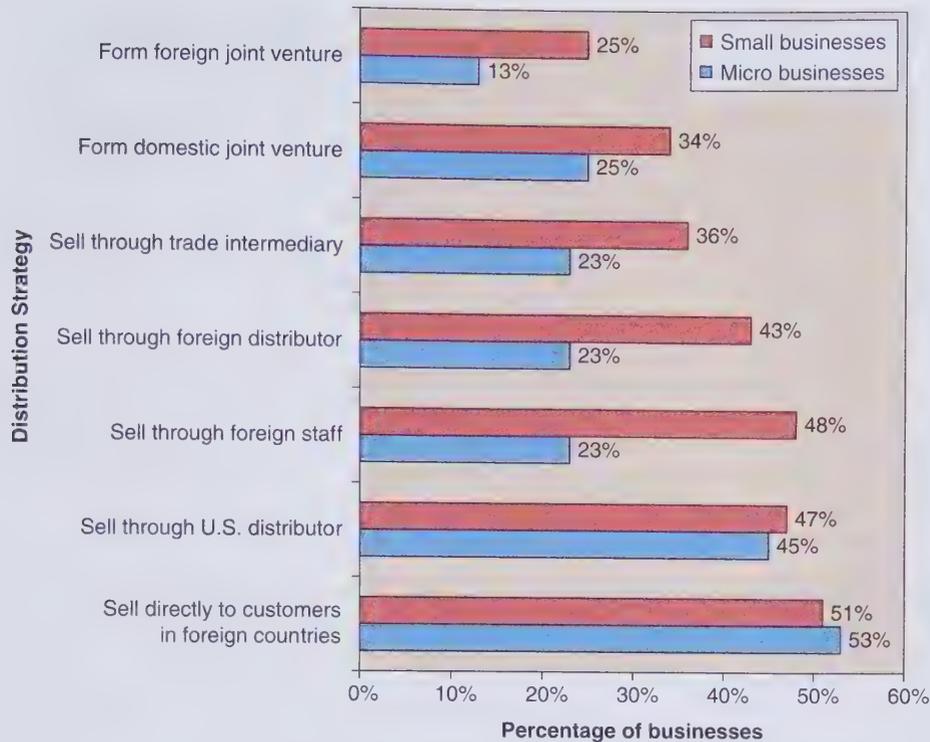


FIGURE 12.8
Distribution Strategies for Exporting by Company Size

Source: Based on Small and Medium Size Business Export Insights and Opportunities, CompTIA, 2010, p. 8.

find most useful. These agencies also have knowledgeable staff specialists experienced in the details of global trade and in the intricacies of foreign cultures. Michigan State University's GlobalEDGE (<http://globaledge.msu.edu>), an international trade information portal, also offers useful information on doing business in more than 200 countries, including directories, tutorials, online courses, and diagnostic tools designed to help companies determine their potential for conducting global business. The International Finance Corporation's Enterprise Surveys (www.enterprisesurveys.org) give entrepreneurs useful profiles of the business environments in 135 countries, including overviews of basic infrastructure and business regulations to corruption and business obstacles. Through its Gold and Platinum Key services, the U.S. Commercial Service provides entrepreneurs who want to take their companies global with a list of prescreened distributors and potential customers and arranges face-to-face meetings with them.

One of the most efficient and least expensive ways for entrepreneurs to locate potential customers for their companies' products and services is to participate in a trade mission. These missions usually are sponsored by either a federal or a state economic development agency or an industry trade association for the purpose of cultivating international trade by connecting domestic companies with prescreened potential trading partners overseas. A trade mission may focus on a particular industry or may cover several industries but target a particular country. "We set up meetings for them with distributors, suppliers, manufacturers, customers, accountants, law firms, the whole gamut, to be able to provide them with the necessary resources to get into that market," says Christian Bartley, president of the World Trade Center Wisconsin, an organization that regularly sponsors trade missions to foreign countries for Wisconsin entrepreneurs who are interested in exploring export markets.⁵³ On a recent trade mission trip to China sponsored by the Maine International Trade Center, representatives from 13 small companies from diverse industries participated in 77 matchmaking meetings with potential customers and distributors in just one week. Previous trade missions had resulted in sales increases from \$3 million to \$8 million for the small companies involved. Lighthouse Imaging, a company based in Portland, Maine, that manufactures optical equipment for the medical industry, participated in the trade mission because China is the second-largest market for medical devices in the world. "We are looking forward to developing the Chinese market for the optical medical products that we manufacture and export," says Lighthouse Imaging chief technology officer Dennis Leiner. "I expect great things to happen."⁵⁴

7. Find financing. One of the biggest barriers to small business exports is lack of financing. The small business owners and other sources of capital don't always understand the intricacies of international sales and view financing them as highly risky ventures. In addition, among major

industrialized nations, the U.S. government spends the least per capita to promote exports. Access to adequate financing is a crucial ingredient in a successful export program because the cost of generating foreign sales often is higher and collection cycles are longer.

Several federal, state, and private programs are operating to fill this export financing void, however. Loan programs from the SBA include its Export Working Capital program (90 percent loan guarantees up to \$5 million), Export Express (a streamlined approach to obtaining SBA-guaranteed financing up to \$500,000), and the International Trade Loan program (90 percent loan guarantees up to \$5 million). In addition, the Export-Import Bank, the Overseas Private Investment Corporation, and a variety of state-sponsored programs offer export-minded entrepreneurs both direct loans and loan guarantees. The Export-Import Bank (www.exim.gov), which has financed the sale of \$456 billion in U.S. exports since 1934, provides small exporters with export credit insurance, loans, and loan guarantees through its working capital line of credit and a variety of preexport and export loan programs. The Overseas Private Investment Corporation (www.opic.gov) provides loans and loan guarantees up to \$250 million to support foreign investments by small and medium-sized companies and offers businesses discounted political risk insurance. The Bankers Association for Foreign Trade (www.baft.org) is an association of 150 banks around the world that matches exporters needing foreign trade financing with interested banks.



ENTREPRENEURIAL PROFILE: Vankee Sharma: Aquatech International Aquatech International, a small company in Canonsburg, Pennsylvania, began exporting in 1994 with the help of loan guarantees from the Export-Import Bank. Since then, the company, which makes industrial water and wastewater treatment products, has seen its export sales increase from \$1 million annually to more than \$42 million. “Ex-Im Bank support of our exports gives us opportunities that we otherwise would not have,” says CEO Vankee Sharma. “The Ex-Im Bank allows us to serve buyers in many different countries. Exports now make up 40 to 60 percent of our business.”⁵⁵

8. Ship your goods. Export novices usually rely on international freight forwarders and custom-house agents—experienced specialists in overseas shipping—for help in navigating the bureaucratic morass of packaging requirements and paperwork demanded by customs. These specialists, also known as transport architects, are to exporters what travel agents are to passengers and normally charge relatively small fees for a valuable service. They move shipments of all sizes to destinations all over the world efficiently, saving entrepreneurs many headaches. Good freight forwarders understand U.S. export regulations, foreign import requirements, shipping procedures (such as packing, labeling, documenting, and insuring goods), customs processes, and maintaining proper records for paying tariffs. In addition, because they work for several companies, freight forwarders can aggregate payloads to negotiate favorable rates with shippers. “[A freight forwarder] is going to be sure that his client conforms with all the government regulations that apply to export cargo,” explains the owner of an international freight forwarding business. “He acts as an agent of the exporter, and, in most circumstances, is like an extension of that exporter’s traffic department.” The Johnston Sweeper Company, a manufacturer of street sweepers, ships its 20,000-pound pieces of equipment worldwide with the help of an international freight forwarder.⁵⁶ Exporters can find an online directory of more than 1,000 freight forwarders located in 140 countries at Freightbook (www.freightbook.net). Another useful resource is the National Customs Brokers and Forwarders Association of America (www.ncbfaa.org), which represents 940 freight forwarders and customs brokers who work with more than 250,000 exporters and importers. Small businesses also can use fulfillment companies such as Shipwire, Amazon Fulfillment, and others that store and ship companies’ products anywhere in the world. Table 12.5 features common international shipping terms and their meaning.

9. Collect your money. Collecting foreign accounts can be more complex than collecting domestic ones; however, by picking their customers carefully and checking their credit references closely, entrepreneurs can minimize bad-debt losses. Businesses engaging in international sales can use four primary payment methods (ranked from least risky to most risky): cash in advance, a letter of credit, a bank (or documentary) draft, and an open account. Collecting cash in advance is the safest method of selling to foreign customers because it eliminates the risk of collection problems and provides immediate cash flow. However, requiring cash payments up front may limit severely a small company’s base of foreign customers.

One tool that small exporters can use to minimize the risk of bad-debt losses on foreign sales is export credit insurance, which protects a company against the nonpayment of its open accounts due to commercial and political problems. The cost of export credit insurance usually is a very

TABLE 12.5 Common International Shipping Terms and Their Meaning

Shipping Term	Seller's Responsibility	Buyer's Responsibility	Shipping Method(s) Used
FOB ("Free on Board") Seller	Deliver goods to carrier and provide export license and clean on-board receipt. Bear risk of loss until goods are delivered to carrier.	Pay shipping, freight, and insurance charges. Bear risk of loss while goods are in transit.	All
FOB ("Free on Board") Buyer	Deliver goods to the buyer's place of business and provide export license and clean on-board receipt. Pay shipping, freight, and insurance charges. Bear risk of loss until goods are delivered to buyer.	Accept delivery of goods after documents are tendered.	All
FAS ("Free Along Side"), vessel	Deliver goods alongside ship. Provides an "alongside" receipt.	Provide export license and proof of delivery of the goods to the carrier. Bear risk of loss once goods are delivered to the carrier.	Ship
CFR ("Cost and Freight")	Deliver goods to carrier, obtain export licenses, and pay export taxes. Provide buyer with clean bill of lading. Pay freight and shipping charges. Bear risk of loss until goods are delivered to buyer.	Pay insurance charges. Accept delivery of goods after documents are tendered.	Ship
CIF ("Cost, Insurance, and Freight")	Same as CFR plus pay insurance charges and provide buyer with insurance policy.	Accept delivery of goods after documents are tendered.	Ship
CPT ("Carriage Paid to . . .")	Deliver goods to carrier, obtain export licenses, and pay export taxes. Provide buyer with clean transportation documents. Pay shipping and freight charges.	Pay insurance charges. Accept delivery of goods after documents are tendered.	All
CIP ("Carriage and Insurance Paid to . . .")	Same as CPT plus pay insurance charges and provide buyer with insurance policy.	Accept delivery of goods after documents are tendered.	All
DDU ("Delivered Duty Unpaid")	Obtain export license, pay insurance charges, and provide buyer documents for taking delivery.	Take delivery of goods and pay import duties.	All
DDP ("Delivered Duty Paid")	Obtain export license and pay import duty, pay insurance charges, and provide buyer documents for taking delivery.	Take delivery of goods.	All

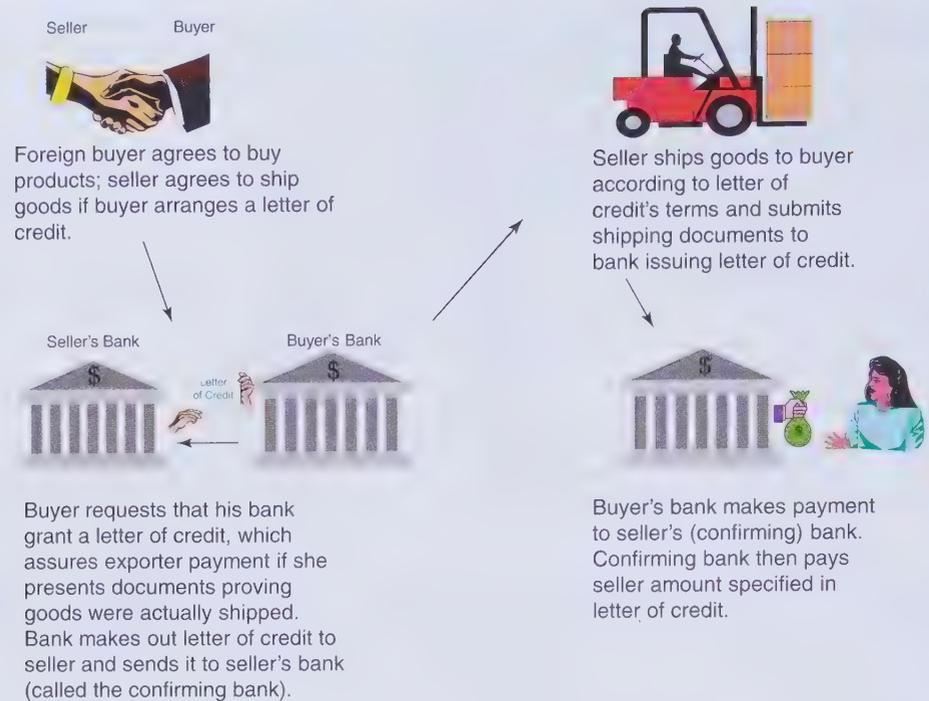
Source: Based on *Guide to the Finance of International Trade*, edited by Gordon Platt (HBSC Trade Services, Marine Midland Bank, and the Journal of Commerce), [http://infoserv2.ita.doc.gov/efm/efm.nsf/503d177e3c63f0b48525675900112e24/6218a8703573b32985256759004c41f3/\\$FILE/Finance_.pdf](http://infoserv2.ita.doc.gov/efm/efm.nsf/503d177e3c63f0b48525675900112e24/6218a8703573b32985256759004c41f3/$FILE/Finance_.pdf), pp. 6–10.

small percentage of the sale that the company is insuring. Private insurers and the Export-Import Bank offer export credit insurance. The Ex-Im Bank provides more than \$6 billion in export credit insurance annually to small businesses.



ENTREPRENEURIAL PROFILE: Martin Weinberg: Xamax Industries Xamax Industries, a small company in Seymour, Connecticut, that makes specialty paper, plastics, and nonwoven fabrics, uses export credit insurance from the Ex-Im Bank to lower the risk associated with its foreign sales. Prior to purchasing insurance from the Ex-Im Bank, Xamax Industries restricted its export sales because of the risk it incurred on open account sales to foreign customers. Then Xamax's president, Martin Weinberg, learned about the Ex-Im Bank's export insurance that protects against nonpayment on international sales and quickly signed on. "The Ex-Im Bank policy lets us sell products where we otherwise could not have sold them," says Weinberg. "We have added sales in China, Spain, Mexico, Canada, and Malaysia—all sales that would not have happened without [Ex-Im Bank] insurance."⁵⁷

FIGURE 12.9
How a Letter of Credit Works



Financing foreign sales often involves special credit arrangements, such as letters of credit and bank (or documentary) drafts. A **letter of credit** is an agreement between an exporter's bank and the foreign buyer's bank that guarantees payment to the exporter for a specific shipment of goods. In essence, a letter of credit reduces the financial risk for the exporter by substituting a bank's creditworthiness for that of the purchaser (see Figure 12.9). A **bank draft** is a document the seller draws on the buyer's bank, requiring the bank to pay the face amount (the purchase price of the goods) either on sight (a sight draft) or on a specified date (a time draft) once the goods are shipped. Bank drafts lower international sellers' risk because the issuing bank guarantees payment for the buyer's purchase. Rather than use letters of credit or bank drafts, some exporters simply sell to foreign customers on open account. In other words, they ship the goods to a foreign customer without any guarantee of payment. This method is riskiest because collecting a delinquent account from a foreign customer is even more difficult than collecting past-due payments from a domestic customer. The parties to an international deal should always come to an agreement in advance on an acceptable method of payment.



Lessons from the Street-Smart Entrepreneur

Finding Your Place in the World

For 20 years, Steve McMenemy designed and sold luxury goods such as luggage, jewelry, watches, and eyewear for the legendary Porsche Design Group. McMenemy was inspired to create eyeglasses made from wood rather than plastic with bold designs that would provide their wearers with a more comfortable fit and started iWood Eco Design. Based in Louisville, Kentucky, iWood Eco Design manufactures its unique glasses by hand in the mid-western United States from reclaimed wood that is used to decorate the interior of luxury private jets. McMenemy purchases the

and Makassar ebony, from local wood laminators that otherwise would go to waste but are ideal for making iWood Eco Design's glasses. Each pair of sunglasses is meticulously sanded by hand and assembled with optical-quality lenses by Carl Zeiss and imported Italian temple grips. Feather-light and perfectly balanced, they look and fit like no other eyewear and are stronger and lighter than glasses made from plastic frames.

McMenemy recognized the potential to sell his company's stylish, unique, and eco-friendly glasses globally. "Many products on the market claim to be eco-friendly, but they are not," he says.



A pair of iWood Eco Design's wood-framed glasses.

Source: Newscom.

"That's where we have a competitive advantage. Our products are Forest Stewardship Council certified, harvested by sustainable methods, and use glue and protective coatings that are formaldehyde free and emit no VOCs." The young company had never sold its products internationally, however, and McMenamín's first task was to identify the countries that would be most interested in eco-friendly, high-fashion products. As an international newcomer, he preferred to work through foreign distributors but didn't know how to find reliable distributors in foreign countries.

Fortunately, McMenamín discovered the U.S. Commercial Service office in nearby Indianapolis, Indiana, and asked the global trade experts there for help. iWood Eco Design qualified for the Commercial Service's Trade Show Assistance Program, which provides financing to small companies to attend international trade shows. With the Commercial Service's help, McMenamín identified the Premiere Classe Show in Paris, France, as the ideal venue for establishing relationships with international vendors and distributors of fashion accessories. The U.S. Commercial Service office in Paris helped iWood Eco Design land an invitation to the trade show and helped promote the company among global fashion companies such as Hermes and Louis Vuitton before the show opened. At the Paris trade show, the company landed deals with distributors in France and in the United Kingdom. When McMenamín returned home, he began receiving orders from distributors across Europe and in Russia, Australia, and the Middle East. "I was excited that our product had even stronger potential in Europe than in the United States," he says. "The U.S. Commercial Service in Indiana worked with us all the way, providing counseling on European Union tariffs and taxes, distribution methods, and providing market intelligence."

iWood Eco Design is now a global business, selling its unique glasses to customers in France, the United Kingdom, Russia, New Zealand, Australia, China, Canada, Spain, Italy, Germany, Denmark, and other nations. "The majority of our sales are international," says McMenamín, "and we expect tremendous growth in international sales. "Exporting has provided us with a steady stream of business through the economic downturn [in the United States]." The company also is planning to expand its reach into global markets by introducing new product lines that include earrings, necklaces, bracelets, and rings made from the same exotic, reclaimed wood from which its glasses are made.

What lessons can other entrepreneurs learn from iWood Eco Design's successful foray into international markets?

- **Analyze foreign markets carefully to determine which ones offer the most promising opportunities for your products or services.** Start by conducting secondary research to develop a short list of countries before investing in costly and time-consuming research, travel time, and money to conduct primary research on the few countries on your

short list. Research showed iWood Eco Designs that global demand existed for its products but that customers in Germany and Japan were extremely interested in their eco-fashion products.

- **Focus on a single market or very small number of similar markets at the outset.** Entering global markets requires a company to invest its resources, including people's time. Don't make the mistake of taking a broad "shotgun" approach, trying to enter a large number of markets at once. Instead, focus your resources on the most promising country first, learn from your mistakes, and establish a foothold there before entering other markets.
- **Learn everything you can about your target country.** The business practices, customs, and tastes of a country are unique and reflect its culture. Make sure that you invest the necessary time to learn how people in the country expect to do business. Is calling other business executives by their first names acceptable? Do potential business partners expect to build relationships with you through informal dinners where no "business" is discussed or attending social events before negotiating a contract? Are certain gestures considered taboo in a culture? Is gift giving appropriate? If so, what kinds of gifts are suitable?
- **Discover whether you must modify your product or service to suit local tastes.** Many companies have discovered that to be successful in foreign markets, they must modify the size of their products, their packages' colors, labels, and other characteristics to suit local customers' preferences. Usually, the required modifications are not extensive, but making them is one key to success and requires research.
- **Take steps to protect your company.** Small companies incur risks such as nonpayment, a customer's bankruptcy, goods that are not delivered, and many others when doing business with domestic customers. Those same risks apply to international sales as well, but their challenges are exacerbated by distance. Small companies that export their goods and services can use standard business tools, such as letters of credit, bank drafts, and export credit insurance, to minimize their risk of loss.
- **Attend a trade show.** One of the best ways to reach a large number of potential distributors or customers in another country is to attend a trade show that focuses on your industry. The Premiere Classe Show in Paris was the key to opening doors to international markets for iWood Eco Design. Be sure to thoroughly investigate the profile of the show's attendees before signing on, however, to make sure that they are your target customers.
- **Use the resources that are available to small businesses as they go global.** Steve McMenamín relied on the expertise of the people at the U.S. Commercial Service to help his company navigate the intricacies of the global market. "The Commercial Service has been instrumental in providing us with information and support for our exporting efforts," he says. As you learned in this chapter, there are many helpful resources available; use them!

Sources: Based on "Export Success Stories: iWood Eco Design," *Export.gov*, January 11, 2013, <http://new.export.gov/community/users/export-success-stories/posts/183-success-story-iwood-eco-design>; Tony Baker, "Special Report: Ten Mistakes Exporters Make and Ways to Avoid Them," *Small Business World*, <http://www.smallbusinessworld.com/Articles/MistakesReport-09-27.pdf>.

Establishing International Locations

Once established in international markets, some small businesses set up permanent locations there. Establishing an office or a factory in a foreign land can require a substantial investment reaching beyond the budgets of many small companies. In addition, setting up an international office can be an incredibly frustrating experience in some countries. Business infrastructure is in disrepair or is nonexistent. Getting a telephone line installed can take months in some places, and finding reliable methods to ship goods to customers is challenging. Securing necessary licenses and permits from bureaucrats often takes more than filing the necessary paperwork; in some nations, bureaucrats expect payments to “grease the wheels of justice.” According to Ernst and Young’s Global Fraud Survey, 39 percent of executives in 43 nations report that bribery or corrupt practices occur frequently in their countries. Alarming, 15 percent of respondents say that they are prepared to make cash payments to win or retain business.⁵⁸ The Foreign Corrupt Practice Act, passed in 1977, considers bribing foreign officials to be a criminal act. One study by the World Bank of “grease payments” made for the purpose of minimizing the red tape imposed by foreign regulations concludes that the payments do *not* work; in fact, companies that make them actually experience *greater* government scrutiny and red tape in their international transactions.⁵⁹ Finally, finding the right person to manage an international office is crucial to success; it also is a major challenge, especially for small businesses. Small companies usually have lean management staffs and cannot afford to send key people abroad without running the risk of losing their focus.

Small companies that establish international locations can reap significant benefits. Start-up costs are lower in some foreign countries (but not all!), and lower labor costs can produce significant savings as well. In addition, by locating in a country, a business learns firsthand how its culture influences business and how it can satisfy customers’ demands most effectively. In essence, the business becomes a local corporate citizen. Clothing retailer J. Crew, which has only one store outside the United States in Toronto, Canada, recently began implementing plans to open stores in key cities in Europe and Asia. Although the company sold only to online customers in the United States, Canada, and Japan, 10 percent of the traffic on its Web site is from outside North America. With its “Hello, World” campaign, J. Crew began testing the potential for its products in foreign countries by shipping its clothing to online customers in 107 countries, ranging from China and Brazil to Latvia and Estonia. Determining where its online orders originate will tell managers where to open international J. Crew retail locations, reducing the risk of the company’s international expansion.⁶⁰

Importing and Outsourcing

In addition to selling their goods in foreign markets, small companies also buy goods from distributors and manufacturers in foreign markets. In fact, the intensity of price competition in many industries—from textiles and handbags to industrial machinery and computers—means that more companies now shop the world market, looking for the lowest prices they can find. In the United States alone, businesses import \$2.7 billion worth of goods and services annually.⁶¹ Because labor costs in countries such as Thailand, Vietnam, Bangladesh, India, and China are far below those in other nations, businesses there can produce goods and services at very low prices. Increasingly, these nations are home to well-educated, skilled workers who are paid far less than comparable workers in the United States or northern and western Europe (see Figure 12.10). For instance, a computer programmer in the United States might earn \$75,000 a year, but in Latvia, a computer programmer doing the same work earns \$15,000 a year or less. As a result, many companies either import goods or outsource work directly to manufacturers in countries where costs are far lower than they would be domestically. According to TPI, a leading outsourcing consulting firm, global outsourcing is a \$464 billion per year industry (up from \$232 billion in 2000).⁶²



ENTREPRENEURIAL PROFILE: Hussein and Hassan Idrissu: Roadstarr Motorsports

Twin brothers Hussein and Hassan Idrissu, immigrants from Ghana, left their corporate jobs and used personal savings and investments from family members to start Roadstarr Motorsports, a Los Angeles–based company that imports high-performance cars from Europe and customizes them to suit the tastes of their upscale owners. Roadstarr Motorsports offers a wide array of customizing options, including sporty wheels, upscale interiors, fancy paint jobs, trim kits, multimedia packages, and almost anything else that customers can imagine. The brothers have generated plenty of “buzz”

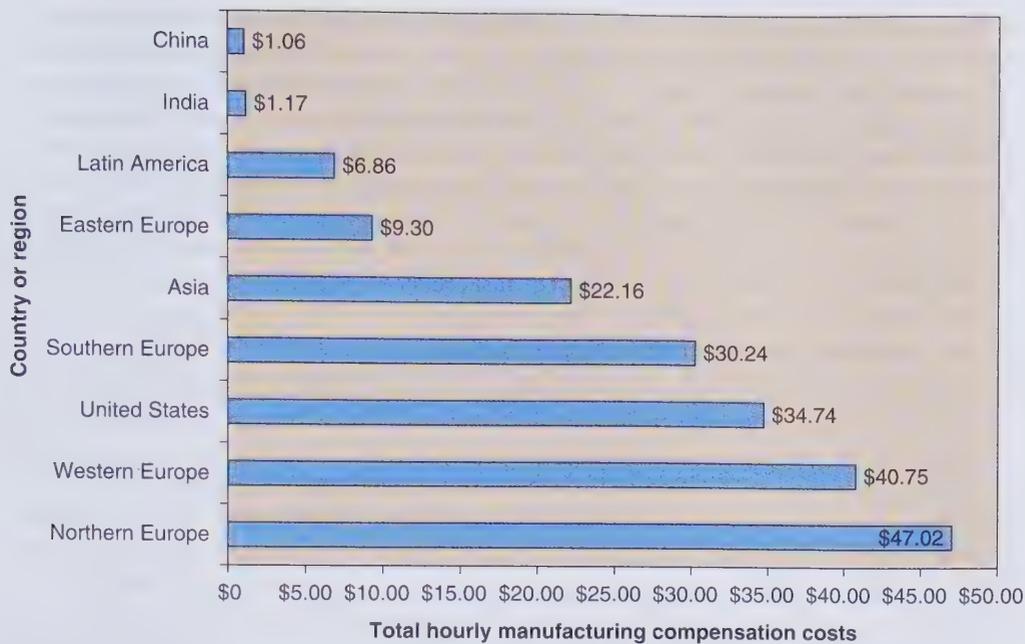


FIGURE 12.10
Total Hourly Manufacturing Compensation Costs for Selected Countries and Regions

Source: Based on *International Labor Comparisons*, Bureau of Labor Statistics, 2012.

for their company by creating unique, customized vehicles for several rap stars, professional basketball players, and international royalty and using social media such as Facebook and Twitter to show off their latest designs. Buoyed by their success in the United States, the Iddrissus are planning to take Roadstarr Motorsports to Moscow, Russia, which has the highest concentration of billionaires in the world.⁶³

Finding the right international suppliers and manufacturers has a direct impact on a small company's reputation and financial performance. Web sites such as *Alibaba.com*, *MadeInChina.com*, and *GlobalSources.com* are good places to start. Entrepreneurs who are considering importing goods and service or outsourcing their service or manufacturing jobs to foreign countries should follow these steps:

- **Make sure that importing or outsourcing is right for your business.** Even though foreign manufacturers often can provide items at significant cost savings, using them may not always be the best business decision. Entrepreneurs sometimes discover that achieving the lowest price may require a tradeoff of other important factors such as quality and speed of delivery. When Patrick Kruse, owner of Ruff Wear, the business that sells dog booties, began outsourcing many of his company's products to Chinese factories, he discovered that the quality of the goods was poor. "We actually had to refuse some shipments, which really hurt our business," he says.⁶⁴ In addition, some foreign manufacturers require sizeable minimum orders, perhaps \$100,000 or more, before they produce a product.
- **Establish a target cost for your product.** Before setting off on a global shopping spree, entrepreneurs first should determine exactly what they can afford to spend on manufacturing a product and make a profit on it. Given the low labor costs of many foreign manufacturers, products that are the most labor intensive make good candidates for outsourcing.
- **Do your research before you leave home.** Investing time in basic research about the industry and potential suppliers in foreign lands is essential before setting foot on foreign soil. Useful resources are plentiful, and entrepreneurs should use them. Refer to Table 12.2 for a list of some of the most popular sources of information on foreign countries and the companies that are based there.
- **Be sensitive to cultural differences.** When making contacts, setting up business appointments, or calling on prospective manufacturers in foreign lands, make sure you understand what is accepted business behavior and what is not. Once again, this is where your research pays off: be sure to study the cultural nuances of doing business in the countries you will visit.

- **Do your groundwork.** Once you locate potential manufacturers, contact them to set up appointments and go visit them. Preliminary research is essential to finding reliable sources of supply, but “face time” with representatives from various companies allows entrepreneurs to judge the intangible factors that can make or break a relationship. Is the factory safe, clean, and well organized? After months of online research, Cathy Raff, founder of My Stone Company, a business that markets religious jewelry and The Friendship Stone, flew to South Africa to evaluate several mines that were potential suppliers of the stones her company used. “I needed to go meet the people I would be working with,” says Raff, who also flew to China to select the factory that produces the embroidered suede pouches that hold her company’s products. “Outsourcing is the best way to go because you can get really high quality work from these countries at much lower rates,” she says.⁶⁵
- **Protect your company’s intellectual property.** A common problem that many entrepreneurs have encountered with outsourcing is “knockoffs.” Some foreign manufacturers see nothing wrong with agreeing to manufacture a product for a company and then selling their own knockoff version of it. Securing a nondisclosure agreement and a contract that prohibits such behavior helps, but experts say that securing a patent for the item in the source country itself (not just the United States) is a good idea.
- **Select a manufacturer.** Using quality, speed of delivery, level of trust, degree of legal protection, costs, and other factors, select the manufacturer that can do the best job for your company. Be aware that delivery times may be longer—sometimes much longer—for outsourced goods. Items that domestic suppliers can supply within a week or two may take months to arrive from some foreign countries.
- **Provide an exact model of the product you want manufactured.** Providing a manufacturer with an actual model of the item to be manufactured will save lots of time, mistakes, and problems. One entrepreneur learned this lesson the hard way when he submitted a rough prototype of a product to a Chinese factory with which he had contracted for production. When the first shipment of the products arrived, he was shocked to see that they were exact duplicates—including imperfections and flaws—of the prototype that he had submitted!
- **Stay in constant contact with the manufacturer and try to build a long-term relationship.** Communication is a key to building and maintaining a successful relationship with a foreign manufacturer. Weekly teleconferences, e-mails, and periodic visits are essential to making sure that your company gets the performance you expect from a foreign manufacturer.

Going global by employing one or more of these nine strategies can put tremendous strain on a small company, but the benefits of cracking international markets can be significant. Not only does going global offer attractive sales and profit possibilities, but it also strengthens the company’s competitive skills and enhances its overall reputation. Pleasing tough foreign customers also keeps companies on their competitive toes.

Barriers to International Trade

Governments have always used a variety of barriers to block free trade among nations in an attempt to protect businesses within their own borders. The benefit of protecting their own companies, however, comes at the expense of foreign businesses, which face limited access to global markets. Ultimately, customers in nations that restrict free trade pay the price in the form of higher prices and smaller supplies of goods available. Numerous trade barriers—both domestic and international—restrict the freedom of businesses in global trading. Despite these barriers, international trade has grown to more than \$17.8 trillion.⁶⁶

Domestic Barriers

Sometimes the biggest barriers potential exporters face are right here at home. Three major domestic roadblocks are common: attitude, information, and financing. Perhaps the biggest barrier to small businesses exporting is the attitude: “I’m too small to export. That’s just for big corporations.” The first lesson of exporting is “Take nothing for granted about who can export and what you can and cannot export.” The first step to building an export program is recognizing that the opportunity to export exists.

4.

Discuss the major barriers to international trade and their impact on the global economy.

Another reason entrepreneurs neglect international markets is a lack of information about how to get started. The key to success in international markets is choosing the correct target market and designing the appropriate strategy to reach it. That requires access to information and research. Although a variety of government and private organizations make volumes of exporting and international marketing information available, many small business owners never use it. A successful global marketing strategy also recognizes that not all international markets are the same. Companies must be flexible and willing to make adjustments to their products and services, promotional campaigns, packaging, and sales techniques.

Another significant obstacle is the lack of export financing available. A common complaint among small exporters is that they lose export business simply because they cannot get the financing to support it. Financial institutions that serve small companies often do not have experience in conducting international business and simply deny loans for international transactions as being too risky.

International Barriers

Domestic barriers are not the only ones that export-minded entrepreneurs must overcome. Trading nations also erect obstacles to free trade. Two types of international barriers are common: tariff and nontariff.

TARIFF BARRIERS A **tariff** is a tax, or duty, that a government imposes on goods and services imported into that country. Imposing tariffs raises the price of the imported goods—making them less attractive to consumers—and protects the makers of comparable domestic products and services. Established in the United States in 1790 by Alexander Hamilton, the tariff system generated the majority of federal revenues for about 100 years. Today, the *Harmonized Tariff Schedule*, which sets tariffs for products imported into the United States, includes 37,000 categories of goods. The United States imposes tariffs on thousands of items ranging from brooms and fish fillets to costume jewelry and fence posts. American tariffs vary greatly depending on the type of product. For instance, women’s bathing suits made from synthetic fibers carry a 24.9 percent tariff, but the tariff on women’s bathing suits made from other materials is 13.2 percent.⁶⁷ The average tariff on goods imported into the United States is 1.8 percent (compared to the global average of 2.7 percent), but the U.S. International Trade Commission (ITC) estimates that eliminating tariffs would expand U.S. exports by \$9 billion and increase imports by \$11.5 billion.⁶⁸ Nations across the globe rely on tariffs to protect local manufacturers of certain products, and tariff rates vary greatly among nations. Singapore, Switzerland, and Hong Kong impose no tariffs at all on imported goods, but Bermuda has the highest average tariff rate in the world at 26.1 percent.⁶⁹ When a small company’s products are subject to a country’s high tariffs, exporting to that nation becomes much more difficult because remaining price competitive with products made by local manufacturers is virtually impossible.

NONTARIFF BARRIERS Many nations have lowered the tariffs they impose on products and services brought into their borders, but they rely on other nontariff structures as protectionist trade barriers.

Quotas Rather than impose a direct tariff on certain imported products, nations often use quotas to protect their industries. A **quota** is a limit on the amount of a product imported into a country. The United States imposes quotas on sugar imports from 40 countries, limiting the amount of sugar they can sell in the U.S. each year. The result of these trade restrictions is that in the United States, sugar sells for 69 cents per pound, but the international market price is just 26 cents per pound, 62 percent lower.⁷⁰ Other countries impose quotas on everything from shoes to movies in an attempt to protect domestic industries. For instance, China allows only 34 foreign films to be released each year. In addition, foreigners can invest in Chinese cinemas, but they can own no more than 49 percent of the joint venture.⁷¹

Embargoes An **embargo** is a total ban on imports of certain products or all products from a particular nation. The motivation for embargoes is not always economic, but it also can involve political differences, environmental disputes, terrorism, and other issues. For instance, the United States imposes embargoes on products from nations it considers to be adversarial, including Cuba, Iran, Iraq, and North Korea, among others. An embargo on trade with Cuba, begun in 1960

when Fidel Castro nationalized all U.S. businesses on the island nation and formed an alliance with the Soviet Union, still exists today. In 1994, the United States lifted a total trade embargo against Vietnam that had stood since 1975, when Saigon fell into communist hands at the end of the Vietnam War. Today, the United States imports \$18.5 billion worth of goods from Vietnam and exports goods worth \$4.2 billion.⁷²

Dumping In an effort to grab market share quickly, some companies have been guilty of **dumping** products, selling large quantities of them in foreign countries at prices that are below those in the home country. The United States has been a dumping target for steel, televisions, tires, barbed wire, shoes, and computer chips in the past. Under the U.S. Antidumping Act, a company must prove that the foreign company's prices are lower here than in the home country and that U.S. companies are directly harmed. In response to a complaint from U.S.-based companies, the ITC recently ruled that manufacturers in Taiwan and Vietnam were dumping wire garment hangers illegally in the United States at unfairly low prices and, as a result, were damaging the ability of U.S. producers to compete. The ITC imposed tariffs ranging from 70 to 125 percent on wire hangers imported from Taiwan and Vietnam.⁷³



Counterfeit goods being destroyed.

Source: Frank Perry/Getty Images.

Piracy Another barrier to conducting business globally is the threat that counterfeit and pirated products pose to businesses and their customers. The World Customs Organization estimates that 5 to 7 percent of goods traded globally are counterfeit, costing the global economy \$600 billion per year.⁷⁴ Pirates and counterfeiters ply their illegal, unethical trade to almost every kind of product, from designer handbags and smart phones to birth control pills and industrial equipment. Not only do counterfeit products erode the profitability of the companies that make the “genuine” articles, but they also can be dangerous or even deadly to consumers who purchase them. In the United States, the most commonly seized counterfeit goods (based on value) are handbags, watches and jewelry, apparel, consumer electronics, and footwear. China is the source of 72 percent of the counterfeit goods that are seized in the United States.⁷⁵

Political Barriers

Entrepreneurs who go global quickly discover a labyrinth of political tangles. Although many American business owners complain of excessive government regulation in the United States, they are often astounded by the complex web of governmental and legal regulations and barriers they encounter in foreign countries.

Companies doing business in politically risky lands face the very real dangers of government takeovers of private property; attempts at coups to overthrow ruling parties; kidnappings, bombings, and other violent acts against businesses and their employees; and other threatening events. Companies' investments of millions of dollars may evaporate overnight in the wake of a government coup or the passage of a law nationalizing an industry (giving control of an entire industry to the government). In 2005, Jeff Ake, owner of Equipment Express, was kidnapped by militants in Iraq while installing bottling equipment that his Laporte, Indiana, company manufactured. His kidnappers called his wife to demand a ransom, and a video of Ake being held at gunpoint appeared on Arabic television network Al-Jazeera. His wife and four children still do not know what happened to Ake.⁷⁶

Business Barriers

American companies doing business internationally quickly learn that business practices and regulations in foreign lands can be quite different from those in the United States. Simply duplicating the practices they have adopted (and have used successfully) in the domestic market and using them in foreign markets is not always a good idea. Perhaps the biggest shock comes in the area of human resources management, where international managers discover that practices common in the United States, such as overtime, women workers, and employee benefits, are restricted, disfavored, or forbidden in other cultures. Business owners new to international business sometimes are shocked at the wide range of labor costs they encounter and the accompanying wide range of skilled labor available. In some countries, what appear to be “bargain” labor rates turn out to be excessively high after accounting for the quality and productivity of the labor force and the mandated benefits their governments impose—from company-sponsored housing, meals, and clothing to required profit sharing and extended vacation periods.

nations, laws mandate that companies provide a minimum of 20 paid vacation days in addition to paid holidays, giving workers an average of nearly 35 days off a year.⁷⁷

Cultural Barriers

The **culture** of a nation includes the beliefs, values, views, and mores that its inhabitants share. Differences in cultures among nations create another barrier to international trade. The diversity of languages, business philosophies, practices, and traditions make international trade more complex than selling to the business down the street. Entrepreneurs who want to do business in international markets must have a clear understanding and appreciation of the cultures in which they plan to do business. Consider the following examples:

- A U.S. entrepreneur, eager to expand into Europe, arrives at his company's potential business partner's headquarters in France. Confidently, he strides into the meeting room, enthusiastically pumps his host's hand, slaps him on the back, and says, "Tony, I've heard a great deal about you; please, call me Bill." Eager to explain the benefits of his product, he opens his briefcase and gets right down to business. The French executive politely excuses himself and leaves the room before negotiations ever begin, shocked by the American's rudeness and ill manners. Rudeness and ill manners? Yes—from the French executive's perspective.
- Another American business owner flies to Tokyo to close a deal with a Japanese executive. He is pleased when his host invites him to play a round of golf shortly after he arrives. He plays well and manages to win by a few strokes. The Japanese executive invites him to play again the next day, and again he wins by a few strokes. Invited to play another round the following day, the American asks, "But when are we going to start doing business?" His host, surprised by the question, says, "But we *have* been doing business."
- The CEO of a successful small company is in China negotiating with several customers on deals, any of which would be significant to the company. On the verge of closing one deal, the CEO sends in his place to the negotiation a young sales representative, thinking that the only thing that remained is to sign the contract. At the meeting, the manager of the Chinese company remarks, "Ah, you are about the same age as my son." Much to the U.S. entrepreneur's surprise, the deal falls through.⁷⁸

When American businesspeople enter international markets for the first time, they often are amazed at the differences in foreign cultures' habits and customs. In the first scenario described, for instance, had the entrepreneur done his homework, he would have known that the French are very formal (back slapping is *definitely* taboo!) and do not typically use first names in business relationships (even among longtime colleagues). In the second scenario, a global manager would have known that the Japanese place a tremendous importance on developing personal relationships before committing to any business deals. Thus, he would have seen the golf games for what they really were: an integral part of building a business relationship. In the final scenario, the U.S. entrepreneur did not understand that status (*shehui dengji*) is extremely important to the Chinese. The Chinese executive would consider negotiating a deal with an executive whose rank in the organization did not at least equal his to be a great insult. That deal was doomed the minute the lower-level salesperson walked into the room.



Understanding the cultural differences in business practices is one key to success in international business.

Source: dotshock/Shutterstock.

Understanding and heeding these often subtle cultural differences is one of the most important keys to international business success. “There’s more to business than just business,” says one writer, “particularly when confronting the subtleties of deeply ingrained cultural customs, conventions, and protocols that abound in today’s global marketplace.”⁷⁹ Conducting a business meeting with a foreign executive in the same manner as one with an American business person could doom the deal from the outset. Business customs, behaviors, and even gestures that are acceptable—even expected—in this country may be taboo in others. For instance, the hand gesture that Americans routinely use to indicate “OK” is considered rude and offensive in many countries in the Middle East and in Brazil.

Entrepreneurs who fail to learn the differences in the habits and customs of the cultures in which they hope to do business are at a distinct disadvantage. When it comes to conducting international business, a lack of understanding of cultures and business practices can be as great a barrier to structuring and implementing a business transaction as an error in the basic assumptions of the deal. Consider, for instance, the American who was in the final stages of contract negotiations with an Indonesian company. Given the size of the contract and his distance from home, the American business executive was nervous. Sitting across from his Indonesian counterpart, the American propped his feet up. Obviously angered, the Indonesian business owner stormed out of the room, refusing to sign the contract and leaving the American executive totally bewildered. Only later did he discover that exposing the soles of one’s shoes to an Indonesian is an insult. Profuse apologies and some delicate negotiations salvaged the deal.⁸⁰

Inaccurate translations of documents into other languages often pose embarrassing problems for companies conducting international business. In other cases, mistranslated ads have left foreign locals scratching their heads, wondering why a company’s advertising message would say *that!* For example, when an ad for Kentucky Fried Chicken that was supposed to say “Finger lickin’ good” was translated into Chinese, it came out as “Eat your fingers off.” An ad for the Parker Pen Company that was supposed to say “Avoid embarrassment” in Spanish actually said “Avoid pregnancy,” leaving Parker Pen executives quite embarrassed themselves.⁸¹ Nike issued an apology to customers in Ireland after the company marketed an athletic shoe named the “Black and Tan,” not realizing that in Ireland, the Black and Tans refers to a paramilitary group that massacred civilians during the Irish war for independence from Great Britain.⁸²

International Trade Agreements

In an attempt to boost world trade, nations have created a variety of trade agreements over the years. The United States has 20 trade agreements with other nations.⁸³ Although hundreds of agreements are paving the way for free trade across the world, the following stand out with particular significance: the World Trade Organization, the North American Free Trade Agreement, and the Dominican Republic-Central American Free Trade Agreement.

World Trade Organization

The World Trade Organization (WTO) was established in January 1995 and replaced the General Agreement of Tariffs and Trade (GATT), the first global tariff agreement, which was created in 1947 and designed to reduce tariffs among member nations. The WTO, currently with 158 member countries, is the only international organization that establishes rules for trade among nations. Its member countries represent 97 percent of all world trade. The rules and agreements of the WTO, called the multilateral trading system, are the result of negotiations among its members. The WTO actively implements the rules established by the Uruguay Round negotiations of GATT from 1986 to 1994 and continues to negotiate additional trade agreements. The ninth round of negotiations, the Doha Development Agenda, began in 2001 and is still under way. Through the agreements of the WTO, members commit themselves to nondiscriminatory trade practices and to reducing barriers to free trade. Member countries receive guarantees that their exports will be treated fairly and consistently in other member countries’ markets. The WTO’s General Agreement on Trade in Services addresses specific industries, including banking, insurance, telecommunications, and tourism. In addition, the WTO’s intellectual property agreement

5.

Describe the trade agreements that have the greatest influence on foreign trade.

which covers patents, copyrights, and trademarks, defines rules for protecting ideas and creativity across borders.

In addition to the development of agreements among members, the WTO is involved in the resolution of trade disputes among members. The WTO system is designed to encourage dispute resolutions through consultation. If this approach fails, the WTO has a stage-by-stage procedure that can culminate in a ruling by a panel of experts.

North American Free Trade Agreement

The North American Free Trade Agreement (NAFTA) created the world's largest free trade zone among Canada, Mexico, and the United States. A **free trade zone** is an association of countries that have agreed to eliminate trade barriers—both tariff and nontariff—among partner nations. Under the provisions of NAFTA, these barriers were eliminated for trade among the three countries, but each remained free to set its own tariffs on imports from nonmember nations.

NAFTA forged a unified U.S.–Canada–Mexico market of 478 million people with a total annual output of more than \$19.2 trillion of goods and services. This important trade agreement binds together the three nations on the North American continent into a single trading unit stretching from the Yukon to the Yucatan. NAFTA has made trade less cumbersome and more profitable for companies of all sizes and has opened new export opportunities for many businesses. Since NAFTA's passage, trade among the three nations has more than tripled.

The Dominican Republic-Central America Free Trade Agreement

The Dominican Republic-Central America Free Trade Agreement (CAFTA-DR) is to Central America what NAFTA is to North America. The agreement, which was implemented in stages between 2006 and 2008, is designed to promote free trade among the United States and six Central American countries: Costa Rica, El Salvador, Guatemala, Honduras, the Dominican Republic, and Nicaragua. Annual trade between the United States and these Central American countries has grown from \$35 billion before CAFTA to \$56 billion today.⁸⁴ In addition to reducing tariffs among these nations, CAFTA-DR protects U.S. companies' investments and intellectual property in the region, simplifies the export process for U.S. companies, and provides easier access to Central American markets.



ENTREPRENEURIAL PROFILE: Wilma Castro: International Export Sales

Lower tariffs and the elimination of other trade barriers through CAFTA-DR allowed International Export Sales, a small company in Santa Rose, Louisiana, to increase sales of its light industrial refrigeration and supermarket equipment to Central America. "Our business with Central America has increased 100 percent since CAFTA-DR took effect," says sales manager Wilma Castro. Because its exports sales have increased, the company has expanded its workforce from four employees to eight.⁸⁵

Conclusion

For a rapidly growing number of small businesses, conducting business on a global basis is the key to future success. A small company going global exposes itself to certain risks, but, if planned and executed properly, a global strategy can produce huge rewards. To remain competitive, businesses of all sizes must assume a global posture. Global effectiveness requires managers to be able to leverage workers' skills, company resources, and customer know-how across borders and throughout cultures across the world. Managers also must concentrate on maintaining competitive costs structures and focus on the core of every business—the *customer!* Robert G. Shaw, CEO of International Jensen Inc., a global maker of home and automobile stereo speakers, explains the importance of retaining that customer focus as his company pursues its global strategy: "We want [our customers] to have the attitude of [our] being across the street. If we're going to have a global company, we have to behave in that mode—whether [the customer is] across the street—or seven miles, seven minutes, or 7,000 miles away."⁸⁶

Few businesses can afford the luxury of defining their target markets solely as the customers who live within the boundaries of their company's home borders. The manager of one global business who discourages the use of the word domestic among his employees says, "Where's the market? The world is your market?"⁸⁷ Although there are no surefire rules for going

global, small businesses wanting to become successful international competitors should observe these guidelines:

- Make yourself at home in all three of the world's key markets—North America, Europe, and Asia. This triad of regions is forging a new world order in trade that will dominate global markets for years to come. Small companies that focus on business opportunities in the fast-growing economies of Brazil, Russia, India, and China are likely to benefit most because forecasts call for these four nations to account for 45 percent of global GDP by 2030, a significant increase from the 18 percent of global GDP that they currently produce.⁸⁸
- Appeal to the similarities within the various regions in which you operate but recognize the differences in their specific cultures. Although the European Union, which produces 25.8 percent of global GDP, is a single trading bloc comprised of 27 countries with a combined population of 503 million people, smart entrepreneurs know that each country has its own cultural uniqueness and do not treat them as a unified market.⁸⁹
- Be willing to commit the necessary resources to make your global efforts successful. Going global requires an investment of time, talent, money, and patience.
- Develop new products for the world market. Make sure your products and services measure up to world-class quality standards.
- Use the many resources available, such as the U.S. Commercial Service and the International Trade Administration, to research potential markets and to determine the ideal target market for your products.
- Familiarize yourself with foreign customs and languages; constantly scan, clip, and build a file on the cultures of countries where you are likely to do business—their lifestyles, values, customs, and business practices.
- Learn to understand your customers from the perspective of *their* culture, not your own. Bridge cultural gaps by being willing to adapt your business practices to suit their preferences and customs.
- “Glocalize.” Make global decisions about products, markets, and management but allow local employees to make tactical decisions about packaging, advertising, and service. Building relationships with local companies that have solid reputations in a region or a country can help overcome resistance, lower risks, and encourage residents to think of them as local companies.
- Make positive and preferably visible contributions to the local community. A company's social responsibility does not stop at the borders of its home country. Seattle-based Starbucks enhances its reputation in the Chinese communities in which it does business by donating coffee and snacks for local celebrations such as the Autumn Moon Festival. Once, when a group of protesters approached the U.S. embassy in Beijing, they stopped at a nearby Starbucks café to buy coffee. Rather than being the object of a protest, the branch actually saw sales climb!⁹⁰
- Train employees to think globally, send them on international trips, and equip them with state-of-the-art communications technology.
- Hire local managers to staff foreign offices and branches.
- Do whatever seems best wherever it seems best, even if people at home lose jobs or responsibilities.
- Consider using partners and joint ventures to break into foreign markets you cannot penetrate on your own.
- Be patient. International business often takes time to cultivate. “Selling to the world does not happen overnight,” says Laurel Delaney, an international business expert and author. “It is a slow process that requires thought, discipline, and lots of hard work. However, go global today, and you could fulfill your own version of the American dream.”⁹¹

By its very nature, going global can be a frightening experience for an entrepreneur considering the jump into international markets. Most of those who have already made the jump, however, have found that the benefits outweigh the risks and that their companies are much stronger because of it.

Chapter Review

1. Explain why “going global” has become an integral part of many entrepreneurs marketing strategies.
 - Companies that move into international business can reap many benefits, including offsetting sales declines in the domestic market’ increasing sales and profits, extending their products’ life cycles, lowering manufacturing costs, improving competitive position, raising quality levels, and becoming more customer oriented.
2. Describe the nine principal strategies for going global.
 - Perhaps the simplest and least expensive way for a small business to begin conducting business globally is to establish a site on the Web. Companies wanting to sell goods on the Web should establish a secure ordering and payment system for online customers.
 - Trade intermediaries, such as export management companies, export trading companies, manufacturer’s export agents, export merchants, resident buying offices, and foreign distributors, can serve as a small company’s “export department.”
 - In a domestic joint venture, two or more U.S. small companies form an alliance for the purpose of exporting their goods and services abroad. In a foreign joint venture, a domestic small business forms an alliance with a company in the target area.
 - Some small businesses enter foreign markets by licensing businesses in other nations to use their patents, trademarks, copyrights, technology, processes, or products.
 - Over the last decade, a growing number of franchises have been attracted to international markets to boost sales and profits as the domestic market has become increasingly saturated with outlets and much tougher to wring growth from. International franchisors sell virtually every kind of product or service imaginable in global markets. Most franchisors have learned that they must modify their products and services to suit local tastes and customs.
 - Some countries lack a hard currency that is convertible into other currencies, so companies doing business there must rely on countertrading or bartering. A countertrade is a transaction in which a business selling goods in a foreign country agrees to promote investment and trade in that country. Bartering involves trading goods and services for other goods and services.
- Although small companies account for 97 percent of the companies involved in exporting, they generate only one-third of the nation’s export sales. However, small companies, realizing the incredible profit potential it offers, are making exporting an ever-expanding part of their marketing plans.
- One established in international markets, some small businesses set up permanent locations there. Although they can be very expensive to establish and maintain, international locations give businesses the opportunity to stay in close contact with their international customers.
3. Explain how to build a thriving export program.
 - Building a successful export program takes patience and research. Steps include the following: realize that even the tiniest firms have the potential to export, analyze your product or service, analyze your commitment to exporting, research markets and pick your target, develop a distribution strategy, find your customer, find financing, ship your goods, and collect your money.
4. Discuss the major barriers to international trade and their impact on the global economy.
 - Three domestic barriers to international trade are common: the attitude that “we’re too small to export,” lack of information on how to get started in global trade, and a lack of available financing.
 - International barriers include tariffs, quotas, embargoes, dumping, and political business, and cultural barriers.
5. Describe the trade agreements that will have the greatest influence on foreign trade into the twenty-first century.
 - Created in 1947, the GATT, the first global tariff agreement, was designed to reduce tariffs among member nations and to facilitate trade across the globe.
 - The WTO was established in 1995 and replaced GATT. The WTO has 158 member nations and represents over 97 percent of all global trade. The WTO is the governing body that resolves trade disputes among members.
 - NAFTA created a free trade area among Canada, Mexico, and the United States. The agreement created an association that knocked down trade barriers, both tariff and nontariff, among these partner nations.

Discussion Questions

12-1. Why must entrepreneurs learn to think globally?

12-2. What are the factors in favor of small businesses entering the global market?

12-3. Comment on the statement, “The business looks at the

12-4. What available trade intermediaries are suited for small businesses?

12-5. What is a domestic joint venture? A foreign joint venture? What advantages does taking on an

international partner through a joint venture offer? Disadvantages?

- 12-6. What mistakes are first-time exporters most likely to make? Outline the steps a small company should take to establish a successful export program.
- 12-7. What are the benefits of establishing international locations? Disadvantages?
- 12-8. Explain how to build a successful export program.
- 12-9. What is a tariff? A quota? What impact do they have on international trade?
- 12-10. Thirty furniture makers in the United States recently asked the ITC to impose high tariffs on Chinese makers of wooden bedroom furniture for dumping their products in the U.S. market at extremely low prices. The U.S. manufacturers claimed that the Chinese imports single-handedly sent their industry into a deep tailspin. The Chinese factory owners contend that their low-cost furniture is the result of taking a labor-intensive product and building it with low-priced workers in high-tech modern factories. Identify the stakeholders in this trade dispute. What are the consequences for each stakeholder likely to be if the ITC were to impose tariffs on Chinese furniture? What impact do tariffs have on international trade? If you served on the ITC, what factors would you consider in making your decision? How would you vote in this case? Explain.
- 12-11. What impact have the WTO and NAFTA had on small companies wanting to go global? What provisions are included in these trade agreements?
- 12-12. What advice would you offer an entrepreneur interested in launching a global business effort?

CHAPTER 13

E-Commerce and Entrepreneurship



Learning Objectives

On completion of this chapter, you will be able to:

1. Understand the factors an entrepreneur should consider before launching into e-commerce.
2. Explain the 10 myths of e-commerce and how to avoid falling victim to them.
3. Explain the basic strategies entrepreneurs should follow to achieve success in their e-commerce efforts.
4. Learn the techniques of designing a killer Web site.
5. Explain how companies track the results from their Web sites.
6. Describe how e-businesses ensure the privacy and security of the information they collect and store from the Web.

Like China, the Internet is a huge new market. It's up to you to figure out what to do with it: use it as a prospecting tool, make connections with people, add value for your existing customers.

—Larry Chase

In the mental geography of e-commerce, distance has been eliminated. There is only one economy and one market.

—Peter Drucker

E-commerce has transformed the way that entrepreneurs conduct business, enabling them to connect to vendors, suppliers, and customers via technology in ways that have never been possible before. The result is a new method of doing business that is turning traditional methods of commerce and industry on their heads. The most successful small companies are embracing the Internet, not merely as another advertising medium or marketing tool but as a mechanism for transforming their companies and changing *everything* about the way they do business. As these companies discover new, innovative ways to use the Internet and communications technology to connect with their vendors and suppliers and to serve their customers better, they are creating a new industrial order. Companies are using the Internet to lower their costs of doing business, to broaden their base of reliable suppliers of quality products and services, and to tap into new markets, some of which are in foreign lands. The Internet allows innovative entrepreneurs to create new business models that they can test, improve, and implement in record time. E-commerce has launched a business revolution. Just as in previous revolutions in the business world, some old players are ousted, and new leaders emerge. The winners are discovering new business opportunities, new ways of serving their customers, and new ways of organizing and operating their businesses.

Perhaps the most visible impact of the Internet is in the world of retailing. Nearly 2.5 billion people around the world are Internet users, creating a huge potential customer base for businesses that are prepared to capitalize on the opportunity. In the United States alone, e-commerce sales total \$385 billion, and the growth rate of online sales continues to outpace the growth rate of in-store sales.¹ Although e-commerce will not replace traditional retailing, no retailer, from the smallest corner store to industry giant Wal-Mart, can afford to ignore the impact of the Internet on their businesses. Most shoppers still prefer to make their purchases in brick-and-mortar stores, but the convenience of e-commerce means that online sales are growing faster than in-store sales. Customers also are utilizing the Internet to change the way they shop, going into retail outlets where they test products before using their mobile devices to comparison shop for the best prices online. Known as **showrooming**, this trend poses a threat to retailers, particularly those who sell luxury items and consumer electronics, which are the items that customers most commonly showroom. Studies show that 7 percent of shoppers are habitual showroomers and that 50 percent of online sales are driven by showrooming.² Entrepreneurs are discovering that a cross-channel approach—meeting customers where they want to buy, whether in-store, online, from a mobile device such as a smart phone or a tablet, or some combination of these—is essential to combating showrooming.

Online companies can take orders at the speed of light from anywhere in the world and at any time of day. The Internet enables companies to collect more information on customers' shopping and buying habits than any other medium in history. This ability means that companies can focus their marketing efforts like never before—for instance, selling garden supplies to customers who are most likely to buy them and not wasting resources trying to sell to those who have no interest in gardening. The capacity to track customers' Web-based shopping habits allows companies to personalize their approaches to marketing and to realize the benefits of individualized (or one-to-one) marketing. Ironically, the same Web-based marketing approach that allows companies to get so personal with their customers also can make shopping extremely impersonal. Entrepreneurs who set up shop on the Internet will likely never meet their customers face-to-face or even talk to them. Yet those customers, who can live anywhere in the world, will visit the online store at all hours of the day or night and expect to receive individual attention and superior customer service. Making an online business model succeed requires a business to strike a balance, creating an e-commerce strategy that capitalizes on the strengths and efficiency of the Internet while meeting customers' expectations of convenience and service.

In this fast-paced world of e-commerce, size no longer matters as much as speed and flexibility do. One of the Internet's greatest strengths is its interactive, social nature and the ability to provide companies with instantaneous customer feedback, giving them the opportunity to learn and to make necessary adjustments. Businesses, whatever their size, that are willing to experiment with different approaches to reaching customers and are quick to learn and adapt will grow and prosper; those that cannot will fall by the wayside.

E-commerce is redefining even the most traditional industries such as the pizza business. Papa John's, Domino's, and Pizza Hut have surpassed the \$3 billion mark in online pizza sales. Online pizza sales are growing so fast that it took Papa John's seven years to reach its first billion

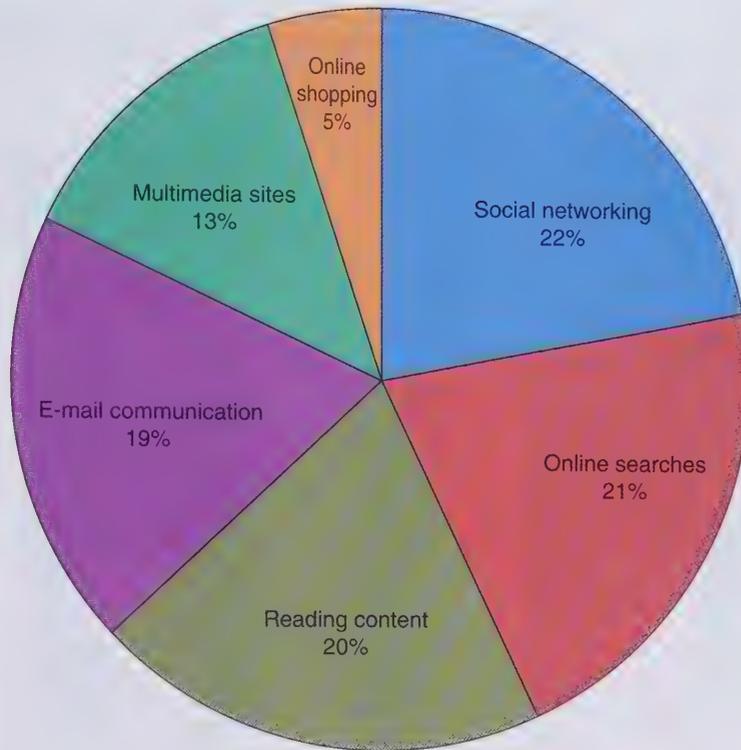


FIGURE 13.1
How People Spend Their Time Online

Source: Based on “How People Spend Their Time Online,” SocialMedia Today, May 9, 2012, <http://socialmediatoday.com/node/504064>.

in online sales but only two years to achieve its second billion and just one year to reach its third billion. Online sales now account for more than 35 percent of Papa John’s sales, but for some franchisees online sales account for more than 50 percent of sales. On a recent Super Bowl Sunday (the busiest single day in the pizza business), Domino’s, where online sales account for more than 30 percent of total sales, took more than 160,000 orders online, and more than 1,000 customers *per minute* were placing online orders just before kickoff.³ Jonathan Kaplan, founder of The Melt, a restaurant with 14 locations in California that specializes in grilled cheese sandwiches and soups, offers customers the convenience of online ordering and speedy pickup by scanning a quick-response (QR) code at the counter.⁴

Globally, people spend 35 billion hours online per month. The average global Internet user spends 16 hours online per month, half the average time spent by Internet users in the United States. Figure 13.1 shows how people spend their time online. Although shopping accounts for just 5 percent of Internet users’ time online, global e-commerce sales total \$1.3 trillion and are growing rapidly (see Figure 13.2).⁵ In 2011, 167 million people in the United States (53 percent of the U.S. population) made an online purchase; by 2016, 192 million people (56 percent of the U.S. population) will make an online purchase. Their average online spending will increase from \$1,207 per person in 2011 to \$1,738 per person in 2016.⁶ The items that customers purchase most often online are apparel, books, and computer hardware and software.⁷ However, companies can—and do—sell practically anything online, from antiques and pharmaceuticals to popcorn and drug-free urine. Even businesses that, at first glance, do not appear to be suited for conducting business online have been able to build successful e-commerce business models.



ENTREPRENEURIAL PROFILE: Mary Helen Bowers: Ballet Beautiful Shortly after Mary

Helen Bowers, a former dancer for the New York City Ballet, started Ballet Beautiful, a company that provides clients with dance training and fitness routines, in New York City, actress Natalie Portman asked her to help Portman prepare for her leading role as a ballet dancer in the film *Black Swan* (for which Portman would win an Oscar). Although the job would cement Bowers’s reputation as a dance and fitness trainer, it demanded almost constant travel, which would require her to put her successful business on hold. Rather than giving up her business, however, Bowers decided to move her training and fitness business online. She put together a team of programmers, videographers, and Web designers; spent \$40,000 to build a proprietary videoconferencing application that syncs with Skype; and began offering live, interactive, streaming classes for her students. Within a year of launching the online class, Ballet Beautiful’s client base had grown by more than 400 percent to 10,000 customers in 35 countries. Bowers has since opened a studio in Manhattan to accommodate

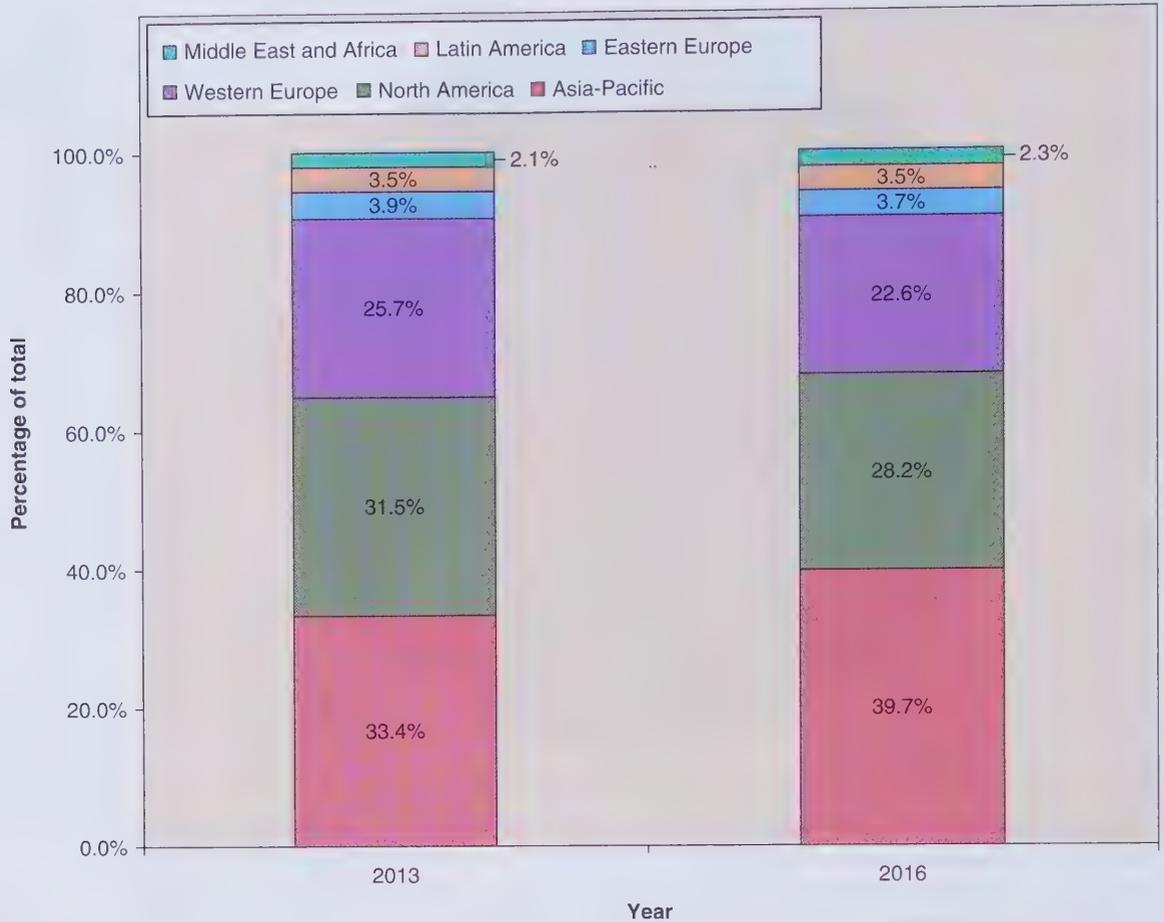


FIGURE 13.2

Global B2C E-Commerce Sales by Region: Percentage of Global Total

Source: “E-Commerce Sales Topped \$1 Trillion for the First Time in 2012,” Marketer, February 5, 2013, http://www.emarketer.com/Article/Ecommerce-Sales_Topped-1-Trillion-First-Time-2012/1009649.

local clients, but 75 percent of her sales are generated online. She also generates online sales with DVDs and streaming videos of her workouts. “Online is the future of the fitness industry, and we can grow a lot bigger from here,” says Bowers.⁸

Consumers have adopted the Internet much more quickly than any other major innovation in the past. The Internet reached an audience of 50 million people in just four years, compared to 38 years for radio and 13 years for television. One of the Internet’s most popular sites, Facebook, reached 50 million users in just two years.⁹ Online sales now account for 8 percent of total retail sales in the United States.¹⁰ In addition, Jupiter Research predicts that online research will influence 52 percent of total retail spending in the United States by 2016, up from 27 percent in 2005 (see Figure 13.3).¹¹ Although the rapid growth rate of online sales will not last indefinitely, the Web represents a tremendous opportunity for both online and offline sales that small businesses cannot afford to ignore. Successful entrepreneurs are learning to engage their customers across multiple platforms, including their companies’ Web sites, mobile sites, social media sites, and apps that give customers easy, convenient access for making purchases.

Factors to Consider Before Launching into E-Commerce

Despite the many benefits the Web offers, not every small business owner has embraced e-commerce. According to a study by advertising and marketing firm AJG, only 82 percent of small companies have Web sites, but many of those businesses do not engage in e-commerce

1.

Understand the factors an entrepreneur should consider before launching into e-commerce.

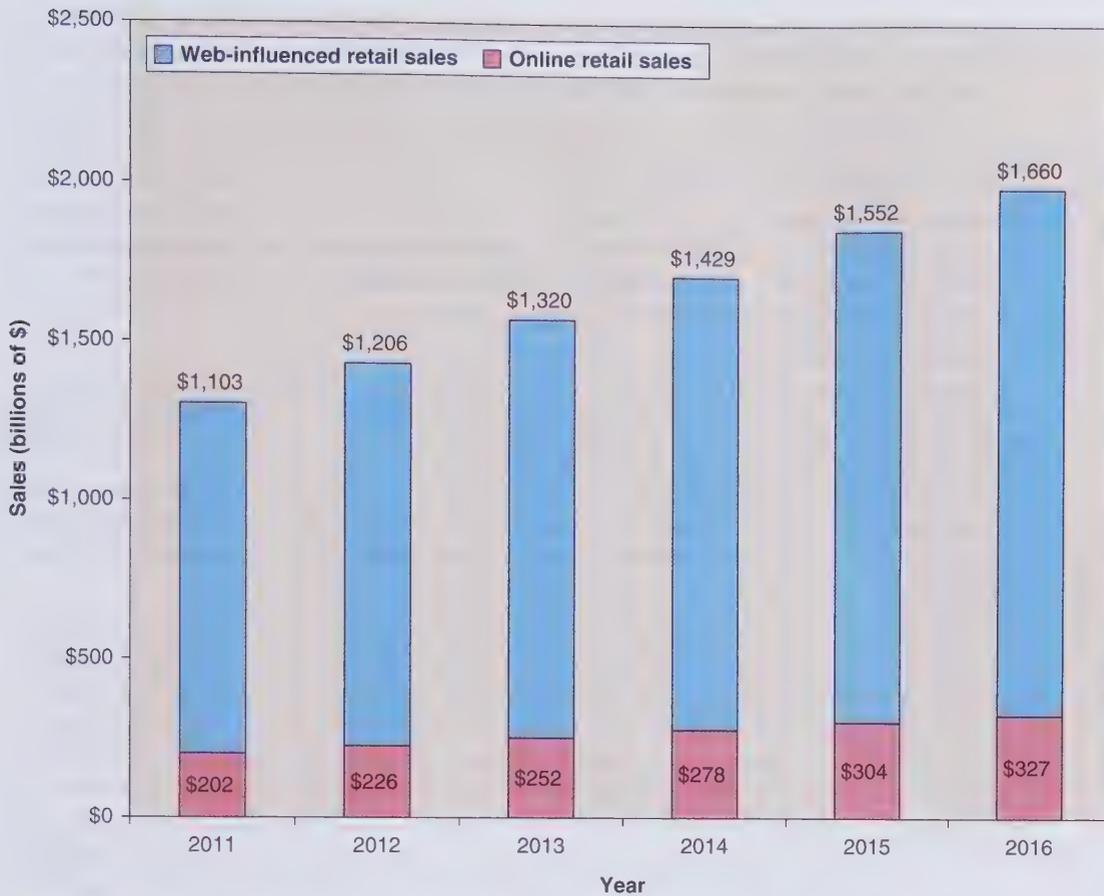


FIGURE 13.3

U.S. Online and Web-Influenced Retail Sales, 2011–2016 (in Billions of \$)

Source: Based on Forrester Research Web Influenced Retail Sales Forecast, 2012.

because their Web sites cannot accept payments.¹² Why are so many small companies hesitant to embrace e-commerce? For many entrepreneurs, the key barrier is not knowing where or how to start an e-commerce effort, whereas for others cost concerns are a major issue. Other roadblocks include the fear that the Web site will not draw customer traffic and the problems associated with ensuring online security.

Whatever the size of their companies, entrepreneurs must realize that establishing a Web presence is a necessity. “A Web site is your ticket to get into the game,” says the CEO of one high-tech company. “If you don’t have one, you might as well not even name your business.”¹³ However, before launching an e-commerce effort, business owners should consider the following important issues:

- Success requires a company to develop a plan for integrating the Web into its overall strategy. The plan should address issues such as site design and maintenance, creating and managing a brand name, marketing and promotional strategies, sales, and customer service.
- How a company exploits the Internet’s interconnectivity and the opportunities it creates to transform relationships with its suppliers and vendors, its customers, and others is crucial to its success. Integrating social media into a company’s Web presence can produce a significant payoff, but engaging customers through social media requires time and resources.
- Developing deep, lasting relationships with customers takes on even greater importance on the Internet. Attracting online customers costs money, and companies must be able to retain them to make their Web sites profitable.
- Creating a meaningful presence on the Internet requires an ongoing investment of money, time, and energy, and talent. Establishing an attractive Web site is only the beginning.

- Measuring the success of its Web-based sales effort is essential to remaining relevant to customers whose tastes, needs, and preferences are always changing. Entrepreneurs must use Web analytics to constantly improve their Web sites' performance.

Doing business online takes more time and energy than many entrepreneurs think. The following factors are essential to achieving e-commerce success:

- **Acquiring customers.** The first e-commerce skill that entrepreneurs must master is acquiring customers, which requires them to drive traffic to their Web sites. Entrepreneurs must develop a strategy for using the many tools that are available, which range from display ads and Google Adwords to social media and search marketing.
- **Optimizing conversions.** Every online entrepreneur's goal is to convert Web site visitors into paying customers. The efficiency with which an online company achieves this goal plays a significant role in determining its profitability. Unfortunately, 98 percent of visitors to the typical online retail site do not purchase anything.
- **Maximizing Web site performance.** Once shoppers find a company's Web site, they should encounter a site that downloads quickly, is easy to navigate, and contains meaningful content that they can find quickly and efficiently. A fast, simple checkout process also is essential. Otherwise, shoppers will abandon the site, never to return.
- **Ensuring a positive user experience.** Achieving customer satisfaction online is just as important as it is offline. Visitors who are satisfied with a site are 71 percent more likely to purchase from the site (and 67 percent more likely to purchase in the future) than visitors who are dissatisfied.¹⁴ An above-average bounce rate (the percentage of single-page visits to a Web site) and shopping cart abandonment rate and a conversion rate that is below average are signs that a company's Web site is not providing a positive customer experience.
- **Retaining customers.** Just as in offline stores, customer retention is essential to the success of online businesses. One study reports that increasing customer retention by 2 percent produces the same financial impact as reducing costs by 10 percent.¹⁵ Entrepreneurs must create an online shopping experience that engages customers, offers them value, and provides them with convenience.
- **Use Web analytics as part of a cycle of continuous improvement.** Entrepreneurs have a multitude of Web analytics tools (many of them free) that they can use to analyze the performance and the effectiveness of their Web sites. A Web site is never really "finished"; it is always a work in progress, and analytics tools provide the data for driving continuous improvement. Unfortunately, a survey conducted by the Small Business Authority reports that 63 percent of small business owners do not use analytics tools to track customers' shopping patterns on their Web sites.¹⁶

We will explain how to achieve these six goals in the "Strategies for E-Success" section of this chapter.

Ten Myths of E-Commerce

Although many entrepreneurs have boosted their businesses with e-commerce, setting up shop on the Web is no guarantee of success. Scores of entrepreneurs have plunged unprepared into the world of e-commerce only to discover that there is more to it than merely setting up a Web site and waiting for the orders to start pouring in. Make sure that you do not fall victim to the following e-commerce myths.

Myth 1. If I Launch a Site, Customers Will Flock to It

Some entrepreneurs think that once they set up their Web sites, their expenses end there. Not true! Without promotional support, no Web site will draw enough traffic to support a business. With more than 634 million Web sites already in existence and more being added every day, getting a site noticed is becoming increasingly difficult.¹⁷ Listing a site with popular Web search engines does not guarantee that online customers will find a small company's Web site. Just like traditional retail stores seeking to attract customers, online companies have discovered that drawing sufficient traffic to a Web site requires promotion—and luck. "You can't just show up on the Web unless you tell them and motivate them to visit," explains Mark Layton, owner of a Web-based distributor of computer supplies and author of a book on e-commerce.¹⁸

2.

Explain the 10 myths of e-commerce and how to avoid falling victim to them.

Entrepreneurs with both physical and online stores must promote their Web sites at every opportunity by printing their URLs on everything related to their physical stores—on signs, in print and broadcast ads, in store windows, on shopping bags, on merchandise labels, on employees' uniforms, and anywhere else their customers will see them. QR codes allow smart phone users to go directly to the appropriate Web page without having to type in a long URL. Entrepreneurs also use social media such as Facebook, Twitter, and Pinterest to drive traffic to their Web sites. A recent survey by VerticalResponse reports that 43 percent of small business owners spend at least six hours a week on social media, mainly on Facebook and Twitter. "My posts and tweets are little messages that tap my clients on the shoulder and remind them to get back in the game," says Johnny Shelby, owner of Third Coast Training, an exercise and training facility in Houston, Texas.¹⁹

ENTREPRENEURIAL PROFILE: John Goscha, Jeff Avallon, and Morgen Newman: IdeaPaint

IdeaPaint, a company founded in 2002 that sells paint that converts almost any surface into a whiteboard, relies on an innovative, comprehensive approach using social media to promote its Web site and engage its customers. The welcome page on IdeaPaint's Web site includes numerous hot spots on which visitors can click to access the company's social media sites and its blog. IdeaPaint's Facebook page includes links to its other social media sites and videos that show potential customers how to install its whiteboard paint. Its Facebook page encourages customers to post comments on the company's wall and includes photographs and videos of installations from customers. In addition to a "like" button, the Facebook page also includes a "send" button that visitors can use to send the company's link to their friends. IdeaPaint also hosts a YouTube channel that includes its "how-to" videos as well as videos that feature the creative ways in which customers use its product. The company repeats this strategy on its Pinterest page. IdeaPaint also sponsors a makeover competition and uses social media to attract applicants and to allow people to vote on a winner. IdeaPaint also engages customers on Twitter. One customer recently tweeted about transforming the front of his family's refrigerator into a whiteboard using IdeaPaint's product and included a photograph and product endorsement. The idea is not only to engage customers through social media but also to encourage satisfied customers to help sell the product by explaining its benefits.²⁰



IdeaPaint.

Source: IdeaPaint.

Virtual shop owners should consider buying ads in traditional advertising media as well as using banner ads, banner exchange programs, and cross-marketing arrangements with companies that sell complementary products on their own Web sites. Other techniques include interacting with customers through a blog, sending Web-based or e-mail newsletters, posting videos about the company's products on YouTube, writing or posting articles that link to the company's site, offering a live chat option that allows customers to interact with company personnel, incorporating customer-generated reviews, or sponsoring a contest.

Blogs are easy to create using software such as WordPress, TypePad, Squarespace, or Blogger, but they require regular updating with fresh content to attract visitors. One recent survey reports that 55 percent of small businesses have blogs; however, 65 percent of business owners say that they have not updated their blogs in at least one year.²¹ Blogs can be an effective way to draw potential customers, but with 42 million blogs online, they must contain fresh, thoughtful, useful, and entertaining content and a (very) soft-sell approach.

ENTREPRENEURIAL PROFILE: Danny Wegman: Wegmans

Wegmans, a family-owned chain of 81 grocery stores founded in 1916 in Rochester, New York, has had tremendous success with its blog, FRESH STORIES: AN INSIDE LOOK AT ALL THINGS WEGMANS. Company employees make regular blog posts about a variety of topics, ranging from the operation of the company's organic research garden and how Wegmans's products get to market to nutritional tips and how the company recycles old employee uniforms into insulation. In an early blog entry, CEO Danny Wegman wrote, "This blog is for you. We'd love to hear what you'd like us to share. So join in and let us know what you've been wondering about." Wegman's blog has become extremely popular with customers and is an important sales driver for the company, which, with \$6.3 billion in annual sales, is one of the largest private companies in the United States and has consistently appeared on *Fortune's* list of the 100 Best Companies to Work For.²²



Danny Wegman, CEO of Wegmans.

Source: Wegmans.

The keys to promoting a Web site successfully is networking—building relationships with customers, bloggers, social media, trade associations, online directories, and other Web sites a company's customers use. and interacting with current and potential customers online and through social media outlets.

Myth 2. Online Customers Are Easy to Please

Customers who shop online today tend to be experienced Internet users whose expectations of their online shopping experiences are high and continue to rise. Experienced online shoppers tend to be unforgiving, quickly clicking to another site if their shopping experience is subpar or they cannot find the products and information they want. In a recent study by 1&1 Internet, 65 percent of Web users say that they are regularly inconvenienced by faulty Web sites; in addition, 68 percent of users say that they are more critical and less tolerant of Web site errors than they were five years ago.²³ Because Web shoppers are becoming more discriminating, companies are finding that they must constantly improve their Web sites to attract and keep their customers.

Although online shoppers rarely encounter a live salesperson, they still have high expectations of customer service in their online purchases. A recent study by comScore and UPS reports that customer satisfaction with online shopping is high; 86 percent of customers express satisfaction with their online shopping experiences. However, e-commerce companies have room for improvement, particularly when it comes to offering free or discounted shipping, easy returns, the variety of products offered, and the ability to track shipments online.²⁴



ENTREPRENEURIAL PROFILE: Heikki Haldre and Paul Pällin: Fits.me Fits.me, a London-based company launched in 2010 by Heikki Haldre and Paul Pällin, provides online retailers with a virtual fitting room designed to combat online clothing retailers' biggest problem: Customers cannot try on garments before they purchase them. Fits.me's goal is to enhance online shoppers' experience by providing e-commerce clothing companies with a virtual fitting room that shows how specific garments look on a robotic mannequin with the exact dimensions of the shopper's body. Fits.me created the robotic mannequins, which can shift shapes and sizes to replicate nearly 100,000 body types, by using 30,000 three-dimensional body scans of real people. Online clothing retailers who have adopted Fits.me's virtual fitting room have seen the conversion rates on their Web sites double, their sales increase by 6 percent, and their returns decrease by 8 percent.²⁵

To be successful online marketers, small companies must create Web sites with the features that appeal to experienced Web shoppers, such as simple navigation, customer reviews, rock-solid security, and quick access to product information, videos, and blogs. Many small businesses outsource most (sometimes all) of the activities associated with conducting business online to companies that specialize in e-commerce services. These companies prefer to focus on their core competencies—product design, marketing, extending a brand, manufacturing, and others—and hire other companies whose core competencies reside in e-commerce to handle Web site design, hosting, order processing, and order fulfillment (“pick, pack, and ship”). Rather than make constant investments in technology that may not produce a reasonable return, these small companies preserve their capital and their energy and focus them on the aspects of business that they do best. Other entrepreneurs prefer to keep the design and operation of their Web sites in house.

Myth 3. Making Money on the Web Is Easy

Promoters who hawk “get-rich-quick” schemes on the Internet lure entrepreneurs with the promise that making money online is easy. It isn't. Doing business online *can* be quite lucrative, but it takes a well-designed strategy and proper execution. Attracting potential customers to a Web site can be challenging; the average Internet user in the United States views 2,750 Web pages per month.²⁶ As hundreds of new Web sites spring up every day, getting a company's site noticed requires more effort and marketing muscle than ever before.

Entrepreneurs engaging in e-commerce recognize the power that the Internet gives customers. Pricing, for example, is no longer as simple as it once was for companies because entrepreneurs can no longer be content to take into account only local competitors when setting their own prices. With the Internet, price transparency is the rule of the day. With a few mouse clicks, customers can compare the prices of the same or similar products and services from companies across the globe. In this wired and connected economy, the balance of power has shifted to customers, and new business models recognize this fact.

Myth 4. Privacy Is Not an Important Issue on the Web

The Internet allows companies to gain access to almost unbelievable amounts of information about their customers. Many sites offer visitors “freebies” in exchange for information about themselves. Companies then use this information to learn more about their target customers and

how to market to them most effectively. Concerns over the privacy of and the use of this information have become the topic of debate by many interested parties, including government agencies, consumer watchdog groups, customers, and industry trade associations. The TRUSTe Privacy Index reports that 90 percent of adults in the United States worry about their privacy online.²⁷

Companies that collect information from their online customers have a responsibility to safeguard their customers' privacy, to protect it from unauthorized use, and to use it responsibly. That means that businesses should post a privacy statement on their Web sites, explaining to customers how they intend to use the information they collect. One of the surest ways to alienate online customers is to experience a security breach that allows their personal information to be stolen, to abuse the information collected from them by selling it to third parties, or to spam customers with unwanted solicitations. A recent survey by online security firm TRUSTe reports that 89 percent of Internet users avoid doing business with companies that they believe do not respect their privacy online.²⁸ BBBOnLine offers a data security guide (www.bbb.org/data-security) that is designed to help business owners maintain proper security over the data they collect from customers.

Businesses that publish privacy policies and then adhere to them build trust among their customers, an important facet of doing business on the Web. According to John Briggs, director of e-commerce for Yahoo!, customers "need to trust the brand they are buying and believe that their online purchases will be safe transactions. They need to feel comfortable that [their] personal data will not be sold and that they won't get spammed by giving their e-mail address. They need to know about shipping costs, product availability, and return policies up front."²⁹ Privacy *does* matter on the Web, and businesses that respect their customers' privacy win their customers' trust. Trust is the foundation on which companies build the long-term customer relationships that are so crucial to success online. Perhaps the best way for an e-commerce company to prove its trustworthiness to potential customers is to have its data collection, debit and credit card handling procedures, and privacy policies and practices certified by companies such as TRUSTe, BBBOnLine, McAfee, or ControlScan.

Myth 5. "Strategy? I Don't Need a Strategy to Sell on the Web! Just Give Me a Web Site, and the Rest Will Take Care of Itself"

Building a successful e-business is no different than building a successful brick-and-mortar business, and that requires a well-thought-out strategy. Building a strategy means that an entrepreneur must first develop a clear definition of the company's target customers and have a thorough understanding of their needs, wants, likes, and dislikes. To be successful, a Web site must be appealing to the customers it seeks to attract just as a traditional store's design and decor must draw foot traffic. Entrepreneurs must build their Web sites with their customers in mind. How do they expect the site to work? How should the site be organized to allow customers to find the products they want most efficiently? What content should the site contain to keep customers coming back? What image should the site create for the business in customers' minds?

Recall from Chapter 4 that one goal of developing a strategy is to set a business apart from its competitors. The same is true for creating a strategy for conducting business online. It is just as important, if not more important, for an online business to differentiate itself from the competition if it is to be successful. Unlike customers in a retail store, who must exert the effort to go to a competitor's store if they cannot find what they want, online customers only have to make a mouse click or two to go to a rival Web site. Therefore, competition online is fierce, and to succeed, a company must have a sound strategy.



ENTREPRENEURIAL PROFILE: Alex Zhardanovsky and Joe Speiser: PetFlow Serial entrepreneur Alex Zhardanovsky's inspiration for his latest e-commerce business came from his tendency to run out of food for his beloved dog. Zhardanovsky teamed up with Joe Speiser to launch PetFlow, an online company that sells healthy pet food, supplies, and toys. Recalling that another online pet supply company, *Pets.com*, began operations in 1998 and burned through \$110 million of investors' money before flaming out and shutting down, Zhardanovsky and Speiser developed a simple e-commerce strategy. PetFlow offers customers a subscription service that allows them to receive regular deliveries of pet food, which enables Zhardanovsky and Speiser to minimize their inventory investment, negotiate favorable terms with suppliers, build long-term relationships with customers, and maintain steady cash flow. "It's the best business model you can ever have," says Zhardanovsky. "I already know how many bags of dog food I've sold in the next 60 days." PetFlow, which required an initial investment of just \$50,000 (excluding inventory), takes 35,000 orders per month, sells 1.5 million pounds of dog food each month, and is growing at a rate of 10 percent per month.³⁰

Myth 6. The Most Important Part of Any E-Commerce Effort Is Technology

Technology advances have reduced significantly the cost of launching an e-commerce business. Brian Walker, an e-commerce expert at Forrester Research, says that a decade ago, the cost to launch an online retail business was three to five times higher than it is today. “The technology to run the site, the physical warehouse, site hosting, and staff required a significant investment before the site even went live,” says Walker.³¹ Modern e-commerce entrepreneurs can build a Web site for next to nothing, outsource the tasks of storing and shipping products, lease space on a server, and rent cloud-computing software to operate their online businesses—all of which lower the cost and the complexity of starting an online company. Julie Wainwright says that building the e-commerce company that she helped launch in 1998 cost between \$7 million and \$10 million (not including the cost of inventory). Wainwright recently launched an online luxury clothing marketplace called TheRealReal at a cost of only \$25,000 to \$30,000.³²

As important as having the right technology to support an e-commerce business is, it is *not* the most crucial ingredient in the recipe for success. What matters most is the ability to understand the underlying business and to develop a workable business model that offers customers something of value at a reasonable price and produces a profit for the company. The entrepreneurs who are proving to be most successful in e-commerce are those who know how their industries work inside and out and then build an e-business around that knowledge. They know that they can hire Web designers, database experts, and fulfillment companies to create the technical aspects of their online businesses but that nothing can substitute for a solid understanding of inner workings of their industry, their target market, and the strategy needed to pull the various parts together. The key is seeing the Web for what it really is: another way to reach and serve customers with an effective business model and to minimize the cost of doing business.

Some entrepreneurs tackle e-commerce by focusing on technology first and then determine how that technology fits their business idea. “If you start with technology, you’re likely going to buy a solution in search of a problem,” says Kip Martin, program director of META Group’s Electronic Business Strategies. Instead, he suggests, “Start with the business and ask yourself what you want to happen and how you’ll measure it. *Then* ask how the technology will help you achieve your goals. Remember: Business first, technology second.”³³

Myth 7. On the Web, Customer Service Is Not as Important as It Is in a Traditional Retail Store

The Internet offers the ultimate in shopping convenience. Numerous studies report that convenience and low prices are the primary drivers of online shopping. In fact, customers say that convenience is more important than getting the lowest prices when shopping online.³⁴ With just a few mouse clicks or taps on the screen of a smart phone or tablet, people can shop for practically anything anywhere in the world and have it delivered to their doorsteps within days. As convenient as online shopping is, customers still expect high levels of service. Unfortunately, some e-commerce companies treat customer service as an afterthought, an attitude that costs businesses in many ways, including lost customers and a diminished public image.

The average conversion rate for e-commerce sites is just 2.1 percent.³⁵ In other words, out of 1,000 visitors to the typical company’s Web site, only 21 of them actually make a purchase! Sites that are difficult to navigate, slow to load, offer complex checkout systems, or confuse shoppers will turn customers away quickly, never to return. Only 22 percent of e-commerce companies are satisfied with their conversion rates.³⁶



ENTREPRENEURIAL PROFILE: Michael Gotfredson: Roadrunner Sports Roadrunner Sports, a small chain of stores with locations in 11 states that Michael Gotfredson started in his garage in 1983, sells running shoes, apparel, and equipment. The company’s Web site offers shoppers a unique tool called Shoe Dog that “fetches” specific shoe recommendations based on their responses to questions about their running habits, including their arch type, body frame, weekly mileage, type of terrain, and specific injuries they may have experienced. The breadth and depth of Roadrunner Sports’s inventory allows shoppers who may not know exactly which style of brand of shoe they need to make the right selection. The result: satisfied customers, a high customer retention rate, and an above-average conversion rate.³⁷

There is plenty of room for improvement in customer service on the Web. More than 66 percent of Web shoppers who fill their online shopping carts abandon them without checking out,

and the average value of the goods in their carts is \$117.³⁸ The most common reasons for leaving a site without purchasing include the following: (1) unexpected shipping and handling charges (70 percent), (2) insufficient product information (56 percent), (3) lack of trust or security concerns about the site (50 percent), and (4) difficulty navigating the Web site to find the right product (46 percent).³⁹ One tool that increases a company's conversion rate and reduces its cart abandonment rate is live help. In fact, a study by Oracle reports that 57 percent of customers say that live help is one of the most important features that a Web site can offer.⁴⁰ For reasonable fees, companies can hire virtual assistants: employees who work remotely to answer online shoppers' questions or to offer advice (e.g., whether an item's sizes tend to run small) in real time. Even small companies that cannot afford to staff a live chat center can incorporate customer-responsive chat options into their Web sites by using virtual chat agents. Loaded onto a company's site, these avatar-like creations can step in at the appropriate time to interact with customers, answering their questions or giving them the extra nudge they need, such as an offer of free shipping, to close the deal.

When customers do abandon their online shopping carts, companies often can close a significant percentage of those sales by sending a prompt follow-up e-mail designed to win back the customer. One study reports that just 26 percent of e-commerce companies send follow-up e-mails to customers who have abandoned their shopping carts.⁴¹ The benefits from doing so can be significant, however. Seventy percent of the companies that send follow-up e-mails to customers who abandon their carts produce increased their sales (and 19 percent reported a large increase in sales).⁴² The faster a company sends the e-mail when a customer abandons a cart, the higher the probability that the customer completes the transaction. Including the company's name and some information about the product(s) that are in the cart in the e-mail's subject line also increases the probability of a completed transaction.⁴³

 **ENTREPRENEURIAL PROFILE: Lisa Mann: Boot Barn** Boot Barn, a company based in Irvine, California, sells western boots, clothing, and accessories through its 87 stores located in 10 states and through its Web site (www.bootbarn.com). E-commerce marketing manager Lisa Mann noticed that Boot Barn's cart abandonment rate was too high and developed a triggered e-mail campaign designed to recover those lost sales. Just 20 minutes after abandoning a cart, a customer would receive a customer service e-mail ("Howdy [customer name]. Oops! Was there a problem?") inviting the customer to contact a customer service representative. If that e-mail failed to produce results, the customer received two more e-mails, the first one "emphasizing trust factors that set us apart," says Mann, and the second one nudging the customer to complete the transaction. Boot Barn's e-mail strategy worked well, generating a 12 percent increase in revenue.⁴⁴

The lesson for e-commerce entrepreneurs is simple: invest time, energy, and money to develop a functional mechanism for providing superior customer service. Those companies that do will build a sizable base of loyal customers who keep coming back. Perhaps the most significant actions online companies can take to bolster their customer service efforts are to provide a quick, intuitive online checkout process; create a well-staffed and well-trained customer response team; offer a simple return process; and provide an easy order-tracking process so customers can check the status of their orders at any time.

Myth 8. Flashy Web Sites Are Better Than Simple Ones

Businesses that fall into this trap pour significant amounts of money into designing flashy Web sites with all of the "bells and whistles." The logic is that to stand out on the Web, a site really has to sparkle. That logic leads to a "more is better" mentality when designing a site. In e-commerce, however, "more" does *not* necessarily equate to "better." A Web site that includes a simple design, easy navigation, clear calls to action on every page, and consistent color schemes shows that a company is putting its customers first. "Form over functions is always a recipe for disaster," says one Web design expert.⁴⁵ A site that performs efficiently and loads quickly is a far better selling tool than one that is filled with "cornea gumbo," slow to download, and confusing to shoppers. Sites that download slowly usually never have the chance to sell because customers click to another site. A study by Akamai reports that 47 percent of online shoppers expect a Web page to load within two seconds and that 40 percent of online shoppers will abandon a Web site that takes more than three seconds to load.⁴⁶ (Shoppers using mobile devices are more patient, taking an average of 6 to 10 seconds to wait for a page to load before abandoning it.) The study also shows that a one-second delay in a Web page loading results in a 7 percent

decrease in the number of conversions.⁴⁷ “Businesses do not understand the impact of poor site performance,” warns Brian Walker, an analyst at Forrester Research. “Customers not only will bail out on a session or a [shopping] cart, but they also may not return.” Walker points out that the company’s research shows that more than 25 percent of customers are less likely to shop at a company’s brick-and-mortar store if they have a bad experience online.⁴⁸ The lesson: keep the design of your site simple so that pages download in no more than two seconds and make sure that the site’s navigation is easy and intuitive.

Myth 9. It’s What’s Up Front That Counts

Designing an attractive Web site is important to building a successful e-business. However, designing the back office, the systems that take over once a customer places an order on a Web site, is just as important as designing the site itself. If the behind-the-scenes support is not in place or cannot handle the traffic from the Web site, a company’s entire e-commerce effort will come crashing down. Although e-commerce can lower many costs of doing business, it still requires a basic infrastructure somewhere in the channel of distribution to process orders, maintain inventory, fill orders, and handle customer service. Many entrepreneurs hoping to launch virtual businesses are discovering the need for a “clicks-and-mortar” approach to provide the necessary infrastructure to serve their customers. “The companies with warehouses, supply-chain management, and solid customer service are going to be the ones that survive,” says Daryl Plummer, head of the Gartner Group’s Internet and new media division.⁴⁹

To customers, a business is only as good as its last order, and some e-companies are not measuring up. Many small e-tailers’ Web sites do not offer real-time inventory lookup, which gives online shoppers the ability to see whether an item they want to purchase is actually in stock. In addition, many have not yet linked their Web sites to an automated back office, which means that processing orders takes longer and that errors are more likely. As software to integrate Web sites with the back office becomes easier to use and more affordable, more small businesses are using them to offer these features.

Web-based entrepreneurs often discover that the greatest challenge their businesses face is not necessarily attracting customers on the Web but creating a workable order fulfillment strategy. Order fulfillment involves everything required to get goods from a warehouse into a customer’s hands and includes order processing, warehousing, picking and packing, shipping, and billing. Some entrepreneurs choose to handle order fulfillment in-house with their own employees, whereas others find it more economical to hire specialized fulfillment houses to handle these functions. **Virtual order fulfillment** (or drop shipping) suits many e-tailers perfectly. When a customer orders a product from its Web site, the company forwards the order to its wholesaler or distributor, which then ships the product to the customer with the online merchant’s label on it. Although e-tailers avoid the risks and problems associated with managing inventory, they lose control over delivery times and service quality. In addition, for some small businesses, finding a fulfillment house willing to handle a relatively small volume of orders at a reasonable price can be difficult. Major fulfillment providers that focus on small companies include Amazon, Federal Express, UPS, DHL, Shipwire, Webgistic, and WeFullfillIt. When Zhardanovsky and Joe Speiser launched PetFlow, they outsourced the company’s storage and shipping operations to a company that specializes in that area at a cost of just \$4 to \$5 per order. (With 35,000 orders rolling in per month, however, the company recently began shipping its own orders from a 65,000-square-foot warehouse that it leases in New Jersey.) PetFlow’s annual sales recently passed the \$30 million mark.⁵⁰

Myth 10. My Business Doesn’t Need a Web Site

Nearly one in five small businesses does not have a Web site, and many of those that do have sites lack the ability to make sales online. To online shoppers, especially, these businesses might as well be invisible because doing business online and offline are inextricably connected. Today’s shoppers prefer to purchase from companies that offer a multichannel approach, particularly those that offer in-store pickup for online orders and in-store returns for online purchases.⁵¹ A multichannel approach pays big dividends. One recent survey reports that 91 percent of shoppers have gone into a store as a result of an online encounter with a business.⁵² When looking to purchase products locally, many shoppers go online to conduct research first. Others prefer the convenience of making online purchases after having a positive encounter with a company’s

physical location. In addition, customers routinely share their opinions online about products and their shopping experience with companies. These trends point to the need for businesses to use a multichannel approach to selling their products and services that includes the Internet as one option. The key is to meet customers *wherever* they want to do business.

One fact of e-commerce is the importance of speed. Companies doing business on the Internet have discovered that those who reach customers first often have a significant advantage over their slower rivals. “The lesson of the Web is not how the big eat the small, but how the fast eat the slow,” says a manager at a venture capital firm specializing in Web-based companies.⁵³ Succumbing to this myth often leads entrepreneurs to make a fundamental mistake once they finally decide to go online: They believe they have to have a “perfect” site before they can launch it. Few businesses get their sites “right” the first time. In fact, the most successful e-commerce sites are works in progress; entrepreneurs are constantly changing them, removing what does not work and experimenting with new features to see what does work. Successful Web sites are much like a well-designed flower garden, constantly growing and improving yet changing to reflect the climate of each season. Their creators worry less about creating the perfect site at the outset than about getting a site online and then using Web analytics to fix it, tweak it, and update it to meet changing customer demands.

Strategies for E-Success

The typical Internet user in the United States spends an average of 104 hours per month online (see Figure 13.4). However, converting these Web users into paying customers requires a business to do more than merely set up a Web site and wait for the hits to start rolling up. Doing business from a Web site is like setting up shop on a dead-end street or a back alley. You may be

3. Explain the basic strategies entrepreneurs should follow to achieve success in their e-commerce efforts.

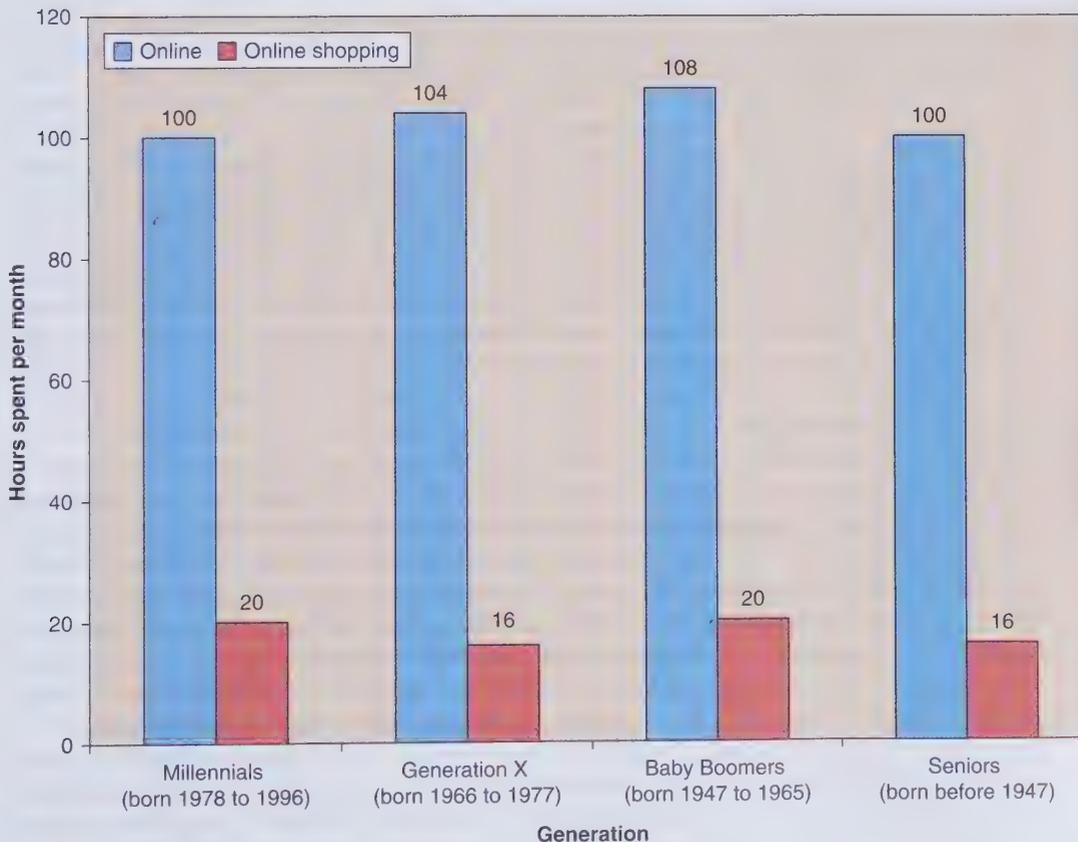


FIGURE 13.4 Average Time Americans Spend Online and Shopping Online per Month

Source: Based on WSL/Strategic Retail, 2013.

ready to sell, but no one knows you are there! Building sufficient volume for a site takes energy, time, money, creativity, and, perhaps most important, a well-defined strategy.

Although the Internet is a unique medium for creating a company, launching an e-business is not much different from launching a traditional offline company. The basic drivers of a successful business are the same on the Internet as they are on Main Street. To be successful, both off-line and online companies require a sound business model and a well-formulated strategy that emphasizes customer service. The goals of e-commerce are no different from traditional off-line businesses—to increase sales, improve efficiency, and generate a profit. How a company integrates the Internet into its overall business strategy determines how successful it ultimately will become. Following are some guidelines for building a successful Web strategy for a small e-company.

Focus on a Niche in the Market

Like Curly, the crusty old trail boss in the movie *City Slickers*, who said that the secret to happiness was “one thing,” many small businesses are finding success on the Internet by focusing on one thing. Rather than compete head-to-head with the dominant players in e-commerce who have the resources and the name recognition to squash smaller competitors, smart entrepreneurs focus on serving the market niches that make up the “long tail” of the market. Because of the efficiency and low cost the Internet offers, small companies can profitably tap into almost microscopic niches that in pre-Internet days would have been too difficult to reach. Small companies’ limited resources usually are better spent serving niche markets than trying to be everything to everyone (recall the discussion of the focus strategy in Chapter 4). Niches exist in every industry and can be highly profitable given the right strategy for serving them. A niche can be defined in many ways, including by geography, by customer profile, by product, by product usage, and many other variables.

The Internet allows small businesses to attract niche customers that would have been impossible to reach in sufficient volume without it.



Jack McCarthy, cofounder of UltimateUglyChristmas.com.

Source: Jack McCarthy.



ENTREPRENEURIAL PROFILE: Jack and Martha McCarthy: *UltimateUglyChristmas.com*

At age 17, Jack McCarthy discovered a unique niche. Jack started *UltimateUglyChristmas.com*, an online company that sells ugly Christmas sweaters, after he and his sister, Martha, sold a tacky sweater on eBay for \$50 (they were expecting it to go for about \$5). “Our parents thought we were crazy,” recalls Jack. “Our Dad wondered why anyone would buy a used ugly sweater, but once he saw how many we were selling, he supported the business and really got into it.” Jack frequents yard sales and thrift stores to purchase his inventory, which he resells online for prices that range from \$20 to \$50. As curator of the ugly sweater collection, Jack writes the hysterical product descriptions and takes photos of his family members and friends modeling them. More than 200,000 people from around the world have visited *UltimateUglyChristmas.com* in search of the perfect tacky sweater. Jack has expanded his business, which has taken over the family’s basement in Milwaukee, Wisconsin, to include “non-Christmas” ugly sweaters.⁵⁴

Develop a Community

On the Web, competitors are just a mouse click away. To attract customers and keep them coming back, e-companies have discovered the need to offer more than just quality products and excellent customer service. Many seek to develop a community of customers with similar interests, the nucleus of which is their Web site. The idea is to increase customer loyalty by giving customers the chance to interact with other like-minded visitors or with experts to discuss and learn more about topics they are passionate about. A company’s social media outlets are natural avenues for small companies to engage their customers because they give visitors the opportunity to have conversations about products, services, and topics that interest them (“What is your favorite sports drink?”). Adding social log-in options to a Web site allows customers to make purchases from their social media accounts without having to create user profiles. Small businesses that are most successful at building a community enlist their most passionate customers as company evangelists through social media outlets such as Facebook, LinkedIn, Twitter, Pinterest, and Instagram. Companies that successfully create a community around their Web sites turn their customers into loyal fans who keep coming back and, better yet, invite others to join them.

Utilizing social media not only creates brand advocates by giving customers a venue to share their experiences with a company but also improves a company’s ability to listen to its customers.

for praise, criticism, and suggestions for improvement. Recently, L.L. Bean, the famous retailer of outdoor gear based in Freeport, Maine, noticed that customers were criticizing one of its top-selling products, Supima cotton sheets, in online customer reviews. After investigating the problem, Bean discovered that a supplier had mistakenly added a wrinkle-resistant treatment to the fabric that was causing it to unravel. Managers acted quickly, offering new sheets (without the treatment) to all 6,300 customers who had purchased them and created a positive buzz online, transforming what could have been a marketing nightmare into a trust-building, customer service victory.⁵⁵

Attract Visitors by Giving Away “Freebies”

One of the most important words on the Internet is “free.” Many successful e-merchants have discovered the ability to attract visitors to their site by giving away something free and then selling them something else. One e-commerce consultant calls this cycle of giving something away and then selling something “the rhythm of the Web.”⁵⁶ The “freebie” must be something that customers value, but it does *not* have to be expensive, nor does it have to be a product. In fact, one of the most common giveaways on the Internet is *information*. Creating a free online or e-mail newsletter with links to your company’s site, of course, is one of the most effective ways of attracting potential customers. Meaningful content presented in a clear, professional fashion is a must. Experts advise keeping online newsletters short—no more than about 600 words.



ENTREPRENEURIAL PROFILE: Tammy Rosen: Fur-Get Me Not In 2000, Tammy Rosen left her job in corporate information technology and started Fur-Get Me Not, a pet-sitting service that she ran out of her home. Over time, she added pet training, day care, and taxi services. Today, Fur-Get Me Not is a full-service pet service center and retail shop in Arlington, Virginia. Wanting to stay connected to her customers and keep them informed about her company’s special events, Rosen began sending plain-text e-mails but soon realized their limitations. She switched to an HTML-based e-mail campaign and added a monthly newsletter that offers customers news about upcoming events, special sales, and new products in addition to training and health care tips and spotlight features of customers’ pets and her employees. Fur-Get Me Not has expanded its e-mail list to more than 1,800 and enjoys an above-average open rate of 35.2 percent. “The e-mails we send help instill loyalty in our customers,” says Rosen. “I know that what I’m sending makes a difference when I see them clicking through to the Web site or when I receive ‘thank you’s’ from customers in response to a newsletter.”⁵⁷



Fur-Get Me Not.

Source: Fur-Get Me Not.

Make Creative Use of E-Mail, but Avoid Becoming a “Spammer”

As Tammy Rosen’s experience proves, when used properly and creatively, e-mail can be an effective, low-cost way to drive traffic to a Web site. The average e-mail **open rate**, the percentage of recipients who actually open a marketing e-mail, is 20.1 percent; the average e-mail **click-through rate**, the percentage of recipients who open an e-mail and click on the link to the company’s Web site, is 5.2 percent.⁵⁸ Marketing e-mails sent on Thursdays have the highest combination of open and click-through rates.⁵⁹ An extensive study of open and click-through rates by GetResponse shows that the best time of day to send marketing e-mails is 8 A.M. to 9 A.M. and 3 P.M. to 4 P.M.⁶⁰

Just as with newsletters, an e-mail’s content should offer something of value to recipients. Customers welcome well-constructed permission e-mail that directs them to a company’s site for information or special deals. Unfortunately, spam, those unsolicited and universally despised e-mail messages (which rank below postal “junk mail” and telemarketing calls as the worst form of junk advertising), limits the effectiveness of companies’ e-mail legitimate marketing efforts. Spam is a persistent problem for online marketers; Internet security firm Symantec reports that 68.4 percent of e-mails sent are spam.⁶¹ Companies must comply with the CAN-SPAM Act, a law passed in 2003 that regulates commercial e-mail and sets standards for commercial e-mail messages. (The penalties can be as much as \$16,000 per e-mail for companies that violate the law.)

To avoid having their marketing messages become part of that electronic clutter, companies rely on permission e-mails, collecting customers’ and visitors’ e-mail addresses (and their permission to send them e-mail messages) when they register on a site to receive a “freebie.” The most successful online retailers post e-mail opt-in messages prominently throughout their Web sites and on their social media pages as well. **Triggered e-mails**, those that are triggered by a particular event, such as a customer signing up to receive a newsletter, downloading a white paper, abandoning a shopping cart, placing an order, and others, generate open and click-through rates that are twice those of conventional e-mail. When customers sign up to receive permission

e-mails, a company should send them “welcome” e-mails immediately. More than one-third of retailers do not despite research showing that welcome e-mails can generate as much as six times the revenue that standard broadcast e-mails do.⁶²



ENTREPRENEURIAL PROFILE: Jim Broadhurst: SmileyCookie Jim Broadhurst, founder of SmileyCookie, a gourmet cookie retailer in Pittsburgh, Pennsylvania, recently implemented a triggered e-mail campaign that sends customers a discount coupon when they sign up. If the customer fails to make a purchase within six days, he or she receives a reminder e-mail. Customers who abandon their SmileyCookie shopping carts also receive up to three e-mails encouraging them to complete their purchases.⁶³

To be successful at collecting a sufficient number of e-mail addresses, a company must make clear to customers that they will receive messages that are meaningful to them and that the company will not sell e-mail addresses to others (which should be part of its posted privacy policy). Once a business has a customer’s permission to send information in additional e-mail messages, it has a meaningful marketing opportunity to create a long-term customer relationship and to build customer loyalty. Table 13.1 includes a spam test to which every company should submit its e-mail campaigns.

Sell the “Experience”

When shoppers enter a retail store, they are courted by an attractive layout, appealing decor, and eye-catching merchandise displays and perhaps are greeted by a salesperson who can offer them information and advice about its products and services. Although e-commerce businesses lack this ability to have face-to-face contact with customers, they can still engender loyalty by creating an engaging and enjoyable online shopping experience. Sites that offer shoppers easy navigation, a simple and fast checkout process, and thorough product descriptions with quality images can provide the same positive shopping experience that the best retail stores do. Athleta, a chain with retail stores in 18 states that sells athletic-inspired apparel and accessories for women, has designed its Web site to replicate the shopping experience that customers enjoy when they walk into one of its retail outlets. A simple layout with high-quality product images and comprehensive product descriptions that include sizing details and laundering tips allow customers

TABLE 13.1 Does Your E-Mail Measure Up to the Anti-Spam Test?

1. Is the content of your e-mail appropriate for your audience? Are recipients likely to be interested in the offers or articles you are sending? The biggest problem with sales-oriented e-mails and the primary cause of low open and click-through rates is irrelevant content.
2. Does the e-mail offer something of value to recipients—an invitation to a special sale, a free newsletter filled with useful information, or something similar? Sending frivolous e-mails that pack little or no value to customers is one surefire way to send your company’s click-through rate plummeting.
3. Has your e-mail provider been blacklisted by spam screening tools?
4. Have the recipients on your e-mail list opted into your e-mail list? Trolling Internet user lists for e-mail addresses is *not* an acceptable way to build a recipient list.
5. Does the subject line include your company’s name? Is the subject line accurate and not misleading? Do *not* include “\$\$\$” in the subject line as so many spam messages do.
6. Is the e-mail readable? Some e-mails sent in HTML format can appear garbled and unreadable on some computers.
7. Is the frequency of the e-mail appropriate? Customers do not appreciate being hammered by 20 e-mails from a company in one week.
8. Is the timing of your e-mail appropriate? Monday mornings, when people are returning to work from the weekend and their in-boxes are full of messages, is *not* the best time to send an e-mail.
9. Can recipients opt out of your e-mail list if they choose to?
10. Does the e-mail contain your company’s valid mailing address? In 2003, Congress passed the CAN-SPAM Act, which did not ban spam but put limitations on how marketers can use e-mail as part of their marketing tools. This is one of the act’s requirements.

to find exactly the items they want. One section of the site displays complete coordinated outfits with links to pages that feature every item included, ready to be added to a shopping cart with one click.⁶⁴

Make Sure Your Web Site Says “Credibility”

Many studies have concluded that trust and security issues are the leading inhibitors of online shopping. Unless a company can build among customers *trust* in its Web site, selling is virtually impossible. Visitors begin to evaluate the credibility of a site as soon as they arrive. In fact, a recent study reports that Internet users judge the credibility of a Web site within the first twenty-fifth of a second (40 milliseconds, or 0.04 seconds)!⁶⁵ “Windows of opportunity, especially in the online environment, close very quickly,” says Jay Bower, president of Crossbow Group, a digital marketing company.⁶⁶ Does the site look professional? Are there misspelled words and typographical errors? If the site provides information, does it note the sources of that information? If so, are those sources legitimate? Are they trustworthy? Is the presentation of the information fair and objective, or is it biased? Has the site been updated recently? Does the company include a privacy policy posted in an obvious place?

One of the simplest ways to establish credibility with customers is to use brand names they know and trust. Whether a company sells nationally recognized brands or its own well-known private brand, using those names on its site creates a sense of legitimacy. People buy brand names they trust, and online companies can use that to their advantage. Another effective way to build customer confidence is by joining an online seal program, such as McAfee, TrustWave, TRUSTe, Norton, BBBOnLine, or others. The online equivalent of the Underwriter Laboratories stamp or the Good Housekeeping Seal of Approval, these seals mean that a company meets certain standards concerning the privacy of customers’ information and the resolution of customer complaints. Posting a privacy policy (more on this later in this chapter) is another key ingredient in building trust. Including customer reviews, which Internet users say they believe more than product descriptions from a business, on product Web pages increases customer loyalty and trust in an online business. Testimonials, either in writing or on video, from real customers enhance a company’s online credibility, especially among first-time customers. Businesses that are the subject of media coverage should include a “media” or “featured in” page with links to articles or videos about the company so that they can magnify the benefits of publicity. Links to the company’s social media accounts using “follow” buttons also lends credibility to an online business. Finally, providing a street address, an e-mail address, and a toll-free telephone number sends a subtle message to shoppers that a legitimate business is behind the Web site. Many small companies include photographs of their brick-and-mortar stores and of their founders and employees to combat the Web’s anonymity and to let shoppers know that they are supporting a friendly small business.

Make the Most of the Internet’s Global Reach

The Internet has reduced dramatically the cost of launching a global business initiative; even the smallest business can engage in international business with a well-designed Web site. Still, despite the Web’s reputation as an international marketplace, many Web entrepreneurs fail to utilize fully its global reach. Nearly 90 percent of the 2.4 billion people around the world who use the Internet live outside the United States. Only 26.8 percent of Web users speak English.⁶⁷ Limiting a Web site to just a small percentage of the world because of a language barrier makes no sense. Figure 13.5 shows the T-Index, a statistical index that measures a nation’s online sales potential using the number of Internet users and gross domestic product per capita.

E-companies aiming to generate sales from foreign markets must design their sites with customers from other lands and cultures in mind. Global shoppers are much more likely to buy from Web sites that are written in their native languages. A common mechanism is to include several “language buttons” on the opening page of a site that take customers to pages in the language of their choice. However, e-commerce companies often find that setting up dedicated Web sites with country-specific domain names attracts more international customers. Companies trying to establish a foothold in foreign markets by setting up Web sites dedicated to them run the same risk that companies setting up physical locations there do: offending international visitors by using the business conventions and standards they are accustomed to using in the United States. Business practices, even those used on the Web, that are acceptable and even expected in the United States,

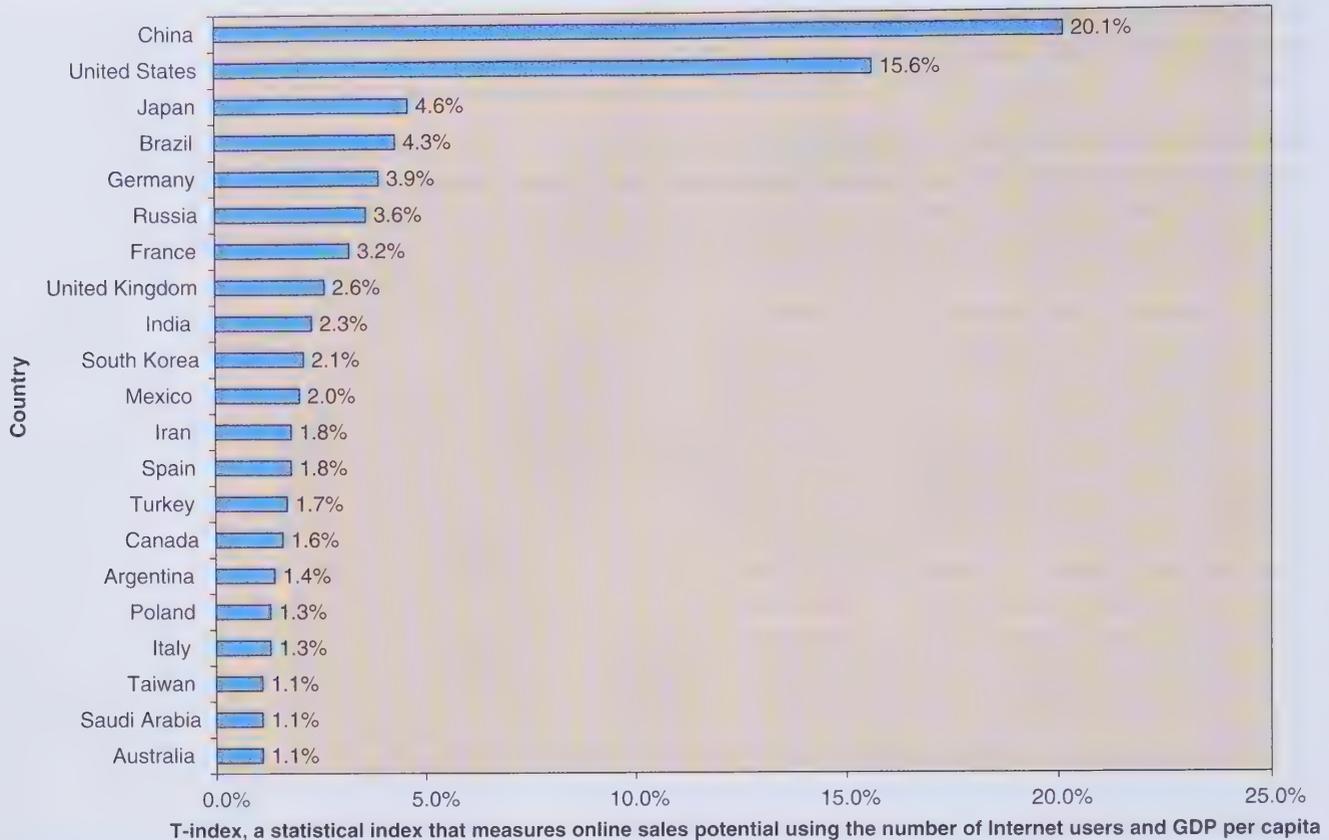


FIGURE 13.5

Markets with the Highest Online Sales Potential

Source: Based on *Translated.net*, 2012.

may be taboo in other countries. Even color schemes are important. Selecting the “wrong” colors and symbols on a site targeting people in a particular country can hurt sales and offend visitors. A little research into the subtleties of a target country’s culture and business practices can save a great deal of embarrassment and money! Creating secure, simple, and reliable payment methods for foreign customers also increases sales. International delivery services offer software that small companies can incorporate into their Web sites that calculate the final “landed cost” (including relevant tariffs and duties) of orders and estimate delivery dates.



ENTREPRENEURIAL PROFILE: Jarrod Rogers: MotoSport MotoSport, an online retailer of motorcycle parts and accessories based in Portland, Oregon, received its first international order from a customer in Canada and filled it promptly. The sale fell through when the shipping company demanded that the customer pay an additional \$100 in tariffs about which Jarrod Rogers, MotoSport’s director of marketing, was unaware. “The tariff was more than the price of the item,” he says. Recognizing the potential of international sales for its product line, MotoSport hired Fifty-One Global Ecommerce, a company that specializes in international shipping and logistics, to integrate software into MotoSport’s Web site that calculates country-specific taxes, tariffs, and shipping charges. Although MotoSport has not yet translated its Web site into its international customers’ languages, it now sells to customers in 84 countries.⁶⁸

When translating the content of their Web pages into other languages, entrepreneurs must use extreme caution. This is *not* the time to pull out their notes from an introductory Spanish course and begin their own translations. Hiring professional translation and localization services to convert a company’s Web content into other languages minimizes the likelihood of a company unintentionally offending foreign customers.



Lessons from the Street-Smart Entrepreneur

How to Make Your Business Ready for Global E-Commerce

In 1999, Robert Beaver and his sons, Bobby and Jeff, created Zazzle, a Redwood City, California–based business that allows customers to create their own customized products—from T-shirts and coffee mugs to posters and postage stamps. Although Zazzle has been shipping its products to customers in 70 countries for several years, the company only recently made a serious effort to increase sales in specific global markets. The Beavers combed through the company's Web analytics to identify the nations from which its foreign traffic and sales originated and targeted the top 15 nations. Then they developed an Internet platform that they could easily adapt to suit local customers' shopping habits, tastes, and payment preferences. The Beavers invested in translating each country-specific Web site into its native language, changed its frequently-asked-questions (FAQ) section to match the specific concerns of customers in each nation, and hired multilingual customer support teams. The payoff has been significant; international sales have propelled the company's growth rate.

Not so long ago, tapping global markets was not a realistic possibility for small companies such as Zazzle because of the resources required to go global, but the Internet has changed all of that, making global markets available to even the smallest of businesses. Almost 89 percent of the estimated 2.4 billion Internet users worldwide live *outside* of North America, and less than 27 percent of Internet users speak English. China, for instance, has 242 million online shoppers (45 percent more than the United States), more than any nation in the world, and they spend an average of \$40,000 per second! No e-commerce company, whatever its size, can afford to ignore the market potential of global markets. Generating e-commerce sales in global markets requires a company to develop an appropriate global e-commerce strategy. Small business can increase the probability of success by following these tips from the Street-Smart Entrepreneur:

- **Study the culture of the countries you are targeting.** To be successful, e-commerce entrepreneurs must learn the habits, customs, and traditions of doing business in a country just as if they were opening a physical location there. Incorporating the lessons you learn into your company's Web site makes international customers feel welcome and increases their willingness to buy and become repeat customers. JRS Consulting, a marketing and management consulting firm, invested months learning about the business culture of France before building a Web site devoted to landing customers there. The effort produced a 95 percent return on investment, and 15 percent of the company's annual revenue now comes from France.
- **Translate your company's Web site into the local language.** Online customers are more likely to buy from Web sites written in their native languages. Skyscanner, an airline flight price comparison Web site, translated its site into the languages of the 23 countries it targeted and saw its international orders skyrocket. International sales now make up 70 percent of the company's revenue. In Russia alone, the number of Skyscanner users increased from 30,000 to 1 million in just 18 months after the company created a dedicated site for Russian customers.
- **Tailor your company's Web site to meet the expectations of customers in each country.** Although Google's search engine dominates the market in the United States, shoppers in other nations often use other search engines to find the products they want to purchase online. For example, companies that want to sell to customers in China should know that Baidu is the leading search engine there and optimize their Web sites for maximum performance on it. Key terms must match the local language. A customer in North America is most likely to use a search engine to look for "pants," but a shopper in Australia would use the term "trousers."
- **Incorporate country-specific pricing.** Product pages should display prices in international shoppers' local currencies, including any tariffs, duties, and taxes that may apply. You can hire companies that specialize in international business transactions to set up this portion of your Web site in exchange for a fee or a percentage of each sale.
- **Provide payment options that international customers expect to use.** In many countries (as in the United States), most customers use credit cards to pay for online purchases. Shoppers in some countries prefer to use other methods of payment. In the Netherlands, direct debit transactions account for 60 percent of online payments. In the Czech Republic, 50 percent of online sales are cash on delivery. In Germany, nearly half of customers use online banking transfers.
- **Display shipping options, charges, and delivery dates up front.** Small companies, in particular, benefit by outsourcing international shipping to companies that specialize in the field. Some exported items are subject to tariffs and taxes that can create nasty surprises for customers and lost sales for companies that are unaware of them. When managers at *DrJays.com*, a retailer of hip-hop clothing aimed at young adults with outlets in New York City, reviewed the company's Web analytics, they discovered that shoppers in Russia were browsing the DrJays Web site. DrJays hired i-parcel LLC, a company that specializes in international shipping services, to handle all of the specifics of shipping its international orders. DrJays has since worked with i-parcel to begin shipping to customers in 20 more countries. In just one year, DrJays's international sales have doubled.
- **Post your company's return policy and customer service information.** You can increase the appeal of your products to international customers by addressing a potential stumbling block to making a sale: your company's return policy. In addition, be sure to tell customers for

Lessons from the Street-Smart Entrepreneur *(continued)*

whom the FAQ section of your company's Web site is not sufficient how to reach customer service representatives with their questions.

- **Incorporate the nuances of a country's business culture into your Web site.** Your Web site should show customers that you understand how business works in each country. For instance, asking customers in Ireland to input a ZIP code on an order form is pointless; outside of Dublin, Ireland does not use ZIP codes. Displaying product sizes in local measurements also increases a site's conversion rate.

Sources: Based on Steven Millward, "China Now Has 242 Million E-Commerce Shoppers Spending \$40,000 per Second," *TechInAsia*, January 18, 2013, www.techinasia.com/china-ecommerce-242-million-online-shoppers-2013-stats; "Internet Usage Statistics: The Internet Big Picture," *Internet World Stats*, June 30, 2012, www.internetworldstats.com/stats.htm; Christian Arno, "Take Your Online Presence Global: Five Foreign-Language Online Marketing Tips," *Marketing Profs*, November 4, 2011, www.marketingprofs.com/articles/2011/6316/take-your-online-presence-global-five-foreign-language-online-marketing-tips; Ryan Underwood, "Clicks from Around the World," *Inc.*, December 2010/January 2011, pp. 146–147; Chris Bishop, "Seven Tips for Global E-commerce," *Econsultancy*, March 22, 2012, <http://econsultancy.com/us/blog/9387-7-tips-for-global-ecommerce>; Paul Demery, "DrJays.com Opens Foreign Doors with i-parcel," *Internet Retailer*, February 26, 2013, www.internetretailer.com/2013/02/26/drjayscom-opens-foreign-doors-i-parcel.

Go Mobile

More people now access the Internet with a mobile device such as a smart phone or a tablet device than with a desktop computer.⁶⁹ More than 55 percent of U.S. adults (about 126 million people) own smart phones, and 25 percent of adults own tablets.⁷⁰ These mobile users continue to increase the frequency with which they make online purchases from their devices (m-commerce). In fact, the average amount per order for smart phones (\$97.82) and tablets (\$96.84) is larger than the average amount per order for desktop computers (\$91.76). However, conversion rates for mobile devices (1.01 percent for smart phones and 3.12 percent for tablets) are lower than those for desktop computers (3.28 percent).⁷¹ Despite the rapid growth of m-commerce (see Figure 13.6), 74 percent of small businesses have not developed a version of their Web sites that is viewable on smart phones, and 86 percent of small companies have not developed a version of their Web sites that is viewable on tablets.⁷² The payoff for companies that cater to mobile shoppers is significant; 84 percent of the companies that have created dedicated mobile Web sites say that they have experienced increased sales.⁷³

Because mobile devices have smaller screens than desktop PCs, they cannot display traditional Web sites properly. One recent survey reports that 96 percent of mobile shoppers have encountered Web sites that were not designed for mobile devices. In addition, 61 percent of mobile users say that they quickly move on to other sites when they cannot navigate a site and find the items they want to purchase. Conversely, 67 percent of mobile users say that when they visit a mobile-friendly site, they are *more* likely to make a purchase from the company.⁷⁴ By investing a little more time and money to create **responsive Web sites**, those that conform naturally and seamlessly to the size and resolution of the screen on which they are displayed, small companies can accommodate customers on *any* device from which they want to shop. A responsive Web design eliminates the necessity of creating multiple versions of a Web site for various platforms and moves a company's Web site higher in Google's all-important search engine rankings. When designing mobile Web sites, companies must be aware that speed is important (although mobile customers are somewhat more forgiving than those who use desktop PCs). Three seconds is the magic download time for mobile Web sites; nearly 60 percent of mobile users expect a Web site to download in three seconds or less, and 40 percent of them say that they abandon sites that require more than three seconds to load.⁷⁵



ENTREPRENEURIAL PROFILE: Deb Palacio and Terri Hunsinger: Webundies In 1999, Deb Palacio and Terri Hunsinger started Webundies, an online specialty retailer that sold novelty boxer shorts in 15 designs. Today, Webundies has expanded its product line to include 1,500 styles of men's, women's, and children's underwear, loungewear, and robes and recently launched a dedicated mobile commerce Web site to reach the growing number of shoppers who access the Internet from mobile devices. The company's mobile sales account for 5.4 percent of its \$3.1 million in annual sales and are growing rapidly. To build its mobile site, Webundies relied on vendors who specialize in m-commerce. "It was so easy," says Hunsinger. "Vendors are so much better at these things than we are. I recognize where our strengths are and where they are not." Webundies' next move is to strengthen its mobile site's search feature to allow shoppers to find the items they want more easily.⁷⁶

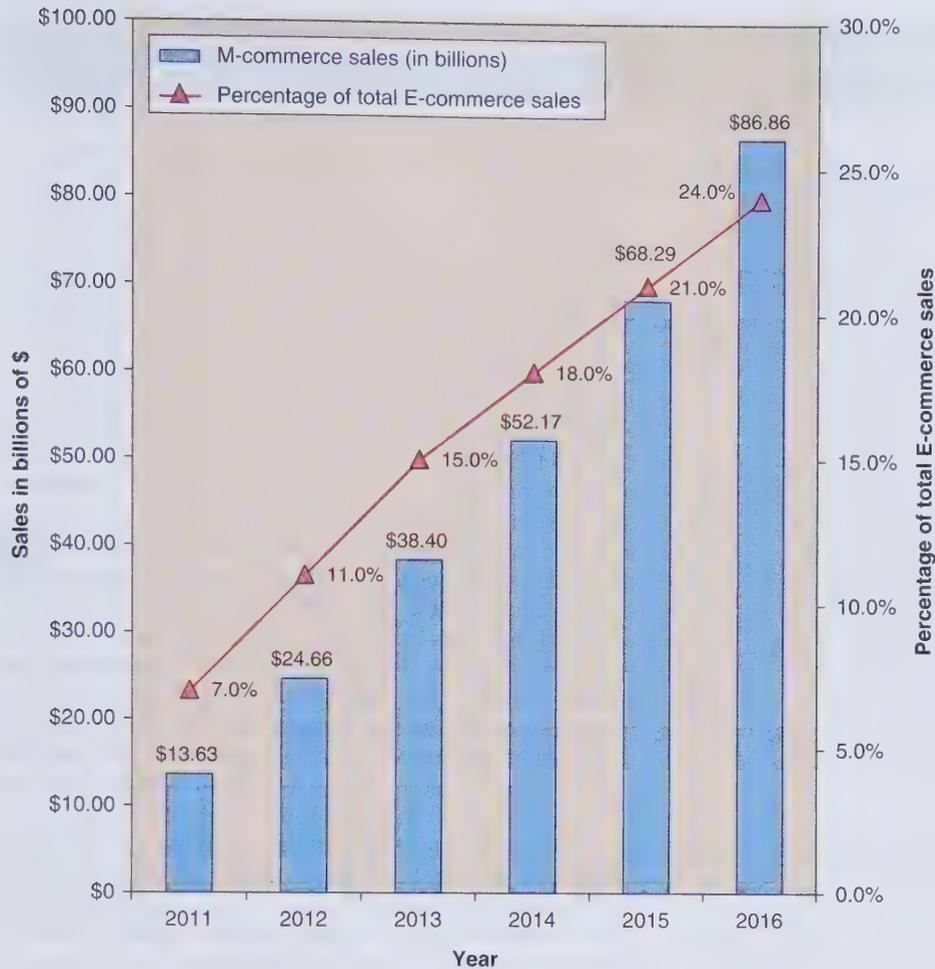


FIGURE 13.6
U.S. Mobile Commerce Sales

Source: Based on eMarketer, January 2013.

Promote Your Web Site Online and Offline

E-commerce entrepreneurs have to use every means available—both online and offline—to promote their Web sites and to drive traffic to it. Cross promotions in which a physical store promotes the Web site and the Web site promotes the physical store can boost sales in both venues. In addition to using traditional online techniques such as registering with search engines, creating banner ads, and joining banner exchange programs, Web entrepreneurs must promote their sites offline as well. Ads in other media such as direct mail or newspapers that mention a site's URL will bring customers to it. It is also a good idea to put the company's Web address on *everything* a company publishes, from its advertisements and letterhead to shopping bags and business cards. A passive approach to generating Web site traffic is a recipe for failure. On the other hand, entrepreneurs who are as innovative at promoting their e-businesses as they are at creating them can attract impressive numbers of visitors to their sites.

Use Social Media Tools to Attract and Retain Customers

Online companies are harnessing the power of social media sites such as Facebook, LinkedIn, Twitter, YouTube, Pinterest, and others to drive traffic to their Web sites. Social media and other online tools recognize that shoppers, especially young ones, expect to take an interactive role in their shopping experience by writing (and reading) product reviews, asking questions, posting comments on social media sites, and engaging in other interactive behavior. Approximately 67 percent of adult Internet users participate in social networking sites, 85 percent watch online videos, and 33 percent read blogs.⁷⁷ Small businesses are responding to the opportunity to connect with their customers online by adding the following social media to their e-commerce strategies:

- **Mashups.** A mashup is a Web site or an application that combines content from multiple



Entrepreneurship in Action

Enhancing E-Commerce with Social Media

Entrepreneurs who use social media to drive traffic to their companies' Web sites can generate impressive returns on their investments. The following companies successfully used two popular social media tools—Facebook and Pinterest—to enhance their e-commerce efforts.

Toll Booth Saddle Shop

Toll Booth Saddle Shop (TBSS), a tack shop located in Eastampton, New Jersey, has built a solid e-commerce business with the help of a creative Facebook strategy. Patricia Janssen and her mother Rose Hunter are co-owners of TBSS, which opened in 1974, but Janssen credits her daughter, Andrea, for the shop's Facebook success. Andrea created the shop's original Facebook page and then taught her mother how to use it as a marketing tool. The site's home page includes a "Follow Us" section with highly visible links to the company's social media pages on Facebook, Twitter, Pinterest, LinkedIn, and YouTube. TBSS's Facebook page is appealing to horse enthusiasts because it includes posts and comments that contain useful tips on proper equine care, reviews of equipment, and answers to visitors' questions about their horses. It also features a photo contests, horse jokes, and horse trivia. Employees frequently engage customers with questions such as "What is your favorite barn boot?" or "What is your favorite cowboy quotation?" The goal is twofold: to engage customers in conversation and to create a page that serves as a valuable source of useful information so that customers keep coming back. "We know our customers pretty well," says Janssen, "and we try to make it fun." TBSS gives visitors an incentive to "like" the company: a 10 percent discount on any purchase from the online store. The Facebook page also has a clickable link, "Shop Now," that takes customers directly to a landing page on the company's Web site and an invitation to sign up for the TBSS e-mail newsletter. One of the most popular features of the TBSS Facebook page is the home-made video that the company posts every Wednesday featuring Harold the Hero Horse, the shop's mascot. (One recent episode featured Harold and his canine sidekick JR, Janssen's Jack Russell Terrier, dreaming that they are shopping for a gift for Harold's girlfriend, Miranda, on the TBSS Web site.) Customers who follow TBSS on Twitter receive tweets announcing the latest videos. TBSS's creative use of Facebook has allowed the company to amass nearly 2,000 likes and to increase its e-commerce sales.

Souchi

Suzi Johnson started Souchi in 1998 to sell a line of luxury cashmere sweaters to upscale women. Within a few months, her sweaters had appeared in national magazines such as *Elle*, *InStyle*, *People*, *Vogue*, and *Seventeen* as well as on characters

in several popular television shows, including *Friends*. Johnson's brand benefited from celebrities such as Jennifer Aniston, Cameron Diaz, Gwyneth Paltrow, and Kim Kardashian appearing in Souchi cashmere sweaters. Johnson invested several thousand dollars building a Web site to showcase her line of sweaters and tops but was disappointed with the sales it generated. She was confident that, with a proper redesign, the site could generate significant sales for Souchi.

Johnson worked with a Web developer to review the site's analytics, navigation, and appearance. Looking at the site through Souchi's customers' eyes, they redesigned it, simplifying its navigation, improving its content with better product descriptions, adding high-quality photographs, incorporating a blog, optimizing it for search engines, and employing a pay-per-click advertising campaign. Johnson also decided to support the Web site with a social media strategy. Because her target customer is virtually all female, Johnson chose to focus on Pinterest because more than 90 percent of its users are women. Pinterest is a virtual pinboard that connects people with common interests ranging from art and hobbies to recipes and sweaters, allowing them to organize and share photographs that appeal to or inspire them. People use Pinterest to find the latest fashions, learn new recipes, share ideas on home decorating, or get tips on landscaping. Johnson saw Pinterest as the ideal way to connect with her target customers and to encourage them to promote Souchi's product line, which now includes a full line of women's clothing, and added a "Pin It" button that allows users to share photos of her fashions on Pinterest. The results amazed Johnson. Almost immediately, customers began pinning Souchi product photographs to Pinterest. Traffic to the Souchi Web site increased by an incredible 5,700 percent, which resulted in an impressive increase in sales for the company.

1. Conduct an online search for tips on integrating social media into a company's e-commerce strategy. Select a social media tool such as Facebook, Pinterest, Twitter, LinkedIn, or others and develop a list of at least five suggestions that entrepreneurs can use to implement it into their e-commerce strategies.
2. Work with a team of your classmates to select a local small business and develop a plan for adding or enhancing the integration of social media into its e-commerce effort.

Sources: Based on Phil Mershon, "9 Facebook Marketing Success Stories You Should Model," *Social Media Examiner*, September 13, 2011, www.socialmediaexaminer.com/9-facebook-marketing-success-stories-you-should-model/; Rose Krebs, "Eastampton Saddle Shop Making a Name for Itself Online," *Philly Burbs*, August 12, 2011, www.phillyburbs.com/news/local/burlington_county_times_news/eastampton-saddle-shop-making-a-name-for-itself-online/article_3fcef6ed-f772-59ed-ac5a-6ba81f41feb4.html; Joe Kutchera, "The Power of Pinterest: Small Business Case Study of Souchi.com," *JoeKutchera.com*, November 6, 2012, <http://joekutchera.com/the-power-of-pinterest-small-business-case-study-of-souchi-com>.

invitations and responses to events. They invite their Twitter followers to an event—the grand opening of a new location, for example—and then receive responses from guests on Twitter.

- **Really Simple Syndication.** Really Simple Syndication (RSS) is an application that allows subscribers to aggregate content from their favorite Web sites into a single feed that is delivered automatically whenever the content is updated. RSS is ideal for companies whose customers are information junkies.
- **Social Media.** Many online businesses attract potential customers to their Web sites through their Facebook and Pinterest pages, Twitter posts, and LinkedIn accounts. They use Web sites as a “hub” supported by the “spokes” of social media. Web sites that include a social sign-in feature, which allows social media users to bypass creating accounts and passwords when they log into a company’s Web site, create a seamless integration between a company’s Web site and social media. Just 24 percent of small businesses integrate social media in a strategic and structured way, but those that do often see big payoffs.⁷⁸ In a recent survey by Manta, 36 percent of small business owners say that at least half of the new customers they acquired in the previous year originated with social media.⁷⁹

ENTREPRENEURIAL PROFILE: Jake Godby and Sean Vahey: Humphrey Slocombe

Humphrey Slocombe, a 14-seat ice cream shop in San Francisco co-owned by Jake Godby and Sean Vahey, has built a large following of dedicated customers almost exclusively using Twitter. “We started using Twitter because we have zero money for any kind of advertising and promotion,” says Vahey. The entrepreneurs, who are known for their sometimes bizarre flavors, including Peanut Butter Curry, Secret Breakfast (corn flakes and bourbon), Butter-Beer (butter, molasses, and oatmeal stout), and government cheese (Mimolette, sour cream, cinnamon, and cayenne), keep their 300,000 Twitter followers updated on the latest featured flavors. “As soon as we put it on Twitter, it moves,” says Vahey.⁸⁰

Other companies find that encouraging customers to post their favorite products to their Pinterest or Facebook pages increases sales and can create an army of brand ambassadors.

- **Wikis.** A **wiki** is a dynamic collection of Web pages that allows users to add to or edit their content. The most popular wiki is Wikipedia, the user-created online encyclopedia for which users provide the content. Some companies use wikis to encourage customers to participate in the design of their products, a process called **co-creation**.
- **Widgets.** Another tool that small companies use to attract attention on the Web is **widgets** (also known as **gadgets**), low-cost applications that appear like small television screens on Web sites, blogs, or computer desktops and perform specific functions. Entrepreneurs can create their own widgets or purchase them from developers and customize them, adding their own names, brands, and logos. Customers and visitors can download the widget to their desktops or, perhaps, post it to their Facebook pages, where other Web users see it, and the social nature of the Web exposes the company to thousands of potential customers. A popular widget not only drives customers to a site but also can improve a company’s ranking on major search engines. “It’s a great way to continually remind people that you exist,” says Ivan Pope, CEO of widget developer Snipperoo.⁸¹ Many companies create shopping widgets that alert customers to special deals and allow them to shop the company’s Web site directly from the widget.

Capture Local Traffic

A well-designed Web site not only opens global markets for a company but also is an important tool for attracting local customers to its storefront. According to the Pew Internet and American Life Project, 51 percent of U.S. adults get information about local businesses on the Internet.⁸² Small companies should include their physical addresses and telephone numbers on their Web sites (60 percent of small businesses do not) and should use geographically specific keywords in pages titles, header tags, and content that search engines will pick up.⁸³ Establishing a presence in online directories such as *YellowPages.com*, Yelp, and Google Places also attracts local shoppers.

Develop an Effective Search Engine Optimization Strategy

Search engine optimization (SEO) strategies have become an essential part of online companies. With more than 246 million domain names in existence, it is no surprise that Internet shoppers use search engines extensively. Search engines are the most common tool that

Source: CartoonStock.



“Why is my site always the caboose on every search engine?”

people use to find the products and services they want; 89 percent of shoppers say that they use search engines to find information about the products and services for which they are shopping.⁸⁴ As a result, companies are devoting more of their marketing budgets to search engine listings that are focused on landing their Web sites at or near the top of the most popular search engines. For a company engaged in e-commerce, a well-defined SEO strategy is an essential component in its business model. Search engines drive more traffic to e-commerce sites (32.0 percent) than either e-mail (4.3 percent) or social media (1.9 percent) and generate higher average order values (\$90.40) than either e-mail (\$82.72) or social media (\$64.19).⁸⁵

One of the biggest challenges facing e-commerce entrepreneurs is maintaining the effectiveness of their search engine marketing strategies. Because the most popular search engines are constantly updating and refining their algorithms, the secretive formulas and methodology search engines use to find and rank the results of Web searches, Web entrepreneurs also must evaluate and refine constantly their search strategies.



ENTREPRENEURIAL PROFILE: Andrew Strauss: Oh My Dog Supply LLC Andrew Strauss, owner of Oh My Dog Supply LLC, an online company based in San Francisco that sells a full range of dog supplies, says that 70 percent of his customers found his company's Web site through natural listings on search engines. His company almost always appeared in the top results list on search engine giant Google. Then Google engineers changed the algorithm used in searches, and Oh My Dog Supply LLC virtually disappeared from its search results. Strauss watched helplessly as his company's search engine traffic plunged by 96 percent and his sales decline by more than 60 percent. “We're completely crippled now,” he says.⁸⁶

A company's Web search strategy must incorporate the two basic types of search engine results: natural or organic listings and paid or sponsored listings. Although shoppers more often click on organic listings (70 percent vs. 30 percent for paid listings), research shows that shoppers are more likely to purchase from a particular Web site that ranks high in both organic and paid or sponsored listings.⁸⁷ **Natural or organic listings** often arise as a result of “spiders,” powerful programs search engines use to crawl around the Web, analyzing sites for keywords, links, and other data. Based on what they find, spiders index Web sites so that a search engine can display a listing of relevant Web sites when a person enters a keyword in the engine to start a search. Some search engines use people-powered searches rather than spider-powered ones to assemble their indexes. With natural listings, an entrepreneur's goal is to get his or her Web site displayed at or near the top of the list of search results. SEO involves managing the content, keywords, titles, tags,

features, and design of a Web site so that it appears at or near the top of Internet search results. The reason that SEO is so important: 75 percent of search engine users never go beyond the first page of organic search results.⁸⁸ (In fact, 53 percent of users click on the first result listed, 15 percent on the second result, and 9 percent on the third result.⁸⁹) “The difference between being seen on page 1 and page 2 of search results can mean thousands, even millions, of dollars for a business in revenue,” says Martin Falle, CEO of SEO Research, a search engine marketing company.⁹⁰ A useful resource for entrepreneurs is SEO Book, a search engine optimization site (www.seobook.com) that offers both free tools and more than 100 training modules on a variety of SEO topics for a fee.

Companies can use the following tips to improve their search placement results:

- Conduct brainstorming sessions to develop a list of keywords and phrases that searchers are likely to use when using a search engine to locate a company’s products and services and then use those words and phrases on your Web pages. Usually, simple terms are better than industry jargon.
- Use Google’s AdWords Keyword Tool to determine how many monthly searches users conduct globally and locally for a keyword or phrase. More specific, lower-volume keywords and phrases usually produce higher search rankings because they provide potential customers the more focused results they are seeking.
- Use these keywords in the title tags (meta tags, which are limited to 140 characters) and headlines of your Web pages. Most search engines are geared to pick them up. For best results, you should focus each page of your site on one specific keyword or phrase, which should appear in the page’s title. Placing keywords in these critical locations can be tedious, but it produces search results for the companies that take the time to do it.
- Create the content of each Web page with your customers in mind. Each page should contain between 500 and 1,500 words that are relevant to the keyword used in the title tag. Organize the text into well-structured paragraphs and include photographs (that have file names that match the keyword of that page) and videos.
- Visit competitors’ sites for keyword ideas but avoid using the exact phrases. Simply right-clicking on a competitor’s Web page and choosing “View Source” will display the keywords used in the meta tags on the site.
- Consider using less obvious keywords and brand names. For instance, rather than use just “bicycles,” a small bicycle retailer should consider keywords such as “racing bikes,” “road racing bike,” or “LeMond” to draw customers.
- Ask customers which words and phrases they use when searching for the products and services the company sells.
- Use data analysis tools to find the words and phrases (and the search engines) that brought visitors to the company’s Web site.
- Check blogs and bulletin boards related to the company’s products and services for potential key terms.
- Don’t forget about misspellings; people often misspell the words they type into search engines. Include them in your list.
- Hire services such as Wordtracker that monitor and analyze Web users’ search engine tendencies.
- Block irrelevant results with “negative keywords,” those that are excluded in a search.
- Land links to your Web site on high-profile Web sites. Search engines rank sites that have external links to high-volume sites higher than those that do not.
- Start a blog. Well-written blogs not only draw potential customers to your site but also tend to attract links from other Web sites. Blogs also allow entrepreneurs to use key words strategically and frequently, which moves their sites up in search result rankings.
- Post videos on your site. In addition to uploading them to video sites such as YouTube, companies can wait for organic listings to appear, or they can submit their videos to search engines for listing. Forrester Research estimates that a properly submitted video is 50 times more likely to achieve a first-page listing on Google than any text-based page.⁹¹

Because organic listings can take months to materialize, many e-commerce companies rely on paid listings, which give them an immediate presence in search engines. **Paid or sponsored**

listings are short text advertisements with links to the sponsoring company's Web site that appear on the results pages of a search engine when a user types in a keyword or phrase. Entrepreneurs use paid search listings to accomplish what natural listings cannot. Fortunately, just four search engines—Google, Microsoft Bing, Yahoo!, and AOL—account for more than 98 percent of the searches conducted in the United States.⁹² Google, the most popular search engine with 67 percent of all searches, displays paid listings as “sponsored links” at the top and down the side of each results page, and Yahoo! shows “sponsored results” at the top and the bottom of its results pages. Advertisers bid on keywords to determine their placement on a search engine's results page. On Google, an ad's placement in search results is a function of the ad's relevance (determined by a quality score of 1 to 10 that Google assigns) and the advertiser's bid on the keyword. The ad that gets the most prominent placement (at the top) of the search engine's results page when a user types in that keyword on the search engine is the one with the highest combination of quality score and bid price. An advertiser pays only when a shopper clicks through to its Web site from the search engine. For this reason, paid listings also are called pay-for-placement, pay-per-click, and pay-for-performance ads. On Google's Adwords program, the minimum keyword bid is 5 cents, but some words can cost \$75 or more!* The average cost for a pay-per-click keyword has risen from 39 cents in 2004 to 53 cents today.⁹³ Although paid listings can be expensive, they allow advertisers to evaluate their effectiveness using the statistical reports the search engine generates. Pay-per-click advertisers can control costs by geo-targeting their ads, having them appear only in certain areas, and by setting a spending limit per day.

Using generic terms results in large numbers of searches but often produces very small conversion rates and very little in sales; normally, entrepreneurs get better results bidding on more precise, lower-volume keywords. Rather than compete with much larger companies for 5 or 10 common keywords, a more effective strategy is to bid on 200 less popular keywords.



ENTREPRENEURIAL PROFILE: Suzanne Golter: Happy Hound Suzanne Golter, owner of Happy Hound, a doggy day care, boarding, and spa located in a renovated warehouse in Oakland, California, credits Google Adwords for her company's rapid growth. Golter began using Adwords shortly after she started her company, bidding on common keywords such as “dog boarding,” “dog walking,” and “dog day care.” The keyword strategy was successful, attracting large numbers of customers, but as Golter learned more about paid advertising, she began to focus her bidding strategy on a larger number of more focused, geographically specific keywords. Golter's company now cares for more than 120 dogs a day, employs more than 30 employees, and is looking to open new locations. “The doors are packed with dog noses waiting to get into Happy Hound,” she says. “Life is great.”⁹⁴

One problem facing companies that rely on paid listings to generate Web traffic is **click fraud**, which occurs when a company pays for clicks that are generated by someone with no interest in or intent to purchase a product or service. “Clickbots,” programs that can generate thousands of phony clicks on a Web site, are a common source of click fraud. Experts estimate that the pay-per-click fraud rate is 19 percent.⁹⁵ Web analytics software can help online merchants detect click fraud, which can be quite costly. Large numbers of visitors who leave within seconds of arriving at a site, computer IP addresses that appear from all over the world, and pay-per-click costs that rise without any corresponding increase in sales are clues that a company is a victim of click fraud.

Designing a Killer Web Site

Web users are not a patient lot. They sit before their computers, their fingers poised on their mouse buttons, daring any Web site to delay them with files that take too long to load. Slow-loading sites or sites that are confusing and poorly designed cause Web users to move on faster than a bolt of lightning can strike. With more than 634 million Web sites online and more added every day, how can an entrepreneur design a Web site that captures and holds potential customers' attention long enough to make a sale? What can they do to keep customers coming back on a regular basis? There is no surefire formula for stopping online customers in their tracks, but the following suggestions will help.

4.

Learn the techniques of designing a killer Web site.

Decide How to Bring Your Site to Life

Merely building a Web site and building a Web site that produces results are not the same. Entrepreneurs who are not technologically savvy should turn to e-commerce hosting companies that provide one-stop services, including site design, built-in shopping carts, security filters, Web analytics, and, in some cases, credit card processing. Many of these services offer customizable templates that allow entrepreneurs to update and modify their sites very easily using “wizards.” Other entrepreneurs choose to hire Web site designers to create a customized Web site. Still others decide to build their sites themselves. Whatever option they choose, entrepreneurs must pay a monthly hosting fee, which can be a flat amount, an amount per transaction, or a percentage of sales. When it comes to e-commerce, the lesson for entrepreneurs is this: focus your efforts on the core competencies that your company has developed, whether they reside in “traditional” business practices or online, and outsource all of the other aspects of doing business online to companies that have the expertise to make your e-commerce business successful.

Start with Your Target Customer

Before creating their Web sites, entrepreneurs must paint a clear picture of their target customers. How would they organize your company’s Web site? The goal is create a design in which customers see themselves when they visit. Creating a site in which customers find a comfortable fit requires a careful blend of market research, sales know-how, and aesthetics. A good Web site demonstrates brand, message, and design consistency throughout. For instance, a Web site selling discount office supplies will have a different look and feel than one selling upscale kitchen appliances. The challenge for a business with a physical presence is to create online the same image, style, and ambiance in its online presence as in its offline stores. Table 13.2 shows a breakdown of the online activities by generation for Internet users.

Give Customers What They Want

The main reason that people shop online is *convenience*. Online companies that fail to provide a fast, efficient, and flawless shopping experience for their customers will not succeed. A well-designed Web site is intuitive, leading customers to a series of actions that are natural and result in a sale. Sites that provide customers with meaningful content and allow them to find what they are looking for easily and to pay for it conveniently and securely keep customers coming back. High-quality images of products with alternative views that allow customers to zoom in for detail, rotate them 360 degrees, and see color changes showcase a company’s products and increase sales. Product descriptions should be simple, detailed, and jargon free. Videos that show product details or the product in use not only increase customer traffic but also produce higher conversion rates. One of the reasons *Amazon.com* has become the largest online retailer is that its five-point strategy is designed to give online shoppers exactly what they want: low prices, wide selection, product availability, shopping convenience, and extensive information about the products it sells.⁹⁶

A recent survey by the Boston Consulting Group reports that the improvements to customers’ online shopping experience that would motivate them to shop more online are free shipping (74 percent), lower prices (56 percent), free returns (35 percent), more secure Web sites (25 percent), and better views of virtual products (25 percent).⁹⁷ Warby Parker, an online store that sells vintage-inspired eyeglasses for as little as \$95 per pair, offers free shipping and returns on up to five pairs of glasses so that customers can try them on. Many customers take photos of themselves wearing the glasses, post them to Facebook, and solicit feedback from their friends, not only increasing the probability that they will purchase at least one pair but also promoting Warby Parker. In its second year of operation, the company’s sales quintupled, and it had to move its headquarters four times to accommodate its rapid growth.⁹⁸

Select an Intuitive Domain Name

Choose a domain name that is consistent with the image you want to create for your company and register it. Entrepreneurs should never underestimate the power of the right domain name or Uniform Resource Locator (URL), which is a company’s address on the Internet. It not only tells Web users where to find a company, but it also should suggest something about the company and what it does. The ideal domain name should be as follows:

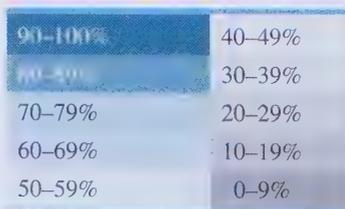
STUDENTS-HUB.com

- **Short.** Short names are easy for people to remember, so the shorter a company’s URL is, the more likely potential customers are to recall it.

Uploaded By: anonymous

TABLE 13.2 Online Activities by Generation

Millennials Ages 18–33	Gen X Ages 34–45	Younger Boomers Ages 46–55	Older Boomers Ages 56–64	Silent Generation Ages 65–73	G.I. Generation Age 74+
Email	Email	Email	Email	Email	Email
Search	Search	Search	Search	Search	Search
Health info	Health info	Health info	Health info	Health info	Health info
Social network sites	Get news	Get news	Get news	Get news	Buy a product
Watch video	Govt website	Govt website	Govt website	Travel reservations	Get news
Get news	Travel reservations	Travel reservations	Buy a product	Buy a product	Travel reservations
Buy a product	Watch video	Buy a product	Travel reservations	Govt website	Govt website
IM	Buy a product	Watch video	Bank online	Watch video	Bank online
Listen to music	Social network sites	Bank online	Watch video	Financial info	Financial info
Travel reservations	Bank online	Social network sites	Social network sites	Bank online	Religious info
Online classifieds	Online classifieds	Online classifieds	Online classifieds	Rate things	Watch video
Bank online	Listen to music	Listen to music	Financial info	Social network sites	Play games
Govt website	IM	Financial info	Rate things	Online classifieds	Online classifieds
Play games	Play games	IM	Listen to music	IM	Social network sites
Read blogs	Financial info	Religious info	Religious info	Religious info	Rate things
Financial info	Religious info	Rate things	IM	Play games	Read blogs
Rate things	Read blogs	Read blogs	Play games	Listen to music	Donate to charity
Religious info	Rate things	Play games	Read blogs	Read blogs	Listen to music
Online auction	Online auction	Online auction	Online auction	Donate to Charity	Podcasts
Podcasts	Donate to charity	Donate to Charity	Donate to Charity	Online auction	Online auction
Donate to charity	Podcasts	Podcasts	Podcasts	Podcasts	Blog
Blog	Blog	Blog	Blog	Blog	IM
Virtual worlds	Virtual worlds	Virtual worlds	Virtual worlds	Virtual worlds	Virtual worlds



Key: % of internet users in each generation who engage in this online activity.

Source: Kathryn Zickuhr, *Generations 2010*, Pew Internet & American Life Project, December 16, 2010, p. 13.

- **Memorable.** Not every short domain name is necessarily memorable. Some business owners use their companies' initials as their domain name (e.g., *www.sbfo.com* for Stanley Brothers Furniture Outlet). The problem with using initials for a domain name is that customers rarely associate the two, which makes a company virtually invisible on the Web.
- **Indicative of a company's business or business name.** Perhaps the best domain name for a company is one that customers can guess easily if they know the company's name. For instance, mail order catalog company L.L. Bean's URL is *www.llbean.com*, and New Pig, a maker of absorbent materials for a variety of industrial applications, uses *www.newpig.com* as its domain name. (The company carries this concept over to its toll-free number, which is 1-800-HOT-HOGS.)
- **Easy to spell.** Even though a company's domain name may be easy to spell, it is usually wise to buy several variations of the correct spelling simply because some customers are not good spellers!

Just because entrepreneurs come up with the perfect URL for their companies' Web sites does not necessarily mean that they can use it. Domain names are given on a first-come, first-served basis. Before business owners can use a domain name, they must ensure that someone else has not already taken it. The simplest way to do that is to go to one of the accredited domain name registration services such as Network Solutions at *www.networksolutions.com*, NetNames at *www.netnames.com*, or Go Daddy at *www.godaddy.com* to conduct a name search. Entrepreneurs who find the domain name they have selected already registered to someone else have two choices: They can select another name, or they can try to buy the name from the original registrant.

With 100 million ".com" domain names currently registered, finding a relevant, unregistered domain name can be a challenge, but several new top-level domain (TLD) names recently became available: .aero (airlines), .biz (any business site), .coop (business cooperatives), .info (any site), .museum (museums), .name (individuals' sites), and .pro (professionals' sites). The Internet Corporation for Assigned Names and Numbers, the organization officially in charge of domain names worldwide, also has authorized the use of generic TLDs, such as .app, .joy, .beauty, .pizza, and others, increasing the number of TLDs from about two dozen to thousands.⁹⁹ Once an entrepreneur finds an unused name that is suitable, he or she must register it (plus any variations of it)—and the sooner, the better! Registering is quite easy: simply use one of the registration services listed above to fill out a form and pay the required fee. Although not required, registering the domain name with the U.S. Patent and Trademark Office at a cost of \$275 provides maximum protection for a company's domain name. The office's Web site (*www.uspto.gov*) not only allows users to register a trademark online but also offers useful information on trademarks and the protection they offer.

Make Your Web Site Easy to Navigate

Research shows that the leading factor in convincing online shoppers to make a purchase from a Web site is its ease of navigation. The starting point for evaluating a site's navigability is to conduct a user test. Find several willing shoppers, sit them in front of a computer, and watch them as they cruise through the company's Web site to make a purchase. It is one of the best ways to get meaningful, immediate feedback on the navigability of a site. Watching these test customers as they navigate the site also is useful. Where do they pause? Do they get lost in the site? Are they confused by the choices the site gives them? Is the checkout process too complex? Are the navigation buttons from one page of the site to another clearly marked, and do they make sense? Patterns that entrepreneurs discern from a site's Web analytics also reveal valuable insights about its navigability.

Because many visitors do not start from a Web site's home page, the starting point for easy navigability involves creating the right **landing pages**, the pages on which visitors land after they click on a sponsored link in a search engine, e-mail ad, or online ad. Ideally, a landing page should have the same marketing message as the link that led to it; otherwise, customers are likely to abandon the site immediately (an occurrence that is measured by a site's **bounce rate**, the percentage of visits in which customers leave a site from the landing page). A good landing page also allows customers to search or to dig deeper into the company's Web site to the products or services that they are seeking.

Successful Web sites recognize that shoppers employ different strategies to make a purchase. Some shoppers want to use a search tool, others want to browse through product categories, and

still others prefer a company to make product recommendations. Effective sites accommodate all three strategies in their design. Shoppers at Gourmet Gift Baskets, an online retailer of gift baskets based in Kingston, New Hampshire, can use an internal search engine to find a gift basket, or they can browse collections of baskets organized by price range, occasion, theme, or popularity.

Provide Customer Ratings and Reviews

Customer ratings and reviews have become extremely important to online shoppers. The Global Consumer Shopping Habits Survey reports that 90 percent of online shoppers read reviews from other shoppers and that 83 percent say that the reviews influence whether they actually make a purchase.¹⁰⁰ Allowing customers to post product reviews and ratings enhances a site's credibility and leads to increased sales.

Offer Suggestions for Related Products

Many online merchants increase sales with the help of recommendation engines, which match keywords that shoppers enter into a site's internal search engine with complementary or supplementary items that the company sells. The goal is to increase total sales by cross-selling. For example, a customer who enters the word "French cuff shirt" into a company's search tool might see a link to the company's selection of cufflinks and ties in addition to all of the French cuff shirts that appear. *Amazon.com* is famous for the success of its product recommendations, which appear as "customers who bought this item also bought . . ." product suggestions.

Add Wish List Capability

Giving customers the ability to create wish lists of products and services they want and then connect other people to those lists not only boosts a company's sales but also increases its visibility.

Create a Gift Idea Center

Online retailers have discovered that one of the most successful tools for improving their conversion rates is to offer a gift idea center. A gift idea center is a section of a Web site that includes a variety of gift ideas where shoppers can browse for ideas based on price, gender, or category. Gift centers can provide a huge boost for e-tailers, particularly around holidays, because they offer creative suggestions for shoppers looking for the perfect gift. Other variations of this approach that have proved to be successful for e-commerce entrepreneurs include suggested items pages, bargain basement sale pages, and featured sale pages.

Establish the Appropriate Call to Action on Each Page

Every page of a Web site should have a purpose, steering customers to take a specific action—place an order, review the company's services, sign up for a newsletter, request information, read customer testimonials, and more. Make sure that the call to action on every page is highly visible and appropriate.

Build Loyalty by Giving Online Customers a Reason to Return to Your Web Site

Just as with brick-and-mortar retailers, e-tailers that constantly have to incur the expense of attracting new customers find it difficult to remain profitable because of the extra cost required to acquire customers. One of the most effective ways to encourage customers to return to a site is to establish an incentive program that rewards them for repeat purchases. "Frequent-buyer" programs that offer discounts or points toward future purchases, giveaways such as T-shirts emblazoned with a company's logo, or special sales only for loyal customers are common elements of incentive programs. Incentive programs that are properly designed with a company's target customer in mind really work. Business Supply, an online office products company, periodically sends its most frequent and highest spending customers a thank-you e-mail that includes a \$10 coupon. The promotion produces a 400 percent return on investment.¹⁰¹

Establish Hyperlinks with Other Businesses, Preferably Those Selling Products or Services That Complement Yours

Listing the Web addresses of complementary businesses on your company's site and having them list your site's address on their sites offers customers more choices and convenience. For instance, the owner of a site selling upscale

kitchen gadgets should consider a cross-listing arrangement with sites that feature gourmet recipes, wines, and kitchen appliances.

Include an E-Mail Option, an Address, and a Telephone Number on Your Site

Customers appreciate the opportunity to communicate with your company, and you should give them many options for doing so. If you include e-mail access on your site, however, be sure to respond to it promptly. Nothing alienates customers faster than a company that is slow to respond or fails to respond to their e-mail messages. Also be sure to include an address and a toll-free telephone number for customers who prefer to write or call with their questions. Unfortunately, many companies either fail to include their telephone numbers on their sites or bury them so deeply within the sites' pages that customers never find them.

Give Shoppers the Ability to Track Their Orders Online

Many customers who order items online want to track the progress of their orders. One of the most effective ways to keep a customer happy is to send an e-mail confirmation that your company received the order and another e-mail notification when you ship the order. The shipment notice should include the shipper's tracking number and instructions on how to track the order from the shipper's site. Order and shipping confirmations instill confidence in even the most Web-wary shoppers.

Offer Web-Only Specials

Give Web customers a special deal that you don't offer in any other advertising piece. Change your specials often (weekly, if possible) and use clever "teasers" to draw attention to the offer. Regular special offers available only on the Web give customers an incentive to keep visiting a company's site.

Use the Power of Social Media

Make it easy for customers to connect with your company on social media such as Facebook, Pinterest, Twitter, and others by including social media sharing links and links to your company's social media pages on your Web site.

Use Customer Testimonials

Customer testimonials about a company and its products and services lend credibility to a site, but the testimonials must be genuine and believable. Video testimonials can be even more powerful than written ones.



ENTREPRENEURIAL PROFILE: Charlie and Eddie Bakhsh: American Pearl American Pearl, a company that sells pearls from its Fifth Avenue showroom in New York City and its Web site (www.americanpearl.com), reinforces the owners' extensive knowledge of and dedication to pearls with a Web page dedicated to customer testimonials. Explaining the importance of the testimonial page, Eddie Bakhsh, whose father, Charlie, started the company in 1950, says, "We understand that purchasing an expensive strand of pearls for a loved one on the Internet can require courage." The highly successful company also instills confidence in customers by offering an unconditional 30-day, money-back guarantee.¹⁰²

Follow a Simple Design

Catchy graphics and photographs are important to snaring customers, but designers must choose them carefully. Designs that are overly complex take a long time to download, and customers are likely to move on before they appear. Web Site Garage (<http://thewebsitegarage.com>), a Web site maintenance company, offers companies a free 21-point inspection of their Web sites and a report that describes problems ranging from slow download speeds to search engine optimization and their potential solutions.

Specific design tips include the following:

- Avoid clutter, especially on your site's home page. "The homepage is like a store's display window, minus the mannequins," explains a report on proper Web design.¹⁰³ The best design is simple and elegant with a balance of both text and graphics. "The minimalist approach makes a site appear more professional," says one design expert.¹⁰⁴

- Use less text on your site’s home page, landing pages, and initial product or service pages. Although including detailed, text-heavy content deeper in your site is acceptable and even desirable, incorporating too much text early on dissuades customers. Allow customers to drill down to more detailed product and service descriptions.
- Avoid huge graphic headers that must download first, prohibiting customers from seeing anything else on your site as they wait (or, more likely, *don’t* wait). Use graphics judiciously so that the site loads quickly; otherwise, impatient customers will abandon the site.
- Include a menu bar at the top of every page that makes it easy for customers to find their way around your site.
- Make the site easy to navigate by including easy-to-follow navigation buttons at the bottom of pages that enable customers to return to the top of the page or to the menu bar. This avoids “the pogo effect,” where visitors bounce from page to page in a Web site looking for what they need. Without navigation buttons or a site map page, a company runs the risk of customers getting lost in its site and leaving. Organizing a Web site into logical categories also helps.
- Minimize the number of clicks required for a customer to get to any particular page in the site. Long paths increase the likelihood of customers bailing out before they reach their intended destination.
- Incorporate meaningful content in the site that is useful to visitors, well organized, easy to read, and current. The content should be consistent with the message a company sends in the other advertising media it uses. Although a Web site should be designed to sell, providing useful, current information attracts visitors, keeps them coming back, and establishes a company’s reputation as an expert in the field.
- Include a FAQ section. Adding a searchable FAQ section to a site can reduce dramatically the number of telephone calls and e-mails customer service representatives must handle. FAQ sections typically span a wide range of issues—from how to place an order to how to return merchandise—and cover topics that customers most often want to know about.
- Be sure to include privacy and return policies as well as product guarantees the company offers.
- Avoid fancy typefaces and small fonts because they are too hard to read.
- Be vigilant for misspelled words, typographical errors, formatting mistakes, and dead links; they destroy a site’s credibility in no time and send customers fleeing to competitors’ sites.
- Don’t put small fonts on “busy” backgrounds; no one will read them!
- Use contrasting colors of text and graphics. For instance, blue text on a green background is nearly impossible to read.
- Be careful with frames. Using frames that are so thick that they crowd out text makes for a poor design.
- Test the site on different Web browsers and on different size monitors. A Web site may look exactly the way it was designed to look on one Web browser and be a garbled mess on another. Sites designed to display correctly on large monitors may not view well on small ones.
- Use your Web site to collect information from visitors but don’t tie up customers with a tedious registration process. Most will simply leave the site never to return. Offers for a free e-mail newsletter or a contest giveaway can give visitors enough incentive to register with a site.
- Incorporate a search function that allows shoppers to type in the items they want to purchase. Unlike in-store shoppers, who might browse until they find the item, online shoppers usually want to go straight to the products they seek. Ideally, the search function acknowledges common misspellings of key terms, avoiding the dreaded “No Results Found” message.
- Include company contact information and an easy-to-find customer service telephone number.
- Avoid automated music that plays continuously and cannot be cut off.
- Make sure the overall look of the site is consistent and appealing. “When a site is poorly designed, lacks information, or cannot support customer needs, that [company’s] reputation is seriously jeopardized,” says one expert.¹⁰⁵
- Remember: Simpler usually is better.

Assure Customers That Online Transactions Are Secure

If you are serious about doing business on the Web, make sure that your site includes the proper security software and encryption devices. Computer-savvy customers are not willing to divulge their credit card numbers on sites that are not secure. Unfortunately, 60 percent of small companies do not tell their customers about the precautions they take to protect customers' data.¹⁰⁶ E-commerce companies also should avoid storing their customers' credit card information. With attacks from hackers increasingly prevalent, the risk is just too high.

Post Shipping and Handling Charges Up Front

A common gripe among online shoppers is that some e-tailors fail to reveal their shipping and handling charges early in the checkout process. Responsible online merchants keep shipping and handling charges reasonable and display them early on in the buying process—before shoppers add items to a cart. When customers' orders qualify for free shipping, the site should automate this step rather than require customers to input a free shipping code. Providing shoppers with multiple shipping options and their associated costs increases a site's conversion rate. At checkout, Gourmet Gift Baskets, the online retailer of gift baskets, displays delivery dates, shipping methods, and their associated costs, enabling shoppers to easily select the shipping option that best suits their needs.¹⁰⁷

Create a Fast, Simple Checkout Process

One surefire way to destroy an online company's conversion rate is to impose a lengthy, convoluted checkout process that requires customers to wade through pages of forms to fill out just to complete a purchase. When faced with a lengthy checkout process, customers simply abandon a site and make their purchases elsewhere. The fewer the steps required for customers to check out, the more successful will be the site at generating sales.

Provide Customers Multiple Payment Options

In the United States, credit cards remain the most popular method of payment online (preferred by 69 percent of shoppers).¹⁰⁸ However, because some customers are skittish about using their credit cards online, online merchants should offer other payment options, such as Paypal, Google Checkout, or some other payment service.

Confirm Transactions

Order-confirmation e-mails, which a company can generate automatically, let a customer know that the company received the online order and can be an important first line of defense against online fraud. If the customer claims not to have placed the order, the company can cancel it and report the transaction and the credit card information as suspicious. Order confirmation e-mails should include shipping information and a tracking number that allows customers to view the status of their orders.

Keep Your Site Fresh

Customers want to see something new when they visit stores, and they expect the same when they visit virtual stores as well. Regularly add new content such as videos, blogs, customer testimonials, or information-rich articles to your site. Delete any hyperlinks that have disappeared and keep the information on your Web site current. One sure way to run off customers on the Web is to continue to advertise your company's "Christmas Special" in August! On the other hand, fresh information and new specials keep customers coming back.

Rely on Analytics to Improve Your Site

Web analytics (see the following section) provide a host of useful information ranging from the keywords that shoppers use to find your site and how long they stay on it to the number of visitors and their locations. The best way to increase a site's conversion rate is to use analytics to determine which techniques work best and integrate them throughout the site. Analytics also are useful for determining what's *not* working on a Web site. Above-average bounce and shopping cart abandonment rates, low traffic counts, and slow-moving inventory are signs that a Web site is in need of an overhaul.

Test Your Site Often

Successful e-commerce entrepreneurs check their sites frequently to make sure they are running smoothly and are not causing customers unexpected problems. A good rule of thumb is to check your site at least monthly—or weekly if its content changes frequently.

Consider Hiring a Professional Designer

Pros can do it a lot faster and better than you can. However, don't give designers free rein to do whatever they want to with your site. Make sure it meets your criteria for an effective site that can sell.

Entrepreneurs must remember that on the Web every company, no matter how big or small it is, has the exact same screen size for its site. What matters most is not the size of your company but how you put that screen size to use.



In the Entrepreneurial Spotlight

Web Site Makeovers

Favi Entertainment

In 2006, Jeremy Yakel launched Favi Entertainment, a provider of electronic devices and accessories including televisions, projection systems, wireless keyboards, and screens that use the latest technology. The company, headquartered in Macomb, Michigan, targets professionals, educators, and home enthusiasts with its high-performing yet affordable devices and generates \$2.6 million in annual sales. Favi Entertainment's Web site contributed only a paltry \$6,000 to the company's annual sales, and Yakel knew that the site was underperforming because it was disorganized and cluttered. "We had grown into a premier manufacturer of consumer electronics, and our site just didn't say that to our customers," admits Yakel.

Yakel and his team of 12 employees undertook a complete overhaul to fix the Web site's problems. The overriding goals were to make the site cleaner and easier to navigate and to improve customers' shopping experience. They started by studying the existing site's Google Analytics report to determine what customers were looking for and how they moved around the Web site. The team improved the site's content, adding more descriptive product explanations and product videos, and used Google's Keyword Tool to upgrade the site's metatags to include the terms that electronics shoppers enter most frequently into the search engine. They also added a foreign currency conversion tool to make shopping easier for customers outside the United States to make purchases. The team's next step was to integrate an e-commerce platform that provides international shoppers with shipping costs, delivery dates, and multilingual customer support and invoices.

Yakel spent \$3,900 revamping the Favi Entertainment Web site, an investment that has paid off well. The company's shopping cart abandonment rate declined 43 percent almost immediately, and the site was on track to generate sales of \$244,000 in the first year.

SKLZ

John Sarkasian started Pro Performance Sports in 2002 to market the Hit-A-Way baseball swing training device that he had developed. In 2005, Sarkasian began marketing a line of athletic training products under the SKLZ brand through its own Web site and through sporting goods retailers around the United States. He then launched an interactive, online training program

under the SKLZ label to teach athletes how to get the greatest benefit from the company's training products. The training program includes postworkout snacks and techniques that help injuries heal faster. Sarkasian wanted to differentiate his company by emphasizing the unique value that the combination of its training devices and online training program provided customers and saw the SKLZ Web site as the ideal place to start. "We're delivering not only hardware—the training devices—but also content for the athlete," he says. His goal is to make SKLZ a destination site for athletes who want the equipment and the skills to train properly.

Sarkasian knew that he would have to overhaul the SKLZ Web site to accomplish his goal. The first change was beefing up the content of the site to include more custom text rather than generic descriptions of the equipment the company sells. Shoppers can browse the site by sport or by specific skills they want to improve. Those who sign up to receive the SKLZ e-mail newsletter receive a 10 percent discount on their online purchases. SKLZ also added video content, creating videos that show customers how to use 83 of its top-selling pieces of equipment. Sarkasian's team also added QR codes on all of its product packaging that customers in retail stores can scan with their smart phones or tablets to access Web pages that contain detailed information and instructional videos about a particular piece of equipment.

Sarkasian invested "hundreds of thousands of dollars" on the Web site overhaul but says that "it's been absolutely worth it." Sales of performance training tools are running 41 percent higher than the company's forecast, and SKLZ total revenue have increased 140 percent since the site relaunched. Sarkasian says that revamping the Web site was essential to the company's long-term success.

1. What lessons about developing the proper e-commerce strategy can you learn from Favi Entertainment and SKLZ?
2. What advice can you offer the management teams at Favi Entertainment and SKLZ as they continue to develop their e-commerce strategies? What additional steps can they take to stay connected to their customers and to keep their customers coming back to their Web sites?

Sources: Based on Gwen Moran, "System Rebuild," *Entrepreneur*, February 2012, p. 45; Gwen Moran, "They've Got SKLZ," *Entrepreneur*, January 2012, p. 43; Tanya Mannes, "SKLZ Aims to Help Amateur Athletes Improve Skills," *U-T San Diego*, September 3, 2011, www.utsandiego.com/news/2011/sep/03/sklz-aims-to-help-amateur-athletes-improve-skills.

Tracking Web Results

Software Solutions

Web sites offer entrepreneurs a treasure trove of valuable information about how well their sites are performing—if they take the time to analyze it. **Web analytics**, tools that measure a Web site's ability to attract customers, generate sales, and keep customers coming back, help entrepreneurs to know what works—and what doesn't—on their sites. Online companies that use Web analytics have an advantage over those that do not. Their owners can review the data collected from their customers' Web site activity, analyze them, make adjustments to the Web site, and then start the monitoring process over again to see whether the changes improve the site's performance. In other words, Web analytics give entrepreneurs the ability to apply the principles of continuous improvement to their sites. In addition, the changes these e-business owners make are based on facts (the data from the Web analytics) rather than on mere guesses about how customers interact with a site. Avi Steinlauf, president of automotive guide publisher *Edmunds.com*, uses an app on his iPad to track the company's Web analytics on the go, giving him the ability to monitor its Web site's performance at any time from anywhere.¹⁰⁹ There are many Web analytics software packages, but effective ones offer the following types of information:

- **Commerce metrics.** These are basic analytics such as sales revenue generated, number of items sold, which products are selling best (and which are not), and others.
- **Visitor segmentation measurements.** These measurements provide entrepreneurs valuable information about online shoppers and customers, including whether they are return customers or new customers, how they arrived at the site (e.g., via a search engine or a pay-per-click ad), which search terms they used (if they used a search engine), and others.
- **Content reports.** This information tells entrepreneurs which products customers are looking for and which pages they view most often (and least often), how they navigate through the site, how long they stay, which pages they are on when they exit, and more. Using this information, an entrepreneur can get an idea of how effective the site's design is.
- **Process measurements.** These metrics help entrepreneurs understand how their Web sites attract visitors and convert them into customers. Does the checkout process work smoothly? How often do shoppers abandon their carts? At what point in the process do they abandon them? These measures can lead to higher conversion rates for an online business.

Other common measures of Web site performance include the following:

- The **click-through rate (CTR)** is the proportion of people who see a company's online ad and actually click on it to reach the company's Web site. Each time an ad is displayed is called an impression:

$$\text{CTR} = \text{number of clicks} \div \text{number of impressions}$$

For instance, if a company's ad is displayed 500 times in one day and 12 people clicked on it, the CTR is $12 \div 500 = .024 = 2.4\%$.

- The **conversion or browse-to-buy rate** is the proportion of visitors to a site who actually make a purchase. It is one of the most important measures of Web success and is calculated as follows:

$$\text{Conversion rate} = \text{number of customers who make a purchase} \div \text{number of visitors to the site}$$

Conversion rates vary dramatically across industries but usually range from 1 to 4 percent. The average conversion rate is 2.1 percent.¹¹⁰ In other words, out of every 1,000 people who visit a Web site, on average 21 of them actually make a purchase.

- The **average number of visits per visitor (AVPV)** measures how many visitors return to a site and how many times they return. It is calculated as follows:

$$\text{AVPV} = \text{total number of visitors} \div \text{number of unique visitors}$$

The AVPV is most meaningful when measured over time.

- The **cost per acquisition (CPA)** is the cost a company incurs to generate each purchase (or customer registration):

$$\text{CPA} = \text{Total cost of acquiring a new customer} \div \text{number of new customers}$$

5.

Explain how companies track the results from their Web sites.

For example, if a company purchases an advertisement in an e-magazine for \$200 and it yields 15 new customers, then the cost of acquisition is $\$200 \div 15 = \13.33 .

- Other important metrics include landing and exit page data, keywords used, and referring URLs. Landing pages are important because not every shopper arrives via a site's home page. Are your site's landing pages producing a suitable conversion rate? Exit page data tell entrepreneurs where in the Web site shoppers tend to leave. If the same pages show up consistently, entrepreneurs should redesign them. Keywords data tell entrepreneurs which words shoppers typed into a search engine to find the site and can be a valuable tool in refining a company's SEO strategy. Referring URL data tell entrepreneurs how people arrive at the company's site. Do they type in the company's URL directly, use a search engine, or arrive from a social media site?

Ensuring Web Privacy and Security

Privacy

6.

Describe how e-businesses ensure the privacy and security of the information they collect and store from the Web.

The Web's ability to track customers' every move naturally raises concerns over the privacy of the information companies collect. E-commerce gives businesses access to tremendous volumes of information about their customers, creating a responsibility to protect that information and to use it wisely. The potential for breaching customers' privacy is present in any e-business, and the results of a data breach can be devastating. A recent survey by online security firm TRUSTe reports that 89 percent of online adults avoid doing business with companies that fail to protect their privacy.¹¹¹ To make sure they are using the information they collect from visitors to their Web sites legally and ethically and safeguarding it adequately, companies should take the steps outlined in the following sections.

TAKE AN INVENTORY OF THE CUSTOMER DATA COLLECTED The first step to ensuring proper data handling is to assess exactly the type of data the company is collecting and storing. How are you collecting the information? Why are you collecting it? How are you using it? Do visitors know how you are using the data? Should you get their permission to use the data in this way? Do you use all of the data you are collecting?

DEVELOP A COMPANY PRIVACY POLICY FOR THE INFORMATION YOU COLLECT A **privacy policy** is a statement explaining the type of information a company collects online, what it does with that information, and the recourse customers have if they believe the company is misusing the information. *Every* online company should have a privacy policy, but many do not. A survey by Symantec and the National Cyber Security Alliance reports that 60 percent of small business's Web sites have no privacy policy.¹¹²

Several online privacy firms, including TRUSTe (www.truste.org), BBBOnline (www.bbbonline.com), and BetterWeb (www.betterweb.com), offer Web "seal programs," the equivalent of a Good Housekeeping seal of privacy approval. To earn a privacy seal of approval, a company must adopt a privacy policy, implement it, and monitor its effectiveness. Many of these privacy sites also provide online policy wizards, automated questionnaires that help e-business owners create comprehensive privacy statements.

POST YOUR COMPANY'S PRIVACY POLICY PROMINENTLY ON YOUR WEB SITE AND FOLLOW IT Creating a privacy policy is not sufficient; posting it in a prominent place on the Web site (accessible from every page on the site) and then abiding by it make a policy meaningful. Whether a company has a privacy policy posted prominently often determines whether customers will do online business with it. Shoppers are more likely to purchase from online merchants who have sound privacy policies and post them. One of the worst mistakes a company can make is to publish its privacy policy online and then fail to follow it. Not only is this unethical, but it also can lead to serious damage awards if customers take legal action against the company.

Security

Concerns about security and fraud present the greatest obstacles to the growth of e-commerce. A study by Kikscore reports that 90 percent of online shoppers have terminated a transaction because of security concerns.¹¹³ Indeed, cybercrime has become a serious threat to e-commerce.

victims each day and costing consumers and companies around the world \$110 billion annually.¹¹⁴ Ninety-six percent of the data that cybercriminals target involves customer records. The companies most often targeted are in the retail, food and beverage, and hospitality industries.¹¹⁵ Every company with a Web site—no matter how small—is a potential target for hackers and other cybercriminals; an alarming 36 percent of online attacks target small businesses.¹¹⁶ Hackers and attackers have become more sophisticated, which makes Web site security a top priority for every company doing business online.

A company doing business on the Web faces two conflicting goals: to establish a presence on the Web so that customers can have access to its site and the information maintained there and to preserve a high level of security so that the business, its site, and the information it collects from customers are safe from hackers and intruders intent on doing harm. According to a survey by the National Cyber Security Alliance and Symantec, 76 percent of small business owners believe that their companies are either somewhat safe or very safe from cybersecurity breaches, yet 83 percent of them have no formal cybersecurity plan (and 69 percent have no informal cybersecurity plan).¹¹⁷ Companies have a number of safeguards available to them, but hackers with enough time, talent, and determination usually can beat even the most sophisticated safety measures. If hackers manage to break into a system, they can do irreparable damage, stealing programs and sensitive customer data, modifying or deleting valuable information, changing the look and content of sites, or crashing sites altogether. Sixty percent of small companies that experience a cyberattack close within six months.¹¹⁸ In the largest data breach to date, hackers broke into the database at one retail company and stole information that included more than 45 million debit and credit card numbers.¹¹⁹ One band of cyberthieves attacked 53 small and medium-size businesses in Seattle, Washington, over a two-year period, stealing data and causing \$3 million in damages to the companies and their customers.¹²⁰ Delayed detection of cybercrimes is typical; the average time between a breach and its discovery is 210 days.¹²¹ In addition to the actual losses scams cause, another real danger is that they erode customers' confidence in e-commerce, posing real threats to every online entrepreneur.

Security threats are real for companies of every size, and entrepreneurs must contend with that reality. To minimize the likelihood of invasion by hackers and viruses, e-companies rely on several tools, including virus detection software, intrusion detection software, and firewalls. At the most basic level of protection is **virus detection software**, which scans computer drives for viruses, nasty programs written by devious hackers and designed to harm computers and the information they contain. The severity of viruses ranges widely, from relatively harmless programs that put humorous messages on a user's screen to those that erase a computer's hard drive or cause the entire system to crash. Because hackers are *always* writing new viruses to attack computer systems, entrepreneurs must keep their virus detection software up to date and must run it often. An attack by one virus can bring a company's entire e-commerce platform to a screeching halt in no time!

Intrusion detection software is essential for any company doing business on the Web. These packages constantly monitor the activity on a company's network server and sound an alert if they detect someone breaking into the company's computer system or if they detect unusual network activity. Intrusion detection software not only can detect attempts by unauthorized users to break into a computer system while they are happening but also can trace the hacker's location. Most packages also have the ability to preserve a record of the attempted break-in that will stand up in court so that companies can take legal action against cyberintruders. Web security companies such as McAfee provide software, such as ScanAlert, that scans a small business's Web site daily to certify that it is "Hacker Safe." Online companies using the software are able to post a certification mark signifying that their sites are protected from unauthorized access.

A **firewall** is software that operates between the Internet and a company's computer network that allows authorized data from the Internet to enter a company's network and the programs and data it contains but keeps unauthorized data, such as viruses, spyware, and other malware, out. The equivalent of the lock on a small company's front door, a firewall serves as the lock on its computer network's front door. Establishing a firewall is essential for any company operating on the Web, but entrepreneurs must make sure that their firewalls are set up properly. Otherwise, they are useless! Even with all of these security measures in place, it is best for a company to run its Web site on a separate server from the network that runs the business. If hackers break into the Web site, they still do not have access to the company's sensitive data and programs.

Increasing the security of a computer system requires using properly installed security tools, perhaps in multiple layers, and making sure that they function properly and are up to date. Even though 65 percent of small businesses store customer data on their computer systems, only 44 percent of small companies check their virus detection software and firewalls weekly to ensure that they are up to date (and 14 percent *never* check them).¹²² The National Cyber Security Alliance (<http://staysafeonline.org>) and the Computer Security Institute (<http://gocsi.com>) offer articles, information, and seminars to help business owners maintain computer security. *Information Security Magazine* (which can be found at <http://searchsecurity.techtarget.com>) also offers helpful advice on maintaining computer security.

In e-commerce just as in traditional retailing, sales do not matter unless a company gets paid! On the Web, customers demand transactions they can complete with ease and convenience, and the simplest way to allow customers to pay for e-commerce transactions is with credit cards. From a Web customer's perspective, however, one of the most important security issues is the security of his or her credit card information. To ensure the security of their customers' credit card information, online retailers typically use **Secure Sockets Layer technology** to encrypt customers' transaction information as it travels across the Internet. By using secure shopping cart features from storefront-building services or Internet service providers, even the smallest e-commerce stores can offer their customers secure online transactions.

Processing credit card transactions requires a company to obtain an Internet merchant account from a bank or financial intermediary. Setup fees for an Internet merchant account typically range from \$500 to \$1,000, but companies also pay monthly access and statement fees of between \$40 and \$80 plus a transaction fee of 10 to 60 cents per transaction. Once an online company has a merchant account, it can accept credit cards from online customers.

Online credit card transactions also pose a risk for merchants; online companies lose \$3.4 billion a year to online payment fraud each year, 1 percent of their sales revenue (see Figure 13.7), 41 percent of it from **charge-backs**, or online credit card transactions that customers

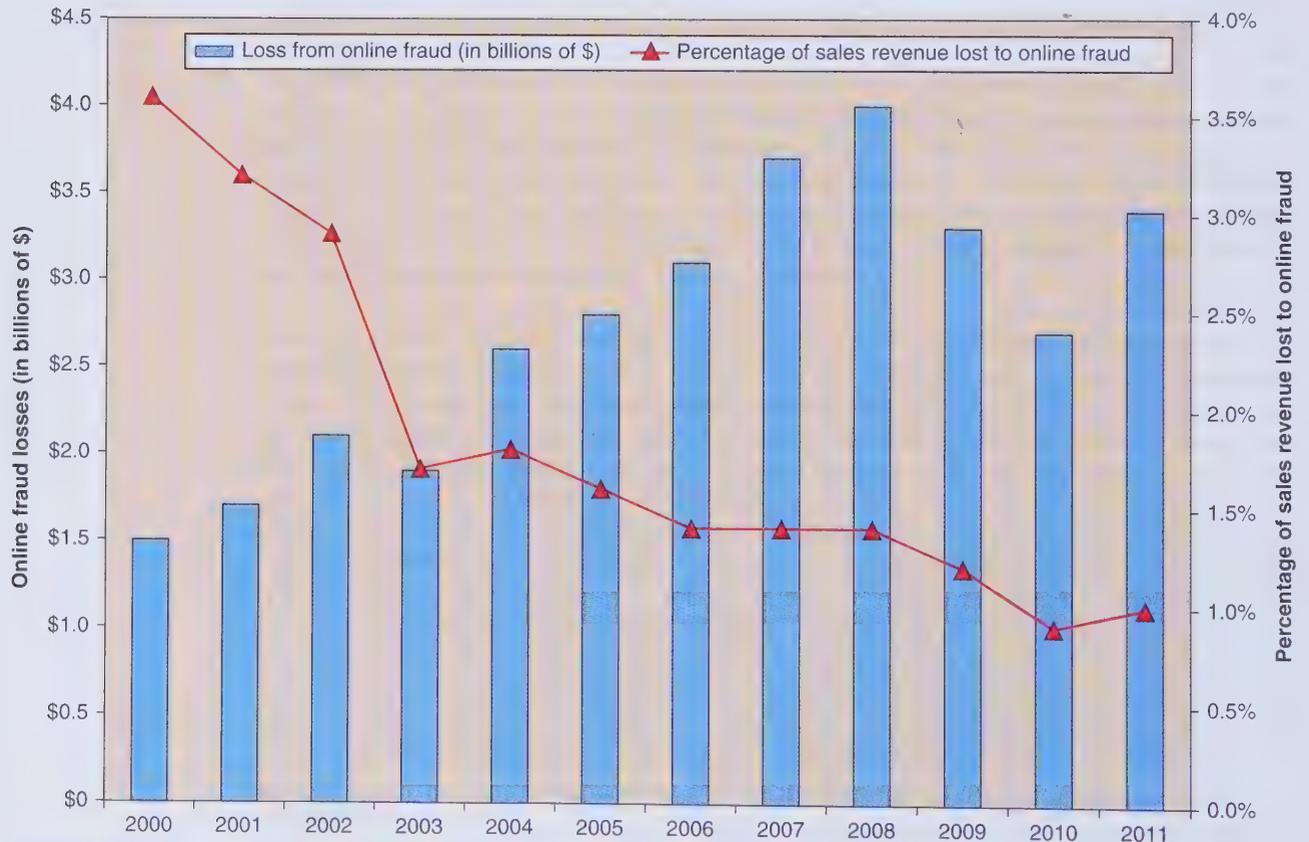


FIGURE 13.7

Losses to Online Fraud

Source: Based on Online Fraud Report: Thirteenth Annual Edition, Cybersource Corporation, Mountain View, California: 2012, p. 1.

dispute.¹²³ Good customer service minimizes the number of legitimate charge-backs. Illegitimate charge-backs usually are the result of thieves stealing credit card numbers and then using them to make online purchases. Unlike credit card transactions in a retail store, those made online (“card not present” transactions) involve no signatures, and Internet merchants incur the loss (and usually a fine from the credit card company) when a customer disputes the transaction.



ENTREPRENEURIAL PROFILE: Jamon Robinson: Sun Tints, Inc. Jamon Robinson, president of Sun Tints, Inc., a company that sells automotive accessories online and from a store in Bountiful, Utah, was frustrated that one out of every 100 online purchases resulted in a charge-back. Robinson recently signed up at *BadCustomer.com*, a Web site that allows merchants to search for customers who have a history of charge-backs, before completing a credit card sale. In the first three months since he began using the service, Robinson had refused several credit card transactions and has not had any charge-backs.¹²⁴

One way to prevent fraud is to ask customers for their card verification value (CVV, CID, or CVV2), the three-digit number above the signature panel on the back of the credit card, as well as their card number and expiration date. Online merchants also can subscribe to a real-time credit card processing service that authorizes credit card transactions, but the fees can be high. Sending confirmation e-mails that include the customer’s shipping information after receiving an order also reduces the likelihood of a charge-back. In addition, using a shipper that provides the ability to track shipments so that online merchants can prove that the customer actually received the merchandise can help minimize the threat of payment fraud.

Chapter Review

E-commerce is creating a new economy, one that is connecting producers, sellers, and customers via technology in ways that have never been possible before. In this fast-paced world of e-commerce, size no longer matters as much as speed and flexibility do. The Internet is creating a new industrial order, and companies that fail to adapt to it will fall by the wayside.

1. Understand the factors an entrepreneur should consider before launching into e-commerce.
 - Before launching an e-commerce effort, business owners should consider the following important issues:
 - How a company exploits the Web’s interconnectivity and the opportunities it creates to transform relationships with its suppliers and vendors, its customers, and other external stakeholders is crucial to its success.
 - Web success requires a company to develop a plan for integrating the Web into its overall strategy. The plan should address issues such as site design and maintenance, creating and managing a brand name, marketing and promotional strategies, sales, and customer service.
 - Developing deep, lasting relationships with customers takes on even greater importance on the Web. Attracting customers on the Web costs money, and companies must be able to retain their online customers to make their Web sites profitable.
 - Creating a meaningful presence on the Web requires an ongoing investment of resources—time, money, energy, and talent. Establishing an attractive Web site is only the beginning.

- Measuring the success of Web-based sales efforts is essential to remaining relevant to customers whose tastes, needs, and preferences are always changing.
2. Explain the 10 myths of e-commerce and how to avoid falling victim to them.
 - The 10 myths of e-commerce are the following:
 - Myth 1. If I launch a site, customers will flock to it.
 - Myth 2. Making money on the Web is easy.
 - Myth 3. Privacy is not an important issue on the Web.
 - Myth 4. “Strategy? I don’t need a strategy to sell on the Web! Just give me a Web site, and the rest will take care of itself.”
 - Myth 5. The most important part of any e-commerce effort is technology.
 - Myth 6. On the Web, customer service is not as important as it is in a traditional retail store.
 - Myth 7. Flash makes a Web site better.
 - Myth 8. It’s what’s up front that counts.
 - Myth 9. E-commerce will cause brick-and-mortar retail stores to disappear.
 - Myth 10. My business doesn’t need a Web site.
 3. Explain the basic strategies entrepreneurs should follow to achieve success in their e-commerce efforts.
 - Following are some guidelines for building a successful Web strategy for a small e-company:
 - Consider focusing on a niche in the market.
 - Develop a community of online customers.
 - Attract visitors by giving away “freebies.”
 - Make creative use of e-mail, but avoid becoming a “spammer.”
 - Make sure your Web site says “credibility.”

- Consider forming strategic alliances with larger, more established companies.
 - Make the most of the Web's global reach.
 - Promote your Web site online and off-line.
4. Learn the techniques of designing a killer Web site.
- There is no surefire formula for stopping surfers in their tracks, but the following suggestions will help:
 - Select a domain name that is consistent with the image you want to create for your company and register it.
 - Be easy to find.
 - Give customers what they want.
 - Establish hyperlinks with other businesses, preferably those selling products or services that complement yours.
 - Include an e-mail option and a telephone number in your site.
 - Give shoppers the ability to track their orders online.
 - Offer Web shoppers a special all their own.
 - Follow a simple design for your Web page.
 - Assure customers that their online transactions are secure.
 - Keep your site updated.
 - Consider hiring a professional to design your site.
5. Explain how companies track the results from their Web sites.
- Web analytics, tools that measure a Web site's ability to attract customers, generate sales, and keep customers coming back, help entrepreneurs to know what works—and what doesn't—on their sites. Information that Web analytics software provide include: commerce metrics, customer segmentation measurements, content reports, and process measurements.
6. Describe how e-businesses ensure the privacy and security of the information they collect and store from the Web.
- To make sure they are using the information they collect from visitors to their Web sites legally and ethically, companies should take the following steps:
 - Take an inventory of the customer data collected.
 - Develop a company privacy policy for the information you collect.
 - Post your company's privacy policy prominently on your Web site and follow it.
 - To ensure the security of the information they collect and store from Web transactions, companies should rely on virus and intrusion detection software and firewalls to ward off attacks from hackers.

Discussion Questions

- 13-1. How has the Internet and e-commerce changed the ways companies do business?
- 13-2. Explain the benefits a company earns by selling on the Web.
- 13-3. What are the road blocks that small companies might encounter in their endeavor to embrace e-commerce?
- 13-4. Comment on the statement, "No one will know you're on the Web unless you tell them and motivate them to visit."
- 13-5. Provide guidelines for building a successful Web strategy for a small e-company.
- 13-6. What design characteristics make for a successful Web site?
- 13-7. Explain the characteristics of an ideal domain name.
- 13-8. Describe the techniques that are available to e-companies for tracking results from their Web sites. What advantages does each offer?
- 13-9. What steps should e-businesses take to ensure the privacy of the information they collect and store from the Web?
- 13-10. What techniques can e-companies use to protect their banks of information and their customers' transaction data from hackers?
- 13-11. Discuss the various techniques of designing an attractive Web site.
- 13-12. When Matt Buchan and Alex Garcia purchased a struggling hair salon in Seattle, Washington, their turnaround strategy included using the Internet as a key component of their business and marketing strategies. What advice can you offer these entrepreneurs for integrating the Web into their hair salon to enhance their customers' experience?

CHAPTER 14

Creating a Solid Financial Plan



Learning Objectives

On completion of this chapter, you will be able to:

1. Understand the importance of preparing a financial plan.
2. Describe how to prepare financial statements and use them to manage a small business.
3. Create projected financial statements.
4. Understand the basic financial statements through ratio analysis.
5. Explain how to interpret financial ratios.
6. Conduct a break-even analysis for a small company.

Success is a lousy teacher. It seduces smart people into thinking they can't lose.

—Bill Gates

The only thing we know about the future is that it is going to be different.

—Peter F. Drucker

1.

Understand the importance of preparing a financial plan.

One of the most important steps in launching a new business venture is fashioning a well-designed, practical, realistic financial plan. Potential lenders and investors expect to see a financial plan before putting their money into a start-up company. More important, however, a financial plan is a vital tool to help entrepreneurs manage their businesses more effectively, steering their way around the pitfalls that cause failures. By understanding the assumptions that drive their financial models, entrepreneurs can better anticipate deviations from their financial forecast and take corrective actions quickly and effectively. Entrepreneurs who ignore the financial aspects of their businesses run the risk of watching their companies become another failure statistic. Many empirical studies have verified the positive correlation between the degree of planning (including financial planning) that entrepreneurs engage in and the success of their new ventures. These studies also show a significant positive relationship between formal planning by small companies and their financial performances.¹ One financial expert says of small companies, “Those that don’t establish sound controls at the start are setting themselves up to fail.”²

However, both research and anecdotal evidence suggests that a significant percentage of entrepreneurs run their companies without any kind of financial plan and never analyze their companies’ financial statements as part of the decision-making process. They generate financial statements weeks after the end of each month and pay little attention to what they tell them about their company’s performance. Why is the level of financial planning and analysis so low among entrepreneurs? The primary reason is the lack of financial know-how. One survey of small business owners by Greenfield Online found that accounting was the most intimidating part of managing their businesses and that more than half had no formal financial training at all.³ To reach profit objectives, entrepreneurs cannot afford to be intimidated by financial management and must be aware of their companies’ overall financial position and the changes in financial status that occur over time. Brian Hamilton, CEO of the financial data firm Sageworks, sees another reason why many entrepreneurs avoid accounting. “Small-business owners tend to hate accounting because it’s boring. The mistake they make is not thinking about how they can use certain numbers as tools to better manage where their business is headed tomorrow.”⁴ Norm Brodsky, a veteran entrepreneur and author, says, “When you learn the basics of accounting, you realize that the numbers aren’t as complicated as you feared and that you’re developing the knowledge you need to be in control of your company.”⁵

This chapter focuses on some very practical tools that help entrepreneurs to develop workable financial plans, keep them focused on their company’s financial plans, and enable them to create a plan for earning a profit. They can use these tools to anticipate changes and plot an appropriate profit strategy to meet them head-on. These profit planning techniques are not difficult to master, nor are they overly time consuming. We will discuss the techniques involved in preparing projected (pro forma) financial statements, conducting ratio analysis, and performing break-even analysis.

Basic Financial Reports

Before we begin building projected financial statements, it will be helpful to review the basic financial reports that measure a company’s overall financial position: the balance sheet, the income statement, and the statement of cash flows. Every business, no matter how small, will benefit from preparing these basic financial statements. Building them is the first step toward securing a small company’s financial future. Most accounting experts advise entrepreneurs to use one of the popular computerized small business accounting programs, such as Intuit’s Quickbooks, Sage 50 (or the cloud version called Sage One), or one of the other products available to manage routine record-keeping tasks that form the underlying framework of these financial statements. A survey by Microsoft, however, reports that less than half of small companies use dedicated accounting software; most use a combination of homemade spreadsheets and paper records to handle their accounting needs.⁶ Accounting software reduces the number of errors in calculations that occur when entrepreneurs try to keep records on their own. The software also easily creates reports and analyses that help improve decision making based on solid financial data. Working with an accountant to set up a smoothly functioning accounting system at the outset and then having an employee or a part-time bookkeeping service enter the transactions is most efficient for the businesses that use these packages.

2.

Describe how to prepare financial statements and use them to manage a small business.

The Balance Sheet

Like a digital camera, the balance sheet takes a “snapshot” of a business, providing owners with an estimate of the company’s worth on a given date. Its two major sections show the assets a business owns and the claims creditors and owners have against those assets. The balance sheet is usually prepared on the last day of the month and at the end of each fiscal year. Figure 14.1 shows the balance sheet for a small business, Sam’s Appliance Shop, for the year ended December 31, 2015.

The balance sheet is built on the fundamental accounting equation $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$. Any increase or decrease on one side of the equation must be offset by an equal increase or decrease on the other side, hence the name *balance sheet*. It provides a baseline from which to measure future changes in assets, liabilities, and equity (or net worth). The first section of the balance sheet lists the company’s **assets** (valued at the original cost, not actual market value) and shows the total cost value of everything the business owns. **Current assets** consist of cash and items to be converted into cash within one year or within the normal operating cycle of the company, whichever is longer, such as accounts receivable and inventory. **Fixed assets** are those acquired for long-term use in the business, such as equipment, furnishings, and buildings. **Intangible assets** include items that, although valuable, do not have tangible value, such as goodwill, copyrights, and patents.

Assets		
Current Assets		
Cash		\$49,855
Accounts Receivable	\$179,225	
Less Allowance for Doubtful Accounts	<u>\$6,000</u>	\$173,225
Inventory		\$455,455
Prepaid Expenses		<u>\$8,450</u>
Total Current Assets		\$686,985
Fixed Assets		
Land		\$59,150
Buildings	\$74,650	
Less Accumulated Depreciation	<u>\$7,050</u>	\$67,600
Equipment	<u>\$22,375</u>	
Less Accumulated Depreciation	<u>\$1,250</u>	\$21,125
Furniture and Fixtures	<u>\$10,295</u>	
Less Accumulated Depreciation	<u>\$1,000</u>	\$9,295
Total Fixed Assets		\$157,170
Intangibles (Goodwill)		<u>\$3,500</u>
Total Assets		<u>\$847,655</u>
Liabilities		
Current Liabilities		
Accounts Payable		\$152,580
Notes Payable		\$83,920
Accrued Wages/Salaries Payable		\$38,150
Accrued Interest Payable		\$42,380
Accrued Taxes Payable		<u>\$50,820</u>
Total Current Liabilities		\$367,850
Long-term Liabilities		
Mortgage		\$127,150
Note Payable		<u>\$ 85,000</u>
Total Long-term Liabilities		\$212,150
Owner's Equity		
Sam Lloyd, Capital		\$267,655
Total Liabilities and Owner's Equity		<u>\$847,655</u>

FIGURE 14.1

Balance Sheet, Sam's Appliance Shop

For Year Ending December 31,
2015.

The second section shows the business's **liabilities**—the creditors' claims against the company's assets. **Current liabilities** are those debts that must be paid within one year or within the normal operating cycle of the company, whichever is longer. **Long-term liabilities** are those that come due after one year. This section of the balance sheet also shows the **owner's equity**, the value of the owner's investment in the business. It is the balancing factor on the balance sheet, representing all of the owner's capital contributions to the business plus all accumulated earnings not distributed to the owner(s).

The Income Statement

The **income statement** (or profit and loss statement) compares expenses against revenue over a certain period of time to show the firm's net income or loss. Like a digital video recorder, the income statement provides a "moving picture" of a company's profitability over time. The annual income statement reports the bottom line of the business over the fiscal or calendar year. Figure 14.2 shows the income statement for Sam's Appliance Shop for the year ended December 31, 2015.

To calculate net income or loss, business owners record sales revenue for the year, which includes all income that flows into the business from the sale of goods and services. Income from other sources (rent, investments, interest, and others) also must be included in the revenue section of the income statement. To determine net revenue, owners subtract the value of returned items and refunds from gross revenue. **Cost of goods sold** represents the total cost of purchasing (including shipping) the merchandise that the company sells during the year. Wholesalers, manufacturers, and retailers calculate cost of goods sold by adding purchases to beginning inventory and subtracting ending inventory. Service companies typically have no cost of goods sold.

Subtracting the cost of goods sold from net sales revenue results in a company's **gross profit**. Allowing the cost of goods sold to get out of control whittles away a company's gross profit, virtually guaranteeing a net loss at the bottom of the income statement. Dividing gross profit by net sales revenue produces the **gross profit margin**, a percentage that every entrepreneur should watch closely. If a company's gross profit margin slips too low, it is likely that it will operate at a loss (negative net income). A declining gross profit margin also restricts a company's ability to invest in revenue-generating activities such as marketing, advertising, and business development.

Many business owners whose companies are losing money mistakenly believe that the problem is inadequate sales volume; therefore, they focus on pumping up sales at any cost. In many

Source: CartoonStock.



"Take this and have a masseuse massage the numbers until they fit into our proposed profit projections."

Uploaded By: anonymous

Net Sales Revenue		\$1,870,841
Cash Sales	\$561,252	
Credit Sales	\$1,309,589	
Cost of Goods Sold		
Beginning Inventory, 1/1/15	\$805,745	
+ Purchases	\$939,827	
Goods Available for Sale	\$1,745,572	
– Ending Inventory, 12/31/15	\$455,455	
Cost of Goods Sold		\$1,290,117
Gross Profit		\$580,724
Operating Expenses		
Advertising	\$139,670	
Insurance	\$46,125	
Depreciation		
Building	\$18,700	
Equipment	\$9,000	
Salaries	\$224,500	
Travel	\$4,000	
Entertainment	\$2,500	
Total Operating Expenses		\$444,495
General Expenses		
Utilities	\$5,300	
Telephone	\$2,500	
Postage	\$1,200	
Payroll Taxes	\$25,000	
Total General Expenses		\$34,000
Other Expenses		
Interest Expense	\$39,850	
Bad Check Expense	\$1,750	
Total Other Expenses		\$41,600
Total Expenses		\$520,095
Net Income		<u>\$60,629</u>

FIGURE 14.2
Income Statement, Sam's Appliance Shop
 For Year Ending December 31, 2015.

cases, however, the losses are due to an inadequate gross profit margin, and pumping up sales only deepens their losses! Repairing a poor gross profit margin requires a company to raise prices, cut manufacturing or purchasing costs, refuse orders with low profit margins, or add new products with more attractive profit margins. *Increasing sales will not resolve the problem.* One business owner admits that he fell victim to this myth of profitability. His company was losing money, and in an attempt to correct the problem, he focused his efforts on boosting sales. His efforts were successful, but the results were not. The costs he incurred to add sales produced withering gross profit margins, and by the time he deducted operating costs, the business incurred an even greater net loss! Cash flow suffered, the business could not pay its bills on time, and the owner ended up filing for Chapter 11 bankruptcy. Now a successful business owner, this entrepreneur says, “Ever since, I’ve tracked my gross [profit] margins like a hawk.”⁷ Monitoring the gross profit margin over time and comparing it to those of other companies in the same industry are important steps to maintaining a company’s long-term profitability.

Operating expenses include those costs that contribute directly to the manufacture and distribution of goods. General expenses are indirect costs incurred in operating the business. “Other expenses” is a catchall category covering all other expenses that don’t fit into the other two categories. Total revenue minus total expenses gives the company’s **net income (or loss)**. Reducing expenses increases the company’s net income, and even small reductions in expenses can add up to big savings.



ENTREPRENEURIAL PROFILE: Peter Jupp: Infocore Peter Jupp, owner of direct-marketing firm Infocore, was facing huge losses in 2008 due to the financial downturn and accounting mistakes that had occurred over the previous three years. “When your financial basis is threatened, and you start to wonder about the viability of the business you own and run, everything seems bleak,” said Jupp. He decided to “face the headwinds and deal with it.” Judd cut Infocore’s expenses across the board, including reducing his staff by half and slashing travel and client entertainment budgets (Infocore’s biggest cost categories). Judd was able to reduce his operating costs by 34 percent, thus saving the company and positioning it for future, more profitable growth.⁸

Business owners must be careful when embarking on cost-cutting missions, however. Although minimizing costs can improve profitability, entrepreneurs must be judicious in their cost cutting, taking a strategic approach rather than imposing across-the-board cuts. Brad Smith, CEO of Intuit, a company that makes software and provides business services for small businesses, knows that research and development and product innovation are keys to the company’s success. “We’re not going to cut innovation,” he vows. “For 25 years, this company has been fueled by new product innovation. We’re protecting the innovation pipeline so that [our future] is strong.”⁹ Cutting costs in areas that are vital to a company’s success—such as a retail jeweler cutting its marketing budget during a recession—can inhibit its ability to compete and do more harm than good. In fact, a study by McGraw-Hill Research reports that companies that advertise consistently even during recessions perform better in the long run; companies that advertised aggressively during a recent recession generated sales that were 256 percent higher than those that did not advertise consistently.¹⁰

In other cases, entrepreneurs on cost-cutting vendettas alienate employees and sap worker morale by eliminating nitpicking costs that affect employees but retaining expensive perks for themselves. One business owner enraged employees by cutting the budget for the company Christmas party to \$5 (for the whole event) and encouraging employees not to skip lines on interoffice envelopes (which, one worker calculated, cost the company \$0.0064 per skipped line). Although his reasons for cutting costs were valid, this CEO lost all credibility because employees knew that when he traveled, he stayed only at upscale, butler-serviced hotels and had a chauffeur drive him to work every day!¹¹

The Statement of Cash Flows

The **statement of cash flows** shows the changes in a company’s working capital from the beginning of the accounting period by listing the sources of funds and the uses of these funds. Many small businesses never need such a statement; instead, they rely on a cash budget, a less formal managerial tool that tracks the flow of cash into and out of a company over time. (We will discuss cash budgets in Chapter 15.) Sometimes, however, creditors, lenders, investors, or business buyers may require this information.

To prepare the statement of cash flows, owners must assemble the balance sheets and the income statements summarizing the year’s operations. They begin with the company’s net income for the accounting period (from the income statement). Then they add the sources of funds—borrowed funds, owner contributions, decreases in accounts payable, decreases in inventory, depreciation, and any others. Depreciation is listed as a source of funds because it is a noncash expense that is deducted as a cost of doing business. Because the owners have already paid for the item being depreciated, its depreciation is a source of funds. Next the owners subtract the uses of these funds—plant and equipment purchases, dividends to owners, repayment of debt, increases in accounts receivable, decreases in accounts payable, increases in inventory, and so on. The difference between the total sources and the total uses of funds is the increase or decrease in working capital. By investigating the changes in their companies’ working capital and the reasons for them, owners can create a more practical financial plan of action for the future.

These statements are more than just complex documents used only by accountants and financial officers. When used in conjunction with the analytical tools described in the following sections, they can help entrepreneurs map their companies’ financial future and actively plan for profit. Merely preparing these statements is not enough, however; entrepreneurs and their employees must *understand and use* the information contained in them to make their businesses more effective and efficient.

Creating Projected Financial Statements

Creating projected financial statements helps entrepreneurs transform their business goals into reality. These projected financial statements answer questions such as the following: What profit can the business expect to earn? If the founder's profit objective is x dollars, what sales level must the business achieve? What fixed and variable expenses can the owner expect at that level of sales? The answers to these and other questions are critical in formulating a successful financial plan for the small business.

This section focuses on creating projected income statements and balance sheets for a small business. These projected (pro forma) statements estimate the profitability and the overall financial condition of the business in the immediate future. They are an integral part of convincing potential lenders and investors to provide the financing needed to get the company off the ground or to expand. In addition, because these statements forecast a company's financial position, they help entrepreneurs plan the route to improved financial strength and healthy business growth. In other words, they lay the foundation for a pathway to profitability.

Because an established business has a history of operating data from which to construct projected financial statements, the task is not nearly as difficult as it is for a brand-new business. When creating projected financial statements for a business start-up, entrepreneurs often rely on published statistics summarizing the operation of similar-size companies in the same industry. These statistics are available from a number of sources (described later), but this section draws on information found in *RMA's Annual Statement Studies*, published by the Risk Management Association (RMA), a compilation of financial data on thousands of companies across hundreds of industries (organized by North American Industry Classification (NAICS) and Standard Industrial Classification (SIC) codes). However, developing a sound business model and business plan (discussed in Chapter 8) helps an entrepreneur develop a realistic financial plan for the specific market segment in which he or she is launching a business. Entrepreneurs should use published industry financial data as a guide for validating their own financial projections. Because conditions and markets change so rapidly, entrepreneurs developing financial forecasts for start-ups should focus on creating projections for two years into the future. Investors mainly want to see that entrepreneurs have realistic expectations about their companies' income and expenses and when they expect to start earning a profit.

Projected Statements for the Small Business

One of the most important tasks confronting an entrepreneur is to determine the capital required to launch the business and to keep going until it begins to generate positive cash flow. The amount of money needed to begin a business depends on the type of operation, its location, inventory requirements, sales volume, credit terms, and other factors. Every new company must have enough capital to cover all start-up costs, including funds to rent or buy plant, equipment, and tools, as well as to pay for employees' salaries and wages, advertising, licenses, insurance, utilities, travel, and other expenses. In addition, the entrepreneur must maintain a reserve of capital to carry the company until it begins to produce positive cash flow. Too often, entrepreneurs are overly optimistic in their financial plans and fail to recognize that expenses initially exceed income for most start-ups, which creates a drain on their cash flow. This period of net losses and the resulting cash drain is normal and may last from just a few months to several years. During this time, entrepreneurs must be able to meet payroll, maintain adequate inventory, take advantage of cash discounts, pay all other business expenses, grant customer credit, and meet their personal obligations. Figure 14.3 provides a model that shows the connections among the various financial forecasts (income statement, balance sheet, and cash flow) entrepreneurs should include in their business plans.

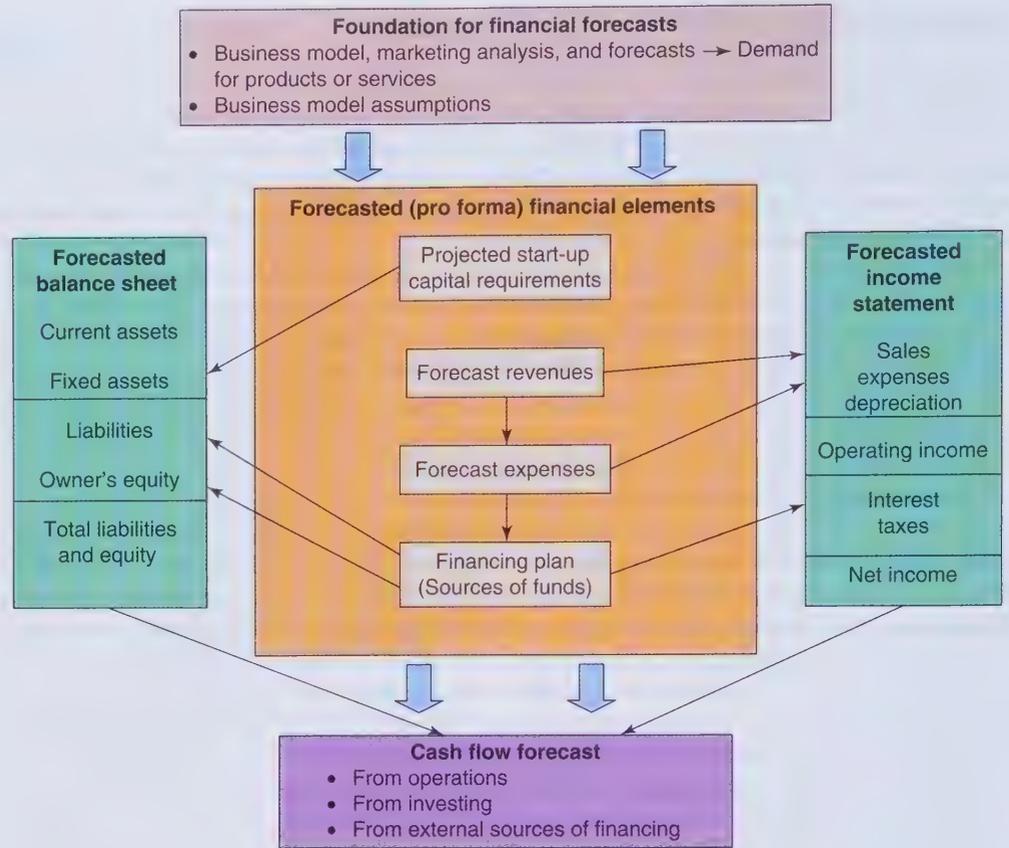
THE PROJECTED INCOME STATEMENT When creating a projected income statement, the first step is to create a sales forecast. An entrepreneur has two options: develop a sales forecast and work down or set a profit target and work up. Many entrepreneurs prefer to use the latter method—targeting a profit figure and then determining the sales level they must achieve to reach it. This approach allows entrepreneurs to better match the size of the businesses to their goals and aspirations, both financial and lifestyle. Of course, it is important to compare this sales target against the results of the marketing plan to determine whether it is realistic. Although all financial

3.
Create projected financial statements.

FIGURE 14.3

Financial Forecasting Model

Source: Adapted from Benjamin B. Gaunsel, "Toward a Framework of Financial Planning in New Venture Creation," presented at the annual meeting of United States Association for Small Business and Entrepreneurship, January 2005, Palm Springs, California, www.sbaer.uca.edu/research/usasbe/2005/pdffiles/papers/25.pdf.



forecasts are projections, they must be based in reality; otherwise, they are nothing more than hopeless dreams. This is why it is so important to test the business model with real customers to develop **proof of concept** for a new venture.

The next step is to estimate all of the expenses the business will incur to generate those sales. In any small business, the resulting profit must be large enough to produce a return for the time the owners spend operating the business and a return on their financial investment in the business. Ideally, a small company's net income after taxes should be at least as much as the owner could earn by working for someone else. An adequate profit must also include a reasonable return on the owner's total financial investment in the business. If a would-be owner has \$200,000 and can invest it in securities that earn 8 percent, pouring the money into a small business that yields only 3 percent may not be the best course of action.

An entrepreneur's target income is the sum of a reasonable salary for the time spent running the business and a normal return on the amount invested in the firm. Determining this amount is the first step in creating the pro forma income statement.

The next step is to translate this target profit into a sales estimate for the forecasted period. To calculate net sales from a target profit, the owner needs published statistics for this type of business. Suppose an entrepreneur wants to launch a small retail flower shop and has determined that his target net income is \$30,000 for the upcoming year. Interviews with entrepreneurs already in the industry and through statistics gathered from the *RMA Annual Statement Studies* show that the typical florist's net profit margin (Net profit ÷ Sales) is 7.2 percent. Using this information, he can compute the sales level required to produce a net profit of \$30,000:

$$\text{Net profit margin} = \frac{\text{Net profit}}{\text{Sales (annual)}}$$

Solving for net sales produces the following result:

$$\begin{aligned} \text{Sales} &= \frac{\$30,000}{0.072} \\ &= \$416,667 \end{aligned}$$

Now the entrepreneur knows that to earn a net profit of \$30,000 (before taxes), he must achieve annual sales of \$416,667. To complete the projected income statement, he simply applies the appropriate statistics from the *RMA Annual Statement Studies* to the annual sales figure. Because the statistics for each income statement item are expressed as percentages of sales, he merely multiplies the proper statistic by the annual sales figure to obtain the desired value. For example, cost of goods sold usually comprises 46.6 percent of sales for the typical small flower shop. The owner of this new flower shop expects the cost of goods sold to be the following:

$$\text{Cost of goods sold} = \$416,667 \times 46.6\% = \$194,167$$

The flower shop's complete projected income statement is shown as follows:

Net sales	(100%)	\$416,667
–Cost of goods sold	(46.6%)	194,167
Gross profit margin	(53.4%)	\$222,500
–Operating expenses	(46.2%)	192,500
Net income (before taxes)	(7.2%)	<u>\$30,000</u>

At this point, the business appears to be a lucrative venture. But remember that this income statement represents a goal that the entrepreneur may not be able to attain. The next step is to determine whether this required sales volume is reasonable. One useful technique is to break down the required annual sales volume into daily sales figures. Assuming that the shop will be open six days per week for 52 weeks (312 days), the owner must average \$1,335 per day in sales:

$$\begin{aligned} \text{Average daily sales} &= \frac{\$416,667}{312 \text{ days}} \\ &= \$1,335/\text{day} \end{aligned}$$

We can break down this estimate even further. If the store will be open 10 hours a day, the owner must average \$133.50 in sales every hour the store is open. If the average customer spends \$20, the store must average about 7 customers per hour (\$133.50 sales per hour \div \$20 spent per customer = 6.675). This calculation gives the owner a better perspective of the sales required to yield an annual profit of \$30,000.

To determine whether the profit expected from the business will meet or exceed the entrepreneur's target income, the prospective owner should create an income statement based on a realistic sales estimate. The previous analysis showed this entrepreneur the sales level necessary to reach the desired profit of \$30,000. But what happens if sales are lower or higher? To answer that question, he must develop a reliable sales forecast using the market research techniques described in Chapter 9.

Suppose that by gathering information from the industry trade association and conducting a marketing survey of local customers, the prospective florist projects first-year sales for the proposed business to be only \$395,000. Using this expected sales figure to develop a pro forma income statement yields the following result:

Net sales	(100%)	\$395,000
–Cost of goods sold	(46.6%)	184,070
Gross profit margin	(53.4%)	210,930
–Operating expenses	(46.2%)	182,490
Net income (before taxes)	(7.2%)	<u>\$28,440</u>

Based on sales of \$395,000, this entrepreneur should expect a net income (before taxes) of \$28,440. If this amount is acceptable as a return on the investment of time and money in the business, he should proceed with his planning.

When developing the financial plan, the entrepreneur should create a more detailed picture of the company's expected operating expenses. One method is to use the statistics found

in publications such as *Dun & Bradstreet's Cost of Doing Business* or reports from industry trade associations. These publications document selected operating expenses (expressed as a percentage of net sales) for different lines of businesses. Although publications such as these offer valuable guidelines for preparing estimates of expenses, the most reliable estimates of a start-up company's expenses are those that entrepreneurs develop for their particular locations. Expenses such as rent, wages, salaries, benefits, utilities, and others vary dramatically from one part of the nation to another, and entrepreneurs must be sure that their forecasted expenses reflect the real cost of operating their particular businesses. Internet searches and a few telephone calls usually produce the necessary cost estimates.

To ensure that they have overlooked no business expenses in preparing their business plans, entrepreneurs should list all of the initial expenses they will incur and have an accountant review the list. Figures 14.4 and 14.5 show two useful forms designed to help assign dollar values to anticipated expenses. Totals derived from this list of expenses should approximate the total expense figures calculated from published statistics. Naturally, an entrepreneur should be more confident of the total from his or her own list of expenses because this reflects his or her particular set of circumstances.

Entrepreneurs who follow the top-down approach to building an income statement—developing a sales forecast and working down to net income—must be careful to avoid falling into the trap of excessive optimism. Many entrepreneurs using this method overestimate their anticipated revenues and underestimate their actual expenses, and the results can be disastrous. To avoid this problem, some experts advise that entrepreneurs use the rule that many venture capitalists apply when they evaluate business start-ups: Divide revenues by two, multiply expenses by two, and, if the business can still make it, it's a winner!

THE PROJECTED BALANCE SHEET In addition to projecting the small company's net profit or loss, the entrepreneur must develop a pro forma balance sheet outlining the fledgling company's assets and liabilities. Most entrepreneurs' primary focus is on the potential profitability of their businesses, but the assets their businesses use to generate profits are no less important. In many cases, small companies begin life on weak financial footing because their owners fail to determine their firms' total asset requirements. To prevent this major oversight, the entrepreneur should prepare a projected balance sheet listing every asset the business will need and all the claims against these assets.

ASSETS Cash is one of the most useful assets the business owns; it is highly liquid and can quickly be converted into other tangible assets. But how much cash should a small business have at its inception? Obviously, there is no single dollar figure that fits the needs of every small firm. One practical rule of thumb, however, suggests that the company's cash balance should cover its operating expenses (less depreciation, a noncash expense) for one inventory turnover period. Using this rule, we can calculate the cash balance for the small flower shop as follows:

$$\begin{aligned}
 \text{Operating expenses} &= \$182,490 \text{ (from projected income statement)} \\
 \text{Less Depreciation (1.9\% of annual sales)} &= \$7,505 \text{ (a noncash expense)} \\
 \text{Equals Cash expenses (annual)} &= \$174,985 \\
 \text{Cash requirement} &= \frac{\text{Cash expenses}}{\text{Average inventory turnover ratio}} \\
 &= \frac{\$174,985}{13.6^*} \\
 &= \$12,867
 \end{aligned}$$

*from the *RMA Annual Statement Studies*

Notice the inverse relationship between a small company's average inventory turnover ratio and its cash requirements. The faster a business turns its inventory, the shorter the time its cash is tied up in inventory and the smaller is the amount of cash at start-up the company requires. For instance, if this florist could turn its inventory 17 times per year, its cash requirement would be \$10,293 ($\$174,985 \div 17$).

ITEM	COLUMN 1	COLUMN 2	COLUMN 3
Estimated Monthly Expenses	Your estimate of monthly expenses based on sales of \$ _____ per year.	Your estimate of how much cash you need to start your business. (See column 3.)	What to put in column 2. (These figures are typical for one kind of business. You will have to decide how many months to allow for in your business.)
Salary of owner-manager	\$	\$	2 times column 1
All other salaries and wages			3 times column 1
Rent			3 times column 1
Advertising			3 times column 1
Delivery expense			3 times column 1
Supplies			3 times column 1
Telephone and telegraph			3 times column 1
Other utilities			3 times column 1
Insurance			Payment required by insurance company
Taxes, including Social Security			4 times column 1
Interest			3 times column 1
Maintenance			3 times column 1
Legal and other professional fees			3 times column 1
Miscellaneous			3 times column 1
Start-up costs you have to pay only once			Leave column 2 blank
Fixtures and equipment			Fill in worksheet 3 and put the total here
Decorating and remodeling			Talk it over with a contractor
Installation of fixtures and equipment			Talk to suppliers from whom you buy these
Starting inventory			Suppliers will probably help you estimate this
Deposits with public utilities			Find out from utilities companies
Legal and professional fees			Lawyer, accountant, and so on
Licenses and permits			Find out from city offices what you have to have
Advertising and promotion for opening			Estimate what you'll use
Accounts receivable			What you need to buy more stock until credit customers pay
Cash			For unexpected expenses or losses, special purchases, etc.
Other			Make a separate list and enter total
Total Estimated Cash You Need to Start		\$	Add up all the numbers in column 2

FIGURE 14.4

Anticipated Expenses

Source: U.S. Small Business Administration, *Checklist for Going into Business*, Small Marketers Aid No. 71 (Washington, DC: Government Printing Office, 1982), pp. 6–7.

List of Furniture, Fixtures, and Equipment					
Leave out or add items to suit your business. Use separate sheets to list exactly what you need for each of the items below.	If you plan to pay cash in full, enter the full amount below and in the last column.	If you are going to pay by installments, fill out the columns below. Enter in the last column your down payment plus at least one installment.			Estimate of the cash you need for furniture, fixtures, and equipment.
		Price	Down payment	Amount of each installment	
Counters	\$	\$	\$	\$	\$
Storage shelves and cabinets					
Display stands, shelves, tables					
Cash register					
Safe					
Window display fixtures					
Special lighting					
Outside sign					
Delivery equipment if needed					
Total Furniture, Fixtures, and Equipment (enter this figure also in worksheet 2 under Starting Costs You Have to Pay Only Once)					\$

FIGURE 14.5
Anticipated Expenditures for Fixtures and Equipment

Source: U.S. Small Business Administration, *Checklist for Going into Business*, Small Marketers Aid No. 71 (Washington, DC: Government Printing Office, 1982), pp. 6–7.

Inventory Another decision facing the entrepreneur is how much inventory the business should carry. An estimate of the inventory needed can be calculated from the information found on the projected income statement and from published statistics:

$$\text{Cost of goods sold} = \$184,070 \text{ (from projected income statement)}$$

$$\text{Average inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Inventory level}} = 13.6 \text{ times/year}$$

Rearranging the equation to solve for inventory level produces the following:

$$\text{Inventory level} = \frac{\$184,070}{13.6 \text{ times/year}} = \$13,535$$

The entrepreneur also includes \$1,800 in miscellaneous current assets. Suppose the estimate of fixed assets is as follows:

Fixtures (including refrigeration units)	\$54,500
Office equipment	5,250
Computers/cash register	5,125
Signs	7,200
Miscellaneous	1,500
	<hr/> \$73,575

LIABILITIES To complete the projected balance sheet, the owner must record all of the small company’s liabilities, the claims against the assets. The florist was able to finance 50 percent of inventory and fixtures (\$34,018) through suppliers and has a short-term note payable of \$3,750. The only other major claim against the store’s assets is a note payable to the entrepreneur’s father-in-law for \$25,000. The difference between the company’s total assets (\$101,776) and its

Assets		Liabilities	
Current Assets		Current Liabilities	
Cash	\$12,867	Accounts Payable	\$34,018
Inventory	13,535	Note Payable	3,750
Miscellaneous	1,800		
Total Current Assets	\$28,201	Total Current Liabilities	\$37,768
Fixed Assets		Long-term Liabilities	
Fixtures	\$54,500	Note Payable	\$25,000
Office equipment	5,250		
Computers/Cash register	5,125	Total Liabilities	\$62,768
Signs	7,200		
Miscellaneous	1,500		
Total Fixed Assets	\$73,575	Owner's Equity	\$39,008
Total Assets	<u>\$101,776</u>	Total Liabilities and Owner's Equity	<u>\$101,776</u>

FIGURE 14.6
Projected Balance Sheet
for a Small Flower Shop

total liabilities (\$62,768) represents the owner's investment in the business (owner's equity) of \$39,008.

The final step is to compile all of these items into a projected balance sheet, as shown in Figure 14.6.

Ratio Analysis

Would you be willing to drive a car on an extended trip without being able to see the dashboard displays showing fuel level, engine temperature, oil pressure, battery status, or the speed at which you were traveling? Not many people would! Yet many small business owners run their companies exactly that way. They never take the time to check the vital signs of their businesses using their "financial dashboards." The result: Their companies develop engine trouble, fail, and leave them stranded along the road to successful entrepreneurship.

Smart entrepreneurs know that once they have their businesses up and running with the help of a solid financial plan, the next step is to keep the company moving in the right direction with the help of proper financial controls. Establishing these controls—and using them consistently—is one of the keys to keeping a business vibrant and healthy. Business owners who don't do so often are shocked to learn that their companies are in serious financial trouble, *and they never knew it*.

A smoothly functioning system of financial controls is essential to achieving business success. These systems serve as an early warning device for underlying problems that could destroy a young business. They allow an entrepreneur to step back and see the big picture and to make adjustments in the company's strategic direction when necessary. According to one writer,

A company's financial accounting and reporting system will provide signals, through comparative analysis, of impending trouble, such as:

- Decreasing sales and falling profit margins.
- Increasing overhead.
- Growing inventories and accounts receivable.

These are all signals of declining cash flows from operations, the lifeblood of every business. As cash flows decrease, the squeeze begins:

- Payments to vendors become slower.
- Maintenance on production equipment lags.

Raw material shortages appear.

- Equipment breakdowns occur.

4. Understand the basic financial statements through ratio analysis.

All of these begin to have a negative impact on productivity. Now the downward spiral has begun in earnest. The key is hearing and focusing on the signals.¹²

What are these signals, and how does an entrepreneur go about hearing and focusing on them? One extremely helpful tool is ratio analysis. **Ratio analysis**, a method of expressing the relationships between any two accounting elements, provides a convenient technique for performing financial analysis. When analyzed properly, ratios serve as barometers of a company's financial health. Using ratios as benchmarks allows entrepreneurs to determine, for example, whether their companies are carrying excessive inventory, experiencing heavy operating expenses, collecting payments from their customers slowly, managing to pay their debts on time and to answer other questions relating to the efficient operation of their businesses. Unfortunately, few business owners actually compute financial ratios and use them in managing their businesses!

Clever business owners use financial ratio analysis to identify problems in their businesses while they are still problems, not business-threatening crises. Tracking these ratios over time permits an owner to spot a variety of “red flags” that are indications of these problem areas. This is critical to business success because an entrepreneur cannot solve problems he or she does not know exist! Business owners also can use ratio analysis to increase the likelihood of obtaining bank loans. By analyzing their financial statements with ratios, entrepreneurs can anticipate potential problems and identify important strengths in advance. When evaluating a business plan or a loan request, lenders often rely on ratio analysis to determine how well managed a company is and how solid its financial footing is.

How many ratios should a small business manager monitor to maintain adequate financial control over the firm? Only the number of accounts recorded on the company's financial statements limits the number of ratios an entrepreneur can calculate. However, tracking too many ratios only creates confusion and saps the meaning from an entrepreneur's financial analysis. The secret to successful ratio analysis is *simplicity*, focusing on just enough ratios to provide a clear picture of a company's financial standing.

12 Key Ratios

In keeping with the idea of simplicity, this section describes 12 key ratios that enable most business owners to monitor their companies' financial position without becoming bogged down in financial details. This chapter presents examples and explanations of these ratios based on the balance sheet and the income statement for Sam's Appliance Shop shown in Figures 14.1 and 14.2. We will group them into four categories: liquidity ratios, leverage ratios, operating ratios, and profitability ratios.

LIQUIDITY RATIOS **Liquidity ratios** tell whether a small business will be able to meet its maturing obligations as they come due. These ratios can forewarn entrepreneurs of impending cash flow problems. A small company with solid liquidity not only is able to pay its bills on time but also is in a position to take advantage of attractive business opportunities as they arise. Liquidity ratios measure a company's ability to convert its assets into cash quickly and without a loss of value to pay its short-term liabilities. The two most common measures of liquidity are the current ratio and the quick ratio.

1. Current Ratio The **current ratio** measures a small company's solvency by showing its ability to pay current liabilities from current assets. It is calculated in the following manner:

$$\begin{aligned}\text{Current ratio} &= \frac{\text{Current assets}}{\text{Current liabilities}} \\ &= \frac{\$686,985}{\$367,850} \\ &= 1.87:1\end{aligned}$$

Sam's Appliance Shop has \$1.87 in current assets for every \$1 it has in current liabilities.

Current assets are those that an entrepreneur expects to convert into cash in the ordinary business cycle and normally include cash, notes or accounts receivable, inventory, and any other

short-term marketable securities. Current liabilities are short-term obligations that come due within one year and include notes or accounts payable, taxes payable, and accruals.

The current ratio is sometimes called the working capital ratio and is the most commonly used measure of short-term solvency. Typically, financial analysts suggest that a small business maintain a current ratio of at least 2:1 (i.e., two dollars of current assets for every one dollar of current liabilities) to maintain a comfortable cushion of working capital. Generally, the higher a company's current ratio, the stronger its financial position, but a high current ratio does not guarantee that the company's assets are being used in the most profitable manner. For example, a business maintaining excessive balances of idle cash or overinvesting in inventory would likely have a high current ratio.

With its current ratio of 1.87:1, Sam's Appliance Shop could liquidate its current assets at 53.5% ($1 \div 1.87 = 53.5\%$) of book value and still manage to pay its current creditors in full.

2. Quick Ratio The current ratio can sometimes be misleading because it does not show the quality of a company's current assets. For instance, a company with a large number of past-due receivables and stale inventory could boast an impressive current ratio and still be on the verge of financial collapse. The **quick ratio** (or the **acid test ratio**) is a more conservative measure of a firm's liquidity because it shows the extent to which its most liquid assets cover its current liabilities. This ratio includes only a company's "quick assets"—those assets that a company can convert into cash immediately if needed—and excludes the most illiquid asset of all, inventory. It is calculated as follows:

$$\begin{aligned}\text{Quick ratio} &= \frac{\text{Quick assets}}{\text{Current liabilities}} \\ &= \frac{\$686,985 - \$455,455}{\$367,850} \\ &= 0.63:1\end{aligned}$$

Sam's has 63 cents in quick assets for every \$1 of current liabilities.

The quick ratio is a more rigorous test of a company's liquidity. It expresses capacity to repay current debts if all sales income ceased immediately. Generally, a quick ratio of 1:1 is considered satisfactory. A ratio of less than 1:1 indicates that the small company is overly dependent on inventory and on future sales to satisfy short-term debt. A quick ratio of more than 1:1 indicates a greater degree of financial security.

LEVERAGE RATIOS **Leverage ratios** measure the financing supplied by a company's owners against that supplied by its creditors; they show the relationship between the contributions of investors and creditors to a company's capital base. Leverage ratios serve as gauges of the depth of a company's debt. These ratios show the extent to which an entrepreneur relies on debt capital (rather than equity capital) to finance the business. Leverage ratios provide one measure of the degree of financial risk in a company. Generally, small businesses with low leverage ratios are less affected by economic downturns, but the returns for these firms are lower during economic booms. Conversely, small firms with high leverage ratios are more vulnerable to economic slides because their debt loads consume cash flow; however, they have greater potential for large profits. "Leverage is a double-edged sword," says one financial expert. "If it works for you, you can really build something. If you borrow too much, it can drag a business down faster than anything."¹³

Companies that end up declaring bankruptcy most often take on more debt than the business can handle.



ENTREPRENEURIAL PROFILE: Shamin Hoque: CurriesOnline Shamin Hoque, the director of CurriesOnline, co-founded the first online food ordering and reservation service dedicated to the Indian restaurants and take-away outlets in the United Kingdom in 2007. The capital needed to start the venture was \$150,000. Each of the three directors of CurriesOnline put in some money. But the venture needed more funds for operation and growth. A few investors were interested in CurriesOnline, but they expected too much equity in return. The founders wanted to retain and control over the business, especially in the early stages. So, they developed a short-term financial plan and a bank

agreed to give a loan. The entrepreneurs found it difficult to forecast the company's cash flow as it was an online business. Shamin Hoque said, "One of our biggest mistakes was not planning finances long-term. What we should have done was set out a five-year plan and considered our financial requirements on that basis."¹⁴

The following ratios help entrepreneurs keep their debt levels manageable.

3. Debt Ratio A small company's **debt ratio** measures the percentage of total assets financed by its creditors. The debt ratio is calculated as follows:

$$\begin{aligned}\text{Debt ratio} &= \frac{\text{Total debt (or liabilities)}}{\text{Total assets}} \\ &= \frac{\$367,850 + \$212,150}{847,655} \\ &= 0.68:1\end{aligned}$$

Sam's creditors have claims of 68 cents against every \$1 of assets that Sam's Appliance Shop owns, which means that creditors have contributed twice as much to the company's asset base as the company's owners have.

Total debt includes all current liabilities and any outstanding long-term notes and bonds. Total assets represent the sum of the firm's current assets, fixed assets, and intangible assets. A high debt ratio means that creditors provide a large percentage of the firm's total financing and, therefore, bear most of its financial risk. Owners generally prefer higher leverage ratios; otherwise, business funds must come either from the owners' personal assets or from taking on new owners, which requires them to surrender more control over the business. In addition, with a greater portion of the firm's assets financed by creditors, the owner is able to generate profits with a smaller personal investment. However, creditors typically prefer moderate debt ratios because a lower debt ratio indicates a smaller chance of creditor losses in case of liquidation. To lenders and creditors, high debt ratios mean a high risk of default.

4. Debt to Net Worth Ratio A small company's **debt to net worth ratio** also expresses the relationship between the capital contributions from creditors and those from owners. This ratio compares what the business "owes" to "what it is worth." It is a measure of a company's ability to meet both its creditor and its owner obligations in case of liquidation. The debt to net worth ratio is calculated as follows:

$$\begin{aligned}\text{Debt to net worth ratio} &= \frac{\text{Total debt (or liabilities)}}{\text{Tangible net worth}} \\ &= \frac{\$367,850 + \$212,150}{\$267,655 - \$3,500} \\ &= 2.20:1\end{aligned}$$

Sam's Appliance Shop owes creditors \$2.20 for every \$1 of equity that Sam owns.

Total debt is the sum of current liabilities and long-term liabilities, and tangible net worth represents the owners' investment in the business (capital + capital stock + earned surplus + retained earnings) less any intangible assets (e.g., goodwill) the company shows on its balance sheet.

The higher this ratio, the lower the degree of protection afforded creditors if the business fails. A high debt to net worth ratio means that the firm has less capacity to borrow; lenders and creditors see the firm as being "borrowed up." In addition, carrying high levels of debt limits a company's options and restricts managers' flexibility. Quite simply, there isn't much "wiggle room" with a debt-laden balance sheet. Metro-Goldwyn-Mayer (MGM), the venerable Hollywood movie studio that has produced many legendary movies since the 1920s, including *The Wizard of Oz* and *A Christmas Story*, has amassed so much debt and the resulting interest expense that it lacks the cash to produce significant numbers of films. In one recent year, MGM released only one film and had to count on DVD sales from its archive of 4,100 titles for revenue. As sales slipped, the



MGM, which released *A Christmas Story* in 1983, has been saddled with so much debt that the company lacked the cash to produce a sufficient number of new films.

Source: Everett Collection Inc.

company's earnings also fell, stretching its ability to make interest payments, and its financial fortunes continued on a vicious downward spiral, forcing the studio to file for Chapter 11 bankruptcy and reorganize.¹⁵

A low debt to net worth ratio typically is associated with a higher level of financial security, giving the business greater borrowing potential. As a company's debt to net worth ratio approaches 1:1, its creditors' interest in the business approaches that of the owners'. If the ratio is greater than 1:1, creditors' claims exceed those of the owners', and the business may be undercapitalized. In other words, the owners have not supplied an adequate amount of capital, forcing the business take on too much debt.

5. Times Interest Earned Ratio The **times interest earned ratio** is a measure of a small company's ability to make the interest payments on its debt. It tells how many times the company's earnings cover the interest payments on the debt it is carrying. This ratio measures the size of the cushion a company has in covering the interest cost of its debt load. The times interest earned ratio is calculated as follows:

$$\begin{aligned} \text{Times interest earned} &= \frac{\text{Earnings before interest and taxes (or EBIT)}}{\text{Total interest expense}} \\ &= \frac{\$60,629 + 39,850}{\$39,850} \\ &= 2.52:1 \end{aligned}$$

Sam's Appliance Shop's earnings are 2.5 times greater than its interest expense.

EBIT is the company's net income (earnings) *before* deducting interest expense and taxes; the denominator measures the amount the business paid in interest over the accounting period.

A high times interest earned ratio suggests that the company has little difficulty meeting the interest payments on its loans; creditors see this as a sign of safety for future loans. Conversely, a low ratio is an indication that the company is overextended in its debts. A company's earnings are not able to cover its debt service if this ratio is less than one. "I look for a [times interest earned] ratio of higher than three-to-one," says one financial analyst, "which indicates that management has considerable breathing room to make its debt payments. When the ratio drops below one-to-one, it clearly indicates management is under tremendous pressure to raise cash. The risk of default or bankruptcy is very high."¹⁶ Many creditors look for a times interest earned ratio of at least 4:1 to 6:1 before pronouncing a company a good credit risk.

Debt is a powerful financial tool, but companies must handle it carefully—just as a demolitionist handles dynamite. Like dynamite, too much debt can be dangerous. Trouble looms on the horizon for companies whose debt loads are so heavy that they must starve critical operations such as research and development, customer service, and others just to pay interest on the debt.

Because their interest payments are so large, highly leveraged companies find that they are

expenditures. Unfortunately, some companies go on borrowing binges, push their debt loads beyond the safety barrier, and end up struggling for survival.



ENTREPRENEURIAL PROFILE: Paige Smith: Pure Belly Wrap Paige Smith, founder of Pure Belly Wrap and mother of four, founded her company after her twins were born. The Pure Belly Wrap is a product that is designed to help pregnant women keep their skin healthy and protect their clothing from the use of body oils and butters both during and after their pregnancies. The wraps, which are made in America, are knitted from bamboo. Smith's husband was laid off from his job the day she launched the company, forcing the couple to rely on personal savings and a growing amount of debt financing to fund the business. "We put a lot of money into this," says Smith. "It's still not paying the bills. We feel like we're drowning."¹⁷

Some entrepreneurs are so averse to debt that they run their companies with a minimum amount of borrowing, relying instead on their business's cash flow to finance growth. Jerry Edwards, president of Chef's Expressions, a small catering company, manages to generate annual sales of \$2 million with just a \$20,000 line of credit. "We've always funded our growth out of cash flow," says Edwards. "I had a credit line that I didn't dip into for 10 years!"¹⁸ Growth may be slower for these companies, but their owners do not have to contend with the dangers of debt. Managed carefully, however, debt can boost a company's performance and improve its productivity. Its treatment in the tax code also makes debt financing a much cheaper means of growth than equity financing.

OPERATING RATIOS Operating ratios help entrepreneurs evaluate their companies' performances and indicate how effectively their businesses are using their resources. The more effectively entrepreneurs use their companies' resources, the less capital their businesses require. These five operating ratios are designed to help entrepreneurs spot those areas they must improve if their businesses are to remain competitive.

6. Average Inventory Turnover Ratio A small company's **average inventory turnover ratio** measures the number of times its average inventory is sold out, or turned over, during the accounting period. This ratio tells owners how effectively and efficiently they are managing their companies' inventory. It indicates whether their inventory level is too low or too high and whether it is current or obsolete and priced correctly. The average inventory turnover ratio is calculated as follows:

$$\begin{aligned} \text{Average inventory turnover ratio} &= \frac{\text{Cost of goods sold}}{\text{Average inventory}} \\ &= \frac{\$1,290,117}{(\$805,745 + \$455,455) \div 2} \\ &= 2.05 \text{ times/year} \end{aligned}$$

Sam's Appliance Shop turns its inventory about two times a year, or once every 178 days ($365 \text{ days} \div 2.05$).

Average inventory is found by adding a company's inventory at the beginning of the accounting period to the ending inventory and dividing the result by 2.

This ratio tells an entrepreneur how fast the merchandise is moving through the business and helps to balance the company on the fine line between oversupply and undersupply. To determine the average number of days units remain in inventory, the owner can divide the average inventory turnover ratio into the number of days in the accounting period (e.g., $365 \div$ average inventory turnover ratio). The result is called **days' inventory** (or **average age of inventory**). Auto dealerships often use days of inventory on hand as a measure of performance and consider 50 to 60 days' worth of new cars to be an adequate inventory. Used car dealers' goal is to have 35 to 45 days' worth of used cars in inventory. Slow-turning inventory cannibalizes car dealers' profitability because of the interest expense they incur. The National Auto Dealers Association estimates that a used car that sells within 10 to 30 days generates an average gross profit of \$2,000; however, if that same car sits on the lot for 90 days before it sells, the average gross profit falls to \$875 (an occurrence known in the industry as "rot lot").¹⁹ Companies with below-average inventory turnover ratios usually suffer from an illiquid inventory characterized by obsolescence, overstocking, stale merchandise, or poor purchasing procedures.

Businesses that turn their inventories more rapidly than average require a smaller inventory investment to produce a particular sales volume. That means that these companies tie up less cash in inventory that sits idly on shelves. For instance, if Sam's could turn its inventory four times each year instead of just two, the company would require an average inventory of just \$322,529 instead of the current level of \$630,600 to generate sales of \$1,870,841. Increasing the number of inventory turns would free up more than \$308,000 currently tied up in excess inventory! Sam's would benefit from improved cash flow and higher profits.



ENTREPRENEURIAL PROFILE: Jonathan and James Murrell: MyDormFood and Candy

Galaxy Managing inventory has been one of the biggest challenges facing Jonathan and James Murrell as they try to scale their online businesses MyDormFood and Candy Galaxy. Their inventory, all of which is perishable, grew from \$15,000 to more than \$100,000 in just six months. This rapid increase in inventory caused two major problems. First, they did not have a system for reordering and constantly ran out of their best-selling items. "When our inventory was small, we could do daily spot checks," said Jonathan Murrell, "but once we grew and moved into a warehouse, our spot-checking system was no longer adequate." The second major challenge was slow turnover. "I never really understood why companies ran large sales until I found myself sitting on \$10,000 of inventory that was nearing expiration and had not turned over in six months," said Murrell. "Cash was tight, and I did not have enough money to keep my hot-selling items in stock because so much money was tied up in slow-moving product." After identifying their slow-moving items, the Murrells ran a sale to help clear them out their slow-moving inventory and generate cash to invest in their faster-moving products.²⁰

The inventory turnover ratio can be misleading, however. For example, an excessively high ratio could mean that the firm has a shortage of inventory and is experiencing stockouts. Similarly, a low ratio could be the result of planned inventory stockpiling to meet seasonal peak demand. Another problem is that the ratio is based on an inventory balance calculated from two days out of the entire accounting period. Thus, inventory fluctuations due to seasonal demand patterns are ignored, which may bias the resulting ratio. There is no universal, ideal inventory turnover ratio. Financial analysts suggest that a favorable turnover ratio depends on the type of business, its size, its profitability, its method of inventory valuation, and other relevant factors. The most meaningful basis for comparison is other companies of similar size in the same industry (more on this later in this chapter). For instance, the typical drugstore turns its inventory about 12 times per year, but a retail shoe store averages just 2.5 inventory turns a year.

7. Average Collection Period Ratio A small company's **average collection period ratio** (or **days sales outstanding [DSO]**) tells the average number of days it takes to collect accounts receivable. To compute the average collection period ratio, you must first calculate the firm's receivables turnover. Given that Sam's *credit* sales for the year were \$1,309,589 (out of the total sales of \$1,870,841), the company's receivables turnover ratio is as follows:

$$\begin{aligned} \text{Receivables turnover ratio} &= \frac{\text{Credit sales (or net sales)}}{\text{Accounts receivable}} \\ &= \frac{\$1,309,589}{\$179,225} \\ &= 7.31 \text{ times/year} \end{aligned}$$

Sam's Appliance Shop turns its receivables 7.31 times per year. This ratio measures the number of times a company's accounts receivable turn over during the accounting period. The higher a company's receivables turnover ratio, the shorter the time lag between making a sale and collecting the cash from it.

Use the following formula to calculate a company's average collection period ratio:

$$\begin{aligned} \text{Average collection period ratio} &= \frac{\text{Days in accounting period}}{\text{Receivables turnover ratio}} \\ &= \frac{365 \text{ days}}{7.31} \\ &= 50.0 \text{ days} \end{aligned}$$

Sam's accounts receivable are outstanding for an average of 50 days. Typically, the higher a company's average collection period ratio, the greater is its chance of bad debt losses. Sales don't count unless a company collects the revenue from them!

One of the most useful applications of the collection period ratio is to compare it to the industry average and to the firm's credit terms. This comparison indicates the degree of the small company's control over its credit sales and collection techniques. Perhaps the most meaningful analysis is to compare the collection period to the company's credit terms. One rule of thumb suggests that a company's collection period ratio should be no more than one-third greater than its credit terms. For example, if a small company's credit terms are "net 30," its average collection period ratio should be no more than 40 days ($30 + 30 \times 1/3$). For this company, a ratio greater than 40 days would indicate poor collection procedures, such as sloppy record keeping or failure to send invoices promptly.



ENTREPRENEURIAL PROFILE: Paul Burns and Eric Edelson: Fireclay Tile Eric Edelson joined Paul Burns as a partner in Fireclay Tile, located in San Jose, California, which manufactures ceramic tile using recycled materials. Edelson noticed that the company's accounts receivable balance was more than \$100,000. "At first, I thought it was kind of neat since we could count on all that cash coming in," Edelson said. "But after I started digging into it, I noticed a lot of stale accounts that were more than six months overdue." The partners tightened up their credit policy by requiring customers to pay for all previous orders before they could get credit for new orders. This change reduced their outstanding accounts receivables to less than \$30,000, all of it current and more likely to be paid.²¹

Just as Eric Edelson has learned, slow payers represent great risk to small businesses. Many entrepreneurs proudly point to rapidly rising sales only to find that they must borrow money to keep their companies going because credit customers are paying their bills in 45, 60, or even 90 days instead of 30. Slow receivables often lead to a cash crisis that can cripple a business. Table 14.1 shows how lowering its average collection period ratio can save a company money.

8. Average Payable Period Ratio The converse of the average collection period ratio, the **average payable period ratio** (or **days payables outstanding [DPO]**), tells the average number of days it takes a company to pay its accounts payable. Like the average collection period, it is measured in

TABLE 14.1 How Lowering Your Average Collection Period Can Save You Money

Too often, entrepreneurs fail to recognize the importance of collecting their accounts receivable on time. After all, collecting accounts is not as glamorous or as much fun as generating sales. Lowering a company's average collection period ratio, however, can produce tangible—and often significant—savings. The following formula shows how to convert an improvement in a company's average collection period ratio into dollar savings:

$$\text{Annual savings} = \frac{(\text{Credit sales} \times \text{Annual interest rate} \times \text{Number of days average collection period is lowered})}{365}$$

where

credit sales = company's annual credit sales in dollars,

annual interest rate = the interest rate at which the company borrows money,

and number of days average collection period is lowered = the difference between the previous year's average collection period ratio and the current one.

Example

The average collection period ratio for Sam's Appliance Shop is 50 days. Suppose that the previous year's average collection period ratio was 58 days, an eight-day improvement. The company's credit sales for the most recent year were \$1,309,589. If Sam borrows money at 8.75 percent, this six-day improvement has generated the following savings for Sam's Appliance Shop:

$$\text{Savings} = \frac{\$1,309,589 \times 8.75\% \times 8 \text{ days}}{365 \text{ days}} = \$2,512$$

By collecting his accounts receivable just eight days faster on the average, Sam has saved his business more than \$2,500! Of course, if a company's average collection period ratio increases, the same calculation will tell the owner how much that change costs.

days. To compute this ratio, first calculate the payables turnover ratio. Sam's payables turnover ratio is as follows:

$$\begin{aligned}\text{Payables turnover ratio} &= \frac{\text{Purchases}}{\text{Accounts payable}} \\ &= \frac{\$939,827}{\$152,580} \\ &= 6.16 \text{ times/year}\end{aligned}$$

To find the average payable period, we use the following computation:

$$\begin{aligned}\text{Average payable period ratio} &= \frac{\text{Days in accounting period}}{\text{Payables turnover ratio}} \\ &= \frac{365 \text{ days}}{6.16} \\ &= 59.3 \text{ days}\end{aligned}$$

Sam's Appliance Shop takes an average of about 59 days to pay its accounts with vendors and suppliers.

An excessively high average payable period ratio may indicate that a company is enjoying extended credit terms from its suppliers, or it may be a sign of a significant amount of past-due accounts payable. Although sound cash management calls for business owners to keep their cash as long as possible, slowing payables too drastically can severely damage a company's credit rating.

Ideally, the average payable period would match (or exceed) the time it takes to convert inventory into sales and ultimately into cash. In this case, the company's vendors are financing its inventory and its credit sales. *Amazon.com* reaps the benefits of this situation. On average, it does not pay its vendors until 15 days *after* it collects payment from its customers.²²

To make this comparison, an entrepreneur subtracts the company's average collection period (DSO) from its average collection period ratio (DPO) to calculate the company's float, the net number of days of cash that flows into or out of a company. The float for Sam's Appliance Shop is the following:

$$\text{Float} = \text{DPO} - \text{DSO} = 59.3 - 50.0 \text{ days} = 9.3 \text{ days}$$

A positive value for float is desirable because it means that cash will accumulate in a company over time. Multiplying float by a company's average daily sales tells Sam how much the company's cash balance will change over the course of the year as a result of its collection and payable processes. For Sam's Appliance Shop, this is calculated as follows:

$$\text{Change in cash position} = \$1,870,841 \div 365 \text{ days} \times 9.3 \text{ days} = \$47,668$$

Another meaningful comparison for this ratio is against the credit terms offered by suppliers (or an average of the credit terms offered). If the average payable period ratio slips beyond vendors' credit terms, it is an indication that the company is suffering from cash shortages or a sloppy accounts payable procedure and that its credit rating is in danger. If this ratio is significantly lower than vendors' credit terms, it may be a sign that a business is not using its cash most effectively.

9. Net Sales to Total Assets Ratio A small company's **net sales to total assets ratio** (also called the **total assets turnover ratio**) is a general measure of its ability to generate sales in relation to its assets. It describes how productively a company employs its assets to produce sales revenue. The total assets turnover ratio is calculated as follows:

$$\begin{aligned}\text{Total assets turnover ratio} &= \frac{\text{Net sales}}{\text{Net total assets}} \\ &= \frac{\$1,870,841}{\$847,655} \\ &= 2.21:1\end{aligned}$$

Sam's Appliance Shop generates \$2.21 in sales for every dollar of assets.

The denominator of this ratio, net total assets, is the sum of all of the firm's assets (cash, inventory, land, buildings, equipment, tools—everything it owns) less depreciation. This ratio is meaningful only when compared to that of similar firms in the same industry category. A total assets turnover ratio below the industry average suggests that a small company is not generating an adequate sales volume for its asset size. In a recent National Federation of Independent Businesses survey, 19 percent of small businesses report poor sales as their number one problem.²³ If a company's sales fall too far, it operates below its break-even point and cannot stay in business for long.

PROFITABILITY RATIOS Profitability ratios indicate how efficiently a small company is being managed. They provide the owner with information about a company's ability to generate a profit. They focus on a company's "bottom line"; in other words, they describe how successfully the business is using its resources to generate a profit.

10. Net Profit on Sales Ratio The **net profit on sales ratio** (also called the **profit margin on sales** or the **net profit margin**) measures a company's profit per dollar of sales. This ratio (which is expressed as a percentage) shows the number of cents of each sales dollar remaining after deducting all expenses and income taxes. The profit margin on sales is calculated as follows:

$$\begin{aligned}\text{Net profit on sales ratio} &= \frac{\text{Net income}}{\text{Net sales}} \times 100\% \\ &= \frac{\$60,629}{\$1,870,841} \times 100\% \\ &= 3.24\%\end{aligned}$$

Sam's Appliance Shop keeps 3.24 cents in profit out of every dollar of sales it generates.

A recent study by *Inc.* magazine and Sageworks shows that the average net profit margin for privately held companies normally falls between 5 and 6.5 percent, but this ratio varies from one industry to another. The retail industry typically produces a net profit on sales ratio that falls between 2 and 4 percent, but profit margins in the health care field range between 10 and 16 percent.²⁴

If a company's profit margin on sales is below the industry average, it is a sign that its prices are relatively low, that its costs are excessively high, or both.

ENTREPRENEURIAL PROFILE: Mario Marsicano and Chris Lenox: Jellio Mario Marsicano and Chris Lenox, cofounders of Jellio, which manufactures whimsical home furnishings, found that although their company's revenues were growing fast (doubling in just one year to nearly \$900,000), profits were not following suit. The company makes products such as four-foot tall gummy-bear lamps, Rubik's Cube tables, and cupcake chairs. Because the owners made each product one at a time, the company's production and material costs were high and its profit margins were low. Marsicano and Lenox began to focus on higher-priced products that had the strongest demand, found ways to reduce the amount of materials they needed to make their products without diminishing their quality, and discovered a way to speed up and simplify manufacturing. The company now generates more than \$1 million a year in sales with solid profits.²⁵

Recall that if a company's net profit on sales ratio is excessively low, the owner should check the gross profit margin (net sales minus cost of goods sold expressed as a percentage of net sales). However, a reasonable gross profit margin varies from industry to industry. For instance, a service company may have a gross profit margin of 75 percent, whereas a manufacturer's may be 35 percent. If this margin slips too low, it puts the company's ability to generate a profit and stay in business in jeopardy.

11. Net Profit to Assets Ratio The **net profit to assets ratio** (also known as the **return on assets [ROA]**) ratio tells how much profit a company generates for each dollar of assets that it owns. This ratio describes how efficiently a business is putting to work all of the assets it owns to generate a profit. It tells how much net income an entrepreneur is squeezing from each dollar's worth of the company's assets. It is calculated as follows:



A Jellio light fixture.

Source: Jellio Inc.

$$\begin{aligned}\text{Net profit to assets ratio} &= \frac{\text{Net profit}}{\text{Total assets}} \times 100\% \\ &= \frac{\$60,629}{\$847,655} \times 100\% \\ &= 7.15\%\end{aligned}$$

Sam's Appliance shop earns a return of 7.15 percent on its asset base. This ratio provides clues about the asset intensity of an industry. Return on assets ratios that are below 5 percent are indicative of asset-intense industries that require heavy investments in assets to stay in business (e.g., manufacturing companies). Return on assets ratios that exceed 20 percent tend to occur in asset-light industries, such as business or personal services (e.g., advertising agencies and computer services). A net profit to assets ratio that is below the industry average suggests that a company is not using its assets very efficiently to produce a profit. Another common application of this ratio is to compare it to the company's cost of borrowed capital. Ideally, a company's return on assets ratio should exceed the cost of borrowing money to purchase those assets. Companies that experience significant swings in the value of their assets over the course of a year often use an average value of the asset base over the accounting period to get a more realistic estimate of this ratio.

12. Net Profit to Equity Ratio The **net profit to equity ratio** (or the **return on net worth ratio**) measures the owners' rate of return on investment. Because it reports the percentage of the owners' investment in the business that is being returned through profits annually, it is one of the most important indicators of a company's profitability or management's efficiency. The net profit to equity ratio is computed as follows:

$$\begin{aligned}\text{Net profit to equity ratio} &= \frac{\text{Net income}}{\text{Owners' equity (or net worth)}} \times 100\% \\ &= \frac{\$60,629}{\$267,655} \times 100\% \\ &= 22.65\%\end{aligned}$$

This ratio compares profits earned during the accounting period with the amount the owners have invested in the business during that time. If this interest rate on the owners' investment is excessively low, some of this capital might be better employed elsewhere. For instance, a business should produce a rate of return that exceeds its cost of capital.



In the Entrepreneurial Spotlight

Pitcher Strikes Out While Trying to Hit a Home Run

Curt Schilling had great success in major league baseball as a right-handed pitcher, including a record of 3–1 in the World Series while playing for three different teams. Besides his passion for baseball, Schilling also was an avid video gamer. After retiring from baseball, Schilling decided to pursue a second career as a video game entrepreneur.

In 2006, Schilling formed his video game company 38 Studios LLC (named after his jersey number) in Massachusetts. The company purchased existing video game companies to add their titles to the company's offerings, hoping to speed up its growth and accelerate its ability to launch a blockbuster video game. 38 Studio hired some of the best executives and developers in the gaming industry, and Schilling invested \$50 million of his own money—most of which he had saved up from his days playing baseball, to fund the company.

Four years after the launch of the company, the Rhode Island Economic Development Corporation approved a \$75 million loan guarantee to lure 38 Studios LLC from Massachusetts to Rhode Island. 38 Studios promised that they would bring more than 400 new jobs to Rhode Island within the next two years. "We need to make a statement . . . this gives us the ability to be a real player in the digital-media area," said then Rhode Island Governor Donald Carcieri, who served as chairman of board of the Economic Development Corporation. Under the terms of the deal, 38 Studios was responsible for repaying the money, but if it defaulted, the state would be responsible for paying back all guaranteed loans.

38 Studio was betting the \$133 million invested into the company on the success of its game "Kingdoms of Amalur: Reckoning," which had to sell at least 2 million copies just to

(continued)

In the Entrepreneurial Spotlight *(continued)*



Curt Schilling.

Source: Getty Images.

cover the development costs and reach its breakeven point. However, the game achieved only modest success, selling a little more than 1 million copies. While its first big game introduction was failing, the company continued to pour millions into developing what 38 Studios executives hoped would be its second big game title, "Copernicus." However, "Copernicus" never made it to market.

In May 2012, 38 Studio was unable to make a \$1.1 million loan payment to the state. The company soon laid off more than 400 employees, citing the burden of millions in state debt that it was unable to pay due to the poor performance of its first major video game launch.

38 Studio ultimately filed for Chapter 7 bankruptcy (liquidation). Court documents indicated that the studio owed \$150 million to more than 1,000 entities. The largest creditor was the Rhode Island Economic Development Corporation. At the time of its bankruptcy filing, 38 Studio had less than \$22 million in assets. Rhode Island taxpayers were left owing the balance of the \$75 million in guaranteed loans to 38 Studios.

Because Shilling personally guaranteed many of the loans to 38 Studio, he was forced to sell the property he used as collateral for those loans. Among the assets he was forced to sell to help cover his personal loan guarantees were his most cherished mementos from his baseball career, including the famed "bloody sock" he wore while pitching in game 2 for the Red Sox in the 2004 World Series and a cap worn by Lou Gehrig. Shilling also was forced to sell most of his personal real estate holdings.

Shilling and other 38 Studio executives faced investigation for fraud and could face further legal actions by state and federal authorities for covering up advance knowledge that the company was failing and would be unable to pay its debts.

1. What factors contributed to the financial collapse of 38 Studio?
2. If you had advised Curt Shilling at the time he launched 38 Studio, what advice would you have offered that might have helped avoid the financial distress that both he and his company experienced?
3. Which ratios and key performance indicators would you have used to manage 38 Studio to help avoid its financial collapse?
4. Why are businesses that require high levels of investment inherently more risky? How could 38 Studio have avoided some of that risk?

Sources: Andy Smith, "Curt Schilling's Video-Game Company Gets \$75-Million Loan to Come to R.I.," *Providence Journal*, July 27, 2010, http://web.archive.org/web/20100731001844/www.projo.com/news/content/38_Studios_vote_07-27-10_JJB71G_v18.3dd3796.html; Michael del Castillo, "Failed Entrepreneur Curt Schilling's Bloody Sock on the Auction Block," *Upstart Business Journal*, January 18, 2013, <http://upstart.bizjournals.com/companies/startups/2013/01/18/38-studios-curt-schilling-selling-sock.html>; Erik Kain, "Is It Game Over for Curt Schilling's 38 Studios?," *Forbes*, May 25, 2012, www.forbes.com/sites/erikkain/2012/05/25/is-it-game-over-for-curt-schillings-38-studios.

Interpreting Business Ratios

5.

Explain how to interpret financial ratios

Ratios are useful yardsticks when measuring a small company's performance and can point out potential problems before they develop into serious crises. However, calculating these ratios is not enough to ensure proper financial control. In addition to knowing how to calculate these ratios, the owner must understand how to interpret them and apply them to managing the business more effectively and efficiently.

Not every business measures its success with the same ratios. In fact, key performance ratios vary dramatically across industries and even within different segments of the same industry. Entrepreneurs must know and understand which ratios are most crucial to their companies' success and focus on monitoring and controlling those. Many successful entrepreneurs identify or develop ratios that are unique to their own operations to help them achieve success. Known as **key performance indicators (KPIs)**, these barometers of business success measure financial and operational aspects of a company's performance. When these KPIs are headed in the right direction, a business is on track to achieve its objectives.



ENTREPRENEURIAL PROFILE: Dawn Gluskin: SolTec In 2008, Dawn Gluskin founded SolTec Electronics, a company that sells highly specialized electronic circuit board components to the electronic manufacturing and aerospace industries, from her living room. She financed her business with her savings and retirement accounts. Within two years, the company had grown to almost \$3 million in sales. “We tripled our staff size, moved from the home office, added a lab, and were spending, spending, spending on equipment,” says Gluskin. When the management team met to go over the final-quarter results from 2010, Gluskin learned that the company suffered its first-ever loss. She hired a consultant who helped develop a financial dashboard to track relevant financial results and financial ratios. The dashboard includes net account receivables, net worth, net sales, gross profit margin, and operating profit margin. Gluskin now reviews all of SolTec’s critical numbers every two weeks to stay on top of her company’s performance.²⁶

Examples of KPIs at other companies include the following:

- The load factor, the number of seats filled with passengers, on a luxury bus targeting business travelers with daily trips from downtown Boston to midtown Manhattan.²⁷
- The number of cases shipped per employee at a food distributor.
- Food costs as a percentage of sales for a restaurant. To maintain profitability, many restaurateurs strive to keep their food costs between 22 and 30 percent of sales.²⁸ At Dos Caminos, a Mexican restaurant in New York City, chef Ivy Stark’s goal is to keep the restaurant’s food cost at or below 26 percent of sales. Stark relies on a five-page spreadsheet generated each morning to keep food costs under control.²⁹
- Subscriber renewal rates at a magazine.
- Room occupancy rates at a hotel. Although a particular hotel’s break-even occupancy rate depends on its cost structure, the average occupancy rate required for hotels to break even ranges from 62 to 65 percent. Other critical numbers in the hospitality industry include the average daily room rate and the revenue per available room.³⁰
- Page rank for Internet searches on major search engines for a retailer’s Web site.
- Response time in seconds for retail mobile app sites.³¹

KPIs may be different for two companies in the same industry, depending on their strategies. The key is identifying *your* company’s KPIs, monitoring them, and then driving them in the right direction. That requires communicating the importance of KPIs to employees, explaining to them *why* these numbers are important, and giving them feedback on how well the business is achieving them.



ENTREPRENEURIAL PROFILE: Norm Brodsky: CitiStorage Over time, Norm Brodsky, owner of CitiStorage, a highly successful records-storage business in New York City that targets law firms, accounting firms, and hospitals, discovered that his company’s critical number was the number of new boxes put into storage each week, so he began tracking it closely. “Tell me how many new boxes came in during [a month],” he says, “and I can tell you our overall sales figure for [that month] within 1 or 2 percent of the actual figure.” That particular critical number surprised Brodsky because new boxes account for only a small percentage of total sales, yet new-box count was the key to allowing Brodsky to forecast his company’s future. Once, during a period of rapid growth (about 55 percent a year), Brodsky saw on his Monday morning report that the new-box count had fallen by 70 percent in the previous week. Alarmed, Brodsky temporarily stopped expanding the company’s workforce to see whether the drop was an aberration or the beginning of a business slowdown. A few weeks later, he knew that the market had changed and that sales growth indeed had slowed to 15 percent. By using his company’s critical number, Brodsky avoided excessive labor costs, a nasty cash crisis, and a morale-destroying layoff and was able to keep his company on track.³²

One of the most valuable ways to utilize ratios is to compare them with those of similar businesses in the same industry. By comparing the company’s financial statistics to industry averages, an entrepreneur can identify problem areas and develop a plan to improve them. “By themselves, these numbers are not that meaningful,” says one financial expert of ratios, “but when you compare them to [those of] other businesses in your industry, they suddenly come alive because they

The principle behind calculating these ratios and other KPIs and then comparing them to industry norms is the same as that of basic medical tests in the health care profession. Just as a healthy person's blood pressure and cholesterol levels should fall within a range of normal values, so should a financially healthy company's ratios. A company cannot deviate too far from these normal values and remain successful for long. When deviations from "normal" do occur (and they will), an entrepreneur should focus on determining the cause of the deviations. In some cases, deviations are the result of sound business decisions, such as building up inventory in preparation for the busy season, investing heavily in new technology, and others. In other cases, however, ratios that are out of the normal range for a particular type of business are indicators of what could become serious problems for a company. When comparing a company's ratios to industry standards, entrepreneurs should ask the following questions:

- Is there a significant difference in my company's ratio and the industry average?
- If so, is this a *meaningful* difference?
- Is the difference good or bad?
- What are the possible causes of this difference? What is the most likely cause?
- Does this cause require that I take action?
- What action should I take to correct the problem?

Properly used, ratio analysis can help owners identify potential problem areas in their businesses early on—*before* they become crises that threaten their very survival. Several organizations regularly compile and publish operating statistics, including key ratios, summarizing the financial performance of many businesses across a wide range of industries. The local library should subscribe to most of these publications and databases:

BizMiner. The resource provides industry financial analysis for almost 5,500 different industries, including detailed industry profit-and-loss statements, summary balance sheets, sources and uses of funds summaries, and 33 industry financial ratios.

RMA Annual Statement Studies. The Risk Management Association publishes its *Annual Statement Studies*, showing ratios and other financial data drawn from more than 280,000 companies' financial statements for more than 800 different industrial, construction, wholesale, retail, and service categories.

Dun & Bradstreet's Key Business Ratios. Since 1932, Dun & Bradstreet has published *Key Business Ratios*, which provides 30 ratios for more than 800 business categories.

Almanac of Business and Industrial Financial Ratios. This handy guide provides key ratios and financial data in 50 areas organized by company size for nearly 200 industries.

Industry Spotlight. Published by Schonfeld & Associates, this publication, which covers more than 250 industries, contains financial statement data and 17 key ratios from more than 95,000 tax returns. *Industry Spotlight* also provides detailed financial information for both profitable companies and those with losses.

Standard and Poor's Industry Surveys. In addition to providing information on financial ratios and comparative financial analysis, these surveys also contain useful details on how the industry operates, current industry trends, key terms in the industry, and others.

Online resources. Many companies publish comparative financial resources online. Some require subscriptions, but others are free:

- BizStats publishes common-size financial statements and ratios for 95 business categories for sole proprietorships, S corporations, and corporations.
- Reuters provides an overview of many industries that includes industry trends and news as well as financial ratios.
- A subscription to Lexis/Nexis allows users to view detailed company profiles, including financial reports and analysis, for publicly held companies.

Industry trade associations. Virtually every type of business is represented by a national trade association that publishes detailed financial data compiled from its membership. For example, the owner of a small coffee shop could consult the National Coffee Association

(and its newsletter, *The Coffee Reporter*), the Specialty Coffee Association of America, the International Coffee Organization, or a variety of state coffee associations for financial statistics relevant to his operation.

Government agencies. Several government agencies (Federal Trade Commission, Interstate Commerce Commission, Department of Commerce, Department of Agriculture, and Securities and Exchange Commission) offer a great deal of financial operating data on a variety of industries, although the categories are more general. In addition, the Internal Revenue Service (IRS) annually publishes *Statistics of Income*, which includes income statement and balance sheet statistics compiled from income tax returns. The IRS also publishes the *Census of Business*, which gives a limited amount of ratio information.

What Do All These Numbers Mean?

Learning to interpret financial ratios just takes a little practice! This section and Table 14.2 shows you how it's done by comparing the ratios from the operating data already computed for Sam's Appliance Shop to those taken from *BizMiner* for retail appliance stores that are of a comparable size to Sam's Appliance Shop. Calculating the variance from the industry average ((company ratio – industry average) ÷ industry average) helps entrepreneurs identify the areas in which the company is out of line with the typical company in the industry.

When comparing ratios for their individual businesses to published statistics, entrepreneurs must remember that the comparison is made against averages. Owners should strive to achieve ratios that are at least as good as these average figures. The goal should be to manage the business so that its financial performance is *better* than the industry average. As owners compare financial performance to those covered in the published statistics, they inevitably will discern differences between them. They should note those items that are substantially out of

TABLE 14.2 Ratios: Sam's Appliance Shop Versus the Industry Averages

Ratio	Sam's Appliance Shop	Industry Average	Variance
<i>Liquidity ratios</i> tell whether a small business will be able to meet its maturing obligations as they come due.			
1. Current ratio	1.87:1	1.69:1	10.70%
Explanation: Sam's Appliance Shop falls short of the rule of thumb of 2:1, but its current ratio is above the industry average by a significant amount. Sam's should have no problem meeting its short-term debts as they come due. By this measure, the company's liquidity is solid.			
2. Quick ratio	0.63:1	0.81:1	-22.20%
Explanation: Sam's is below the rule of thumb of 1:1 and below industry standards. This may mean that Sam's has too much of its current assets tied up in inventory. Sam's relies on selling inventory to satisfy short-term debt (as do most appliance shops). If sales slump, the result could be liquidity problems for Sam's.			
<i>Leverage ratios</i> measure the financing supplied by the company's owners against that supplied by its creditors and serve as a gauge of the depth of a company's debt.			
3. Debt ratio	0.68:1	0.71:1	-4.20%
Explanation: Creditors provide 68 percent of Sam's total assets, slightly below the industry average of 71%. Although Sam's does not appear to be overburdened with debt and is quite close to the industry average, the company might have difficulty borrowing additional money, especially from conservative lenders.			
4. Debt to net worth ratio	2.20:1	2.51:1	-12.40%
Explanation: Sam's Appliance Shop owes \$2.20 to creditors for every \$1.00 the owners have invested in the business (compared to \$2.51 in debt to every \$1.00 in equity for the typical business). Although this is not an exorbitant amount of debt by industry standards, many lenders and creditors see Sam's as "borrowed up." Borrowing capacity is somewhat limited because creditors' claims against the business are more than twice those of the owners.			

TABLE 14.2 (continued)

Ratio	Sam's Appliance Shop	Industry Average	Variance
5. Times interest earned	2.52:1	9.44:1	-73.30%
<p>Explanation: Sam's earnings are high enough to cover the interest payments on its debt by a factor of 2.52, which is right at the typical marginal threshold that bankers want to see of 2.5. The typical firm in the industry has a much higher coverage ratio of more than nine times. Sam's Appliance Shop should be able to meet its interest payments, but bankers like to see a larger cushion than Sam's has. Sam's bank will be keeping a close eye on this ratio!</p> <p><i>Operating ratios</i> evaluate a company's overall performance and show how effectively it is putting its resources to work.</p>			
6. Average inventory turnover	2.05 times/year	4.3 times/year	-52.33%
<p>Explanation: Inventory is moving through Sam's at a very slow pace-half the industry average. Whereas the typical business in its industry turns its inventory over about every three months, Sam's turns its over every six months. The company has a problem with slow-moving items in its inventory and, likely, too much inventory. Which items are they, and why are they slow moving? Does Sam need to drop some product lines?</p>			
7. Average collection period	50.0 days	26.9 days	85.90%
<p>Explanation: Sam's Appliance Shop collects the average accounts receivable after 50 days, compared with the industry average of about 27 days, nearly twice as long. A more meaningful comparison is against Sam's credit terms; if credit terms are net 30 (or anywhere close to that), Sam's has a dangerous collection problem, one that drains cash and profits and demands immediate attention!</p>			
8. Average payable period	59.3 days	25.5 days	132.50%
<p>Explanation: Sam's payables are <i>significantly</i> slower than those of the typical firm in the industry. Stretching payables too far could seriously damage the company's credit rating, causing suppliers to cut off future trade credit. This could be a sign of cash flow problems or a sloppy accounts payable procedure. This problem, which indicates that the company suffers cash flow problems, also demands immediate attention.</p>			
9. Net sales to total assets	2.21:1	4.3:1	-48.60%
<p>Explanation: Sam's Appliance Shop is not generating enough sales given the size of its asset base. This could be the result of a number of factors—improper inventory (as indicated by the inventory turnover ratio above), inappropriate pricing, poor location, poorly trained sales personnel, and many others. The key is to find the cause—fast!</p> <p><i>Profitability ratios</i> measure how efficiently a firm is operating and offer information about its bottom line.</p>			
10. Net profit on sales	3.24%	3.60%	-10.00%
<p>Explanation: After deducting all expenses, 3.24 cents of each sales dollar remains as profit for Sam's—10% below the industry average. Sam should review his company's gross profit margin and investigate its operating expenses, checking them against industry standards and looking for those that are out of balance.</p>			
11. Net profit to assets	7.15%	15.28%	-53.20%
<p>Explanation: Sam's generates just a return of 7.15% for every \$1 in assets, which is less than half the industry average. This is consistent with the previous ratio that indicated profits that are weaker than the industry average.</p>			
12. Net profit to equity	22.65%	53.40%	-57.60%
<p>Explanation: Sam's Appliance Shop's owners are earning 22.65% on the money they have invested in the business. This yield is half of the industry average, which indicates that the company's profits are below average.</p>			

line from the industry average. However, a ratio that varies from the average does not necessarily mean that a small business is in financial jeopardy. Instead of making drastic changes in financial policy, entrepreneurs must explore why the figures are out of line. Steve Cowan, co-owner of Professional Salon Concepts, a wholesale beauty products distributor, routinely performs such an analysis on his company's financial statements. "I need to know whether the variances for expenses and revenues for a certain period are similar," he says. "If they're not, are the differences explainable? Is an expense category up just because of a decision to spend more, or were we just sloppy?"³⁴

In addition to comparing ratios to industry averages, owners should analyze their firms' financial ratios over time. By themselves, these ratios are "snapshots" of the firm's finances at a single instant, but by examining these trends over time, the owner can detect gradual shifts that otherwise might go unnoticed until a financial crisis is looming.



Lessons from the Street-Smart Entrepreneur

Gaining a Competitive Edge

Do You Know How Your Company Will Make Money?

When they launch their businesses, entrepreneurs instinctively know that their companies must make a profit to survive. However, many entrepreneurs never take the time to examine the factors in their business models that drive their companies' profitability. The following model is a useful tool for visualizing these factors, analyzing their impact on a company's profits, and identifying strategies for improving them so that a business can improve its profitability. Four factors determine a company's ability to produce an attractive profit: revenue drivers, margins, operating leverage, and volumes (see Figure 1).

Revenue drivers include all of the ways a company generates revenue. For instance, an automobile dealership revenue drivers may be new cars sales, used cars sales, auto leases, service, parts, and short-term rentals. For instance, one small jewelry store identified its revenue generators as new jewelry, estate jewelry, watches, and gift items. Small companies with extensive inventories, such as hardware stores, can organize their revenue-generating product lines into a manageable number of major categories—for example, power tools, hand tools, lawn and garden, home repair, plumbing, electrical, and others. The next step is to assess the impact of each of the company's revenue drivers on total sales and their interaction with one another. For instance, an auto dealer may discover that the business generates more sales from used cars than from new cars.

Entrepreneurs must then consider how much control they have over pricing their revenue drivers. Pricing may be either fixed or flexible. A company relies on fixed pricing if it sells goods or services at standard prices without negotiation or variation—for example, the items on the menu of a restaurant. Flexible pricing means that a company can offer different prices depending on when customers make a purchase, how many items they purchase, whether other items are bundled into the purchase, and other variables. Even though a restaurateur may be limited to fixed pricing on the menu, he or she would be able to use

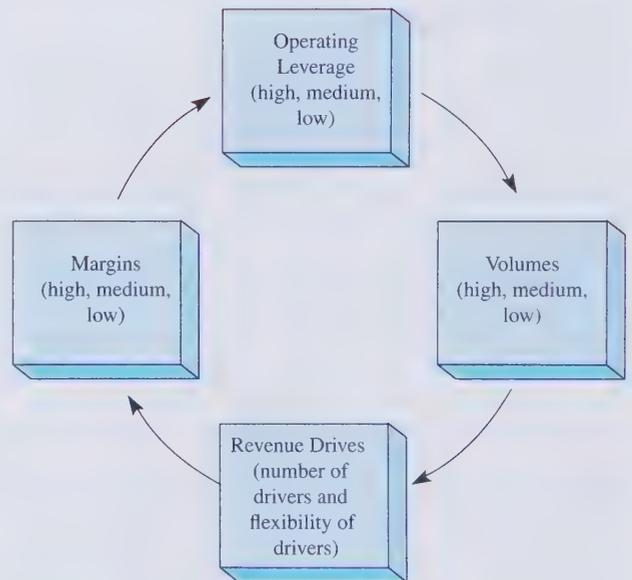


FIGURE 1
Four Key Elements of a Firm's Economic Model

flexible pricing on catering jobs. Flexible pricing gives entrepreneurs greater ability to maximize total revenue (and profitability).

Margins reflect how much each revenue driver contributes to the profitability of a company. Margins are the price that a customer pays minus the cost to the company of providing that good or service. A small company can increase its margins either by raising its prices or by improving its efficiency and providing goods and services at lower costs. The goal is to determine which revenue drivers are capable of generating the greatest profit. For instance, an auto dealership may find that its profit margin on used cars is much higher than new cars and that the margin on auto repairs is higher still.

Volumes are another important determinant of a company's profitability. A small company's volume depends on the

Lessons from the Street-Smart Entrepreneur (continued)

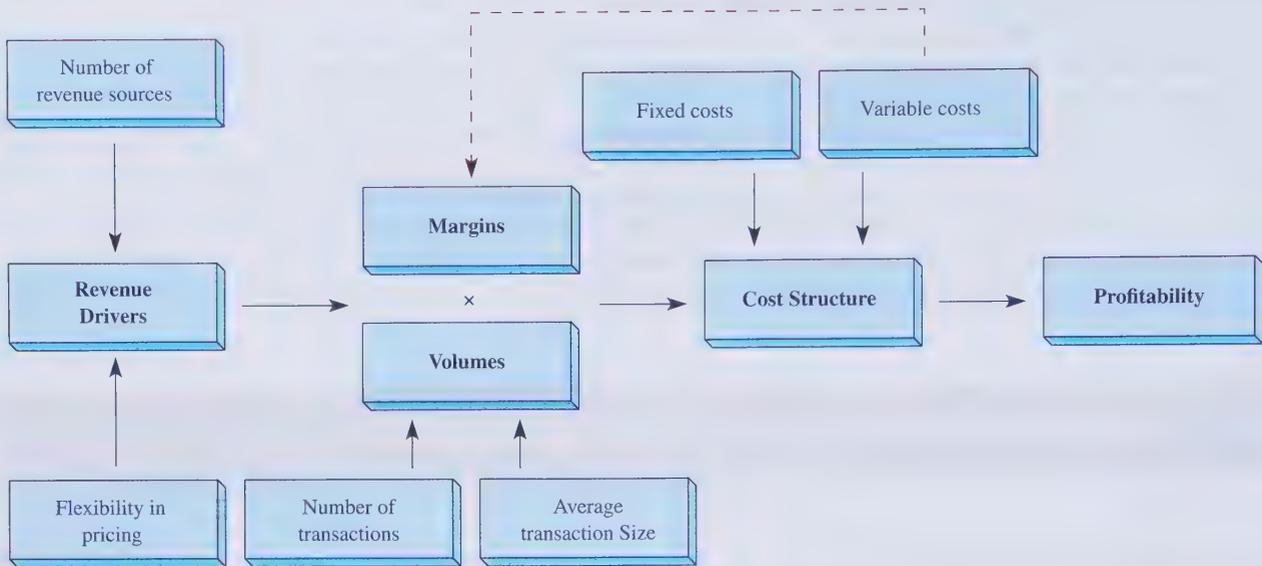


FIGURE 2
Keys to Profitability

number of sales transactions it generates over a given time period and the value of each transaction. For instance, a fast-food restaurant counts on selling a large number of relatively low-priced meals, but an upscale restaurant generates revenue from a smaller number of meals at much higher average prices. At the fast-food restaurant, the average check may be \$5.18, but at the upscale restaurant, the average check may be \$45.80.

Operating leverage is the impact that a change in a company's sales volume has on its net income. If a small company achieves positive operating leverage, its expenses as a percentage of sales revenues flatten or even decline as sales increase. As a result, the company's net profit margin will increase as it grows. Operating leverage is a function of a business's cost structure. Companies that have high levels of fixed costs have high operating leverage; conversely, companies that have high levels of variable costs have low operating leverage. Profits are more volatile when a company has high operating leverage because slight changes in revenue cause dramatic swings in profits as the company's sales fluctuate above and below its break-even point.

Once entrepreneurs have analyzed the four components of a company's profitability, they can formulate strategies to enhance them (see Figure 2). For instance, if a company's current business model is characterized by a single revenue driver, low margins, low volumes, and high operating leverage, it is not likely to be a highly profitable venture. The entrepreneur in this

situation, however, might change the business model to make it more profitable using the following questions:

- Can I add more revenue drivers to my business?
- How can I increase the number of transactions and/or the average transaction size that make up our volume?
- What can I do to reduce the level of fixed costs in my company?
- Can I change to a flexible pricing strategy and move away from a fixed pricing strategy?
- How can I improve the efficiency with which my company provides products and services to customers?
- In what other ways can I improve my company's profit margins?

Ron Towry, owner of Truck Gear SuperCenter, a small-truck accessories business, was able to increase his company's sales by 25 percent and profits by 32 percent after making a strategic decision to begin selling his products at wholesale to truck and auto dealerships in addition to selling to his traditional retail customers. Although the company's wholesale prices and profit margins were lower, wholesale customers purchased in higher volumes, and Towry's company could sell to them at a lower cost per transaction, resulting in higher sales and profits.

Sources: Adapted from April Murdoch and Michael Morris, "Is Your Economic Model Working?," *Orange Entrepreneur*, Fall 2006, pp. 16–19; Ron Stodghill, "Bolt Down Those Costs," *FSB*, May 2006, pp. 85–87.

Break-Even Analysis

Another key component of every sound financial plan is a break-even analysis (or cost-volume-profit analysis). A small company's **break-even point** is the level of operation (sales dollars or production quantity) at which it neither earns a profit nor incurs a loss. At this level of activity, sales revenue equals expenses—that is, the company "breaks even." A business that generates sales that are greater than its break-even point will generate a profit, but one that operates below its break-even point will incur a net loss. The break-even point is the single most important

6.

Conduct a break-even analysis for a small company.

financial figure for an entrepreneur to understand because it is the point at which his or her business is able to sustain itself through generating revenues. It is the point at which the business generates enough revenues to pay all of its bills *and* provide the entrepreneur with a paycheck!



ENTREPRENEURIAL PROFILE: Todd Campbell: E.B. Capital Markets Todd Campbell's business, E.B. Capital Markets, provides research on the stock market to portfolio managers. When the recession hit in 2008, he realized that he had to keep better track of his company's finances to ensure that he could meet its financial obligations, such as payroll for his employees. The company's monthly expenses were \$20,000, and its gross profit margin was 50 percent. To calculate the company's breakeven point, he divided \$20,000 by 50 percent. Campbell knew that his business had to sell \$40,000 per month to break even. "It is the single best indicator because it helps you see if the canary in the coal mine is getting woozy," Campbell says. "Now I know what decisions I have to make today so that I don't have to panic a few months from now."³⁵

By analyzing expenses using break-even analysis, an entrepreneur can calculate the minimum level of activity required to keep a business in operation. These techniques can then be refined to project the sales needed to generate a desired level of profit. Most potential lenders and investors require entrepreneurs to prepare a break-even analysis so that they can judge the earning potential of a new business and the likelihood that it will be successful. In addition to its being a simple, useful screening device for financial institutions, break-even analysis can serve as a planning device for entrepreneurs. It can show an entrepreneur who might have unreasonable expectations about a business idea just how unprofitable a proposed business venture is likely to be.

Calculating the Break-Even Point

A small business owner can calculate a firm's break-even point by using a simple mathematical formula. To begin the analysis, the owner must determine fixed costs and variable costs. **Fixed expenses** are those that do not vary with changes in the volume of sales or production (e.g., rent, depreciation expense, insurance, salaries, lease or loan payments, and others). **Variable expenses**, on the other hand, vary directly with changes in the volume of sales or production (e.g., raw material purchases, sales commissions, hourly wages, and others).

Some expenses cannot be neatly categorized as fixed or variable because they contain elements of both. These semivariable expenses change, although not proportionately, with changes in the level of sales or production (electricity would be one example). These costs remain constant up to a particular production or sales volume and then climb as that volume is exceeded. To calculate the break-even point, an entrepreneur must separate these expenses into their fixed and variable components. A number of techniques can be used (which are beyond the scope of this text), but a good cost accounting system can provide the desired results.

Here are the steps an entrepreneur must take to compute the break-even point using an example of a typical small business, the Magic Shop:

- Step 1. Determine the expenses the business can expect to incur.** With the help of a budget, an entrepreneur can develop estimates of sales revenue, cost of goods sold, and expenses for the upcoming accounting period. The Magic Shop expects net sales of \$950,000 in the upcoming year, with a cost of goods sold of \$646,000 and total expenses of \$236,500.
- Step 2. Categorize the expenses estimated in step 1 into fixed expenses and variable expenses and separate semivariable expenses into their component parts.** From the budget, the owner anticipates variable expenses (including the cost of goods sold) of \$705,125 and fixed expenses of \$177,375.
- Step 3. Calculate the ratio of variable expenses to net sales.** For the Magic Shop, this percentage is $\$705,125 \div \$950,000 = 74$ percent. So the Magic Shop uses \$0.74 out of every sales dollar to cover variable expenses, leaving \$0.26 ($\$1.00 - 0.74$) as a contribution margin to cover fixed costs and make a profit.
- Step 4. Compute the break-even point by inserting this information into the following formula:**

$$\text{Sales needed} (\$) = \frac{\text{Total fixed cost}}{\text{Contribution margin expressed as a percentage of sales}}$$

For the Magic Shop,

$$\begin{aligned}\text{Break-even sales} &= \frac{\$177,375}{0.26} \\ &= \$682,212\end{aligned}$$

Thus, the Magic Shop will break even with sales of \$682,212. At this point, sales revenue generated will just cover total fixed and variable expense. The Magic Shop will earn no profit and will incur no loss. To verify this, make the following calculations:

Sales at break-even point	\$682,212
– Variable expenses (74% of sales)	–504,837
Contribution margin	177,375
– Fixed expenses	–177,375
Net income (or net loss)	<u>\$ 0</u>

Some entrepreneurs find it more meaningful to break down their companies' annual break-even point into a daily sales figure. If the Magic Shop will be open 312 days per year, then the average daily sales it must generate just to break even is $\$682,212 \div 312 \text{ days} = \$2,187$ per day.

Adding a Profit

What if the Magic Shop's owner wants to do *better* than just break even? His analysis can be adjusted to consider such a possibility. Suppose the owner expects a reasonable profit (before taxes) of \$80,000. What level of sales must the Magic Shop achieve to generate this? He can calculate this by treating the desired profit as if it were a fixed cost. In other words, he modifies the formula to include the desired net income:

$$\begin{aligned}\text{Sales (\$)} &= \frac{\text{Total fixed expenses} + \text{Desired net income}}{\text{Contribution margin expressed as a percentage of sales}} \\ &= \frac{\$177,375 + \$80,000}{0.26} \\ &= \$989,904\end{aligned}$$

To achieve a net profit of \$80,000 (before taxes), the Magic Shop must generate net sales of \$989,904. Once again, if we transform this sales annual volume into a daily sales volume, we get $\$989,904 \div 312 \text{ days} = \$3,173$ per day.

Break-Even Point in Units

Some small businesses may prefer to express the break-even point in units produced or sold instead of in dollars. Manufacturers often find this approach particularly useful. The following formula computes the break-even point in units:

$$\text{Break-even volume} = \frac{\text{Total fixed costs}}{\text{Sales price per unit} - \text{Variable cost per unit}}$$

For example, suppose that Trilex Manufacturing Company estimates its fixed costs for producing its line of small appliances at \$390,000. The variable costs (including materials, direct labor, and factory overhead) amount to \$12.10 per unit, and the selling price per unit is \$17.50. Thus, Trilex computes its contribution margin as follows:

$$\begin{aligned}\text{Contribution margin} &= \text{Price per unit} - \text{Variable cost per unit} \\ &= \$17.50 \text{ per unit} - \$12.10 \text{ per unit} \\ &= \$5.40 \text{ per unit}\end{aligned}$$

Thus, Trilex's break-even volume is as follows:

$$\begin{aligned}\text{Break-even volume (units)} &= \frac{\text{Total fixed costs}}{\text{Per unit contribution margin}} \\ &= \frac{\$390,000}{\$5.40 \text{ per unit}} \\ &= 72,222 \text{ units}\end{aligned}$$

To convert this number of units to break-even sales dollars, Trilex simply multiplies it by the selling price per unit:

$$\text{Break-even sales} = 72,222 \text{ units} \times \$17.50 = \$1,263,889$$

Trilex could compute the sales required to produce a desired profit by treating the profit as if it were a fixed cost:

$$\text{Sales (units)} = \frac{\text{Total fixed costs} + \text{Desired net income}}{\text{Per unit contribution margin}}$$

For example, if Trilex wanted to earn a \$60,000 profit, its required sales would be as follows:

$$\text{Sales (units)} = \frac{\$390,000 + \$60,000}{5.40} = 83,333 \text{ units}$$

Constructing a Break-Even Chart

The following outlines the procedure for constructing a graph that visually portrays the firm's break-even point (that point where revenues equal expenses):

- Step 1.** *On the horizontal axis, mark a scale measuring sales volume in dollars (or in units sold or some other measure of volume).* The break-even chart for the Magic Shop shown in Figure 14.7 uses sales volume in dollars because it applies to all types of businesses, products, and services.
- Step 2.** *On the vertical axis, mark a scale measuring income and expenses in dollars.*
- Step 3.** *Draw a fixed expense line intersecting the vertical axis at the proper dollar level parallel to the horizontal axis.* The area between this line and the horizontal axis represents the firm's fixed expenses. On the break-even chart for the Magic Shop shown in Figure 14.7, the fixed expense line is drawn horizontally beginning at \$177,375 (point A). Because this line is parallel to the horizontal axis, it indicates that fixed expenses remain constant at all levels of activity.
- Step 4.** *Draw a total expense line that slopes upward beginning at the point at which the fixed cost line intersects the vertical axis.* The precise location of the total expense line is determined by plotting the total cost incurred at a particular sales volume. The total cost for a given sales level is found by the following formula:

$$\text{Total expenses} = \text{Fixed expenses} + \text{Variable expenses expressed as a percentage of sales} \times \text{Sales level}$$

Arbitrarily choosing a sales level of \$950,000, the Magic Shop's total costs would be as follows:

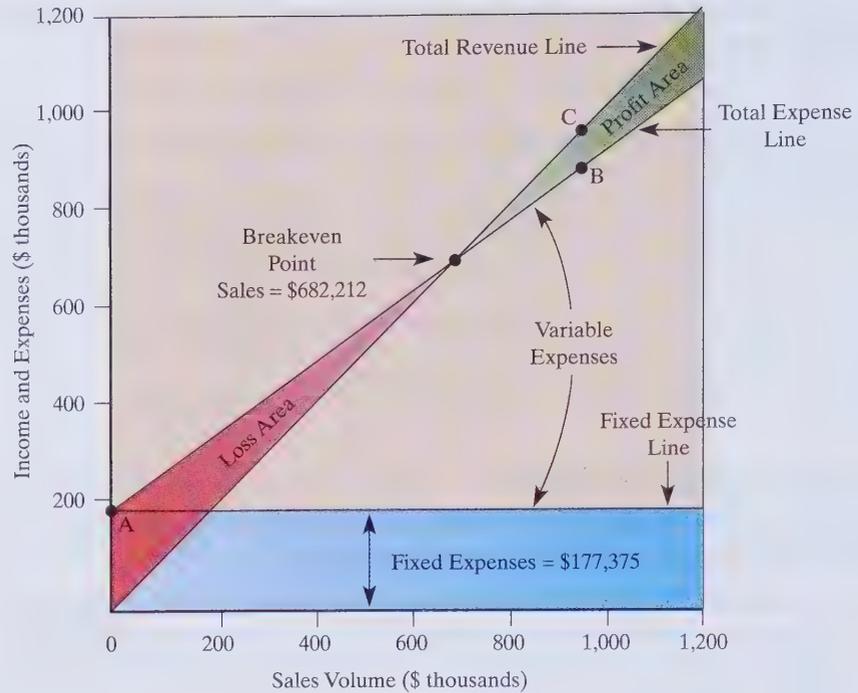
$$\begin{aligned} \text{Total expenses} &= \$177,375 + (0.74 \times \$950,000) \\ &= \$880,375 \end{aligned}$$

Thus, the Magic Shop's total cost is \$880,375 at a net sales level of \$950,000 (point B). Connecting points A and B creates the variable cost line. The area between the total cost line and the horizontal axis measures the total costs the Magic Shop incurs at various levels of sales. For example, if the Magic Shop's sales are \$850,000, its total costs will be \$806,375.

Step 5. *Beginning at the graph's origin, draw a 45-degree revenue line showing where total sales volume equals total income.* For the Magic Shop, point C shows that sales = income = \$950,000.

Step 6. *Locate the break-even point by finding the intersection of the total expense line and the revenue line.* If the Magic Shop operates at a sales volume to the left of the break-even point, it will incur a loss because the expense line is higher than the revenue line over this range. The triangular section labeled "Loss Area" shows this. On the other hand, if the firm operates at a sales volume to the right of the break-even point, it will earn a profit because the revenue line lies above the expense line over this range. The triangular section labeled "Profit Area" shows this.

FIGURE 14.7
Break-Even Chart, the
Magic Shop



Using Break-Even Analysis

Break-even analysis is a useful planning tool for entrepreneurs, especially when approaching potential lenders and investors for funds. It provides an opportunity for integrated analysis of sales volume, expenses, income, and other relevant factors. Break-even analysis is a simple, preliminary screening device for the entrepreneur faced with the business start-up decision. It is easy to understand and use. With just a few calculations, an entrepreneur can determine the minimum level of sales needed to stay in business as well as the effects of various financial strategies on the business. It is a helpful tool for evaluating the impact of changes in investments and expenditures.



ENTREPRENEURIAL PROFILE: Fergus McCann: LimoLiner Before launching LimoLiner, a company that provides luxury bus service with full amenities aimed at businesspeople traveling between downtown Boston and midtown Manhattan, entrepreneur Fergus McCann calculated his venture's break-even point. Knowing that it would take a while to build a solid base of customers, McCann determined that to break even, his buses had to be only half full on each one-way trip. A LimoLiner trip is priced at \$89, which is \$20 less than Amtrak's Acela Express and \$120 less than a full-fare airline ticket. Satisfied that he would be able to generate at least \$483 per one-way trip within a short time of opening, McCann launched LimoLiner.³⁶

Break-even analysis does have certain limitations. It is too simple to use as a final screening device because it ignores the importance of cash flows. In addition, the accuracy of the analysis depends on the accuracy of the revenue and expense estimates. Finally, the assumptions pertaining to break-even analysis may not be realistic for some businesses. Break-even calculations make the following assumptions: Fixed expenses remain constant for all levels of sales volume, variable expenses change in direct proportion to changes in sales volume, and changes in sales volume have no effect on unit sales price. Relaxing these assumptions does not render this tool useless, however. For example, the owner could employ nonlinear break-even analysis using a graphical approach.



In the Entrepreneurial Spotlight

Open Book Management

In 1982, Jack Stack led a management buyout of a failing division of International Harvester that refurbished engines. In one of the most highly leveraged buyouts in corporate history, the managers invested \$100,000 of their own money and borrowed \$9 million to purchase the business, leaving the company, Springfield Remanufacturing Company (SRC), with an incredible debt to equity ratio of 90 to 1! Facing a huge debt load and a short time horizon to turn SRC around, Stack and his team of managers knew that one key to success was to ignite a passion for the company among its employees. Stack's idea was to give everyone in the factory, from cam rod grinders to purchasing agents, access to SRC's financial statements and to teach them how to read, analyze, and understand the company's critical numbers.

Managers met with teams of employees in weekly meetings to discuss the numbers, answer questions, and solicit ideas about how to improve them in a process he called open book management, a revolutionary concept at the time. The idea behind open book management, says Stack, "is to get employees to start approaching their jobs as if they owned the place, which, in fact, they might." Some companies that practice open book management, including SRC, share ownership of the business with their employees through employee stock ownership plans. "Our goal was to teach our employees to think and act like owners," says Stack. "We started by trying to improve their financial literacy by turning topics like accounting into a game. We played this game with real money, however, and the game's pieces were each and every employee's quality of life. We called it The Great Game of Business."

Using The Great Game of Business, managers transformed employees into owners of every line of the company's balance sheet, income statement, and cash flow statement, enabling workers at every level of operation to understand how they could move the numbers in the right direction. "Rather than having some engineer with a stopwatch trying to get people to work faster for less money, open book management gives everyone the chance to see what they need to do to succeed," says Stack. In its first full year of operation, SRC lost \$60,500 on sales of \$16 million. Within 10 years, the company was earning a profit of \$1.3 million on sales of \$66 million. Today, SRC is the leading success story of open book management, having evolved into a collection of 37 employee-owned businesses that employ more than 1,200 workers and make everything from race car engines to home furnishings.

Stack's daughter, who owns a small upscale clothing store in Missouri, learned the lessons of open book management from

her father. She operates her small business using open book management with her seven employees. "She now has seven people who think like she does," observes Stack. "They now understand inventory turns and [profit margins] and the relationship between the two."

A growing number of privately owned businesses are taking open book management to another level with a system called open enterprise. Whereas open book management provides access to relevant information that employees need to do their jobs better, the open enterprise movement opens up *all* information within the business to all employees. For example, SumAll, a data-analytics company, posts information online about investor agreements, company financials, performance appraisals, hiring decisions, and employee pay and bonuses for all employees to see. Peer Insight, a consulting company, provides information on salaries, bonuses, and performance appraisals to all employees. Peer Insight employees can also view detailed financial information, including the current cash balance in the bank.

1. Use online resources to identify the management principles on which traditional open book management is based.
2. What benefits does traditional open book management offer a company and its employees? Do these benefits also apply to firms that take the "open enterprise" approach?
3. Conduct an online search for a company that uses open book management or the open enterprise approach and write a one-page summary of its experience with this technique. Identify at least two keys to using open book management or open enterprise successfully.
4. What limits should be placed on opening information to employees? What are the risks to taking the "open enterprise" approach to managing a small business? What limits to opening up information would you implement within your business? Would you be willing to follow the practices of SumAll and Peer Insight and share everything with everyone in your company? Explain.

Sources: Based on Jack Stack, "Introducing 'Open the Books: Why Would Anyone Do This?'" *New York Times*, December 15, 2009, <http://boss.blogs.nytimes.com/2009/12/15/introducing-open-the-books-why-would-anyone-do-this>; Jack Stack, "The Great Game of Business," *Institute for Entrepreneurial Excellence*, April 10, 2010, www.entrepreneur.pitt.edu/eventfiles/1010.pdf; Darren Dahl, "Open Book Management Lessons for Detroit," *New York Times*, May 21, 2009, www.nytimes.com/2009/05/21/business/smallbusiness/21open.html; Laura Lorber, "An Open Book," *Wall Street Journal*, February 23, 2009, p. R8; Jack Stack, "Open Wide," *Inc.*, January/February 2009, p. 76; Rachel Silverman, "Psst . . . This Is What Your Co-Worker Is Paid," *Wall Street Journal*, January 30, 2013, p. B6.

Chapter Review

1. Understand the importance of preparing a financial plan.
 - Launching a successful business requires an entrepreneur to create a solid financial plan. Not only is such a plan an important tool in raising the capital needed to get a company off the ground, but it also is an essential ingredient in managing a growing business.
 - Earning a profit does not occur by accident; it takes planning.
2. Describe how to prepare the basic financial statements and use them to manage the small business.
 - Entrepreneurs rely on three basic financial statements to understand the financial conditions of their companies:
 1. The balance sheet. Built on the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Owner's equity (capital)}$, it provides an estimate of the company's value on a particular date.
 2. The income statement. This statement compares the firm's revenues against its expenses to determine its net income (or loss). It provides information about the company's bottom line.
 3. The statement of cash flows. This statement shows the change in the company's working capital over the accounting period by listing the sources and the uses of funds.
3. Create projected financial statements.
 - Projected financial statements are a basic component of a sound financial plan. They help the manager plot the company's financial future by setting operating objectives and by analyzing the reasons for variations from targeted results. In addition, the small business in search of start-up funds will need these pro forma statements to present to prospective lenders and investors. They also assist in determining the amount of cash, inventory, fixtures, and other assets the business will need to begin operation.
4. Understand the basic financial statements through ratio analysis.
 - The 12 key ratios described in this chapter are divided into four major categories: liquidity ratios, which show the small firm's ability to meet its current obligations; leverage ratios, which tell how much of the company's financing is provided by owners and how much by creditors; operating ratios, which show how effectively the firm uses its resources; and profitability ratios, which disclose the company's profitability.
 - Many agencies and organizations regularly publish such statistics. If there is a discrepancy between the small firm's ratios and those of the typical business, the owner should investigate the reason for the difference. A below-average ratio does not necessarily mean that the business is in trouble.
5. Explain how to interpret financial ratios.
 - To benefit from ratio analysis, the small company should compare its ratios to those of other companies in the same line of business and look for trends over time.
 - When business owners detect deviations in their companies' ratios from industry standards, they should determine the cause of the deviations. In some cases, such deviations are the result of sound business decisions; in other instances, however, ratios that are out of the normal range for a particular type of business are indicators of what could become serious problems for a company.
6. Conduct a break-even analysis for a small company.
 - Business owners should know their firm's break-even point, the level of operations at which total revenues equal total costs; it is the point at which companies neither earn a profit nor incur a loss. Although just a simple screening device, break-even analysis is a useful planning and decision-making tool.

Discussion Questions

- 14-1. Why is it important for entrepreneurs to develop financial plans for their companies?
- 14-2. What are the financial statements used to manage a business? Why are they important?
- 14-3. Outline the key points of the 12 ratios discussed in this chapter. What signals does each give a business owner?
- 14-4. Describe the method for building a projected income statement and a projected balance sheet for a beginning business.
- 14-5. Comment on the statement, "Creating projected financial statements helps entrepreneurs transform their business goals into reality."
- 14-6. How can break-even analysis help an entrepreneur planning to launch a business? What information does it give an entrepreneur?

CHAPTER 15

Managing Cash Flow



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain the importance of cash management to the success of a small business.
2. Differentiate between cash and profits.
3. Understand the five steps in creating a cash budget and use them to build a cash budget.
4. Describe the fundamental principles involved in managing the “big three” of cash management: accounts receivable, accounts payable, and inventory.
5. Explain how bootstrapping can help a small business avoid a cash crunch.

The three most important things you need to measure in a business are customer satisfaction, employee satisfaction, and cash flow.

—Jack Welch

*Beware of little expenses;
a small leak will sink a great ship.*

—Benjamin Franklin

Cash—a four-letter word that has become a curse for many small businesses. Lack of this valuable asset has driven countless small companies into bankruptcy. Unfortunately, many more firms will become failure statistics because their owners have neglected the principles of cash management, which can spell the difference between success and failure. One small business consultant says that a serious mistake that entrepreneurs make is trying to run their businesses without accurate cash flow projections. “This is like driving along on the freeway at 70 miles per hour with a blindfold on. It’s not a question of whether you are headed for an accident. It’s a question of how serious the accident will be and whether or not you will survive it.”¹

Developing cash forecasts is important for every small business but is essential for new businesses in particular because early sales levels usually do not generate sufficient cash to keep the company afloat. Too often, entrepreneurs launch their companies with insufficient cash to cover their start-up costs and the cash flow gap that results while expenses outstrip revenues. The result is business failure. Controlling the financial aspects of a business with the profit-planning techniques described in the previous chapter is immensely important; however, by themselves, these techniques are insufficient to achieve business success. Entrepreneurs are prone to focus on their companies’ income statements—particularly sales and profits. The balance sheet and the income statement, of course, show an important part of a company’s financial picture, but it is just that: only part of the total picture. It is entirely possible for a business to have a solid balance sheet and to make a profit and still go out of business by *running out of cash*. Even if a company’s revenue exceeds its expenses for a given period, the cash flow from that revenue may not arrive in time to pay the company’s cash expenses. Managing cash effectively requires an entrepreneur to look beyond the “bottom line” and focus on what keeps a company going—cash.

Cash Management

1.

Explain the importance of cash management to the success of a small business.

Managing cash flow is a struggle for many business owners. In fact, research by the National Federation of Independent Businesses (NFIB) shows that managing cash flow consistently ranks among the top 10 problems that small business owners face. Surveys by American Express OPEN Small Business Monitor and Visa show similar concerns: Cash flow management ranks as the number one issue facing small business owners. Figure 15.1 shows the most common cash flow challenges that business owners encounter.

Cash management involves forecasting, collecting, disbursing, investing, and planning for the cash a company needs to operate smoothly. For a start-up business, managing cash depends on the accuracy of the financial forecasts that come from a well-developed business model and business plan. These forecasts guide fund-raising for the new venture. For an operating small

Source: CartoonStock.



“I’ll covet this trophy right up to the time
I sell it to meet my payroll.”

In recent surveys, at least 50 percent of small business owners report experiencing cash flow problems. The most common challenges they encounter are as follows:

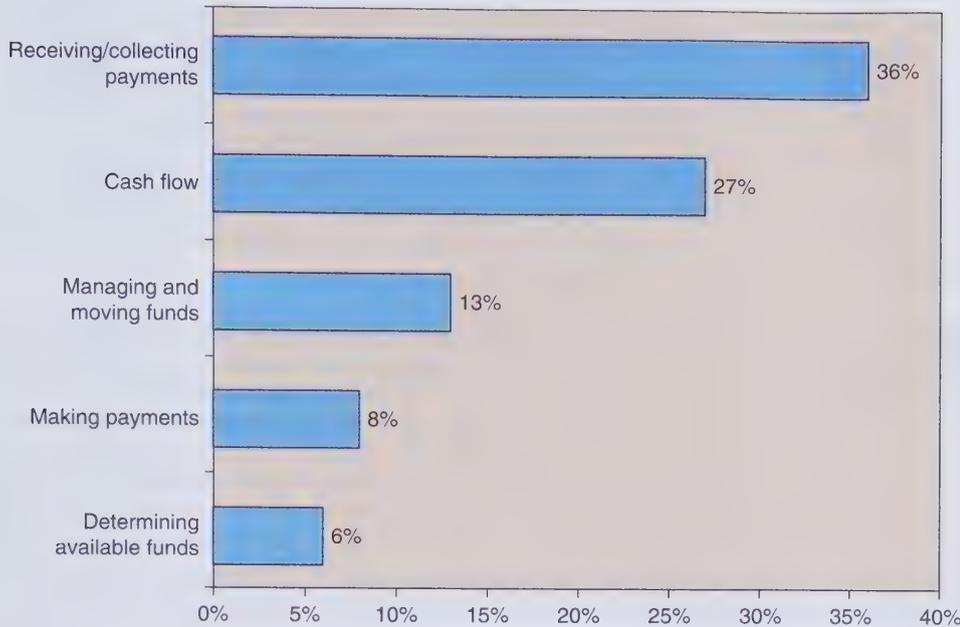


FIGURE 15.1

Cash Flow Challenges

Source: Visa 2012 Small Business Cash Management Survey, September 26, 2012.

business, managing cash is a matter of timing—gaining control over when a company collects cash and when it pays it out. Managing cash is an important task because cash is the most important yet least productive asset that a small business owns. A business must have enough cash to meet its obligations as they come due, or it will eventually experience bankruptcy. The Small Business Administration recommends that business owners have enough cash on hand to cover at least six months of operating expenses, and many experts recommend up to a year's worth during a slow economy. Creditors, employees, and lenders expect to be paid on time no matter how tough the economy may get, and cash is the required medium of exchange to meet these expectations.

Proper cash management permits entrepreneurs to adequately meet the cash demands of their businesses, to avoid retaining unnecessarily large cash balances, and to stretch the profit-generating power of each dollar their companies own. Entrepreneurs must have the discipline to manage cash flow from the business's first day of operation.



ENTREPRENEURIAL PROFILE: Henry Ford: Ford Motor Company Shortly after he launched his new company on June 16, 1903, entrepreneur Henry Ford ran headlong into a cash crisis that nearly wiped out the Ford Motor Company. Start-up expenses (including \$10,000 to the Dodge brothers for engines and other parts and \$640 to the Hartford Rubber Works for 64 tires) quickly soaked up Ford's \$28,000 in start-up capital he and eleven associates invested, and by July 10, the company's cash balance had fallen a mere \$223.65. Another payroll and more parts orders were just around the corner, and the 25-day-old company was already on the brink of a financial collapse. On July 11, an investor saved the day with a \$5,000 contribution. Four days later the Ford Motor Company sold its first car to Dr. E. Pfennig of Chicago, pushing the company's cash balance to \$6,486.44. From this shaky financial beginning grew one of the largest automakers in the world!²

Although cash flow problems afflict companies of all sizes and ages, young businesses are prone to suffering cash shortages because they act like “cash sponges,” soaking up every available dollar and then some. The reason is that their cash-generating “engines” have not had the opportunity to “rev up” to full speed and cannot generate sufficient power to produce the cash necessary to cover rapidly climbing expenses.

Owners of fast-growing businesses also must pay particular attention to cash management because the greatest potential threat to cash flow occurs when a company is experiencing rapid growth. If a company's sales are rising, the owner also must hire more employees, expand product lines, increase the sales force and customer service staff, buy

inventory, and incur other drains on the firm's cash supply. In addition to these cash demands, collections from sales often slip as a company grows, and the result is a cash crisis.

Unfortunately, many small business owners do not engage in cash planning. One study of 2,200 small businesses found that 68 percent performed no cash flow analysis at all!³ The result is that many successful, growing, and profitable businesses fail because they become insolvent; they do not have adequate cash to meet the needs of a growing business with a booming sales volume. The head of the National Federation of Independent Businesses says that many small business owners “wake up one day to find that the price of success is no cash on hand. They don't understand that if they're successful, inventory and receivables will increase faster than profits can fund them.”⁴ The resulting cash crisis may force an entrepreneur to lose equity control of the business or, ultimately, declare bankruptcy and close.



ENTREPRENEURIAL PROFILE: Peter Justen: MyBizHomepage After 94 years in business, Cerf Brothers Bag Company, a family-owned business that made duffle, cargo, and storage bags and a line of outdoor gear under the brand names Hideaway Hunting Gear and Camp Inn, fell victim to a cash crisis. In an attempt to lower its costs, the company shifted most of its production from its three manufacturing operations in the United States to factories in Asia. When these vendors accelerated their collection terms, insisting on payment for products when Cerf Brothers placed an order rather than after it was delivered, the company found itself in a cash flow bind. [Our vendors] were asking us to pay for goods three to five months before we would be paid by our customers,” says Jerry Michelson, the company's CEO. The company's cash flow evaporated and debt piled up, forcing its owners to declare bankruptcy and sell the once-successful business.⁵

Table 15.1 describes the five key cash management roles every entrepreneur must fill.

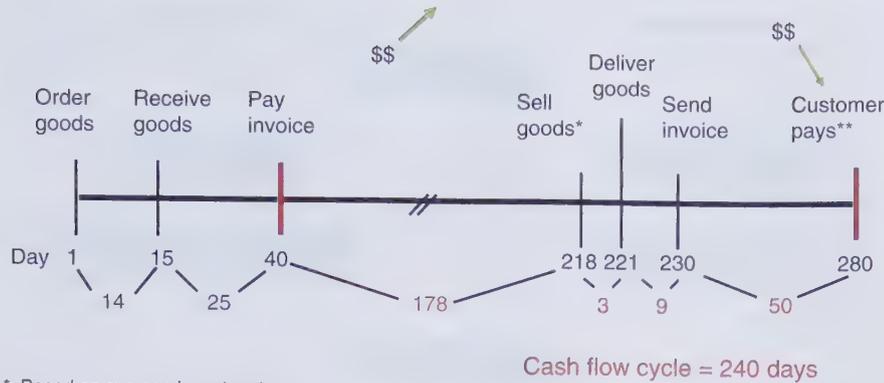
The first step in managing cash more effectively is to understand the company's **cash flow cycle**—the time lag between paying suppliers for merchandise and receiving payment from customers (see Figure 15.2). The longer this cash flow cycle, the more likely the business owner is to encounter a cash crisis. Preparing a cash forecast that recognizes this cycle, however, helps avoid a crisis.



ENTREPRENEURIAL PROFILE: John Fernsell: Ibex Outdoor Clothing John Fernsell recognizes the importance of cash management because of the length of his company's cash flow cycle. Fernsell, a former stockbroker, is the founder of Ibex Outdoor Clothing, a company that makes outdoor clothing from high-quality European wool. Ibex's sales are growing rapidly, but cash is a constant problem because of its lengthy cash flow cycle. Fernsell orders wool from his European suppliers in February and pays for it in June. The wool then goes to garment makers in California,

TABLE 15.1 Five Cash Management Roles of the Entrepreneur

-
- Role 1: Cash Finder.** This is your first and foremost responsibility. You must make sure that there is enough capital to pay all present (and future) bills. This is not a one-time task; it is an ongoing job.
- Role 2: Cash Planner.** As cash planner, you make sure that your company's cash is used properly and efficiently. You must keep track of its cash, make sure that it is available to pay bills, and plan for its future use. Planning requires you to forecast your company's cash inflows and outflows for the months ahead with the help of a cash budget (discussed later in this chapter).
- Role 3: Cash Distributor.** This role requires you to control the cash needed to pay the company's bills and the priority and the timing of those payments. Forecasting cash disbursements accurately and making sure that the cash is available when payments come due is essential to keeping your business solvent.
- Role 4: Cash Collector.** As cash collector, your job is to make sure that your customers pay their bills on time. Too often, entrepreneurs focus on pumping up sales while neglecting to collect the cash from those sales. Having someone in your company responsible for collecting accounts receivable is essential. Uncollected accounts drain a small company's pool of cash very quickly.
- Role 5: Cash Conserver.** This role requires you to make sure that your company gets maximum value for the dollars it spends. Whether you are buying inventory to resell or computer systems to keep track of what you sell, it is important to get the most for your money. Avoiding unnecessary expenditures is an important part of this task. The goal is to spend cash so that it produces a return for the company.
-



* Based on average inventory turnover:

$$\frac{365 \text{ days}}{2.05 \text{ times/year}} = 178 \text{ days}$$

** Based on average collection period:

$$\frac{365 \text{ days}}{7.31 \text{ times/year}} = 50 \text{ days}$$

who ship finished clothing to Ibx in July and August, when Fernsell pays for the finished goods. Ibx ships the clothing to retailers in September and October but does not get paid until November, December, and sometimes January! Ibx's major cash outflows are from June to August, but its cash inflows during those months are virtually nil, making it essential for Fernsell to manage the company's cash balances carefully.⁶

The next step in effective cash management is to begin whittling down the length of the cash flow cycle. Reducing the cycle from 240 days to, say, 180 days would free up incredible amounts of cash that this company could use to finance growth and dramatically reduce its borrowing costs. What steps do you suggest that the owner of the business whose cash flow cycle is illustrated in Figure 15.2 take to reduce the cycle's length?

Cash and Profits Are Not the Same

When analyzing cash flow, entrepreneurs must understand that cash and profits are not the same. Both are important financial concepts for entrepreneurs, but they measure very different aspects of a business. **Profit** (or net income) is the difference between a company's total revenue and its total expenses. It is an accounting concept designed to measure how efficiently a business is operating. On the other hand, cash is the money that is readily available to use in a business. **Cash flow** measures a company's liquidity and its ability to pay its bills and other financial obligations on time by tracking the flow of cash into and out of the business over a period of time. Many factors determine a company's cash flow, including its sales patterns, the timing of its accounts receivable and accounts payable, its inventory turnover rate, its debt repayment schedule, and its schedule of capital expenditures (e.g., fixtures, equipment, facilities expansion, and others).

ENTREPRENEURIAL PROFILE: Anne-Marie Faiola: Bramble Berry Anne-Marie Faiola founded Bramble Berry, a soap-making supply company, in 1998. From the beginning, Faiola grew her company by aggressively introducing new products. However, even though Bramble Berry was showing a profit on its income statement, the business never seemed to have any cash at the end of the month. The problem was that the money that Faiola spent on product development outpaced her ability to earn it back with increased cash flow from sales. Faiola had to use credit cards and drawing on her company's line of credit to fund the gap in cash flow. "If you do that for too many years, you will find yourself heavily in debt—while still being profitable—and wondering why you can't seem to get ahead," says Faiola. Once she recognized that more money was going out than was coming in, Faiola slowed spending on new products for period of time to generate positive cash flow that she could use to pay down her debt. Bramble Berry now offers more than 2,500 products to thousands of customers across the country.⁷

2.

Differentiate between cash and profits.



Anne-Marie Faiola, founder of Bramble Berry.

Source: BrambleBerry Inc.

FIGURE 15.3
Cash Flow

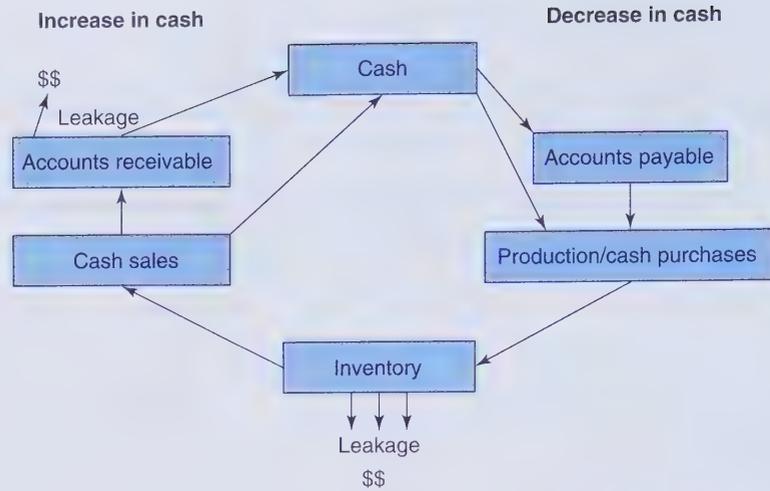


Figure 15.3 shows the flow of cash through a typical small business. Decreases in cash occur when a business purchases, on credit or for cash, goods for inventory or materials for use in production. The company sells the goods either for cash or on credit. When it takes in cash or collects accounts receivable, a company's cash balance increases. Notice that purchases for inventory and production *lead* sales; that is, these bills typically must be paid *before* sales materialize. However, collection of accounts receivable *lags* behind sales; that is, customers who purchase goods on credit may not pay until a month or more later.

As important as earning a profit is, no business owner can pay creditors, employees, and lenders in profits; that requires *cash*! "Cash flow is more important than earnings," says Evan Betzer, founder of a financial services firm.⁸ A company can operate in the short run with a net loss showing on its income statement, but if its cash flow becomes negative, the business is in trouble. It can no longer pay suppliers, meet payroll, pay its taxes, or any other bills. In short, the business is out of business!



In the Entrepreneurial Spotlight

Cash Flow and Pass-Through Entities

Jean Young was excited about the first full year of operations of the company that she and her sister Susan had started just a year and a half ago. The Young sisters had started their fashion and jewelry boutique, Young Fashion, in the summer of 2011 as a limited liability company (LLC). Although the first few months were rather slow, their store picked up business during the holiday season. At the end of 2011, they had sold enough so that they had broken even during their company's first partial year of operation. Not a bad start for a new store!

The momentum they had gained in 2011 carried over into 2012. Like many retailers, they broke even for the first four quarters of the year. Their store's second holiday season was a phenomenal success. When they ran the year-end financial statements for 2012, they showed a profit of a little more than \$80,000. Even better was the fact that they had earned that much profit even after paying themselves very modest salaries throughout the year.

Excited about their success, Jean and Susan decided to use the extra cash they had built up for three things. First, they expanded their company's inventory. With a bit of careful planning, Young Fashion could easily hold quite a bit more inventory on the floor without making it too crowded.

Second, they bought new racks and display cases to give the store a better look. They had bootstrapped the start-up and had bought a variety of used and even discarded equipment to keep their initial costs down. Now that they had cash on hand, they wanted to replace that equipment with new, more professional-looking displays. Third, because they launched their business right out of college, neither of them had much money to invest. They had to borrow the money from their parents and other family members to cover the start-up costs for Young Fashion. Thus, they used most of the rest of their business's excess cash to pay down that debt to their family. They kept enough cash on hand to cover day-to-day needs.

In early April, they met with the accountant who prepared the tax returns for Young Fashion. "You certainly had a great year," he said. "But, as you know, with that success you are going to owe a bit to Uncle Sam in taxes."

"I am not sure I understand," said Susan with more than a bit of worry. "How much to we owe?"

"The \$80,000 profit will be split between the two of you, so I will issue each of you a K-1 tax form that you will include with your personal tax return. Each of you will owe the additional \$40,000 above the salaries you earned. At your tax

rate, each of you will probably owe at least another \$10,000 in taxes in a couple of weeks.”

“But we don’t have any extra cash,” said Jean. “We put it all back into the business!”

What Jean and Susan are facing is not an unusual situation for new business owners. Because they set the business up as an LLC, it is treated as a pass-through entity. Therefore, any profit from the business is not taxed at the corporate rate but rather passes directly through to each of the owners based on their shares of ownership.

Jean and Susan had spent excess cash on items that did not increase the business’s profits. They bought inventory, which merely exchanged one asset, cash, for another asset, inventory, which does not become an expense until it is sold. They bought equipment, which they will depreciate over time as an expense, but in the short run also trades one asset for another. Finally, they paid down debt, which decreases cash and decreases a liability on the balance sheet. None of these transactions had an impact on the company’s income statement. Thus, even though they spent the cash, their business still showed a profit.

Experienced entrepreneurs learn to manage cash more strategically. Many use the 1/3-1/3-1/3 rule of thumb. One-third of cash flow from profits is set aside for the taxes that owners will owe when profits flow through to their personal tax returns. Whereas some business owners build this up throughout the year and then distribute it at tax time, others distribute cash to cover taxes each quarter based on the profits for those three months. At that point, the business has done what it is

responsible for—paying out the cash to cover the tax liability. If any of the owners decide to spend it rather than save it for taxes, that is their responsibility!

Entrepreneurs keep the second third of cash from profits in the business to support growth. They use it to build up inventory, buy equipment, upgrade fixtures, and so forth, or they can simply hold it to build up cash reserves (for that eventual “rainy day”).

They use the final third of cash from profits to pay down the principle on any debt that the business owes. If the business has no debt, this final third can be distributed to the owners as dividends. Because the business already has paid taxes on the earnings from which the dividends originate, owners of pass-through entities do not pay taxes on them.

By following this approach to managing cash created by the profits of a business, entrepreneurs should never face the kind of surprise that Jean and Susan did when they met with their accountant.

1. Why is it so important for owners of pass-through entities to pay attention to personal income taxes even if they did not receive dividends or distributions of earnings?
2. If the owners of a pass-through entity are personally responsible for pay the taxes for the profits of their businesses, why is it advisable to choose an LLC or S corporation for a small business?
3. Identify and explain at least three recommendations you can make to Jean and Susan that would help them manage their company’s cash flow more effectively.

Preparing a Cash Budget

The need for a reliable cash forecast arises because in every business, the cash flowing in is rarely “in sync” with the cash flowing out. This uneven flow of cash creates periodic cash surpluses and deficits, making it necessary for entrepreneurs to track the flow of cash through their businesses so that they can project realistically the pool of cash that is available throughout the year. Many owners operate their businesses without knowing the pattern of their cash flows, believing that the process is too complex or time consuming. In reality, entrepreneurs simply cannot afford to ignore cash management. They must ensure that an adequate but not excessive supply of cash is on hand to meet their companies’ operating needs.

How much cash is enough? What is suitable for one business may be totally inadequate for another, depending on each company’s size, sales, collections, expenses, and other factors. Entrepreneurs should prepare a **cash budget**, which is nothing more than a “cash map” showing the

3. Understand the five steps in creating a cash budget and use them to build a cash budget.



Preparing a Cash Budget.
Source: Rido/Shutterstock.

amount and the timing of the cash receipts and the cash disbursements week by week or month by month. Entrepreneurs use it to predict the amount of cash they will need to cover expenses, operate smoothly, and grow the business over time, making it a valuable tool in managing a company successfully.



Lessons from the Street-Smart Entrepreneur

A Short Season

Dennis and Steve Vourderis, owners of Deno's Wonder Wheel Amusement Park on the boardwalk at New York's famous Coney Island, know that their business has to make the most of its revenue generating potential when the time is right. The company, started by their parents and home to the Wonder Wheel, a famous Ferris wheel built in 1920, generates all of its sales in the six month stretch from April to October. Years of experience have taught them that the business must be operating profitably by the July 4 holiday, or the company will struggle. Operating a highly seasonal business is a challenge in many ways. "You have to budget carefully to make sure you don't overspend," says Dennis. "Maintenance, taxes, and equipment financing are based on a 12-month year. You need to know that you'll have enough funding to cover those expenses during the time you have no cash flow." During the winter months, the Vourderis brothers are busy preparing for the next season. They and their staff disassemble the seats and other parts of the rides, inspect and refurbish them, and store them until the spring. Every year, they also repaint the Wonder Wheel, which stands 150 feet tall and weighs 400,000 pounds.

"A seasonal business is infinitely more difficult to manage than most other businesses," says Les Charm, who teaches entrepreneurship at Babson College. How can business owners whose companies face highly seasonal sales patterns manage the uneven cash flow? The Street-Smart Entrepreneur offers the following tips:

- **Put aside cash in a separate account that you use only for the lean months of your seasonal business.** Creating a separate account imposes a degree of discipline and discourages excess spending when a company is flush with cash.
 - **Maximize your productivity in the off-season.** Use the slow season to conduct market research, perform routine maintenance and repairs, revise your Web site, and stay in touch with customers. Steve Kopelman's company, *HauntedHouse.com*, earns all of its \$2.6 in annual revenue in a six-week period leading up to Halloween. Starting in November, Kopelman surveys his customers so that he can refine his marketing efforts for the next season and solicit suggestions for improvement. He visits trade shows to look for the latest technology and gadgets to keep his haunted houses fresh and exciting for his customers. Kopelman also negotiates leases on properties for the next season and studies his competition by visiting every haunted house Web site that he can find.
 - **Use the off-season to reconnect with customers.** The off-season is the ideal time to catch up on all of the small but important customer service tasks that you do not have time to perform during the height of the busy season. The owner of one small company increased his company's annual sales and reduced customer turnover by 75 percent when he set up one-on-one meetings with clients during the slow season with the purpose of discovering their needs and getting feedback about how his company could serve them better.
 - **Keep inventory at minimal levels during the off-season.** As you learned in this chapter, holding inventory unnecessarily merely ties up valuable cash uselessly.
 - **Offer off-peak discounts.** Doing so may generate some revenue during slow periods.
 - **Consider starting a complementary seasonal business.** Jan Axel, founder of Delphinium Design Landscaping in South Salem, New York, sees her business slow down considerably during the winter and decided to launch a holiday decorating service that generates cash flow when landscape sales evaporate.
 - **Create a cash flow forecast.** Perhaps one of the most important steps that seasonal business owners can take is to develop a forecast of their companies' cash flow. Doing so allows them to spot patterns and trends and to make plans for covering inevitable cash shortages. Make sure that you include a pessimistic or worst-case scenario in your cash forecast.
 - **Establish a bank line of credit.** The line of credit should be large enough to cover at least three months' worth of
- **Be financially disciplined.** Seasonal business owners must establish a realistic budget, stick to it, and avoid the temptation to spend lavishly when cash flow is plentiful. Teevan McManus, owner of the Coronado Surfing Academy in San Diego, California, failed to heed this advice in his first year of business. "I burned through everything I made in the summer and was living off of my business line of credit before the next season came around," he recalls. "I barely made it to the next June."
 - **Manage your time and your employees' time carefully.** During the busy season, employees may be working overtime to serve the rush of customers; during the off-season, a business owner may cut back to 20-hour workweeks or operate with a skeleton crew.
 - **Use permanent employees sparingly.** Many owners of seasonal businesses use a small core of permanent employees and then hire part-time workers or student interns during their busy season. Planning for the right number of seasonal employees and recruiting them early ensures that a business will be able to serve its customers properly.

expenses. Use your cash flow forecast to show the banker how and when your company will be able to repay the loan. “[A good cash forecast] shows the banker that you know exactly where the peaks and valleys are and what your cash needs are,” says one banker.

1. What impact do highly seasonal sales have on a small company's cash flow?
2. What other advice can you offer owners of seasonal businesses about coping with the effects of their companies'

highly irregular sales patterns? About managing cash flow in general?

Sources: Based on John Grossman, “A Tourist-Dependent Business Decides to Reboot,” *New York Times*, July 18, 2012, <http://boss.blogs.nytimes.com/2012/07/18/a-tourist-dependant-business-decides-to-reboot/>; John Grossman, “A Seasonal Business Aims to Survive the Off-Season,” *New York Times*, July 11, 2012, p. B9; “Make the Most of the Slow Season,” *Marketing Profs*, May 28, 2009, pp. 1–2; Rich Mintzer, “Running a Seasonal Business,” *Entrepreneur*, March 16, 2007, www.entrepreneur.com/management/operations/article175954.html; Sarah Pierce, “Surviving a Seasonal Business,” *Entrepreneur*, July 15, 2008, www.entrepreneur.com/startingabusiness/businessideas/article195680.html; Rich Mintzer, “Running a Seasonal Business,” *Entrepreneur*, March 16, 2007, <http://www.entrepreneur.com/management/operations/article175954.html>.

Typically, a small business owner should prepare a projected monthly cash budget for at least one year and quarterly estimates one or two years beyond that. To be effective, a cash budget must cover all seasonal sales fluctuations. The more variable a company's sales pattern, the shorter its planning horizon should be. For example, a firm whose sales fluctuate widely over a relatively short time frame might require a weekly cash budget rather than a monthly one. The key to managing cash flow successfully is to monitor not only the amount of cash flowing into and out of a company but also the *timing* of those cash flows.

Regardless of the time frame selected, a cash budget must be in writing for an entrepreneur to visualize a company's cash position. Creating a written cash plan is not an excessively time-consuming task and can help the owner avoid unexpected cash shortages, a situation that can cause a business to fail. One financial consultant describes “a client who won't be able to make the payroll this month. His bank agreed to meet the payroll for him—but banks don't like to be surprised like that,” he adds.⁹ Preparing a cash budget will help business owners avoid unpleasant surprises such as that. It will also let owners know whether they are keeping excessive amounts of cash on hand. Computer spreadsheets, such as Excel, make the job fast and easy to complete and allow for instant updates and “what-if” analysis. In addition, many accounting software packages also have effective cash management tools integrated into their reports.

A cash budget is based on the cash method of accounting, which means that cash receipts and cash disbursements are recorded in the forecast only when the cash transaction is expected to take place. For example, credit sales to customers are not reported until the company expects to receive the cash from them. Similarly, purchases made on credit are not recorded until the owner expects to pay them. Because depreciation, bad debt expense, and other noncash items involve no cash transfers, they are omitted entirely from the cash budget.

A cash budget is nothing more than a forecast of a company's cash inflows and outflows for a specific time period, and it will never be completely accurate. However, it does give a small business owner a clear picture of a company's estimated cash balance for the period, pointing out where external cash infusions may be required or where surplus cash balances may be available for investing. A good cash budget serves as an early warning system for cash flow challenges. In addition, by comparing actual cash flows with projections, an entrepreneur can revise his or her forecast so that future cash budgets will be more accurate. “Watch your income on a daily basis until you fully understand your revenue and expenses,” says Robin Wilson, CEO of Robin Wilson Home. “Make sure your bookkeeper is your partner and never settle for being told ‘everything is handled.’”¹⁰

Formats for preparing a cash budget vary depending on the pattern of a company's cash flow. Table 15.2 shows a monthly cash budget for a small retail store over a four-month period. Each monthly column should be divided into two sections—estimated and actual (not shown)—so that subsequent cash forecasts can be updated according to actual cash transactions. There are five steps to creating a cash budget:

1. Determining an adequate minimum cash balance
2. Forecasting sales
3. Forecasting cash receipts
4. Forecasting cash disbursements
5. Estimating the end-of-month cash balance.

Step 1: Determining an Adequate Minimum Cash Balance

What is considered an excessive cash balance for one small business may be inadequate for another, even though the two firms are in the same industry. Some suggest that a company's cash balance should equal at least one-fourth of its current liabilities, but this simple guideline does not work for all small businesses. The most reliable method of deciding cash balance is based on past experience. Past operating records should indicate the proper cash cushion needed to cover any unexpected expenses after all normal cash outlays are deducted from the month's cash receipts. For example, past records may indicate that it is desirable to maintain a cash balance equal to five days' sales. Seasonal fluctuations may cause a company's minimum cash balance to change. For example, the desired cash balance for a retailer in December may be greater than in June.

Step 2: Forecasting Sales

The heart of the cash budget is the sales forecast. It is the central factor in creating an accurate picture of a company's cash position because sales ultimately are transformed into cash receipts and cash disbursements. For most businesses, sales constitute the primary source of the cash flowing into the business. Similarly, sales of merchandise require entrepreneurs to use

TABLE 15.2 Cash Budget for Small Department Store

Assumptions:

Cash balance on December 31 = \$12,000

Minimum cash balance desired = \$10,000

Sales are 75% credit and 25% cash.

Credit sales are collected in the following manner:

- 60% collected in the first month after the sale.
- 30% collected in the second month after the sale.
- 5% collected in the third month after the sale.
- 5% are never collected.

Sales Forecasts Are as Follows:

	Pessimistic	Most Likely	Optimistic
October (actual)		\$300,000	
November (actual)		350,000	
December (actual)		400,000	
January	\$120,000	150,000	\$175,000
February	160,000	200,000	250,000
March	160,000	200,000	250,000
April	250,000	300,000	340,000

The store pays 70% of sales price for merchandise purchased and pays for each month's anticipated sales in the preceding month.

Rent is \$2,000 per month.

An interest payment of \$7,500 is due in March.

A tax prepayment of \$50,000 must be made in March.

A capital addition payment of \$130,000 is due in February.

Utilities expenses amount to \$850 per month.

Miscellaneous expenses are \$70 per month.

Interest income of \$200 will be received in February.

Wages and salaries are estimated to be

January—\$30,000

February—\$40,000

March—\$45,000

April—\$50,000

TABLE 15.2 (continued)

Cash Budget—Pessimistic Sales Forecast

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
<i>Cash Receipts:</i>							
Sales	\$300,000	\$350,000	\$400,000	\$120,000	\$160,000	\$160,000	\$250,000
Credit Sales	225,000	262,500	300,000	90,000	120,000	120,000	187,500
<i>Collections:</i>							
60%—1st month after sale				\$180,000	\$ 54,000	\$ 72,000	\$ 72,000
30%—2nd month after sale				78,750	90,000	27,000	36,000
5%—3rd month after sale				11,250	13,125	15,000	4,500
Cash Sales				30,000	40,000	40,000	62,500
Interest				0	200	0	0
Total Cash Receipts				\$300,000	\$197,325	\$154,000	\$175,000
<i>Cash Disbursements:</i>							
Purchases				\$112,000	\$112,000	\$175,000	\$133,000
Rent				2,000	2,000	2,000	2,000
Utilities				850	850	850	850
Interest				0	0	7,500	0
Tax Prepayment				0	0	50,000	0
Capital Addition				0	130,000	0	0
Miscellaneous				70	70	70	70
Wages/Salaries				30,000	40,000	45,000	50,000
Total Cash Disbursements				\$144,920	\$284,920	\$280,420	\$185,920
<i>End-of-Month Balance:</i>							
Cash (beginning of month)				\$ 12,000	\$167,080	\$ 79,485	\$ 10,000
+ Cash Receipts				300,000	197,325	154,000	175,000
– Cash Disbursements				144,920	284,920	280,420	185,920
Cash (end of month)				167,080	79,485	(46,935)	(920)
Borrowing/Repayment				0	0	56,935	10,920
Cash (end of month [after borrowing])				\$167,080	\$ 79,485	\$ 10,000	\$ 10,000

Cash Budget—Most Likely Sales Forecast

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
<i>Cash Receipts:</i>							
Sales	\$300,000	\$350,000	\$400,000	\$150,000	\$200,000	\$200,000	\$300,000
Credit Sales	225,000	262,500	300,000	112,000	150,000	150,000	225,000
<i>Collections:</i>							
60%—1st month after sale				\$180,000	\$ 67,500	\$ 90,000	\$ 90,000
30%—2nd month after sale				78,750	90,000	33,750	45,000
5%—3rd month after sale				11,250	13,125	15,000	5,625
Cash Sales				37,500	50,000	50,000	75,000
Interest				0	200	0	0
Total Cash Receipts				\$307,500	\$220,825	\$188,750	\$215,625
<i>Cash Disbursements:</i>							
Purchases				\$140,000	\$140,000	\$210,000	\$175,000
Rent				2,000	2,000	2,000	2,000

(continued)

TABLE 15.2 (continued)**Cash Budget—Most Likely Sales Forecast**

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
Utilities				850	850	850	850
Interest				0	0	7,500	0
Tax Prepayment				0	0	50,000	0
Capital Addition				0	130,000	0	0
Miscellaneous				70	70	70	70
Wages/Salaries				30,000	40,000	45,000	50,000
Total Cash Disbursements				<u>\$172,920</u>	<u>\$312,920</u>	<u>\$315,420</u>	<u>\$227,920</u>
<i>End-of-Month Balance:</i>							
Cash [beginning of month]				\$ 12,000	\$146,580	\$ 54,485	\$ 10,000
+ Cash Receipts				307,500	220,825	188,750	215,625
– Cash Disbursements				<u>172,920</u>	<u>312,920</u>	<u>315,420</u>	<u>227,920</u>
Cash (end of month)				146,580	54,485	(72,185)	(2,295)
Borrowing/Repayment				0	0	82,185	12,295
Cash (end of month [after borrowing])				<u>\$146,580</u>	<u>\$ 54,485</u>	<u>\$ 10,000</u>	<u>\$ 10,000</u>

Cash Budget—Optimistic Sales Forecast

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
<i>Cash Receipts:</i>							
Sales	\$300,000	\$350,000	\$400,000	\$175,000	\$250,000	\$250,000	\$340,000
Credit Sales	225,000	262,500	300,000	131,250	187,500	187,500	255,000
<i>Collections:</i>							
60%—1st month after sale				\$180,000	\$ 78,750	\$112,500	\$112,500
30%—2nd month after sale				78,750	90,000	39,375	56,250
5%—3rd month after sale				11,250	13,125	15,000	6,563
Cash Sales				43,750	62,500	62,500	85,000
Interest				0	200	0	0
Total Cash Receipts				<u>\$313,750</u>	<u>\$244,575</u>	<u>\$229,375</u>	<u>\$260,313</u>
<i>Cash Disbursements:</i>							
Purchases				\$175,000	\$175,000	\$238,000	\$217,000
Rent				2,000	2,000	2,000	2,000
Utilities				850	850	850	850
Interest				0	0	7,500	0
Tax Prepayment				0	0	50,000	0
Capital Addition				0	130,000	0	0
Miscellaneous				70	70	70	70
Wages/Salaries				30,000	40,000	45,000	50,000
Total Cash Disbursements				<u>\$207,920</u>	<u>\$347,920</u>	<u>\$343,420</u>	<u>\$269,920</u>
<i>End-of-Month Balance:</i>							
Cash [beginning of month]				\$ 12,000	\$117,830	\$ 14,485	\$ 10,000
+ Cash Receipts				313,750	244,575	229,375	296,125
– Cash Disbursements				<u>207,920</u>	<u>317,920</u>	<u>343,120</u>	<u>269,920</u>
Cash (end of month)				117,830	14,485	(99,560)	36,205
Borrowing/Repayment				0	0	109,560	0
Cash (end of month [after borrowing])				<u>\$117,830</u>	<u>\$ 14,485</u>	<u>\$ 10,000</u>	<u>\$ 36,205</u>

cash to replenish inventory. As a result, the cash budget is only as accurate as the sales forecast from which it is derived; an accurate sales forecast is essential to producing a reliable cash flow forecast.

For an established business, the sales forecast can be based on past sales, but entrepreneurs must be careful not to be excessively optimistic in projecting sales. Economic swings, inflation, increased competition, fluctuations in demand, and other factors can drastically alter sales patterns. A good cash budget must reflect the seasonality of a company's sales. Simply deriving a realistic annual sales forecast and then dividing it by 12 does *not* produce a reliable monthly sales forecast. Most businesses have sales patterns that are “lumpy” and not evenly distributed throughout the year. For instance, Super Bowl Sunday is the single-largest revenue-generating day of the year for most pizzerias (and ranks second only to Thanksgiving as the largest food consumption day). David Evans, owner of EasySeat, an online ticket broker for concerts and sporting events, knows about the challenges of owning a seasonal business. “With opening day of Major League Baseball over, I breathe a deep sigh of relief as a ticket broker,” says Evans. “It means my company has started shipping all of the baseball tickets that it has been purchasing for the last 7 months. That means cash flow will soon turn positive again.”¹¹ Highly seasonal sales patterns such as these can make managing cash flow a challenge for entrepreneurs.

The task of forecasting sales for a new firm is difficult but not impossible. For example, an entrepreneur might conduct research on similar firms and their sales patterns in the first year of operation to come up with a forecast. The local chamber of commerce and industry trade associations also collect such information. Publications such as *BizMiner* and the Risk Management Association's *Annual Statement Studies*, which profile financial statements for companies of all sizes in many industries, also are useful tools. Other potential sources that may help predict sales include Census Bureau reports, newspapers, radio and television customer profiles, polls and surveys, and local government statistics. Talking with owners of similar businesses (outside the local trading area, of course) can provide entrepreneurs with realistic estimates of start-up sales. Table 15.3 provides an example of how one entrepreneur used a variety of marketing information to derive a sales forecast for his first year of operation in the automotive repair business.

No matter what techniques entrepreneurs use to forecast cash flow, they must recognize that even the best sales estimates will be wrong. Many financial analysts suggest that entrepreneurs create *three estimates*—a most likely, an optimistic, and a pessimistic sales estimate—and then make a separate cash budget for each forecast (a very simple task with a computer spreadsheet).

TABLE 15.3 Forecasting Sales for a Business Start-Up

Robert Adler wants to open a repair shop for imported cars. The trade association for automotive garages estimates that the owner of an imported car spends an average of \$485 per year on repairs and maintenance. The typical garage attracts its clientele from a trading zone (the area from which a business draws its customers) with a 20-mile radius. Census reports show that the families within a 20-mile radius of Robert's proposed location own 84,000 cars, of which 24 percent are imports. Based on a local market consultant's research, Robert believes he can capture 9.9 percent of the market this year. Robert's calculations to estimate of his company's first year's sales are as follows:

Number of cars in trading zone	84,000 autos
× Percent of imports	× 24%
= Number of imported cars in trading zone	20,160 imports
Number of imports in trading zone	20,160
× Average expenditure on repairs and maintenance	× \$485
= Total import repair sales potential	\$9,777,600
Total import repair sales potential	\$9,777,600
× Estimated share of market	× 9.9%
= Sales estimate	\$967,982

Now Robert Adler can convert this annual sales estimate of \$967,982 into monthly sales estimates

This dynamic forecast enables entrepreneurs to determine the range within which their business's sales and cash flows will likely fall as the year progresses. By using the forecast that most closely reflects their sales patterns, entrepreneurs can project their companies' cash flow more accurately.

Step 3: Forecasting Cash Receipts

As noted earlier, sales constitute the major source of cash receipts. When a company sells goods and services on credit, the cash budget must count for the delay between the sale and the actual collection of the proceeds. Remember: You cannot spend cash you haven't collected yet! For instance, a commercial carpet cleaning company might not collect the cash from carpets they clean in hotels and restaurants in February until March or April (or even later), and the cash budget must reflect this delay. To project accurately a firm's cash receipts, entrepreneurs must analyze their companies' accounts receivable to determine their collection pattern. For example, an entrepreneur may discover that 20 percent of sales are for cash, 50 percent are paid in the month following the sale, 20 percent are paid two months after the sale, 7 percent are paid after three months, and 3 percent are never collected. In addition to cash and credit sales, a cash budget must include any other cash the company receives, such as interest income, rental income, dividends, and others.

Some small business owners never discover the hidden danger in accounts receivable until it is too late for their companies. Receivables act as cash sponges, tying up valuable dollars until an entrepreneur collects them.



ENTREPRENEURIAL PROFILE: Mary and Phil Baechler: Baby Jogger Company

When Mary and Phil Baechler started Baby Jogger Company to make strollers that would enable parents to take their babies along on their daily runs, Mary was in charge of the financial aspects of the business and watched its cash flow closely. As the company grew, the couple created an accounting department to handle its financial affairs. Unfortunately, the financial management system could not keep up with the company's rapid growth and failed to provide the necessary information to keep its finances under control. As inventory and accounts receivable ballooned, the company headed for a cash crisis. To ensure Baby Jogger's survival, the Baechlers were forced to reduce their company's workforce by half. Then they turned their attention to the accounts receivable and discovered that customers owed the business almost \$700,000! In addition, most of the accounts were past due. Focusing on collecting the money owed to their company, the Baechlers were able to steer clear of a cash crisis and get Baby Jogger back on track.¹²

Figure 15.4 demonstrates how vital it is to act promptly once an account becomes past due. Notice how the probability of collecting an outstanding account diminishes the longer the account is delinquent. Table 15.4 illustrates the high cost of failing to collect accounts receivable on time.

Many banks now offer cash management tools designed to speed up the collection of invoices to small companies that once were reserved only for large businesses. Once set up with a bank, **electronic (or Automated Clearing House, ACH) collections** automatically deduct invoice amounts from a customer's account and deposit them into the seller's account within 24 hours. Businesses can use electronic collections for single or periodic transactions, but they are ideal for recurring transactions. **Remote deposit** allows businesses to scan customers' checks and deposit them from anywhere using a smart phone or portable scanner, a computer, and an Internet connection. Scanned checks create an online, digital deposit that eliminates time-consuming runs to the bank. Banks typically charge a monthly fee and a charge for each scanned check to provide the remote deposit service. Entrepreneurs should compare the benefits and the costs of these services at various banks, which should be able to provide a daily list of transactions to allow entrepreneurs to reconcile payments with their accounts receivable records.

Step 4: Forecasting Cash Disbursements

Most owners of established businesses have a clear picture of a company's pattern of cash disbursements. In fact, many cash payments, such as rent, salaries, loan repayments, and insurance premiums, are fixed amounts due on specified dates. The key factor in forecasting disbursements for a cash budget is to *record them in the month in which they will be paid, not*

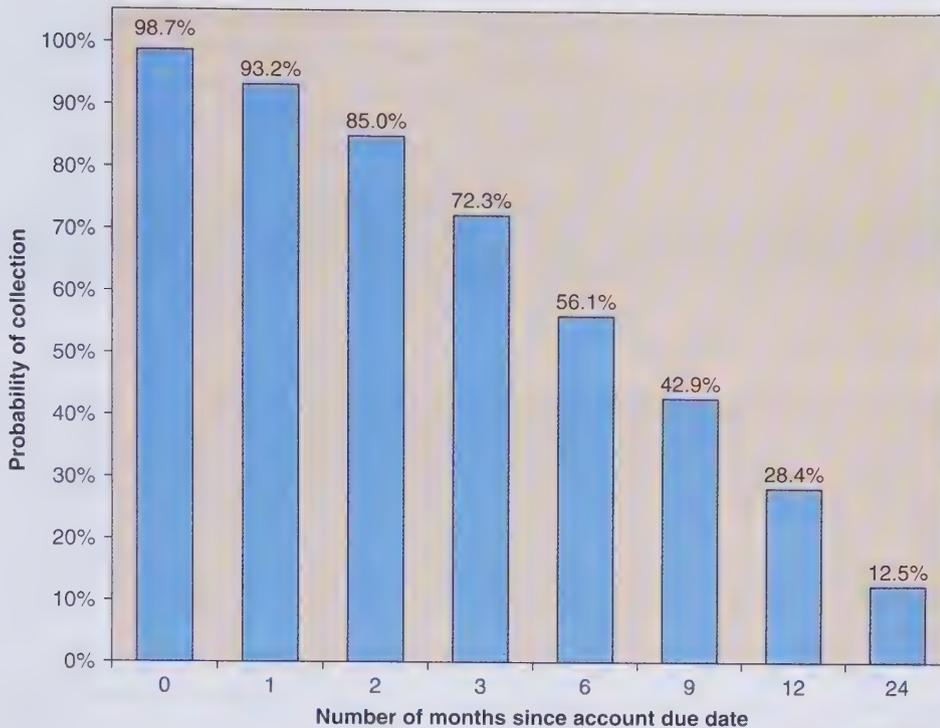


FIGURE 15.4
Probability of Collecting Accounts Receivable

Source: Based on Commercial Collection Agency Section of the Commercial Law League of America.

TABLE 15.4 Managing Accounts Receivable

Are your customers who purchase on credit paying late? If so, these outstanding accounts receivable probably represent a significant leak in your company’s profits. Regaining control of these late payers will likely improve your company’s profits and cash flow.

Slow-paying customers, in effect, are borrowing money from your business interest free! They are using your money without penalty while you forgo opportunities to put it to productive use in your company or to place it in interest-bearing investments. Exactly how much are poor credit practices costing you? The answer may surprise you.

The first step is to compute the company’s average collection period ratio, which tells the number of days required to collect the typical account receivable. Then you compare this number to your company’s credit terms. The following example shows how to calculate the cost of past-due receivables for a company whose credit terms are “net 30”:

Average collection period	65 days
Less: credit terms	<u>-30 days</u>
Excess in accounts receivable	35 days
Average daily sales of \$21,500 × 35 days excess*	\$752,500
Normal rate of return on investment	<u>×5%</u>
Annual cost of excess	\$37,625

Slow paying customers are costing this company nearly \$38,000 per year. If your business is highly seasonal, quarterly or monthly figures may be more meaningful than annual ones.

$$* \text{ Average daily sales} = \frac{\text{Annual sales}}{365} = \frac{\$7,847,500}{365} = \$21,500$$

when the debt or obligation is incurred. Of course, the number and type of cash disbursements varies with each particular business, but the following disbursement categories are standard: purchases of inventory or raw materials, wages and salaries, rent, taxes, loan repayments, interest, marketing and selling expenses, Internet and Web site expenses, utility expenses, and miscellaneous expenses.

When preparing a cash budget, one of the worst mistakes entrepreneurs can make is to underestimate cash disbursements, which can result in a cash crisis. To prevent this, wise entrepreneurs

cushion their cash disbursements, assuming that they will be higher than expected. This is particularly important for entrepreneurs opening new businesses. In fact, some financial analysts recommend that people starting new businesses make the best estimates of their companies' cash disbursements and then add another 25 to 50 percent of that total as a contingency, recognizing that business expenses often run higher than expected. When setting up his company's cash budget, one entrepreneur included a line called "Murphy," an additional amount each month to account for Murphy's Law ("What can go wrong will go wrong").

Sometimes business owners have difficulty developing initial forecasts of cash receipts and cash disbursements. One of the most effective techniques for overcoming the "I don't know where to begin" hurdle is to make a *daily* list of the items that generated cash (receipts) and those that consumed it (disbursements).



ENTREPRENEURIAL PROFILE: Susan Bowen: Champion Awards Susan Bowen, CEO of Champion Awards, a \$9 million T-shirt screen printer, monitors cash flow by tracking the cash that flows into and out of her company every day. Focusing on keeping the process simple, Bowen sets aside a few minutes each morning to track updates from the previous day on four key numbers:

Accounts receivable: (1) What was billed yesterday? (2) How much was actually collected?
Accounts payable: (3) What invoices were received yesterday? (4) How much in total was paid out?

If Bowen observes the wrong trend—more new bills than new sales or more money going out than coming in—she makes immediate adjustments to protect her cash flow. The benefits produced (not the least of which is the peace of mind knowing no cash crisis is looming) more than outweigh the 10 minutes she invests in the process every day. "I've tried to balance my books every single day since I started my company in 1970," says Bowen.¹³

Step 5: Estimating the End-of-Month Cash Balance

To estimate a company's final cash balance for each month, entrepreneurs first must determine the cash balance at the beginning of each month. The beginning cash balance includes cash on hand as well as cash in checking and savings accounts. The cash balance at the *end* of one month becomes the *beginning* balance for the following month. Next, the owner simply adds to that balance the projected total cash receipts for the month and then subtracts projected total cash disbursements to obtain the end-of-month balance before any borrowing takes place. A positive balance indicates that the business has a cash surplus for the month, but a negative balance shows that a cash shortage will occur unless the entrepreneur is able to collect, raise, or borrow additional cash.

Normally, a company's cash balance fluctuates from month to month, reflecting seasonal sales patterns. These fluctuations are normal, but entrepreneurs must watch closely any increases and decreases in the cash balance over time. A trend of increases indicates that the small firm has ample cash that could be placed in some income-earning investment. On the other hand, a pattern of cash decreases should alert the owner of an impending cash crisis.

Preparing a cash budget not only illustrates the flow of cash into and out of the small business but also allows a business owner to *anticipate* cash shortages and cash surpluses. By planning cash needs ahead of time, an entrepreneur is able to do the following:

- Increase the amount and the speed of cash flowing into the company.
- Reduce the amount and the speed of cash flowing out of the company.
- Develop a sound borrowing and repayment program.
- Impress lenders and investors with a plan for repaying loans or distributing dividends.
- Reduce borrowing costs by borrowing only when necessary.
- Take advantage of money-saving opportunities, such as cash discounts.
- Make the most efficient use of the cash available.
- Finance seasonal business needs.
- Provide funds for expansion.
- Improve profitability by investing surplus cash.

The message is simple: Managing cash flow means survival for a business. Businesses tend to succeed when their owners manage cash effectively. Entrepreneurs who neglect cash flow management techniques are likely to see their companies fold; those who take the time to manage their cash flow free themselves of worrying about their companies' solvency to focus on what they do best: taking care of their customers and ensuring their companies' success.

 **Entrepreneurship in Action**

Rowena's Cash Budget

Rowena Rowdy had been in business for slightly more than two years, but she had never taken the time to develop a cash budget for her company. Based on a series of recent events, however, she knew the time had come to start paying more attention to her company's cash flow. The business was growing fast, with sales more than tripling from the previous year, and profits were rising. However, Rowena often found it difficult to pay all of the company's bills on time. She didn't know why exactly, but she knew that the company's fast growth was requiring her to incur higher levels of expenses.

Last night, Rowena attended a workshop on managing cash flow sponsored by the local chamber of commerce.

Much of what the presenter said hit home with Rowena. "This fellow must have taken a look at my company's financial records before he came here tonight," she said to a friend during a break in the presentation. On her way home from the workshop, Rowena decided that she would take the presenter's advice and develop a cash budget for her business. After all, she was planning to approach her banker about a loan for her company, and she knew that creating a cash budget would be an essential part of her loan request. She started digging for the necessary information, and this is what she came up with:

Current cash balance	\$10,685
Sales pattern	63% on credit and 37% in cash
Collections of credit sales	61% in 1 to 30 days; 27% in 31 to 60 days; 8% in 61 to 90 days; 4% never collected (bad debts).

Sales forecasts:

	Pessimistic	Most Likely	Optimistic
January (actual)	—	\$24,780	—
February (actual)	—	\$20,900	—
March (actual)	—	\$21,630	—
April	\$19,100	\$23,550	\$25,750
May	\$21,300	\$24,900	\$27,300
June	\$23,300	\$29,870	\$30,000
July	\$23,900	\$27,500	\$29,100
August	\$20,500	\$25,800	\$28,800
September	\$18,500	\$21,500	\$23,900
Utilities expenses		\$950 per month	
Rent		\$2,250 per month	
Truck loan		\$427 per month	

The company's wages and salaries (including payroll taxes) estimates are as follows:

April	\$3,550	July	\$6,255
May	\$4,125	August	\$6,060
June	\$5,450	September	\$3,525

Entrepreneurship in Action *(continued)*

The company pays 66 percent of the sales price for the inventory it purchases, an amount that it actually pays in the following month. (Rowena has negotiated “net 30” credit terms with her suppliers.)

Other expenses include the following:

Insurance premiums	\$1,200, payable in April and September
Office supplies	\$125 per month
Maintenance	\$75 per month
Uniforms/cleaning	\$80 per month
Office cleaning service	\$85 per month
Internet and computer service	\$225 per month
Computer supplies	\$75 per month
Advertising	\$450 per month
Legal and accounting fees	\$250 per month
Miscellaneous expenses	\$95 per month

A tax payment of \$3,140 is due in June.

Rowena has established a minimum cash balance of \$1,500.

If Rowena must borrow money, she uses her line of credit at the bank, which charges interest at an annual rate of 10.25 percent. Any money that Rowena borrows must be repaid the next month.

1. Help Rowena put together a cash budget for the six months beginning in April.
2. Does it appear that Rowena’s business will remain solvent, or could the company be heading for a cash crisis?
3. What suggestions can you make to help Rowena improve her company’s cash flow?

The “Big Three” of Cash Management

It is unrealistic for entrepreneurs to expect to trace the flow of every dollar through their businesses. However, by concentrating on the three primary causes of cash flow problems, they can dramatically lower the likelihood of experiencing a devastating cash crisis. The “big three” of cash management are accounts receivable, accounts payable, and inventory. When it comes to managing cash flow, entrepreneurs’ goals should be to accelerate their companies’ accounts receivable and to carefully manage their accounts payable. Business owners also must monitor inventory carefully to avoid tying up valuable cash in an excess inventory. Figure 15.5 illustrates the interaction of the “big three” (inventory, accounts receivable, and accounts payable) in a company’s cash conversion cycle and a measure for each one (days’ inventory outstanding, days’ sales’ outstanding, and days’ payable outstanding).

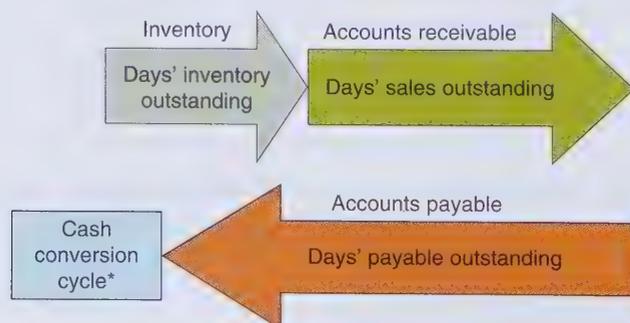
Accounts Receivable

Selling merchandise and services on credit is a necessary evil for most small businesses. Many customers expect to buy on credit, and entrepreneurs extend it to avoid losing customers to competitors. However, selling to customers on credit is expensive; it requires more paperwork, more

4.

Describe the fundamental principles involved in managing the “big three” of cash management: accounts receivable, accounts payable, and inventory.

FIGURE 15.5
The Cash Conversion Cycle



*Cash conversion cycle = Days' inventory + Days' sales outstanding - Days' payable

staff, and *more cash* to service accounts receivable. In addition, because extending credit is, in essence, lending money, the risk involved is higher. Every business owner who sells on credit will encounter customers who pay late or, worst of all, who never pay at all.



ENTREPRENEURIAL PROFILE: Trish and Richard Wolfe: Artisan Shutter Co. Trish and

Richard Wolfe, co-owners of Artisan Shutter Co., felt the pinch of late payments by customers on accounts receivable. Their company makes custom shutters for high-end residential and commercial buildings. In the aftermath of the real estate collapse that was part of the Great Recession, half of Artisan Shutter's customers were late on their payments, which was a dramatic increase from the 5 percent late payments the company experienced before the real-estate decline started. "The bigger they are, the less they want to give us up front," says Trish. At one point, a large architecture firm called to say it couldn't pay the \$40,000 balance it owed for \$180,000 worth of shutters it had purchased for a high-end hotel development. Artisan Shutter was forced to lay off about 15 percent of its employees.¹⁴

According to a survey by Decipher Inc. and software publisher Intuit, the average small business has \$1,500 in past-due accounts receivable per month. The same survey also reports an average of \$1,900 in bad debt losses each year for the typical small business, which adds up to a total annual loss of \$42 billion for all small businesses!¹⁵ As you can imagine, this revenue leakage can be the source of severe cash flow problems for a small business. Much like a leak in a water pipe, revenue leakages from undisciplined collection procedures can become significant over time and cause serious damage. One expert estimates that revenue leakages rob companies of 2 percent of their sales. Health care and Web service providers, for instance, typically lose 5 to 10 percent of their revenues each year.¹⁶

Selling on credit is a common practice in business. "Extending credit is a [double]-edged sword," says Robert Smith, president of his own public relations firm in Rockford, Illinois. "I give credit so more people can afford my publicity services. I also have people who still owe me money—and who will probably never pay."¹⁷

Because so many entrepreneurs sell on credit, an assertive collection program is essential to managing a company's cash flow. A credit policy that is too lenient can destroy a business's cash flow, attracting nothing but slow-paying and "deadbeat" customers. On the other hand, a carefully designed credit policy can be a powerful selling tool, attracting customers and boosting cash flow. "A sale is not a sale until you collect the money," warns the head of the National Association of Credit Management. "Receivables are the second most important item on the balance sheet. The first is cash. If you don't turn those receivables into cash, you're not going to be in business very long."¹⁸



ENTREPRENEURIAL PROFILE: David Barker: 4D Data Centre David Barker founded

4D Data Centres in 1999 in the United Kingdom at the age of 14. During its growth phase, the company had to take short-term loans from shareholders for two consecutive months to pay their suppliers, leading to a cash-flow crisis. The problem occurred because some of the clients delayed payment of the fixed recurring charges beyond the invoice due date.¹⁹

HOW TO ESTABLISH A CREDIT AND COLLECTION POLICY The first step in establishing a workable credit policy that preserves a company's cash flow is to screen customers carefully before granting credit. Unfortunately, few small businesses conduct any kind of credit investigation before selling to a new customer. According to one study, nearly 95 percent of small firms that sell on credit sell to anyone who wants to buy.²⁰ If a debt becomes past due and a business owner has gathered no information about the customer, the odds of collecting the account are virtually nil.

The first line of defense against bad debt losses is a detailed credit application. Before selling to any customer on credit, a business owner should have the customer complete a customized application designed to provide the information needed to judge the potential customer's creditworthiness. At a minimum, this credit profile should include the following information about customers:

- Name, address, Social Security number, and telephone number
- Form of ownership (proprietorship, S corporation, LLC, corporation, and so on) and number of years in business
- Credit references (e.g., other suppliers), including contact names, addresses, and telephone numbers

After collecting this information, entrepreneurs should use it by checking the potential customer's credit references! The savings from lower bad debt expenses can more than offset the cost of using a credit reporting service. Companies such as Dun & Bradstreet (www.dnb.com), Experian (www.experian.com), Equifax (www.equifax.com), and TransUnion (www.transunion.com) enable entrepreneurs to gather credit information on potential customers. For entrepreneurs who sell to other business, Dun & Bradstreet offers many useful services for evaluating the credit risk of new and existing businesses. The National Association of Credit Management (www.nacm.org) is another important source of credit information because it collects information on many small businesses that other reporting services ignore. The cost to check a potential customer's credit at reporting services such as these starts at \$119, a small price to pay when a small business is considering selling thousands of dollars worth of goods or services to a new customer. Before Terri Wilson, a top executive at OE Construction, agrees to do any work as a subcontractor, she conducts a credit check on the contractor to see how promptly the contractor pays its bills. She also gathers information about the company's owner, financial manager, and the volume of work it does to gauge the credit risk it poses to OE Construction.²¹

The next step involves establishing a firm written credit policy and letting every customer know in advance the company's credit terms. "Our cash flow won't allow us to carry customers with a tendency to slow-pay," says Anita McKinney, controller of Luttrell Belting & Supply Co. "With a couple of potential customers, we said, 'We can't give you credit. Pay cash or give us a credit card.' They're not necessarily people who are out to do us wrong. It's just they're struggling like many people are to keep their businesses going."²² The credit agreement must be in writing and should specify a customer's credit limit (which usually varies from one customer to another, depending on their credit ratings) and any deposits required (often stated as a percentage of the purchase price). It should state clearly all of the terms the business will enforce if the account goes bad, including interest, late charges, attorney's fees, and others. Failure to specify these terms in the contract means that they *cannot* be added later after problems arise. When will you send invoices? How soon is payment due: immediately, 20 days, or 30 days? Will you offer early-payment discounts? Will you add a late charge? If so, how much? The credit policies should be as tight as possible but remain within federal and state credit laws. According to the American Collectors Association, if a business is writing off more than 5 percent of sales as bad debts, the owner should tighten its credit and collection policy.²³

The third step in an effective credit policy is to send invoices promptly because customers rarely pay before they receive their bills. Unfortunately, a recent study reports that 20 percent of small business owners forget to send invoices or to follow up on past-due invoices.²⁴ The sooner a company sends invoices, the sooner its customers will pay them. Manufacturers and wholesalers should make sure invoices are en route to customers as soon as the shipments go out the door (if not before). Service companies should keep track of billable hours daily or weekly and bill as often as the contract or agreement with the client permits. Online or computerized billing software makes managing accounts receivable much easier, is less expensive, and produces faster payments than paper invoices, but only 34 percent of small businesses use these programs.²⁵ Some businesses also use **cycle billing**, in which a company bills a portion of its credit customers each day of the month to smooth out uneven cash receipts.



ENTREPRENEURIAL PROFILE: Bob Dempster: American Imaging Inc. Bob Dempster, cofounder of American Imaging Inc., a distributor of X-ray tubes, once handled receivables the same way most entrepreneurs do: When customers ignored the "net 30" terms on invoices, he would call them around the forty-fifth day to ask what the problem was. Payments usually would trickle in within the next two weeks, but by then 60 days had elapsed, and American Imaging's cash flow was always strained. Then Dempster decided to try a different approach. Now he makes a "customer relations call" on the twentieth day of the billing period to determine whether the customer is satisfied with the company's performance on the order. Before closing, he reminds the customer of the invoice due date and asks if there will be any problems meeting it. Dempster's proactive approach to collecting receivables has cut his company's average collection period by at least 15 days, improved cash flow, and increased customer satisfaction!²⁶

overdue, many business owners send a “second notice” letter requesting immediate payment. If that fails to produce results, the next step is a telephone call. A better system is to call the customer the day after the payment is due to request payment. If the customer cannot pay the entire amount, get him or her to commit to a schedule of smaller payments. If that fails, collection experts recommend the following:

- Send a letter from the company’s attorney.
- Turn the account over to a collection attorney.
- As a last resort, hire a collection attorney.

Collection agencies collect nearly \$55 billion annually in past due accounts for businesses.²⁷ Although collection agencies and attorneys take a portion of any accounts they collect (typically around 30 percent), they are often worth the price. According to the American Collector’s Association, only 5 percent of accounts more than 90 days delinquent will be paid voluntarily.²⁸

Business owners must be sure to abide by the provisions of the federal Fair Debt Collection Practices Act, which prohibits any kind of harassment when collecting debts (e.g., telephoning repeatedly, issuing threats of violence, telling third parties about the debt, or using abusive language). When collecting past-due accounts, the primary rule in dealing with past-due accounts is, “Never lose your cool.” Even if the debtor launches into an X-rated tirade when questioned about an overdue bill, the *worst* thing a collector can do is respond out of anger. Keep the call strictly business and begin by identifying yourself, your company, and the amount of the debt. Ask the creditor what he or she intends to do about the past-due bill.

TECHNIQUES FOR ACCELERATING ACCOUNTS RECEIVABLE Although “net 30” credit terms are common, 64 percent of small business owners say that they have accounts receivable that have gone unpaid for more than 60 days.²⁹ Entrepreneurs can rely on a variety of techniques to speed cash inflow from accounts receivable:

- Speed up orders by having customers e-mail or fax them to you.
- Send invoices when goods are shipped rather than a day or a week later; consider e-mailing or faxing invoices to reduce “in transit” time to a minimum. For small monthly and per-transaction fees, Pat Jackson, an executive at Jackson Comfort Heating and Cooling Systems in Northfield, Ohio, equips her 22 fieldworkers with Bluetooth-enabled devices that can accept credit card payments on the job site. “It’s one of the best things we’ve done by far,” says Jackson. “It’s speeded up our cash inflow.”³⁰
- Indicate in conspicuous print or color the invoice due date and any late-payment penalties imposed. (Check with an attorney to be sure all finance charges comply with state laws.) One study by Xerox Corporation found that highlighting the “balance due” section of invoices increased the speed of collection by 30 percent.³¹
- Include a telephone number and a contact person in your organization in case the customer has a question or a dispute about an invoice.
- Respond quickly and accurately to customers’ questions about their bills.
- Allow customers to use multiple payment methods, including checks, credit cards, PayPal, money orders, and cash.
- Restrict the customer’s credit until past-due bills are paid. Salespeople should know which of their customers are behind in their payments. If not, they will continue to sell (most likely on credit) to those delinquent customers!
- Deposit customer checks and credit card receipts daily.
- Identify the top 20 percent of your customers (by sales volume), create a separate file system for them, and monitor them closely. Twenty percent of the typical company’s customers generate 80 percent of all accounts receivable.
- Ask customers to pay a portion of the purchase price up front. Tired of chasing late payers after completing their public relations projects, Mike Clifford, founder of Clifford Public Relations, began checking potential clients’ credit ratings and requiring an up-front payment of one-third of the cost of a job. Clifford also instituted a monthly billing system that

tracks billable hours and related expenses. Since implementing the new system, Clifford has not experienced a single past-due account.³²

- Watch for signs that a customer may be about to declare bankruptcy. Late payments from previously prompt payers and unreturned phone calls concerning late payments usually are the first clues that a customer may be heading for bankruptcy. If that happens, creditors typically collect only a small fraction, on average just 10 percent, of the debt owed.³³ Cynthia McKay, owner of a Le Gourmet Gift Basket franchise, lost thousands of dollars when five of her corporate clients filed for bankruptcy within a 10-month period. “That money is a weekly payroll for several employees,” says McKay.³⁴
- If a customer does file for bankruptcy, the bankruptcy court notifies all creditors with a “Notice of Filing” document. If an entrepreneur receives one of these notices, he or she should create a file to track the events surrounding the bankruptcy and takes action immediately. To have a valid claim against the debtor’s assets, a creditor must file a proof-of-claim form with the bankruptcy court within a specified time, often 90 days. (The actual time depends on which form of bankruptcy the debtor declares.) If, after paying the debtor’s secured creditors, any assets remain, the court will distribute the proceeds to unsecured creditors who have legitimate proof of claim.
- Consider using a bank’s lockbox collection service (located near customers) to reduce mail time on collections. In a **lockbox** arrangement, customers send payments to a Post Office box that the bank maintains. The bank collects the payments several times each day and deposits them immediately into the company account. The procedure sharply reduces processing and clearing times from the usual two to three days to just hours, especially if the lockboxes are located close to the company’s biggest customers’ business addresses. The system can be expensive to operate and is most economical for companies with a high volume of large checks (at least 200 checks each month).
- Track the results of the company’s collection efforts. Managers and key employees (including the sales force) should receive a weekly report on the status of the company’s outstanding accounts receivable.

Another strategy that small companies, particularly those selling high-priced items, can use to protect the cash they have tied up in receivables is to couple a security agreement with a financing statement. This strategy falls under Article 9 of the Uniform Commercial Code (UCC), which governs a wide variety of business transactions, including the sale of goods and security interests. A **security agreement** is a contract in which a business selling an asset on credit gets a security interest in that asset (the collateral), protecting the company’s legal rights in case the buyer fails to pay. To get the protection it seeks in the security agreement, the seller must file a financing statement called a UCC-1 form with the proper state or county office (a process that the UCC calls “perfection”). The UCC-1 form gives notice to other creditors and to the general public that the seller holds a secured interest in the collateral named in the security agreement. The UCC-1 form must include the name, address, and signature of the buyer; a description of the collateral; and the name and address of the seller. If the buyer declares bankruptcy, the small business that sells the asset is not *guaranteed* payment, but the filing puts its claim to the asset ahead of those of unsecured creditors. A small company’s degree of safety on a large credit sale is much higher with a security agreement and a properly filed financing statement than it would be if it did not file the security agreement.

Accounts Payable

The second element of the “big three” of cash management is accounts payable. Although it may be tempting to stretch out the payment of accounts payable as long as possible, there are a few cautions with this practice. First, developing good relationships with your suppliers ensures that they will provide good service. Second, when cash flow gets tight, having the goodwill of suppliers can make the phone call to let them know that you may be a bit late with your payment this month a lot easier on both ends. Third, many suppliers offer or are willing to negotiate discounts for quick payment. Fourth, when an entrepreneur strives to stretch out payables too long, there is a serious risk of *damaging the company’s credit rating*. Paying late could cause suppliers to begin demanding prepayment or cash-on-delivery (C.O.D.) terms, which severely impair a company’s cash flow. Finally, there is the ethical dimension: you expect prompt payment from your customers, so isn’t it right to pay your suppliers promptly as well?

Unfortunately, many large companies use their economic power to delay payments to their small business suppliers and vendors. A survey of 5,000 small businesses by the Kauffman Foundation reports that 14 percent cite late payments as their biggest business challenge.³⁵

ENTREPRENEURIAL PROFILE: James Callahan: Callahan Aircraft Service, LLC James Callahan was forced to lay off 16 of the 17 employees at his aircraft engineering company, Callahan Aircraft Service, LLC, which designs repairs for major airlines, because of customers' unpaid bills. One customer owed Callahan Aircraft Service, which is based in Albertville, Alabama, \$50,000. Callahan believes that the airlines are trying to keep their maintenance costs down by delaying payments to their vendors.³⁶

Small business owners should regulate their payments to vendors and suppliers to synchronize with their collection of accounts receivable. Ideally, a company will purchase an item on credit, sell it, and collect payment for it in time for the company to pay the supplier's invoice. In that case, the vendor's credit terms amount to an interest-free loan. Apple Inc. is an example of a company that turns the cash conversion cycle to its advantage. Its high inventory turnover ratio of 71 times a year, coupled with its ability to negotiate favorable credit terms with its suppliers and to collect customers' payments quickly, means that the company enjoys a cash conversion cycle of *negative* 61 days. On average, Apple collects payments from its customers and gets to use that cash before having to pay its suppliers 61 days later (see Figure 15.6).³⁷ Unfortunately, the typical small business experiences the opposite situation, paying its accounts payable in 40 days and collecting its accounts receivable in 59 days, which makes managing cash flow all the more important.³⁸

Even when the timing of a company's cash flow isn't ideal, efficient cash managers benefit by setting up a payment calendar each month that allows them to pay their bills on time and to take advantage of cash discounts for early payment.

ENTREPRENEURIAL PROFILE: Nancy Dunis: Dunis & Associates Nancy Dunis, CEO of Dunis & Associates, a Portland, Oregon, marketing firm, recognizes the importance of controlling accounts payable. "Our payables must be functioning just right to keep our cash flow running smoothly," says Dunis. She has set up a simple five-point accounts payable system:

1. **Set scheduling goals.** Dunis strives to pay her company's bills 45 days after receiving them and to collect all her receivables within 30 days. Even though "it doesn't always work that way," her goal is to make the most of her cash flow.
2. **Keep paperwork organized.** Dunis dates every invoice she receives and carefully files it according to her payment plan. "This helps us remember when to cut the check," she says, and "it helps us stagger our payments over days or weeks," significantly improving the company's cash flow.
3. **Prioritize.** Dunis cannot stretch out all of her company's creditors for 45 days; some demand payment sooner. Those suppliers are at the top of the accounts payable list.
4. **Be consistent.** "Companies want consistent customers," says Dunis. "With a few exceptions," she explains, "most businesses will be happy to accept 45-day payments, so long as they know you'll always pay your full obligation at that point."
5. **Look for warning signs.** Dunis sees her accounts payable as an early warning system for cash flow problems. "The first indication I get that cash flow is in trouble is when I see I'm getting low on cash and could have trouble paying my bills according to my staggered filing system," she says.³⁹

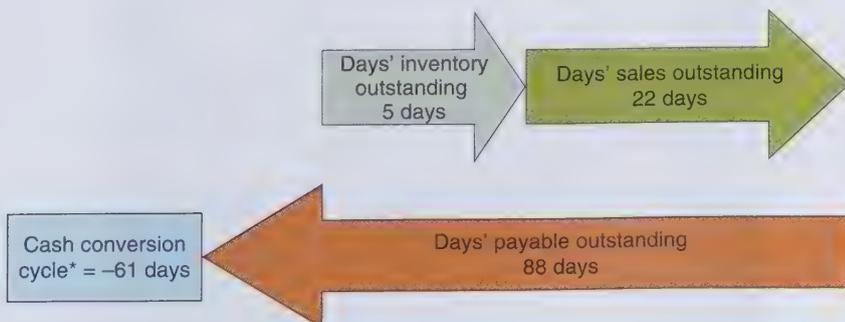


FIGURE 15.6
Apple Inc.'s Cash Conversion Cycle

*Cash conversion cycle = Days' inventory + Days' sales outstanding - Days' payable
= 5 + 22 - 88 = -61 days

Business owners should verify all invoices before paying them. Some unscrupulous vendors will send out invoices for goods they never shipped, knowing that many business owners will simply pay the bill without checking its authenticity. Someone in the company—for instance, the accounts payable clerk—should have the responsibility of verifying every invoice received.

Generally, taking advantage of cash discounts vendors offer benefits a small company. A cash discount (e.g., “2/10, net 30”—take a 2 percent discount if you pay the invoice within 10 days; otherwise, total payment is due in 30 days) offers a price reduction if the owner pays an invoice early. The savings that the discount provides usually exceeds the cost of giving up the use of a company’s cash by paying early. Chris Zane of Zane’s Cycles always pays his bills early and consistently captures discounts for doing so. “I make my salary on the discounts we get from paying our vendors early,” Zane says.⁴⁰

Clever cash managers also negotiate the best possible credit terms with their suppliers. Almost all vendors grant their customers trade credit, and entrepreneurs should take advantage of it. However, because trade credit can be relatively easy to get, entrepreneurs must be careful not to abuse it, putting their businesses in a precarious financial position. Favorable credit terms can make a tremendous difference in a firm’s cash flow. Table 15.5 shows the same most likely cash budget (from Table 15.2) with one exception: Instead of purchasing on C.O.D. terms (Table 15.2), the owner has negotiated “net 30” payment terms (Table 15.5). Notice the drastic improvement in this small company’s cash flow that results from the improved credit terms.

If owners do find themselves financially strapped when payment to a vendor is due, they should avoid making empty promises that “the check is in the mail.” Instead, they should discuss openly the situation with the vendor. Most suppliers are willing to work out payment terms for extended credit, particularly if you have treated them fairly and paid them in a timely manner in the past. One small business owner who was experiencing a cash crisis claims,

One day things got so bad I just called up a supplier and said, “I need your stuff, but I’m going through a tough period and simply can’t pay you right now.” They said they wanted to keep me as a customer, and they asked if it was okay to bill me in three months. I was dumbfounded: They didn’t even charge me interest.⁴¹

Entrepreneurs also can improve their firms’ cash flow by scheduling controllable cash disbursements so that they do not come due at the same time. For example, paying employees every two weeks (or every month) rather than every week reduces administrative costs and gives the business more time to use its cash. Owners of fledgling businesses may be able to conserve cash by hiring part-time employees or by using freelance workers rather than full-time, permanent workers. Scheduling insurance premiums monthly or quarterly rather than annually also improves cash flow.

Inventory

Carrying too much inventory increases the chances that a business will run out of cash. Although inventory represents the largest investment for many businesses, many entrepreneurs manage it haphazardly. As a result, the typical small business has not only too much inventory but also too much of the wrong kind of inventory! Because inventory is illiquid, it can quickly siphon off a

Controlling inventory is an essential part of avoiding a cash crisis.

Source: © Blend Images/Alamy.



TABLE 15.5 Cash Budget: Most Likely Sales Forecast After Negotiating “Net 30” Trade Credit Terms

	Jan.	Feb.	Mar.	Apr.
<i>Cash Receipts:</i>				
Sales	\$150,000	\$200,000	\$200,000	\$300,000
Credit Sales	112,500	150,000	150,000	225,000
<i>Collections:</i>				
60%—1st month after sale	\$180,000	\$ 67,500	\$ 90,000	\$ 90,000
30%—2nd month after sale	78,750	90,000	33,750	45,000
5%—3rd month after sale	11,250	13,125	15,000	5,625
Cash Sales	37,500	50,000	50,000	75,000
Interest	0	200	0	0
Total Cash Receipts	\$307,500	\$220,825	\$188,750	\$215,625
<i>Cash Disbursements:</i>				
Purchases ^a	\$105,000	\$140,000	\$140,000	\$210,000
Rent	2,000	2,000	2,000	2,000
Utilities	850	850	850	850
Interest	0	0	7,500	0
Tax Prepayment	0	0	50,000	0
Capital Addition	0	130,000	3	0
Miscellaneous	70	70	70	70
Wage/Salaries	30,000	40,000	45,000	50,000
Total Cash Disbursements^a	\$137,920	\$312,920	\$245,420	\$262,920
<i>End-of-Month Balance:</i>				
Cash (beginning of month) ^a	\$ 12,000	\$181,580	\$ 89,485	\$ 32,815
+Cash Receipts	307,500	220,825	188,750	215,625
– Cash Disbursements ^a	137,920	312,920	245,420	262,920
Cash (end of month) ^a	181,580	89,485	32,815	(14,480)
Borrowing/Repayment	0	0	0	24,480
Cash (end of month [after borrowing/repayment]) ^a	<u>\$181,580</u>	<u>\$ 89,485</u>	<u>\$32,815</u>	<u>\$ 10,000</u>

^aAfter negotiating “net 30” trade credit terms.

company’s pool of available cash. Managing inventory requires entrepreneurs to play a balancing game. “In good times, you never want to lose a sale by running out of an item,” says Jay Goltz, owner of several retail stores. “But if you’re not vigilant when sales are slow, that mentality can fill your warehouse and empty your checking account.”⁴²

Small businesses need cash to grow and to survive, which is difficult to do if they have money tied up in excess inventory yielding a zero rate of return. “The cost of carrying inventory is expensive,” says one small business consultant. “A typical manufacturing company pays 25 percent to 30 percent of the value of the inventory for the cost of borrowed money, warehouse space, materials handling, staff, lift-truck expenses, and fixed costs. This shocks a lot of people. Once they realize it, they look at inventory differently.”⁴³ Tracking inventory consistently enables a business owner to avoid purchasing or manufacturing goods unnecessarily. Experienced entrepreneurs often maintain different levels of inventory for different items depending on how critical they are to the company’s operation and how quickly they can be replenished. For instance, the owner of one small landscape company knew that hardwood mulch was one of his best-selling items in the spring, but he refused to purchase excessive amounts of it because his primary supplier was nearby and could deliver mulch within a few hours of receiving an order.

Marking down items that don’t sell keeps inventory lean and allow it to turn over quickly. Trade volume discounts lower inventory costs, large purchases may lead to

the company's valuable cash. Wise business owners avoid overbuying inventory, recognizing that excess inventory ties up valuable cash unproductively. In fact, only 20 percent of a typical business's inventory turns over quickly, meaning that owners must watch constantly for stale items.⁴⁴

In addition to the cost of the inventory itself, the activities required to purchase, store, monitor, and control inventory are also costly. Efficient cash management calls for a business to commit just enough cash to inventory to meet demand. Paring down the number of suppliers enables a business to gain more bargaining power, minimize paperwork, and perhaps earn quantity discounts. Scheduling inventory deliveries at the latest possible date prevents premature payment of invoices. Finally, given goods of comparable quality and price, entrepreneurs should purchase goods from those suppliers who are best at making fast, frequent deliveries to keep inventory levels low.

Monitoring the "big three" of cash management—accounts receivable, accounts payable, and inventory—can help every business owner avoid a cash crisis while making the best use of available cash.



In the Entrepreneurial Spotlight

Be Ready for Inflation!

Mark and Nancy Roesner are owners of Copley Feed and Supply, and their business is highly susceptible to the effects of inflation. Operating expenses, including electricity to run their store and fuel used when delivering feed to customers, have been going up for several years. In addition, inventory costs, which are primarily seed, animal food, and fertilizer, have been hit particularly hard due to demand for corn for gasoline additives and demand in emerging markets overseas.

"In one year," Mrs. Roesner says, "the price of a 50-pound bag of fertilizer more than doubled to \$19.99, from \$7.89, a bale of hay rose to \$6.29, from \$4.29, and a 50-pound bag of horse feed to \$10.49, from \$6.99."

"We have always been very frugal," Mrs. Roesner says. They are careful to turn off lights in rooms that they are not using and have learned to spend more time planning their delivery routes. They are trying to do fewer routes and do them more efficiently whenever possible.

To deal with rising expenses, the Roesners have tried to keep pace with price increases. However, many of their customers are still feeling the pinch of the Great Recession, are not able to afford higher prices, and are beginning to cut back on their orders.

Although inflation has not raced out of control in the United States since the late 1970s, there has remained a consistent concern that inflation may heat up again sometime in the near future, particularly as the economy begins to grow. Many small business owners worry that the official measure of inflation does not reflect the inflation they experience in their businesses.

"Unfortunately, it's the steady and surging increase in fuel prices over the past few months that is the root of all this evil," says small business owner Jimmy Collins. "When fuel costs go up, so do manufacturing costs as well as transportation costs and so on. The end result is everything becoming more expensive, and when this type of inflation happens at an unexpected rate like it has been recently, my small business suffers."

Large businesses are better able to buffer themselves from the impacts of inflation. Small businesses are generally in a much

weaker position to adjust prices when inflation heats up. Many small businesses are justifiably cautious about raising prices, especially in a weak economy.

Here are some steps that small businesses take to prepare for inflation:

- **Be aggressive with frequent small price increases.** This is generally a better strategy than waiting and trying to catch up at some point with one big jump in prices. For businesses that post prices, such as restaurant menus, this strategy creates a challenge. However, it is worth the effort, as customers are more willing to accept smaller increases in prices.
- **Build up cash reserves in the business.** This may sound counterintuitive because the value of cash decreases during inflation due to its diminishing buying power as prices go up. However, cash does become a critical asset for small businesses facing inflationary pressures. Cash reserves can serve as a buffer because costs can often increase faster than the entrepreneur can raise prices. "Cash is king" even during inflationary periods, so it is important to build cash reserves to buy time until you are able to pass along higher prices to your customers.
- **Stay vigilant in collecting accounts receivables.** Don't let your customers manage their own cash flow challenges at your expense.
- **Control your company's debt.** The Federal Reserve uses interest rate hikes to battle inflation. Pay down variable-interest loans as soon as possible when there is any hint of widespread inflation because interest rates are likely to increase and drive up the cost of using debt.
- **Stock up on inventory before prices from your suppliers go up.** However, be careful not to jeopardize your cash reserves when buying ahead with inventory.

- **Focus on efficiency and productivity of your workforce.** Workers demand higher wages to keep up with inflation. By increasing worker's productivity, you can offset some of the impact of higher wages on your company's profits.
- **Watch your margins carefully.** Focus on increasing your company's profits, not just its sales.

Sources: Based on Micky Meece, "Small Businesses (and Their Customers) Feel Sting of Inflation," *New York Times*, May 22, 2008, www.nytimes.com/2008/05/22/business/smallbusiness/22sbiz.html?_r=1&; Jimmy Collins, "First Person: Inflation Is Hitting My Small Business Hard," *Yahoo! Finance*, April 23, 2012, <http://finance.yahoo.com/news/first-person-inflation-hitting-small-business-hard-160200537-finance.html>; Jeff Cornwall, "Inflation: How Small Businesses Can Deal with Soaring Prices," *Christian Science Monitor*, April 25, 2011, www.csmonitor.com/Business/The-Entrepreneurial-Mind/2011/0425/Inflation-how-small-businesses-can-deal-with-soaring-prices.

Bootstrapping to Avoid the Cash Crunch

Bootstrapping is defined as the "process of finding creative ways to exploit opportunities to launch and grow businesses with the limited resources available for most start-up ventures."⁴⁵ Bootstrapping is often associated with entrepreneurs who are able to launch businesses when they don't have access to significant start-up funding. They simply find ways to get done what has to get done despite their business's lack of funding, or, as the old saying goes, "They pull themselves up by their own bootstraps." Although bootstrapping is a common approach for many start-ups, it is also a key strategy for entrepreneurs managing growing businesses. By continuing to bootstrap, an entrepreneur can lower his or her breakeven point and better manage cash flow. Figure 15.7 displays the relationship between the various means of bootstrapping, its impact on breakeven, and the resulting benefits for a small business.

There are four basic rules for effective bootstrapping:

1. **Overhead matters.** The overhead used to run a business, also known as its fixed costs, is one of the two determinants of its break-even point (refer to Chapter 14). The lower a company's overhead, the lower the level of sales it must generate to break even and produce a profit. Lowering overhead expenses also makes a business more profitable as it grows.
2. **Employee costs are the single biggest recurring cost.** Because employee expenses are the biggest expense category for most small businesses, bootstrapping these expenses can have a significant impact on controlling costs and preserving cash.
3. **Reduce operating costs.** The contribution margin is the other determinant of a company's break-even point. By bootstrapping operating costs, an entrepreneur can increase the company's contribution margin and lower its break-even point. Thus, just like bootstrapping overhead, reducing operating costs can make a growing business more profitable and preserve its cash.
4. **Marketing matters, but know your customers and where they go for information.** The final aspect of bootstrapping involves marketing. Bootstrapping the marketing of a business is also known as *guerrilla marketing*, which was covered in detail in Chapter 9.

5. Explain how bootstrapping can help a small business avoid a cash crunch.

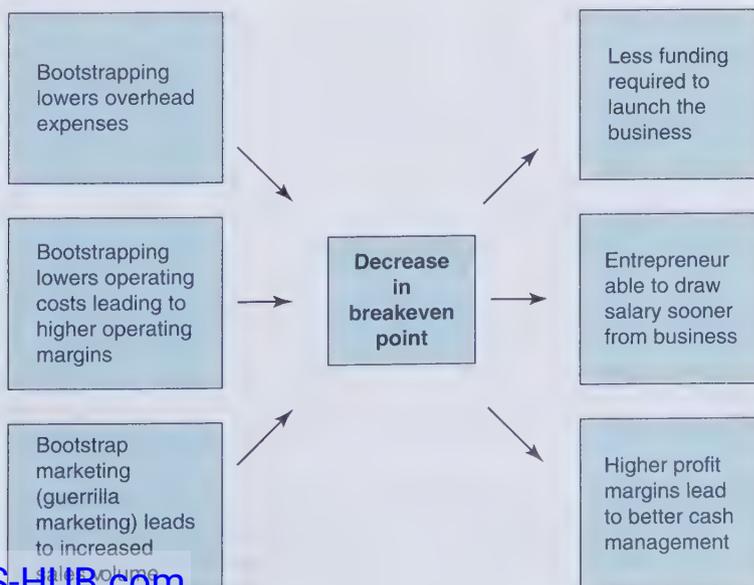


FIGURE 15.7
Bootstrapping and the Breakeven Point

Nearly every small business has the potential to improve its cash position. The key is to make an objective evaluation of a company's financial policies, searching for inefficiency in its cash flow and ways to squeeze more cash out of operations. Young firms cannot afford to waste resources, especially one as vital as cash. By utilizing the following bootstrapping tools, entrepreneurs can get maximum benefit from the company's pool of cash.

Bootstrapping Overhead

BUY USED OR RECONDITIONED EQUIPMENT, ESPECIALLY IF IT IS "BEHIND-THE-SCENES" MACHINERY Many shrewd entrepreneurs purchase their office furniture at flea markets and garage sales! One restaurateur saved significant amounts of cash in the start-up phase of his business by purchasing used equipment from a restaurant equipment broker.



ENTREPRENEURIAL PROFILE: John Paulsen: Lost Coffee John Paulsen, cofounder of Lost Coffee, had been planning to make the transition from selling coffee out of a food truck to opening a coffee shop. However, the cost of equipment was a barrier. "Then a local Borders bookstore closed," said Paulsen, "and they liquidated everything, including the coffee shop. We went for everything we could get, spending about \$15,000 for probably \$250,000 worth of kitchen equipment." Paulsen and his partner were able to buy freezers, cabinets, and an espresso machine at a fraction of their value. The money they saved helped them to open two locations and cover staff costs. Within three months, Lost Coffee was operating at a profit.⁴⁶

WHEN PRACTICAL, LEASE INSTEAD OF BUY U.S. businesses use leases to purchase 55 percent of the \$1.3 trillion that they spend on equipment and software each year. Leasing is a common strategy among small businesses. Small companies (those with sales of less than \$1 million) use leasing in 49 percent of their equipment acquisitions.⁴⁷ By leasing automobiles, computers, office equipment, machinery, and other assets rather than buying them, entrepreneurs can conserve valuable cash. The value of such assets is not in *owning* them but in *using* them. Leasing is popular among entrepreneurs because of its beneficial effects on a company's cash flow. Leasing also gives business owners maximum flexibility when acquiring equipment and protection against the risk of purchasing assets that become obsolete quickly.



ENTREPRENEURIAL PROFILE: Andy Fleischer: Alabanza Corporation Andy Fleischer, CFO of Web-hosting business Alabanza Corporation, recently switched from purchasing the company's servers to leasing them. Not only does leasing conserve the fast-growing company's precious cash, but it also enables it to keep its technology up to date, a vital factor given the nature of Alabanza's business. "In the past, we bought large blocks of servers up front," explains Fleischer. Leasing, however, allows Alabanza to spread the payment terms over 36 months, freeing up sizable amounts of cash the company can use elsewhere.⁴⁸

Although total lease payments often are greater than those for a conventional loan, most leases offer 100 percent financing, meaning that the owner avoids the large capital outlays required as down payments on most loans. In addition, leasing is an "off-the-balance-sheet" method of financing; the lease is considered an operating expense on the income statement, not a liability on the balance sheet. Thus, leasing conserves not only a company's cash flow but also its borrowing capacity. Leasing companies typically allow businesses to stretch payments over a longer time period than those of a conventional loan. Lease agreements also are flexible; entrepreneurs can customize their lease payments to coincide with the seasonal fluctuations in their companies' cash balances.

Entrepreneurs can choose from two basic types of leases: operating leases and capital leases. At the end of an **operating lease**, a business turns the equipment back over to the leasing company with no further obligation. Businesses often lease computer and telecommunications equipment through operating leases because it becomes obsolete so quickly. At the end of a **capital lease**, a business may exercise an option to purchase the equipment, usually for a nominal sum. Table 15.6 compares the characteristics of leasing, borrowing, and paying cash for business assets.

AVOID NONESSENTIAL OUTLAYS Smart entrepreneurs spend cash only when it is necessary. By forgoing costly ego indulgences, such as ostentatious office equipment, first-class travel, and flashy company cars, business owners can make efficient use of their companies' cash. Even expenses that may at first seem unavoidable actually may not be necessary. Before putting scarce

TABLE 15.6 Lease, Borrow, or Pay Cash?

When faced with the need to purchase equipment, many entrepreneurs wonder whether they should choose to lease the asset, borrow the money, or use the company's available cash to purchase it. The following table describes some of the characteristics of each option.

Feature	Lease	Borrow	Cash
Time frame	Monthly payments made over life of lease	Monthly payments made over life of loan	No monthly payments; total payment made at time of purchase
Actual cost	Current value of all future lease payments	Cost of equipment plus interest on loan	Cost of equipment plus opportunity cost of investing cash up front
Initial cost	Small (sometimes no) down payment	Substantial down payment often required	Entire purchase price of equipment
Impact on company's borrowing capacity	None. Leasing is an "off-the-balance-sheet" method of financing	Reduced borrowing capacity	None. Company incurs no additional liabilities
Risk of obsolescence	Low. In an operating lease, company returns equipment to lessor at end of lease	High. Company owns the equipment after repaying the loan	High. Company owns the equipment up front
Tax implications	Lease payments are a deductible business expense	Interest payments on loan are a deductible business expense; company depreciates equipment over time	Company depreciates equipment over time
Impact on cash flow	Moderate. Company must make monthly lease payments	Moderate. Company must make monthly loan payments	Significant. Company pays entire purchase price up front. Cash is no longer available for other uses

Source: Based on "Leasing Gives You More IT Bang for Your Buck," Small and Medium Businesses: Hewlett Packard, *HP.com*, http://h20330www3.hp.com/news_article.php?topiccode=20061212.

cash into an asset, every business owner should put the decision to the acid test by asking, "What will this purchase add to the company's ability to compete and to become more successful?"



ENTREPRENEURIAL PROFILE: Evan Saks: Create-A-Mattress Evan Saks, founder of Create-A-Mattress, kept his start-up costs low by launching a virtual mattress company. Create-A-Mattress employees work from home, and the company is able to use just-in-time manufacturing to keep inventory costs to a minimum. The company manages all administrative functions, including order processing, customer service, and payment processing, through a Web-based platform. This business model keeps overhead costs to a few hundred dollars a month. "A typical mattress retailer our size would have to raise \$1.5 million to get started," says Saks. "My business started on one-tenth that amount."⁴⁹



Evan Saks, founder of Create-A-Mattress.

Source: Rachel Aronis.

NEGOTIATE FIXED LOAN PAYMENTS TO COINCIDE WITH YOUR COMPANY'S CASH FLOW CYCLE Many banks allow businesses to structure loans so that they can skip specific payments when their cash flow ebbs to its lowest point. Negotiating such terms gives businesses the opportunity to customize their loan repayments to their cash flow cycles. For example, Ted Zoli, president of Torrington Industries, a construction-materials supplier and contracting business, consistently uses "skipped payment loans" in his highly seasonal business. "Every time we buy a piece of construction machinery," he says, "we set it up so that we're making payments for eight or nine months, and then skipping three or four months during the winter."⁵⁰

DO IT YOURSELF Many creative entrepreneurs find ways to cut costs by doing work that they might normally hire someone else to do for them. For example, one coffee shop owner did all of his own renovation work on the old house he converted into his coffee shop, saving thousands of dollars. There are also ways to save on overhead costs by doing your own bookkeeping, maintenance, cleaning, and so forth.



ENTREPRENEURIAL PROFILE: Brian Meert: Handbago.com Brian Meert, CEO of Handbago.com, set up his own Web site when he first started his handbag Web site. He used an inexpensive template to create his initial Web site and registered his domain name through GoDaddy.com. Then he hired a freelance designer to customize the site to his specifications. In all, he spent

about \$1,000 on the site, which he used to test his business model and determine the features that customers really wanted. After a year, he was able to hire a professional designer to incorporate everything he had learned from his first year of business. “If I had spent all that money in the beginning,” said Meert, “I would have had to spend it all over again in the redesign.”⁵¹

Bootstrapping Employee Costs

HIRE PART-TIME EMPLOYEES AND FREELANCE SPECIALISTS WHENEVER POSSIBLE Hiring part-timers and freelancers rather than full-time workers saves on both the cost of salaries and employee benefits. Robert Ross, president of Xante Corporation, a maker of laser printer products in Mobile, Alabama, hires local college students for telemarketing and customer support positions, keeping his recruiting, benefits, and insurance costs down.

OUTSOURCE One way that many entrepreneurs conserve valuable cash is to outsource certain activities to businesses that specialize in performing them rather than hiring someone to do them in-house (or doing the activities themselves). In addition to saving cash, outsourcing enables entrepreneurs to focus on the most important aspects of running their businesses.



ENTREPRENEURIAL PROFILE: Sean Broihier: Fine Art America Sean Broihier launched Fine Art America, an e-commerce marketplace for works of art, by outsourcing almost every function of his business. Artists upload digital images of their artwork to his Web site, where customers can purchase the images in a variety of formats ranging from framed prints to greeting cards. Fine Art America outsources the printing, framing, matting, stretching, packaging, shipping, and insuring. The company also outsources all administrative functions, including payroll, managing Web servers, and payments to businesses that specialize in performing these functions. All Broihier does is focus on creating a high-quality online storefront for artists.⁵²

Bootstrapping Operating Costs

USE E-MAIL OR FAXES RATHER THAN MAIL Whenever appropriate, entrepreneurs should use e-mails or faxes rather than mail to communicate with customers, suppliers, and others to reduce costs.

LOOK FOR SIMPLE WAYS TO CUT COSTS Allowing expenses to creep up over time is a common tendency in any business, but smart entrepreneurs are always on the lookout for ways to cut costs and to operate more efficiently. One useful technique is to sit down with employees periodically with a list of company expenses and brainstorm ways the company can conserve cash without endangering product quality or customer service. Ideas might range from installing more energy-efficient equipment to adding more fuel-efficient cars to the company fleet.

Entrepreneurs must be careful to avoid making across-the-board spending cuts to conserve cash, however. Doing so is a risky strategy because the owner runs the risk of cutting expenditures that literally drive the business. One common mistake during business slowdowns is cutting marketing and advertising expenditures. “As competitors pull back,” says one adviser, “smart marketers will keep their ad budgets on an even keel, which is sufficient to bring increased attention to their products.”⁵³ The secret to success is cutting nonessential expenditures. “If the lifeblood of your company is marketing, cut it less,” advises one advertising executive. “If it is customer service, that is the last thing you want to cut back on. Cut from areas that are not essential to business growth.”⁵⁴

Other Tools for Bootstrapping and Preserving Cash

BARTER Bartering, the exchange of goods and services for other goods and services, is an effective way to conserve cash. An ancient concept, bartering has remained an important cash preservation tool, especially during recessions. More than 500 barter exchanges (up from just 40 in 1980) operate across the United States, catering primarily to small- and medium-size businesses and many of them operating on the Internet. The dollar value of bartering transactions among companies in North America totals more than \$12 billion each year, with businesses trading everything from accounting services and computers to carpet and meals.⁵⁵ Nearly one-fourth of small companies in the United States use bartering as a cash management strategy, but more business owners turn to bartering during economic recessions.⁵⁶ These entrepreneurs use bartering to buy much-needed materials, equipment, and supplies—*without using cash*. The president of one barter exchange estimates that business owners can save “between \$3,000 and

\$150,000 in yearly business costs.”⁵⁷ In addition to conserving cash, companies using bartering can transform slow-moving and excess inventory into much-needed goods and services. Often, business owners who join barter exchanges find new customers for the products and services they sell.

Of course, there is a cost associated with bartering, but the real benefit is that entrepreneurs “pay” for products and services at their wholesale cost and get credit in the barter exchange for the retail price. In a typical arrangement in a formal barter exchange program, businesses accumulate trade credits when they offer goods or services through the exchange. Then they can use accumulated trade credits to purchase other goods and services from other members of the exchange.

The typical formal barter exchange charges a one-time membership fee that ranges from \$250 to \$800 and a 5 to 10 percent transaction fee (usually split evenly between the buyer and the seller) on every deal. Some exchanges also charge a monthly fee of \$10 to \$30. The exchange acts as a barter “bank,” tracking the balance in each member’s account and sending monthly statements summarizing account activity. Rather than join a barter exchange, many enterprising entrepreneurs choose to barter on an individual basis. The natural place to start is with the vendors, suppliers, and customers with whom a company normally does business.



ENTREPRENEURIAL PROFILE: Barbara Taylor: Synergy Business Services Like many business brokers, Barbara Taylor, co-owner of Synergy Business Services, was hit hard by the Great Recession, but she discovered that bartering was an effective tool to keep her costs down. She has bartered her expertise in small business operations for various services. She traded consulting on social media for legal fees associated with a deposition, exit planning in exchange for search engine optimization services, and developing a marketing plan in exchange for general business coaching services. “While my husband and I feel lucky to still be in business,” said Taylor, “we have had to re-group and find new ways to bolster our bottom line.”⁵⁸

USE CREDIT CARDS TO MAKE SMALL PURCHASES Using a credit card to make small purchases from vendors who do not offer credit terms allows entrepreneurs to defer payment for up to 30 days. Entrepreneurs who use this strategy must be disciplined, however, and pay off the entire credit card balance each month. Carrying a credit card balance from month to month exposes an entrepreneur to annual interest rates of 15 to 25 percent—*not* a cash conserving technique!

Many credit card companies now offer cash back when customers make certain types of purchases with their cards. The percentage of cash back can range from 1 to 5 percent of the amount purchased. Because business owners make many purchases with credit cards, they can earn large rebates by using these cards.



ENTREPRENEURIAL PROFILE: Chris Zane: Zane’s Cycles Chris Zane, founder of Zane’s Cycles, uses various business credit cards with cash-back programs to make almost all of the purchases for his company. Zane’s Cycles buys most of its inventory with credit card that gives it 1.5 percent back. He and his employees use a different card that offers 2 percent back on travel. Its American Express card gives Zane’s Cycles 5 percent back on supplies and on its cell phone bill. Zane estimates that he saves \$40,000 a year with all of his various cash-back rebates. “The key is to use [the cards] like cash and pay them off immediately,” says Zane.⁵⁹

ESTABLISH AN INTERNAL SECURITY AND CONTROL SYSTEM Too many owners encourage employee theft by failing to establish a system of controls. Reconciling the bank statement monthly and requiring special approval for checks more than a specific amount, say, \$1,000, helps minimize losses. Separating record-keeping and check-writing responsibilities rather than assigning them to a single employee offers more protection.

DEVELOP A SYSTEM TO BATTLE CHECK FRAUD Although the use of checks in the United States continues to decline, Americans still write more than 67 million checks per day. Unfortunately, nearly 336,000 of them are bad checks that “bounce,” costing businesses nearly \$123 billion annually.⁶⁰ Bad checks and check fraud can wreak havoc on a small company’s cash flow. The most effective way to battle bad or fraudulent checks is to subscribe to an electronic check approval service. The service works at the cash register, and approval takes less than a minute.

The fee a small business pays to use the service depends on the volume of checks. For most small companies, charges amount to 1 to 2 percent of the cleared checks’ value.

CHANGE YOUR SHIPPING TERMS Changing a company’s shipping terms from “F.O.B. (free on board) buyer,” in which the seller pays the cost of freight, to “F.O.B. seller,” in which the buyer absorbs all shipping costs, will improve cash flow.

SWITCH TO ZERO-BASED BUDGETING Zero-based budgeting primarily is a shift in the philosophy of budgeting. Rather than build the current year’s budget on increases from the previous year’s budget, zero-based budgeting starts from a budget of zero and evaluates the necessity of every item. The idea is to start the budget at zero and review all expenses, asking whether each one is necessary.

START SELLING GIFT CARDS Prepaid gift cards can be a real boost to a small company’s cash flow. Customers pay for the cards up front, but the typical recipient does not redeem the gift card until later (sometimes much later), giving the company the use of the cash during that time. In addition, gift card recipients usually spend more than the value of the gift cards when they redeem them. Gift cards are appropriate for many businesses, especially those in the retail or service sector.



ENTREPRENEURIAL PROFILE: Eva Sztupka-Kerschbaumer: ESSpa Kozmetika Organic

SkinCare Eva Sztupka-Kerschbaumer, owner of a day spa in Pittsburgh, Pennsylvania, found her company in a cash bind but needed \$14,000 to replace two facial steamers and a microdermabrasion machine. To get the cash she needed, Sztupka-Kerschbaumer sent e-mails to her 8,000 customers, offering them discounted gift cards in return for payment up front. “This way, I lock in my customer base, purchase equipment, and get the cash flow,” she says.⁶¹

INVEST SURPLUS CASH Because of the uneven flow of receipts and disbursements, a company will often temporarily have more cash than it needs—for a week, month, quarter, or even longer. When this happens, most small business owners simply ignore the surplus because they are not sure how soon they will need it. They believe that relatively small amounts of cash sitting around for just a few days or weeks are not worth investing. However, this is not the case. Small business owners who put surplus cash to work *immediately* rather than allowing it to sit idle soon discover that the yield adds up to a significant amount over time. This money can help ease the daily cash crunch during business troughs. “Your goal . . . should be to identify every dollar you don’t need to pay today’s bills and to keep that money invested to improve your cash flow,” explains a consultant.⁶²

However, when investing surplus cash, an entrepreneur’s primary objective should *not* be to earn the highest yield (which usually carries with it high levels of risk); instead, the focus should be on the safety and the liquidity of the investments. Making high-risk investments with a company’s cash cushion makes no sense and could jeopardize its future. The need to minimize risk and to have ready access to the cash restricts an entrepreneur’s investment options to just a few such as money market accounts, zero-balance accounts, and sweep accounts. A **money market account** is an interest-bearing account offered by a variety of financial institutions ranging from banks to mutual funds. Money market accounts pay interest while allowing depositors to write checks (most have minimum check amounts) without tying their money up for a specific period of time. After surviving a cash crisis shortly after launching their branding and communications company, Jaye Donaldson and her partner Chester Makoski now keep enough cash invested in a money market account to cover at least three to six months’ worth of expenses.⁶³ Some entrepreneurs try to store up as much as one year’s worth of expenses as a cash surplus—just in case.

A **zero-balance account (ZBA)** is a checking account that technically never has any funds in it but is tied to a master account. The company keeps its money in the master account where it earns interest, but it writes checks on the ZBA. At the end of the day, the bank pays all of the checks drawn on the ZBA, then it withdraws enough money from the master account to cover them. ZBAs allow a company to keep more cash working during the float period, the time between a check’s being issued and its being cashed. A **sweep account** automatically “sweeps” all funds in a company’s checking account above a predetermined minimum into an interest-bearing account, enabling it to keep otherwise idle cash invested until it is needed to cover checks.

BE ON THE LOOKOUT FOR EMPLOYEE THEFT Because small business owners often rely on informal procedures for managing cash (or no procedures at all) and often lack proper control procedures, they are most likely to become victims of employee theft. The employee most likely to

by their employees. The Association of Certified Fraud Examiners estimates that U.S. companies lose 5 percent of their annual revenue to fraud by employees. The median loss suffered by small businesses is \$147,000, higher than the median loss of \$140,000 experienced by all companies. The most common methods that employees use to steal from small businesses are fraudulent billing, corruption (for example, accepting bribes and kickbacks), and check tampering schemes. Alarming, the typical fraud lasts 18 months before the owner discovers it, usually as a result of a tip from another employee.⁶⁴ One source of the problem is the typical entrepreneur's attitude that "we're all family here; no one would steal from family."

Conclusion

Successful owners run their businesses "lean and mean" by employing wise cash management and bootstrapping. Trimming wasteful expenditures, investing surplus funds, and carefully planning and managing the company's cash flow enable them to compete effectively in a hostile market. The simple but effective techniques covered in this chapter can improve every small company's cash position. One business writer says, "In the day-to-day course of running a company, other people's capital flows past an imaginative CEO as opportunity. By looking forward and keeping an analytical eye on your cash account as events unfold (remembering that if there's no real cash there when you need it, you're history), you can generate leverage as surely as if that capital were yours to keep."⁶⁵

Chapter Review

1. Explain the importance of cash management to the success of a small business.
 - Cash is the most important but least productive asset the small business has. Entrepreneurs must maintain enough cash to meet a company's normal operating requirements (plus a reserve for emergencies) without retaining excessively large, unproductive cash balances.
 - Without adequate cash, a small business will fail.
2. Differentiate between cash and profits.
 - Cash and profits are not the same. More businesses fail for lack of cash than for lack of profits.
 - Profits, the difference between total revenue and total expenses, are an accounting concept. Cash flow represents the flow of actual cash (the only thing businesses can use to pay bills) through a business in a continuous cycle. A business can be earning a profit and be forced out of business because it runs out of cash.
3. Understand the five steps in creating a cash budget and use them to build a cash budget.
 - The cash budgeting procedure outlined in this chapter tracks the flow of cash through the business and enables the owner to project cash surpluses and cash deficits at specific intervals.
 - The five steps in creating a cash budget are as follows: forecasting sales, forecasting cash receipts, forecasting cash disbursements, and determining the end-of-month cash balance.
4. Describe the fundamental principles involved in managing the "big three" of cash management: accounts receivable, accounts payable, and inventory.
 - Controlling accounts receivable requires business policies and to screen customers before granting them credit. Sending invoices promptly and acting on past-due accounts quickly also improve cash flow. The goal is to collect cash from receivables as quickly as possible.
 - When managing accounts payable, an entrepreneur's goal is time payables to coincide with cash being collected from customers. Techniques to better manage payables include verifying invoices before paying them, taking advantage of cash discounts, and negotiating the best possible credit terms.
 - Inventory frequently causes cash headaches for small business managers. Excess inventory earns a zero rate of return and ties up a company's cash unnecessarily. Owners must watch for stale merchandise.
5. Explain how bootstrapping can help a small business avoid a cash crunch.
 - Minimizing a company's overhead expenses through bootstrapping lowers the break-even point for the business and makes it much more profitable over the long term.
 - Employee-related expenses are usually the highest single expense category for small businesses, so employing bootstrapping techniques to trim employee costs is critical for effective cash management.
 - Bootstrapping can also be used to trim operating expenses, which in turn increases the gross profit margin of the business and lowers breakeven.

Discussion Questions

- 15-1. Why must small business owners concentrate on effective cash flow management?
- 15-2. Explain the difference between cash and profit.
- 15-3. Outline the steps involved in developing a cash budget.
- 15-4. Which are the common challenges that an entrepreneur encounters in cash flow management?
- 15-5. Explain the cash conversion cycle.
- 15-6. How can bartering improve a company's cash position?
- 15-7. Alan Ferguson, owner of Nupremis, Inc., a Web-based application service provider, says, "We lease our equipment and technology because our core business is deploying it, not owning it." What does he mean? Is leasing a wise cash management strategy for small businesses? Explain.
- 15-8. What steps should business owners take to conserve cash in their companies?
- 15-9. Comment on the statement, "Successful owners run their businesses 'lean and mean' by employing wise cash management and bootstrapping."
- 15-10. What are the four rules for effective bootstrapping? How could you apply these rules to a business that you have started or are hoping to start some day?
- 15-11. Fritz Maytag, owner of Anchor Steam, says, "Just because you are the best around doesn't mean that you have to expand. You can stay as you are and have a business that's profitable and rewarding and a great source of pride." Do you agree? Do you think that most entrepreneurs would agree? Explain.

CHAPTER 16

Sources of Equity Financing



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain the differences between the two types of capital small businesses require: fixed and working.
2. Describe the various sources of outside equity capital available to entrepreneurs, including friends and relatives, crowdsourcing, accelerators, angels, corporations, venture capital, and public stock offerings.
3. Describe the seven sources of funding that the founders can contribute to their new businesses.
4. Describe the types of businesses that attract venture capital financing and explain the criteria that venture capitalists use to decide on their investments.
5. Explain the process, the advantages, and challenges of making an initial public offering.

Don't confuse fundability with viability.

—Guy Kawasaki

There are two kinds of investors: [those] who try to create value by finding good people and helping them create something great, and others, who want a piece of someone else's things. The builders and the extractors. Avoid the extractors.

—Chris Dixon, cofounder/
CEO of Hunch

Raising the money to launch a new business venture has always been a challenge for entrepreneurs. Capital markets rise and fall with the stock market, overall economic conditions, and investors' fortunes. These swells and troughs in the availability of capital make the search for financing look like a wild roller-coaster ride. This ride has gotten even more challenging since the financial market crisis that began with the recession in 2008. Entrepreneurs, especially those in less glamorous industries or those just starting out, soon discover the difficulty of finding outside sources of financing. Many banks shy away from making loans to start-ups, venture capitalists are looking for ever-larger deals, private investors have grown cautious, and making a public stock offering remains a viable option for only a handful of promising companies with good track records and fast-growth futures. Family and friends, the most common source of outside funding for entrepreneurs, have not seen their personal investment portfolios recover to prerecession highs. Because of this, family and friends have become much more cautious about putting their money at risk in an uncertain entrepreneurial endeavor. The result has been a credit crunch for entrepreneurs looking for small to moderate amounts of start-up capital. Entrepreneurs and business owners who need between \$100,000 and \$3 million are especially hard hit because of the vacuum that exists at that level of financing.

In the face of this capital crunch, business's need for capital has never been greater. When searching for the capital to launch their companies, entrepreneurs must remember the following "secrets" to successful financing:

- **Choosing the right sources of capital for a business can be just as important as choosing the right form of ownership or the right location.** It is a decision that will influence a company for a lifetime; therefore, entrepreneurs must weigh their options carefully and understand the consequences of the deal before committing to a particular funding source. Avoid the tendency to jump at the first check that comes your way; instead, consider the long-term impact on your business of accepting that check.
- **The money is out there; the key is knowing where to look.** Entrepreneurs must do their homework *before* they set out to raise money for their ventures. Understanding which sources of funding are best suited for the various stages of a company's growth and then taking the time to learn how those sources work are essential to success.
- **Creativity counts.** To find the financing their businesses demand, entrepreneurs must use as much creativity in attracting financing as they did in generating the ideas for their products and services.



ENTREPRENEURIAL PROFILE: Drue Kataoka and Svetlozar Kazanjiev: Aboomba

When Drue Kataoka and Svetlozar Kazanjiev began planning their wedding, they took a different approach to their wedding registry. Rather than list the typical household appliances that appear on most wedding registries, the couple created "The World's First Start-Up Registry," listing items to help them launch their e-commerce site called Aboomba. They took elements from their business plan, such as "feed an engineer for a day (\$273.97)," "Red Bull for a week (\$52.41)," and "Amazon EC2 Cloud Web hosting for a week (\$134.40)," and incorporated them into their start-up registry. Guests and others responded to the creative approach to raising capital, providing the couple with every item on their start-up registry at least three times over.¹

- **The Internet puts at entrepreneurs' fingertips vast resources of information that can lead to financing.** The Internet often offers entrepreneurs, especially those looking for relatively small amounts of money, the opportunity to discover sources of funds that they otherwise might miss. The growth of crowdsourcing further expands the power of the Internet as a fund-raising tool for small businesses. The Web site created for this book (www.prenhall.com/scarborough) provides links to many useful sites related to raising both start-up and growth capital. The Internet also provides a low-cost, convenient way for entrepreneurs to get their business plans into potential investors' hands anywhere in the world. When searching for sources of capital, entrepreneurs must not overlook this valuable tool!
- **Raise only as much money as you really need.** Entrepreneurs tend to fall into one of two traps when raising money for a new business. If the entrepreneur does not raise enough money, the business will most likely run out of cash before it reaches its break-even point. If the entrepreneur raises too much money, the temptation can be to spend the excess funding on unnecessary overhead and other expenses that become a burden if the business does not grow quickly enough. Careful business planning and prudent financial decisions determine the right balance between raising too much or too little cash for a start-up.

- **Be thoroughly prepared before approaching potential lenders and investors.** In the hunt for capital, tracking down leads is tough enough; don't blow a potential deal by failing to be ready to present your business idea to potential lenders and investors in a clear, concise, convincing way. That, of course, requires a solid business plan.
- **Looking for “smart” money is more important than looking for “easy” money.** Some entrepreneurs have little difficulty attracting investors' money. However, easy money is not always smart money. Even though it may be easy to acquire, money from the wrong investor can spell disaster for a small company. Entrepreneurs cannot overestimate the importance of making sure that the “chemistry” among themselves, their companies, and their funding sources is a good one. Too many entrepreneurs get into financial deals because they needed the money to keep their businesses growing only to discover that their plans do not match those of their financial partners.



ENTREPRENEURIAL PROFILE: Brian Carlton: New Breed Wireless When Brian Carlton launched CEIG, a company that sells content and applications for mobile phones under the brand name New Breed Wireless, he accepted an offer from a private investor who put up \$400,000, payable in two installments, in exchange for 25 percent of the company. The relationship was rocky from the beginning, and the investor made clear his expectations of the company's performance. When CEIG missed one benchmark one year into the deal, the investor refused to invest the second installment, and Carlton was forced to scramble for money to keep the company afloat. “That investor didn't understand how technology businesses grow,” says Carlton, whose company ultimately received the remaining \$200,000 from the investor. Wiser for the experience, Carlton has revised his capital searching strategy, relying on smaller amounts of money and screening carefully every potential investor. With his new approach, Carlton has raised \$1.1 million from 25 investors and has retained 75 percent of the equity in his business.²

- **Plan an exit strategy.** Although it may seem peculiar for entrepreneurs to plan an exit strategy for investors when they are seeking capital to *start* their businesses, doing so increases their chances of closing a deal. Investors do not put their money into a business with the intent of leaving it there indefinitely. Their goal is to get their money back—along with an attractive return on it. Entrepreneurs who fail to define potential exit strategies for their investors reduce the likelihood of getting the capital their companies need to grow.

Rather than rely primarily on a single source of funds as they have in the past, entrepreneurs must piece together capital from multiple sources tied to each stage of the growth of the business, a method known as **layered financing**. They have discovered that raising capital successfully requires them to cast a wide net to capture the financing they need to launch and grow their businesses. Much like assembling a patchwork quilt by using fabric from many different sources, financing a small business often requires entrepreneurs to find capital from many different sources. During the earliest stages of a business, financing most often comes from the entrepreneur, family, and friends. If the entrepreneur has partners, they also will be expected to help fund the business. Crowdfunding and accelerators are two emerging sources of funding for early stage businesses to help them move from an idea to launch. During a company's earliest growth stages, angel investors may provide growth capital. As increasing acceptance from the market proves the business model, venture capitalists provide additional financing for high-growth, high-potential ventures. All the while, most entrepreneurs add various forms of debt financing to the financing mix, which will be discussed in Chapter 17. Figure 16.1 shows how the various types of equity financing are layered over the stages of growth of an entrepreneurial firm.



ENTREPRENEURIAL PROFILE: Matt Matros: The Protein Bar Matt Matros lost 60 pounds by following a high-protein diet. He decided to turn his experience into a business and launched his Chicago-based restaurant, The Protein Bar, to offer urban professionals a quick, fast, healthy lunch alternative. Matros funded his start-up with a personal investment of \$250,000. As the business began to take off, he was able to secure a loan guaranteed by the Small Business Administration (SBA). Matros successfully expanded his concept to four more locations in the Chicago area with a \$1.3 million investment from angel investors. Based on the success of his initial expansion, he was then able to raise an additional \$2 million angel investment from customers and local real estate investors who saw his business model's potential. Nine months later, he raised an additional \$2 million from angel investors and expanded into Washington, D.C., where he opened two additional locations. Each new restaurant costs about \$800,000 to open.³



Matt Matros, founder of The Protein Bar

Source: Protein Bar.

FIGURE 16.1
Possible Sources
of Equity Financing

Start-ups:	Early growth:	High growth and expansion:
Self-funding	Family and friends	Angels
Family and friends	Partners	Corporate venture capital
Partners	Crowdfunding	Venture capital
Crowdfunding	Angels	Public offering
Seed funding		

For most entrepreneurs, raising the money to start or expand their businesses is a challenge that demands time, energy, creativity, and a measure of luck. “Raising money is a marathon, not a sprint,” says one entrepreneur who has raised \$4 million for her four-year-old company.⁴ This chapter and the next one will guide you through the myriad financing options available to entrepreneurs, focusing on both sources of equity (ownership) and debt (borrowed) financing.

Planning for Capital Needs

1.

Explain the differences between the two types of capital small businesses require: fixed and working.

Becoming a successful entrepreneur requires one to become a skilled fund-raiser, a job that usually requires more time and energy than most business founders anticipate. The money required to launch a new business is known as **seed capital**. In start-up companies, raising seed capital can easily consume as much as one-half of the entrepreneur’s time and can take many months to complete. Where to find this seed money depends, in part, on the nature of the proposed business and on the amount of money required. For example, the creator of a computer software firm would have different capital requirements than the founder of an ice cream shop. Although both entrepreneurs might approach some of the same types of lenders or investors, each would be more successful targeting specific sources of funds best suited to their particular financial needs and businesses.

The need for money is not limited to the start-up stage of a business. Once entrepreneurs prove the validity of their business models and attract a growing base of customers, they often must raise additional capital, called **growth capital**. For example, a small health care software business built its business pursuing a niche strategy selling software to small town hospitals. The business was profitable, but the entrepreneurs wanted to grow the business. To achieve this goal, they needed to acquire much larger customers. When they finally landed their first large, national hospital corporation as a customer, a new challenge emerged. The hospital corporation had multiple hospitals in cities across the country. To accommodate the demands of this new customer, the software company had to quickly add staff, buy more equipment and furniture, secure more computer servers, add satellite offices, and lease a much larger space for its headquarters. All of this required significant growth capital, which they secured from an investor. Investors providing growth capital expect the funds to improve a company’s profitability and cash flow, thus ensuring a return on their investments.

Capital is any form of wealth employed to produce more wealth. It exists in many forms in a typical business, including cash, inventory, plant, and equipment. Entrepreneurs need two different types of capital: fixed and working.

Fixed Capital

Fixed capital provides funding for the purchase of a business’s permanent or fixed assets, such as buildings, land, computers, and equipment. Money invested in these fixed assets tends to be frozen because it cannot be used for any other purpose. Typically, large sums of money are involved in purchasing fixed assets. When using equity funding for fixed capital, investors expect their investment in the business to produce long-term growth that creates a return on the investment over time. If credit is used to purchase fixed assets, the terms of the loans usually are lengthy. The assumption is that the fixed assets create growth that leads to sufficient cash flow to ensure repayment.

Working Capital

Working capital represents a business's temporary funds; it is the capital used to support a company's normal short-term operations. Accountants define working capital as current assets minus current liabilities. New businesses need working capital to help fund day-to-day expenses until the time that the business reaches its breakeven point and has positive cash flow. The need for working capital in an existing business arises because of the uneven flow of cash into and out of the business due to normal seasonal fluctuations or timing differences between when business sells a product or service and when the customer actually pays for it. Credit sales, seasonal sales swings, or unforeseeable changes in demand create fluctuations in *any* small company's cash flow. Working capital normally is used to buy inventory, pay bills, finance credit sales, pay wages and salaries, and take care of any unexpected emergencies. Equity financing is the most common source of working capital for a start-up business. Investors expect working capital to help launch the business so that it can achieve its high growth potential and generate a return on investment over time. Lenders are the most common source of working capital for seasonal or other short-term needs in established businesses. Lenders expect repayment as soon as the cash comes into the business from normal operations.

Sources of Equity Financing

Equity capital represents the personal investment of the owner (or owners) and any investment from outside sources in a business. Equity capital is sometimes called *risk* capital because these investors assume the primary risk of losing their funds if the business fails.



ENTREPRENEURIAL PROFILE: Dan Hanlon: Excelsior-Henderson Dan Hanlon's dream was to build a new motorcycle company that revived a classic brand called Excelsior-Henderson. At the age of 36, he launched his business and began raising money. During the 1990s, Hanlon raised more than \$100 million in investments that helped build a state-of-the-art factory in Minneapolis-St. Paul, Minnesota, and fund the start-up expenses of the business. Early investments came from his family and friends. Eventually, the company raised money through a public offering of its stock. However, the business never was able to reach positive cash flow. Although Hanlon and his two cofounders were able to promote the concept of the business to investors and raise money, they were not as skilled at managing a growing business. Former employees said that they were micromanagers, unreceptive to suggestions from managers and employees, and unable to building a solid dealer network. In addition, they overbuilt what they needed for manufacturing, draining much of their capital. By the end of 1999, the company was down to its last million dollars, and the entrepreneurs were looking at various options to save it. In the end, however, the only option was to declare bankruptcy. "1999 was not a fun year. I started the year with a \$20 million net worth and ended the year below zero," says Hanlon. "My brother Dave and his wife took a big hit. My mom and dad put in almost a third of their retirement savings." In addition, all of the shareholders in Excelsior-Henderson, many of whom were local citizens of the Twin Cities hoping to cash in on Hanlon's dream, lost all of the money they had invested in Excelsior-Henderson stock.⁵

If a venture succeeds, however, founders and investors share in the benefits, which can be quite substantial. The founders of and early investors in Yahoo!, Sun Microsystems, Federal Express, Intel, and Microsoft became multimillionaires when the companies went public and their equity investments finally paid off. To entrepreneurs, the primary advantage of equity capital is that it does not have to be repaid like a loan does. Equity investors are entitled to share in the company's earnings (if there are any) and usually to have a voice in the company's future direction.

The primary disadvantage of equity capital is that the entrepreneur must give up some—perhaps *most*—of the ownership in the business to outsiders. Although 50 percent of something is better than 100 percent of nothing, giving up control of your company can be disconcerting and dangerous. Many entrepreneurs who give up majority ownership in their companies or agree to the heavy-handed terms that professional investors insist on in exchange for equity capital find themselves forced out of the businesses they started! Entrepreneurs are most likely to give up more equity in their businesses in the start-up phase than in any other.

2. Describe the various sources of outside equity capital available to entrepreneurs, including friends and relatives, crowdsourcing, accelerators, angels, corporations, venture capital, and public stock offerings.

We now turn our attention to eight common sources of equity capital.

3.

Describe the seven sources of funding that the founders can contribute to their new businesses.

Funding from Founders

The *first* place entrepreneurs should look for start-up money is in their own pockets. It's the least expensive source of funds available! For the majority of start-ups, self-funding is the only source of funding available. Limited funding does not stop entrepreneurs from pursuing their vision, however. The amount of capital required to launch new businesses is surprisingly small. For new businesses with employees, more than half of start-ups launch with less than \$50,000. For those entrepreneurs who start their businesses with no employees (about 80 percent of all start-ups), almost half start with less than \$10,000.⁶



ENTREPRENEURIAL PROFILE: Sharon Munroe: Little Green Beans

After spending 21 years working in large corporations, Sharon Munroe decided it was time to leave the long hours and stress that come with a corporate career and open her own business. Munroe volunteered at a nonprofit thrift store and observed the strong demand for used children's products, so she launched a consignment store, called Little Green Beans, which specializes in children's clothing, toys, and accessories such as strollers and high chairs. As a first-time entrepreneur, she knew that she would have to self-fund her business start-up. She had carefully saved her money for several years in anticipation of launching a business. "When it's your savings, it's a bit scary to take such a big risk," says Munroe. "But it was a calculated risk where I wasn't going to just throw money at things and hope they worked. I knew where I was going to get a return on my investment." Monroe developed a carefully planned start-up budget that fit within the savings she had accumulated for her new business. She was able to lease a space in a high-traffic area, build out that space, buy the latest technology available for a retail operation, and pay for rent and other operating costs—all for about \$20,000. Unlike most other retailers, she had no inventory costs because everything was sold on consignment. She invested the remaining \$10,000 of her budget in marketing and public relations to ensure that her store would get off to a strong start. Monroe had a successful launch and needed no additional financing.⁷

Lenders and investors *expect* entrepreneurs to put their own money into a business start-up. If an entrepreneur is not willing to risk his or her own money, potential investors are not likely to risk their money in the business either. Furthermore, failing to put up sufficient capital of their own means that entrepreneurs must either borrow excessive amounts of capital or give up significant shares of ownership to outsiders to fund their businesses properly. Excessive borrowing in the early days of a business puts intense pressure on its cash flow, and becoming a minority shareholder may dampen a founder's enthusiasm for making a business successful. Neither outcome presents a bright future for the company involved. Using their own money at start-up allows entrepreneurs to minimize the debt their companies take on and to retain control of their companies' future.

There are seven common approaches used by entrepreneurs to self-finance part or all of their new businesses.⁸

PERSONAL SAVINGS A common source of start-up funding is to use savings accounts, cash from the sale of investments such as publicly traded stocks, and funds withdrawn from retirement accounts. This cash provides seed capital for buying equipment and funding working capital. Entrepreneurs also rely on personal savings to cover their own living expenses until the business generates enough cash flow to provide them with a paycheck. Entrepreneurs forgoing their paychecks during the start-up phase is known as **sweat equity**. However, entrepreneurs' personal expenses don't stop during the start-up phase, which is why they should have enough money saved to cover the early financial needs of their businesses and to pay their own living expenses for up to six months.

As we saw in Chapter 5, entrepreneurs often do not launch a business alone. They may take on partners as cofounders to both expand the capital base for the business and provide complementary skills and experience.



ENTREPRENEURIAL PROFILE: Lida Orzeck and Gale Epstein: Hanky Panky

Lida Orzeck and Gale Epstein cofounded Hanky Panky in New York in 1977. Hanky Panky manufactures and sells women's lingerie through department stores such as Nordstrom and Lord & Taylor as well as in upscale boutiques. Key to the success of their business partnership for more than 30 years is that Lida and Gale are quite different; they bring complementary skills to the business. "Gail designs, and I don't," explains Lida Orzeck. "Gale appreciates my style and my eye, but she thinks of me as the woman on the street, which is a very important role to play. I'm more in charge of the business." Orzeck is in charge of sales, marketing, and operations. The two also have

very different personalities. Epstein is the creative spirit. She is a vegetarian who would rather be riding horses in the country. Orzeck prefers life in the big city, with its fast pace and excitement. They have found that their differences make working together easier, more effective, and enjoyable. With its founders' complementary skills, Hanky Panky has grown to 150 employees and sells more than \$50 million a year in merchandise.⁹

Before entering into any partnership arrangement, entrepreneurs must consider the impact of giving up some personal control over operations and of sharing profits with others. Whenever entrepreneurs give up equity, they run the risk of losing control over the business.

OTHER PERSONAL ASSETS An entrepreneur may already own some of the equipment necessary to run a new business, such as a computer, a smart phone, or a vehicle. Rather than spending precious cash to buy duplicates of these items, their personal assets can become a part of the investment the entrepreneur makes in the business. It is not uncommon for a business to grow out of a hobby or out of an area studied in school. In this case, the entrepreneur may already have some of the specialized equipment needed for the business. For example, Kurt Nelson and Tyler Seymour started their video production company, Just Kidding Productions, as they were nearing graduation from college. They had already purchased much of the video equipment and computers that they needed to launch their business while they were students. The partners assigned a fair market value to the equipment that each contributed into the business, and this counted as a part of their investment in the corporation they formed.

UNSECURED PERSONAL CREDIT As you will learn in Chapter 17, banks rarely provide loans to start-up businesses. However, an entrepreneur may be able to secure a personal loan through credit cards or a personal line of credit. Although many entrepreneurs use multiple credit cards to fund their businesses, doing so is a risky strategy. By using credit cards to fund a new business, entrepreneurs put their personal credit rating at risk if their businesses fail. In addition, they may be violating the terms of use from the credit card company, which often prohibits the use of a personal credit cards for business purposes.



ENTREPRENEURIAL PROFILE: Jane Poynter and Taber MacCallum: Paragon Space Development

Jane Poynter and Taber MacCallum started their business while living in the experimental Biosphere 2 outside of Tucson, Arizona. They had been experimenting with self-sustaining ecosystems—basically mini-biospheres—while part of the crew was sealed within the experimental Biosphere 2. Once their time in Biosphere 2 was over, Poynter and MacCallum relied on student loans and credit cards to finance their new company, Paragon Space Development, which was based on the prototypes they developed during their time in the Biosphere 2. Fortunately, Paragon Space was able to sell its miniature biospheres to NASA, JAXA (the Japan Aerospace Exploration Agency), and other governmental agencies for various experimental projects. The partners were able to pay back the personal credit they used to fund the launch of Paragon Space Development.¹⁰

SECOND MORTGAGE ON PROPERTY If an entrepreneur owns a house or a condominium—and has equity in the property above the amount he or she borrowed through a primary mortgage—he or she can use the equity in the home to secure a second mortgage on the property to help fund a business start-up. A second mortgage, just like unsecured personal credit discussed above, is a personal credit obligation. If the business fails, the entrepreneur must personally pay off the balance of the second mortgage.

PLEDGING OTHER PERSONAL ASSETS If an entrepreneur owns personal assets, such as publicly traded stock, rental property, or an interest in a family trust, he or she can use the property as collateral to secure a loan for the business. This approach is not without risk; if the business fails and the entrepreneur is unable to repay the loan, the lender can seize the personal assets pledged as collateral to repay the loan.

WORKING A SECOND JOB Because the entrepreneur's living expenses are an important part of the cash necessary to launch a business, many new business owners continue working other jobs as they launch their businesses. This is known as “extending the runway” for the launch of the new business because it gives the start-up more time to succeed before the owner takes money out of the business to cover personal living expenses. Because entrepreneurs can do much of what they have to do during the start-up at any time of day, they often work paying jobs by day and work on their new businesses at night and on weekends. Even after their business launches,

some entrepreneurs continue to hold a second job at night, such as waiting tables or bartending, to make ends meet. At some point, the business will demand too much time to allow one to also work a second job. Ideally, this occurs when the new venture is able to pay you a regular salary!



ENTREPRENEURIAL PROFILE: Brian Morgan: Adventure Life Brian Morgan traveled to Ecuador, Bolivia, and Peru to learn Spanish, trek in the shadow of volcanoes, and raft through the rain forest. After returning home to Montana, Morgan had an idea for a business that related to his experiences in South America. “I thought I could put a group of people together a few times a year and take them to Ecuador—show them the things that I found most spectacular,” he says. He launched his business, Adventure Life, on a shoestring. He had only a couple of thousand dollars in savings, so he continued to work during the day at a software company. Morgan worked on Adventure Life evenings and weekends and used his limited start-up funding to print brochures and build a Web site. After a year of operations, the business was making enough to pay him a salary and cover all of its expenses. He was able to quit his job and focus on growing his business. Over the next 10 years, the company grew to more than \$11 million in sales and sixteen employees.¹¹

BOOTSTRAPPING As we saw in Chapter 8, because they are often unable to attract capital from outside sources, entrepreneurs bootstrap their companies. That is, the entrepreneur finds ways to accomplish all of the activities required to launch the business even though he or she has little or no money. It takes creativity, boldness, and a certain degree of brashness and moxie, but it works.



ENTREPRENEURIAL PROFILE: Johnny Earle: Johnny Cupcakes Johnny Earle was a struggling rock musician. To pay for his living expenses, he worked at a music store. One of his co-workers gave him many nicknames that were variations on his name Johnny. One of them, Johnny Cupcakes, somehow stuck. When Earle was ordering T-shirts for his metal band, he decided on a whim to get some shirts printed with his nickname Johnny Cupcakes. The shirts were a hit, and he was soon selling dozens each week out of the trunk of his car. Earle soon began to come up with creative designs for his T-shirts combining cupcakes with cultural icons, such as the Statue of Liberty holding a cupcake and a skull and crossbones with a cupcake in place of the skull. His T-shirt designs developed a strong following of loyal customers. Earle signed up with an inexpensive Web store called Merchline.com to sell his shirts and stored his inventory at his parents’ house. The popularity of his T-shirt designs continued to grow. After eight years of bootstrapped growth, Johnny Cupcakes had reached almost \$4 million in sales and employed 30 people.¹²



In the Entrepreneurial Spotlight

Bootstrapping a Technology Start-Up

Debbie Gordon worked in a series of jobs in the technology industry. In a job she held in 2002, the entrepreneur for whom she worked was facing serious cash flow challenges. He came to Debbie to ask whether she would be willing to loan the company \$15,000 to make payroll. Rather than put her money at risk for her employer, Debbie decided to leave and explore possible start-up opportunities for herself.

Debbie had become intrigued by the success of eBay as an online auction site and was curious about the opportunities it might hold. She began experimenting with eBay by selling items that she liked to buy—particularly shoes. Debbie would buy large quantities of designer shoes at a local outlet store of an upscale retailer. She bought the shoes at a significant discount and then marked them back up to retail price, offering them for sale on eBay. Because the store offered a 30-day return policy, her inventory risk was almost nonexistent. She found the process not only fun but also financially rewarding.

When other friends saw her success selling shoes using the auction site and began asking her to help them sell things they no

longer wanted on eBay. Debbie realized that there must be many more people just like her friends who would be willing to pay her to sell items on eBay. Between the end of 2002 and the middle of 2003, Debbie developed a business plan for her new venture, Snappy Auction. Her plan was to set up retail locations where people who did not want to sell items on their own through eBay could drop these items off and they would be placed on eBay and sold by the staff at these retail outlets. She would take a significant percentage fee based on the sale price of each item.

While developing her business plan, Debbie recognized that she would need help establishing and growing the venture and began to recruit a number of veterans with experience in the areas of business development, software consulting, marketing, and legal representation to assist her in formulating a business model with a clear value proposition. She bootstrapped their compensation by offering them equity in the business and delayed bonuses to offset what their salaries would be in the open market.

Debbie soon found herself fielding calls from many strangers wanting to franchise Snappy Auction. She decided that

franchising was a cost-effective way to grow her business. She could bootstrap expansion by having her franchisees pay for each new Snappy Auction outlet. However, pursuing such an option would require her to develop a formal franchise agreement. The Federal Trade Commission (FTC) requires all franchisees to create a Uniform Franchise Disclosure Document (UFDD), a document designed to provide potential franchisees with the important information they need to make fully informed decisions about investing in a franchise. Debbie found that hiring consultants to develop the UFDD would cost at least \$100,000, which was beyond the funding she had available to invest in the business. Rather than try to borrow money or find an investor, she decided to bootstrap this part of her company by writing her own UFDD agreement. With FTC regulations in one hand and a copy of *Franchising for Dummies* in the other, Debbie completed her franchise agreement just in time for a franchising expo. The expo resulted in significant interest from potential franchisees, confirming Debbie's belief. Based primarily on word-of-mouth and press coverage, the franchising of Snappy Auction had begun in earnest. Snappy Auction would go on to sign 40 franchise agreements in 10 states by early 2005. At the beginning of 2006, the number of signed franchise agreements would reach more than 100, with 50 of those locations up and running.

Snappy Auction's software system helps the salesperson determine an item's value based on market demand and even determine the best day to kick off bidding. Once again, Debbie used bootstrapping to develop her software platform. She had a software background and was able to find a software engineer to work with her. The software allowed Snappy Auction to

provide an easy eBay interface to franchisees, giving her company a significant competitive advantage over other retail auction businesses that were entering the market.

Snappy Auction was already at a crossroads because of its rapid growth. Debbie wanted to continue to grow the business as aggressively as possible. People had been coming to her eager to invest in her successful business. Up until this point, she had been the only shareholder and had no long-term debt. She had financed all of her company's growth from her initial investment, bootstrapping, and the cash flow that Snappy Auction generated from its operations.

1. Bootstrapping was an essential ingredient in Snappy Auction's successful and rapid growth. What advantages did bootstrapping offer Debbie as she grew her company? What limitations can bootstrapping create?
2. Evaluate possible sources of equity financing that Debbie could have used if she had not bootstrapped. What would equity investors expect from their investment in Snappy Auction? Is Snappy Auction an attractive business model for outside investors? Explain.
3. What would you recommend to Debbie in terms of future financing of Snappy Auction's growth? Should she continue to bootstrap? Should she seek outside investments? Justify your recommendations regarding future financing for Snappy Auction and give details on how you might implement them.

Source: Based on Mark Schenkel, Jeffrey Cornwall, and Jane Finley, "Snappy Auction," *Entrepreneurship Theory and Practice* 36, no. 3 (2012).

Friends and Family Members

Although most entrepreneurs look to their own bank accounts first to finance a business, many do not have sufficient resources to launch their businesses alone. After emptying their own pockets, entrepreneurs should look to friends and family members who might be willing to invest in a business venture. Because of their relationships with the founder, these people are most likely to invest.



ENTREPRENEURIAL PROFILE: Gauri Nanda: Nanda Home Gauri Nanda had never really wanted to be an entrepreneur. Growing up, she had seen her parents struggle as small business owners. Nanda developed the first product for her business, Nanda Home, while attending graduate school at the Massachusetts Institute of Technology. The product was an alarm clock called Clocky that offered a unique way of waking up its owner. When the user presses the snooze bar, Clocky rolls off the table on its oversized wheels and finds a place to "hide" in the room. Clocky's mobile maneuvering forces the sleepy owner to get out of bed to turn off the alarm. Nanda had never intended her invention to become a business. It was simply a device she invented because of her own challenges with waking up for class on time. However, several tech bloggers discovered her product. The publicity, including being featured on national television news programs, convinced her that she should take advantage of the demand resulting from all the attention that Clocky had been getting. Nanda raised \$80,000 from family members to launch her business. Because Nanda outsourced manufacturing, she was able to reach profitability without any additional outside investment beyond the funds from her family.¹³

The Global Entrepreneurship Monitor, a study of entrepreneurial trends across the globe, reports that family members and friends are the biggest source of external capital used to launch new businesses. Investments from family and friends are an important source of capital for entrepreneurs, but the amounts invested typically are small, often no more than just a few thousand dollars. In the United States, business founders and their family members' investments in start-up businesses make up 36 percent of the typical start-up business's total capital.¹⁴

Investments (or loans) from family and friends are an excellent source of seed capital and can get a start-up far enough along to attract money from private investors or venture capital companies. Research by the Small Business Administration shows that 62 percent of start-up companies with employees and 59.6 percent of start-ups with no employees rely on personal and family savings to finance their businesses.¹⁵ Inherent dangers lurk in family business investments and loans, however. Unrealistic expectations or misunderstood risks have destroyed many friendships and have ruined many family reunions. To avoid problems, an entrepreneur must honestly present the investment opportunity and the nature of the risks involved to avoid alienating friends and family members if the business fails. Smart entrepreneurs treat family members and friends who invest in their companies in the same way they would treat business partners. Some investments in start-up companies return more than friends and family members ever could have imagined. In 1995, Mike and Jackie Bezos invested \$300,000 into their son Jeff's start-up business, Amazon.com. Today, Mike and Jackie own 6 percent of *Amazon.com*'s stock, and their shares are worth more than \$8 billion!¹⁶

Table 16.1 offers suggestions for structuring family and friendship financing deals.

Crowdfunding

Historically, securities laws limited who can invest in small businesses. Investing in entrepreneurial businesses has been the realm of those with the knowledge and financial ability to assume the risks that come with such investments. These investors are called **accredited investors**. A few creative entrepreneurs have raised money from investors who do not meet the requirements of accredited investors using a funding technique called **crowdfunding**. Crowdfunding uses the Internet to generate many small contributions from a large number of people to fund a business. Crowdsourcing has been used primarily to help raise money to support social causes, help fund struggling artists, or support local small business start-ups. The money received from crowdfunding was considered a contribution or a donation rather than an investment. In most cases, something nominal is usually offered in return for financial support. For example, a musician might show appreciation to contributors by giving each of them a free download of a new song. Likewise, an owner of a new restaurant may offer contributors a special discount. The contributions are motivated by the desire to help out the struggling musician or restaurateur. The most commonly used Web sites that promote traditional crowdfunding are Kickstarter and IndieGoGo.



ENTREPRENEURIAL PROFILE: Eric Migicovsky: Pebble Eric Migicovsky had tried to raise money from traditional equity financing sources for his new wristwatch, called Pebble, that pairs with smart phones via Bluetooth. However, he was unable to attract the funding he needed, so he decided to take the unconventional approach of mounting a Kickstarter campaign. Although his initial goal was to raise \$100,000, Migicovsky was able to raise more than \$10 million to help launch Pebble. In exchange for their contributions, Migicovsky promised contributors that they would have preference to buy Pebbles when the watches were introduced to the market. "I think our campaign was successful because people can actually imagine themselves using Pebble," said Migicovsky. "If we're building something people want, why don't we ask the people?"¹⁷

The Jumpstart Our Business Startups (JOBS) Act of 2012 significantly expands the use of crowdfunding as a means for raising equity investment for small businesses. Crowdfunding for small business no longer must be treated as a contribution. Under the provisions of this bill, those who provide funding can become equity investors with ownership in the business. The JOBS Act opens up funding of start-ups to a much broader group of investors who do not meet the legal criteria to be considered accredited investors. To be eligible for crowdfunding, the business must have annual revenues of less than \$1 billion. An eligible business can raise up to \$1 million from a crowdfunding offering each year. There are limitations on how much individuals can invest in a crowdfunding deal that is based on their income and net worth. Using crowdfunding under the JOBS Act, *anyone* can invest some amount in a business start-up. Entrepreneurs are no longer limited to seeking funding only from accredited investors.¹⁸

Attracting investors through crowdfunding requires a different approach than an entrepreneur uses when pursuing more sophisticated and experienced investors. Unlike experienced investors who invest more in people than in their ideas, crowdfunding investors are attracted to compelling stories and business ideas they can see themselves using. Crowdfunding works through social media, so the people in an entrepreneur's existing network must be educated and

TABLE 16.1 Suggestions for Structuring Family and Friendship Financing Deals

Tapping family members and friends for start-up capital, whether in the form of equity or debt financing, is a popular method of financing business ideas. In a typical year, some 6 million individuals in the United States invest in entrepreneurial ventures started by family members and friends. Unfortunately, these deals don't always work to the satisfaction of both parties. Chris Baggott, at the age of 31, quit his corporate job and bought a dry-cleaning store that he built into a chain with seven locations. He financed the business with a loan of \$45,000 from his father-in-law, James Twiford Anderson, a physician.

Anderson also cosigned a \$600,000 bank loan for his son-in-law. However, the business soon fell on hard times, falling well short of Baggott's projections. Baggott was unable to meet his loan obligations. To try to find out what was going on, the bank went straight to Baggott's father-in-law, who would then call Baggott to get answers. "He'd call us and say, 'What the heck is going on here?'" says Baggott. "And then he'd have to write a check to cover it from his own funds." Eventually, Baggott had no choice but to sell his business. His father-in-law lost tens of thousands of dollars on the venture. "It was painful," says Baggott, who felt that the business failure strained the relationship with his father-in-law.

The following suggestions can help entrepreneurs avoid needlessly destroying family relationships and friendships:

- **Keep the arrangement strictly business.** The parties should treat all loans and investments in a business-like manner, no matter how close the friendship or family relationship, to avoid problems down the line. If the transaction is a loan exceeding \$13,000, it must carry a rate of interest at least as high as the market rate; otherwise, the Internal Revenue Service may consider the loan a gift and penalize the lender.
- **Validate the business plan.** Seek business counseling from outside experts, such as a local SBDC (Small Business Development Center) or a SCORE (Service Corps of Retired Executives) chapter, to test the strength of the business plan before you present it to family members.
- **Educate "naive" investors.** Family members and friends usually invest in a business because of their relationships with the founder, not because they understand the business itself. Take the time to explain to potential investors the basics of the business idea, how it will make money, and the risks associated with investing in it.
- **Never accept more than investors can afford to lose.** No matter how much capital you may need, accepting more than family members or friends can afford to lose is a recipe for disaster—and perhaps financial hardship or even bankruptcy for the investors. Brian Scudamore, founder of 1-800-Got-Junk?, was unwilling to take money from family members even when his business was in danger of failing (it did not) because of a lack of cash. "My dad could have given me the money. However, I didn't want him to worry that things weren't going well . . . I wanted to show dad that I could do it myself, even if that meant stretching things a bit too far. Also, taking money from him would cause problems if things went sour."
- **Create a written contract.** Don't make the mistake of closing a financial deal with just a handshake. The probability of misunderstandings skyrockets! Settle all of the details of the deal up front in a formal agreement. Putting an agreement in writing demonstrates the parties' commitment to the deal and minimizes the chances of disputes from faulty memories and misunderstandings. If it is an equity agreement, create a formal shareholder agreement. If the money from family is a loan, use a formal promissory note.
- **Treat the money as "bridge financing."** Although family and friends can help you launch your business, it is unlikely that they can provide enough capital to sustain it over the long term. Sooner or later, you will need to establish a relationship with other sources of capital if your company is to grow. Consider money from family and friends as a bridge to take your company to the next level of financing. Have an exit plan for family members to show them how they will get their equity investment, plus a fair return, out of the business.
- **Develop a payment schedule that suits both the entrepreneur and the lender or investor.** Although lenders and investors may want to get their money back as quickly as possible, a rapid repayment or cash-out schedule can jeopardize a fledgling company's survival. Establish a realistic repayment plan that works for the parties without putting excessive strain on the young company's cash flow.
- **Keep everyone informed.** Entrepreneurs should keep investors informed about the company's progress, its successes and failures, and the challenges it faces. Investors will want to know both good news and bad news. Hold regular formal meetings with family investors.

Sources: Based on Alison Stein Wellner, "Blood Money," *Inc.*, December 1, 2003, www.inc.com/magazine/20031201/gettingstarted.html; Jenny McCune, "Tips for Feud-Free Financing from Friends and Family," *Bankrate*, July 24, 2000, www.bankrate.com/brm/news/biz/Capital_borrowing/20000724.asp; Paul Kvinta, "Frogskins, Shekels, Bucks, Moolah, Cash, Simoleans, Dough, Dinero: Everybody Wants It. Your Business Needs It. Here's How to Get It," *Smart Business*, August 2000, pp. 74–89; Alex Markels, "A Little Help from Their Friends," *Wall Street Journal*, May 22, 1995, p. R10; Heather Chaplin, "Friends and Family," *Your Company*, September 1999, p. 26; Nicole Carter, "How to Get Your Family to Invest Without Drama," *Inc.*, June 15, 2001, www.inc.com/guides/201106/how-to-get-drama-free-funding-from-parents.html; Noam Wasserman, *The Founder's Dilemmas* (Princeton, NJ: Princeton University Press, 2012), p. 259.

Source: CartoonStock.



"I call my invention 'The Wheel', but so far I've been unable to attract any venture capital."

lend credibility to a broader network of potential investors.¹⁹ Although the JOBS Act significantly broadens the pool of people who can invest in small businesses, it also creates new challenges for entrepreneurs who use crowdfunding. The use of crowdfunding may complicate future fund-raising if an entrepreneur uses layered financing, so entrepreneurs should seek advice from financing experts to develop a long-term financing plan. Crowdfunding creates a large number of owners all of whom have a certain set of expectations and may require time and attention from the entrepreneur. If adding one additional partner increases the complexity of running a business, imagine what a crowd of partners can do to complicate an entrepreneur's life!

Accelerators

Inexperienced entrepreneurs have difficulty finding early-stage seed funding. The first-time entrepreneur doesn't have the credibility to attract professional investors and typically doesn't have the personal wealth necessary to provide personal funding. To help bridge this gap in funding, many communities and universities have established **accelerator programs** that offer new entrepreneurs a small amount of seed capital and a wealth of additional support. Accelerator programs help move entrepreneurs from the idea stage to a point when the business has a proven story and a successful business model that they can pitch for more significant funding. "An accelerator takes single-digit chunks of equity in externally developed ideas in return for small amounts of capital and mentorship," says Paul Bricault, cofounder of Amplify, a Los Angeles-based accelerator.²⁰ Accelerators offer a structured program that lasts from three months to one year. A select group of entrepreneurs, typically 10 to 20, are invited to participate as a group in an accelerator program. The accelerator provides entrepreneurs with about \$15,000 to \$25,000 in seed capital, gives them temporary space to work on their businesses and their pitches, and connects them with a team of mentors, each of whom gets a small share of equity in the business in return for their guidance. All of this requires the entrepreneur to give up 6 to 10 percent of the ownership in the business. At the end of the program, the accelerator hosts a large pitch event. Local angel investors and venture capitalists are invited to hear accelerator participants pitch their business ideas. Investors who are interested can join the mentor team as investors in businesses that "graduate" from the accelerator program. There are private accelerators located in most major cities, and a growing number of universities, such as the Arizona State University program highlighted in the "Entrepreneurship in Action" section in this chapter, have accelerator programs to assist student and alumni entrepreneurs.

Two of the largest accelerator programs are Y Combinator and TechStars. Although accelerators do provide small investments, the most important contribution they offer is the coaching and mentoring from angel investors and experienced entrepreneurs. "Most angel investors have a couple of coffee-shop meetings, write a check, and then cross their fingers," explains David Cohen, founder of the global accelerator network called TechStars. "At TechStars, investors and mentors actually work with the companies for three months. At the end of that time, you've become part of the team—and you know whether or not you want to invest more."²¹ The TechStars accelerator program reports that 70 percent of its participants receive subsequent funding after

going through its program. An amazing 94 percent of businesses launched through the Y Combinator accelerator program receive additional funding.²²



ENTREPRENEURIAL PROFILE: Ben Stucki: Dalo Ben Stucki was an experienced software engineer and app developer and noticed that app developers had only one option for developing new apps—using their computers. He recognized that developers were not happy about having to lug their computers around when working with clients on new apps. He determined that there was a need in the market for software that would allow app developers to use their iPads or other tablets to develop new apps. “Many in our market want to work on mobile devices,” said Stucki. “When you go to a client meeting, you don’t really bring your laptop anymore. It’s an iPad or a tablet.” However, Stucki did not have the business experience necessary to secure funding for his new product, so he entered JumpStart Foundry, an accelerator that is part of the TechStars network. JumpStart Foundry provided Stucki with a space to work and seed capital. However, most important for Stucki, JumpStart Foundry provided mentors who had both investment and start-up experience. During the summer that he was in the accelerator program, Stucki worked on both developing his software and his business skills. After leaving the program at the end of the summer, he was able to raise \$400,000 in capital from a venture capital firm and two angel investors, allowing him to hire his first employee, build his business, and begin to sell his product.²³



Entrepreneurship in Action

Launching a Business in a University Accelerator

SkySong is a 43-acre technology park in Scottsdale, Arizona, developed by Arizona State University (ASU). SkySong will eventually include more than 1.2 million square feet of office, research and retail space; multifamily residential units; a hotel; and a conference center. One of the programs within SkySong is ASU’s Edson Student Accelerator. Edson provides teams of student entrepreneurs from across the ASU campus with up to \$20,000 in seed funding, office space for one year within SkySong, training and coaching, and an intensive mentoring program. The Edson accelerator program gives student entrepreneurs the opportunity to develop their innovative ideas and launch viable businesses. The program accepts student entrepreneurs pursuing any enterprise, large or small, for-profit or not-for-profit, domestic or global. Each year teams of aspiring student entrepreneurs submit written proposals to apply to become part of the accelerator program. It is a highly competitive process. The written proposals go through two rounds of judging. The finalists are invited to make presentations on their proposals to a panel of judges. Applications for a recent

accelerator cohort included 340 start-up teams that included more than 1,000 ASU students from all university disciplines. Those 340 applicants were narrowed down to the top 30, who then pitched to an independent panel of judges comprised of local business leaders and successful entrepreneurs. The judges then chose the top 20 companies to receive funding and support from the Edson program. Brent Sebold, a venture manager at SkySong, says that helping entrepreneurs build the right team that can successfully transform the idea into a business that generates revenues and creates new jobs is the value of an accelerator program.

Three of the five finalists for *Entrepreneur* magazine’s College Entrepreneur of 2011 participated in the Edson Student Accelerator program, including the winner of the award, Gabrielle Palermo. Palermo is COO and cofounder of a business called G3Box, which sells medical clinics made out of converted steel shipping containers to nonprofits and nongovernmental organizations. “I wasn’t thinking I would be running a business while I was in college,” said Palermo. The idea for the business came



Source: ASU SkySong.



Source: ASU SkySong.

Entrepreneurship in Action *(continued)*

from a challenge posed by professors in one of her engineering classes. The challenge was to come up with a use for the numerous used shipping containers abandoned at ports around the world. The professor teamed Gabrielle Palermo with classmates Billy Walters, Susanna Young, and Clay Tyler. “The team’s thinking immediately turned to ways to convert the containers into something that could help people,” says Palermo. Their idea from the class project soon evolved into their start-up business.

G3Box solves two problems: It uses freight shipping containers that are left to rust in ports around the world, and it addresses the problem of inadequate medical facilities in rural areas. “For every seven containers we sell, we can donate a free maternity clinic,” Palermo says. Shipping containers are ideal because they are durable, available all around the world, and can be made mobile, allowing access to remote locations. When converting the shipping container into clinics, G3Box must include an electrical power system, a ventilation/air-conditioning system, usable clinic space, and access to potable water.

G3Box is developing a prototype clinic to address maternal mortality in rural Africa, which has one of the highest maternal mortality rates in the world. In Malawi, Africa, for every 100,000 live babies born, 1,200 women will die. Most of these deaths, due to hemorrhage, sepsis, and hypertensive diseases, are preventable when there is access to quality medical facilities and educated health care administrators. “After the first clinic is set up, we will be able to tailor their designs for the future

clinics based on the feedback from the villagers,” says cofounder Susanna Young.

1. Work with a small team of your classmates to develop a plan to create an accelerator program on your campus. Make sure to develop a plan that fits within the mission and resource constraints of your school. If your school already has an accelerator program, what are the similarities and differences between your program and the program at ASU?
2. Evaluate possible equity funding options for G3Box as it prepares to leave its one-year stay in the accelerator program.
3. What tips can you offer the G3Box team before they approach the sources of financing you have listed?
4. Assuming that you have the financial means to invest in a small company, would you invest in G3Box? Explain. If so, what questions would you ask before investing?

Sources: <http://skysong.asu.edu>; Mary Shinn, “Engineering Classes Help Students Reach Out,” *Statepress.com*, September 12, 2010, www.statepress.com/2010/09/12/engineering-classes-help-students-reach-out/; Stacie Spring, “3 ASU Student Businesses Up for Entrepreneur Prize,” *Ahwatukee Foothills News*, February 12, 2012, www.ahwatukee.com/news/business/article_52964369-7515-550b-8af1-4057486e6bdf.html; Carolyn Horwitz, “Meet the Entrepreneur of 2011 Award Winners,” *Entrepreneur*, December 21, 2011, <http://www.entrepreneur.com/article/222469>; Maria Muto-Porter, “An Inside Look at Arizona State University’s SkySong Incubator,” *Young Entrepreneur*, May 17, 2012, www.youngentrepreneur.com/blog/an-inside-look-at-arizona-state-universitys-skysong-incubator.

Angels

After they dip into their own pockets and convince friends and relatives to invest, some entrepreneurs still need even more money for seed and early growth capital.¹ At this point, entrepreneurs often turn to private investors. These private investors, known as **angel investors**, are wealthy individuals, often entrepreneurs themselves, who invest in business start-ups in exchange for equity stakes in the companies. Angel investing has a long history of supporting successful start-ups. For example, Alexander Graham Bell, inventor of the telephone, used angel capital to start Bell Telephone in 1877. More recently, companies such as Google, Facebook, Apple, Starbucks, Amazon, and the Costco relied on angel financing in their early years to finance growth.

In many cases, angels invest in businesses for more than purely economic reasons (often because they have experience and a personal interest in the industry), and they are willing to put money into companies in the earliest stages (often before a company generates any revenue), long before venture capital firms jump in. Angel financing is ideal for companies that have outgrown the capacity of investments from friends and family but are still too small to attract the interest of venture capital companies.



ENTREPRENEURIAL PROFILE: Elizabeth Thorpe: Posh Brood Based on her experience as a mom trying to plan vacations for her own family, Elizabeth Thorpe decided that there was a need for a Web site that offered family-friendly choices on where to stay. Thorpe’s business, Posh Brood, targets young, upscale families with incomes of \$150,000 to \$300,000. She started the business with a personal investment of \$20,000, but her ability to build a sizable following of customers and the publicity from several very favorable reviews in the media attracted interest from investors. Posh Brood is a certified travel agency that generates revenues primarily through commissions paid by hotels. Thorpe built relationships with large hotel chains, such as Omni Hotels and Resorts, and established relationships with Expedia.com and Travelzoo. She chose to work with an angel investor to fund her business rather than seek a large investment from venture capital firms. The angel invests \$12,000 each month to cover Posh Brood’s payroll for five employees and other operating expenses. Thorpe believes that this approach to financing gives her time to fully develop her business model and determine the best growth path for Posh Brood over the long term.²⁴

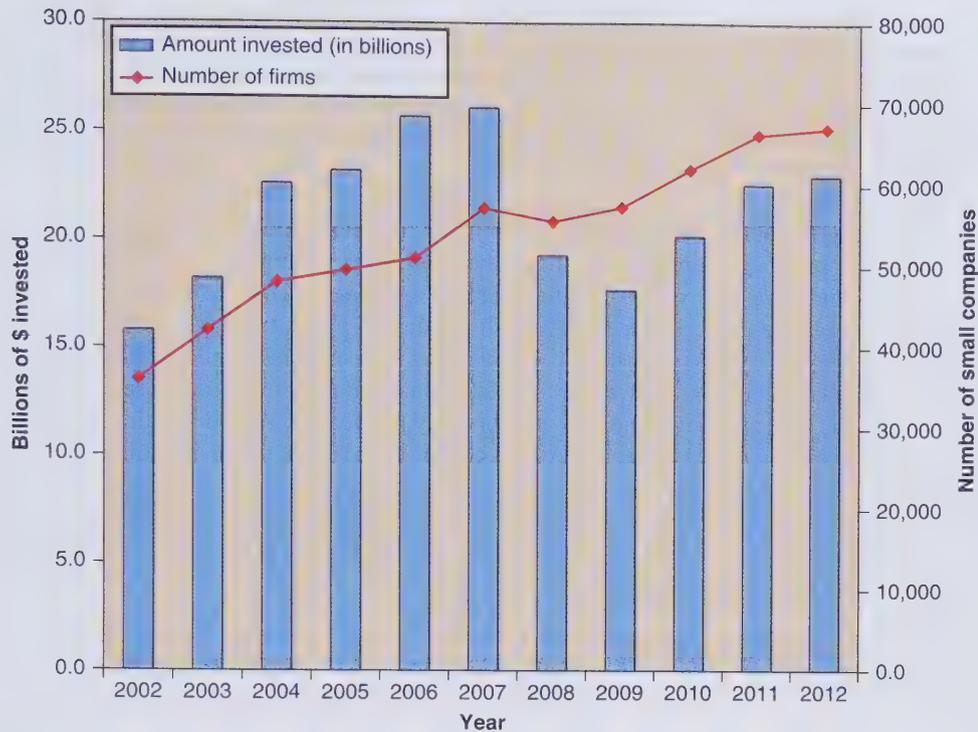


FIGURE 16.2
Angel Financing

Angels are a primary source of capital for companies that have the potential for significant growth in the start-up stage through the growth stage. The Center for Venture Research at the University of New Hampshire estimates that more than 268,000 angels invest \$22.9 billion a year in more than 67,000 small companies, most of them in the start-up phase (see Figure 16.2).²⁵ Angels invest almost as much money in small companies as do venture capital firms, but they put it into nearly 18 times as many companies as do venture capital firms. Because the angel market is so fragmented and, in many cases, built on anonymity, we may never get a completely accurate estimate of its investment in business start-ups. However, experts concur on one fact: Angels are a vital source of equity capital for small businesses.

Angels fill a significant gap in the seed capital market. They are most likely to finance start-ups with capital requirements in the \$10,000 to \$2 million range, well below the \$5 million to \$25 million minimum investments most professional venture capitalists prefer. Because they invest in earlier stages of a business, angels also tolerate risk levels that would make venture capitalists shudder. In fact, 52 percent of angels' investments lose money, returning less than the angels' original investment. The potential for investing in big winners exists as well; 7 percent of angels' investments produce a return of more than 10 times their original investments.²⁶ In general, angel investors hope to realize a return of 10 times their original investment for seed stage funding, eight times their investment for a start-up business, and from three to five times their investment for funding in business seeking growth capital.²⁷

Lewis Gersh, an experienced angel investor, says that out of 10 companies that an angel invests in, five will fail, two will break even, and two will return two to three times the original investment. Just one company out of 10 will produce a significant return, "which means that every one of them has to have the potential of being a home run," says Gersh. Most angels consider a "home run" investment to be one that results in a return of 10 to 30 times the original investment in five to seven years, somewhat lower than the returns that venture capital firms expect.²⁸ One angel investor, a retired entrepreneur, says that of the 31 companies he has invested in, "more than half have gone under, but four were home runs, returning 25 times my investment. The others gave me a small return or at least some of my money back."²⁹ Angel financing is important because angels often finance deals that venture capitalists will not consider.

ENTREPRENEURIAL PROFILE: Angelo Nunez and Cary Williams-Nunez: Prime Time

Boxing. Angelo Nunez and Cary Williams-Nunez combine the Baby Boomer Generation's interest in keeping in shape with nostalgia for boxing that can be traced back to the *Rocky* movies that

were popular during their youth. Prime Time Boxing offers members boxing lessons as a path to fitness. The success of the company's first three Prime Time Boxing locations led the owners to seek angel funding to expand their business to additional locations. They plan to buy existing gyms and convert them to Prime Time Boxing gyms using the funds raised from angel investors. Although their existing locations are profitable, they need \$500,000 in growth capital from angel investors to fund their expansion goals for their company.³⁰

Because angels prefer to maintain a low profile, the real challenge lies in *finding* them. Most angels are seasoned entrepreneurs themselves; on average, angel investors have founded 2.7 companies and have 14.5 years of entrepreneurial experience. They also are well educated; 99 percent have college degrees. Research also shows that 88 percent of angel investors are men (their average age is 57 years) who have been investing in promising small companies for nine years. The typical angel invests an average of \$50,000 in a company that is at the seed or start-up growth stages and makes an investment in one company per year.³¹ The average time required to close an angel financing deal is 67 days.³² Angels accept 14.5 percent of the investment proposals they receive.³³ When evaluating a proposal, angels look for a qualified management team (“We invest in people,” says one angel), a business with a clearly defined niche, the potential to dominate the market, and a competitive advantage. They also want to see market research that proves the existence of a sizable and profitable customer base.

Because angels frown on “cold calls” from entrepreneurs they don’t know, locating them boils down to making the right contacts. Asking friends, attorneys, bankers, stockbrokers, accountants, other business owners, and consultants for suggestions and introductions is a good way to start. “Angels are more likely to invest in a company that was referred to them by someone they know and trust,” says Marianne Hudson, director of the angel initiative at the Kauffman Foundation.³⁴ Networking is the key. Angels almost always invest their money locally, so entrepreneurs should look close to home for them—typically within a 50- to 100-mile radius. Angels also look for businesses they know something about, and most expect to invest their knowledge, experience, and energy as well as their money in a company. In fact, the advice and the network of contacts that angels bring to a deal can sometimes be as valuable as their money!

Angel investing has become more sophisticated, with investors pooling their resources to form angel networks and angel capital funds, dubbed “super-angels,” that operate like miniature versions of professional venture capital firms and draw on their skills, experience, and contacts to help the start-ups in which they invest succeed. Angel networks are affiliations of independent angel investors. The network carefully screens potential deals before they are presented to the angel investors. Most networks have a team that works with entrepreneurs to improve their business plans and polish the pitches of those entrepreneurs who make it through the initial screening. Each angel investor makes an individual decision about whether to invest in each deal presented to the group. Membership fees from the angels and sponsorships paid by local professional organizations, such as law firms, accounting firms, and commercial banks, support the operating costs of the angel network. Angel super-funds go one step further and pool money from a group of angels to directly invest in deals. A committee of angels participating in the super-fund or staff hired to manage the pool of investment capital picks the companies in which the super-fund invests. Veteran angel investor Mike Maples operates Floodgate, a super-angel fund that manages \$35 million in angel capital and invests between \$250,000 and \$1 million in promising start-ups, including Twitter and Digg.³⁵

Today, more than 300 angel capital networks operate in cities of all sizes across the United States (up from just 10 in 1996) with as many operating in other countries.³⁶ Entrepreneurs can find angel networks in their areas with the help of the Angel Capital Association’s directory (www.angelcapitalassociation.org). With the right approach, an entrepreneur can attract more money and a larger network of advisers from an angel capital group than from individual investors. The typical angel capital group has 44 members who invest \$1.77 million each year in 6.3 companies on average.³⁷



ENTREPRENEURIAL PROFILE: Stephanie Hanbury-Brown: Golden Seeds Golden Seeds’s angel investor network of 250 members is the fourth-largest angel group in the United States. Its focus is on investing in women-led businesses. “It’s very difficult for any entrepreneur to get capital, and it’s even harder for women,” says Stephanie Hanbury-Brown, founder of Golden Seeds. Members of the Golden Seeds angel network include both men and women, but the majority of members are women. So far, members of the network have invested approximately \$34 million in 42 promising

companies. “The top three things we look for are a great entrepreneur, a great entrepreneur, and a great entrepreneur,” says Hanbury-Brown. “We back the jockey over the horse, unlike some venture capitalists who are OK backing the idea or the technology.” Golden Seeds makes investments in multiple industries, including technology, consumer goods, life sciences, and media. The group has locations in New York, Boston, Philadelphia, and San Francisco. “I like investing in people who really know a particular industry and maybe worked at a corporation within a particular industry,” says Hanbury-Brown. “And while they were there, they identified a real gap and need in the marketplace. Those people are in a really good position to know where the future of the industry is going and how they can disrupt that course.”³⁸

Angels are an excellent source of “patient money,” often willing to wait five to seven years or longer to cash out their investments. They earn their returns through the increased value of the business, not through dividends and interest. For example, more than 1,000 early investors in Microsoft Inc. are now millionaires, and the original investors in Genentech Inc. (a genetic engineering company) have seen their investments increase more than 500 times.³⁹ Angels’ return-on-investment targets tend to be lower than those of professional venture capitalists. Although venture capitalists shoot for 60 to 75 percent returns annually, angel investors usually settle for 20 to 50 percent (depending on the level of risk involved in the venture). A study by the Kauffman Foundation reports that the average return on angels’ investments in small companies is 2.6 times the original investment in 3.5 years, which is the equivalent of an annual 27 percent internal rate of return.⁴⁰ Angel investors typically purchase 15 to 30 percent ownership in a small company, leaving the majority ownership to the company founder(s). They look for the same exit strategies that venture capital firms look for: either an initial public offering or a buyout by a larger company.

Strategic Investments Through Corporate Venture Capital

Large corporations are in the business of financing small companies. Today, about 15 percent of all venture capital deals involve strategic investments by corporations. The average investment that large corporations make in small companies is \$3.5 million, an amount that represents 8.4 percent of total venture capital investments.⁴¹ Approximately 300 large corporations across the globe, including Intel, Motorola, Cisco Systems, Chevron, Comcast, Nokia, UPS, and General Electric, have venture capital divisions that invest on average \$2.2 billion a year in young companies, most often those in the product development and sales growth stages. The large companies are looking not only for financial returns from the small companies in which they invest but also innovative products that can benefit them. Young companies get a boost from the capital injections that large companies give them, but they also stand to gain many other benefits from the relationship. The right corporate partner may share technical expertise, distribution channels, and marketing know-how and provide introductions to important customers and suppliers. Another intangible yet highly important advantage that an investment from a large corporate partner gives a start-up is credibility, often referred to as “market validation.” Doors that otherwise would be closed to a small company magically open when the right corporation becomes a strategic partner.

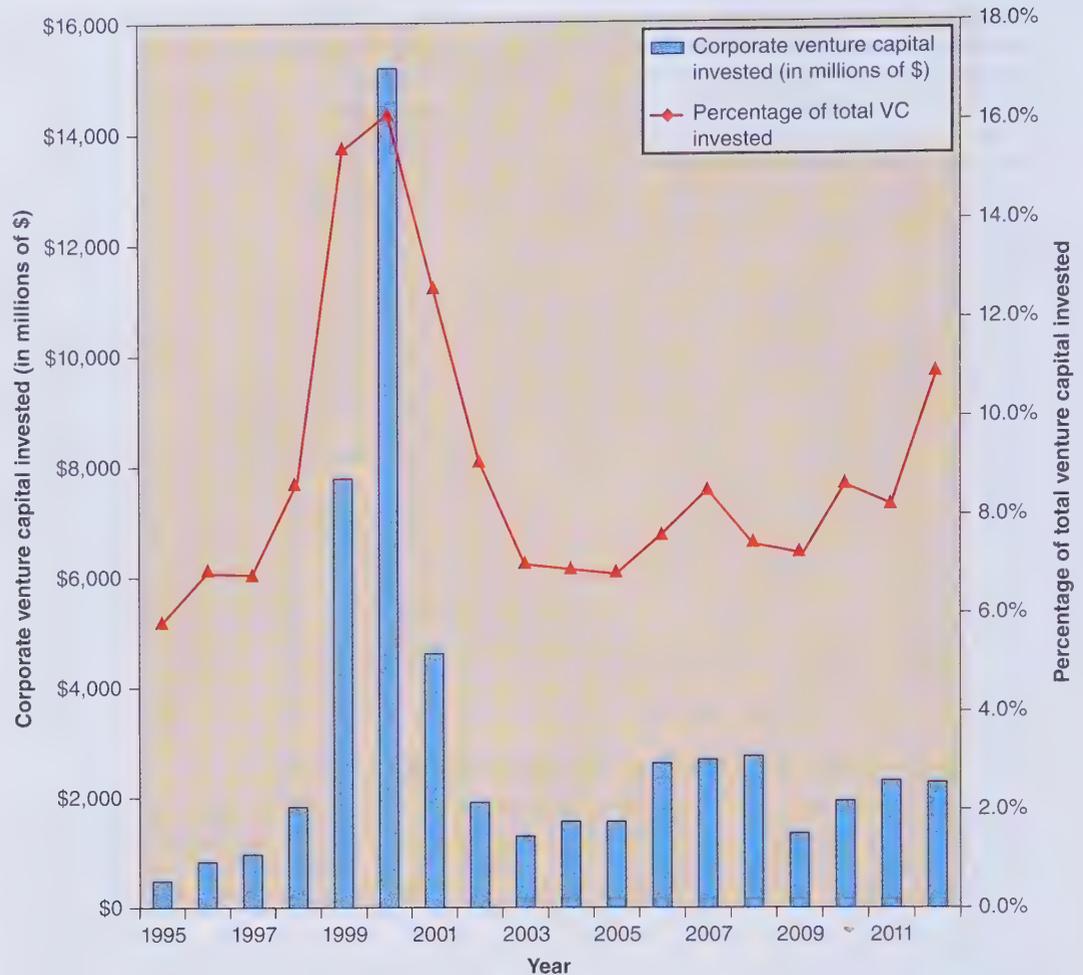
Foreign corporations also are interested in investing in small U.S. businesses. Often, these corporations are seeking strategic partnerships to gain access to new technology, new products, or access to lucrative U.S. markets. In return, the small companies that they invest in benefit from the capital infusion as well as from their partners’ international experience and extensive network of connections. Figure 16.3 shows recent trends in corporate venture capital.



ENTREPRENEURIAL PROFILE: Cisco Systems Since its inception, Cisco Systems’s venture capital fund has invested more than 100 technology start-up companies. In addition, the Cisco venture capital fund leverages its funding by investing in regional venture capital funds that have a focus on technology investments around the globe. Cisco looks for more than just product fit in their investments. “The best way to think of our research and development organization is that, to some extent, it’s a collection of tribes,” says Guido Jouret, chief technology officer of Cisco’s emerging technologies group. “We have business units focused on their own products, with their own competitors and their own partnership alliances. When it comes to acquiring new technologies, Cisco has a ‘simple and rigorous checklist’ for evaluating opportunities. In addition to proving its technology is beneficial to Cisco in both the short and long term, a company should have a corporate culture that blends seamlessly with Cisco.” For example, Cisco’s venture fund invested \$100 million in Insieme, which develops software for cloud computing and networking. With its investment, Cisco also has the right to demand an additional \$750 million in the future. Cisco executives recognize that not all research and development can come from inside their company and that strategic investments broaden Cisco’s development of new and innovative products.⁴²

FIGURE 16.3
Corporate Venture Capital

Source: Based on PriceWaterhouse-Coopers MoneyTree Report.



In the Entrepreneurial Spotlight

Funding Does Not Ensure Success

Christopher Cashman founded Protez Pharmaceuticals in 2003 using a creative financing plan. In exchange for 25 percent of the stock of Protez, Influx Pharmaceuticals agreed to give Protez some promising new drugs that it was not able to bring to market because of its commitment to several other new drugs. To develop these drugs, Protez received \$3.3 million in government grants that Influx had been awarded. Protez also received an \$800,000 investment from a small corporate venture capital division of a London-based drug company. Protez Pharmaceuticals's mission was to engage in the discovery and development of new antibiotics for difficult-to-treat infections, particularly those tied to infections in hospitals, using the technology they received from Influx.

In 2005, Cashman raised \$800,000 in seed funding from an angel capital network, Robin Hood Ventures, and another \$250,000 from Innovation Philadelphia, a nonprofit economic development organization that serves the Philadelphia

metropolitan region. His pitch to investors was that Protez was working on four different drug technologies, each of which could represent an annual market of \$250 million to \$500 million. The most promising of the four was known as Compound Y, a broad-spectrum antibiotic first developed in Japan.

Based on the progress Protez was making, Cashman quickly began pursuing a substantial B round of funding that he hoped would raise another \$15 million. Cashman pitched to investors that \$10 million would be enough to get Compound Y through Phase I clinical trials and that the full \$15 million would take the drug all the way through Phase II. To be approved by the U.S. Food and Drug Administration, drugs must go through three phases of human trials: Phase I establishes safety and dosage, Phase II measures efficacy in a limited population, and Phase III measures efficacy in a broader population. Protez's monthly burn rate (the amount of negative cash flow each month) was \$190,000. Cashman expected Protez's burn rate to double over

the next six months, so a capital infusion was critical for Protez to move ahead. When fund-raising for the B round of financing was completed, Cashman had exceeded his goal, raising \$21 million from a group of eight venture capital firms.

Only two years later, just as Compound Y was entering Phase II clinical trials, Protez announced that there was an agreement for Novartis to acquire the company. As optimistic as Cashman was about Protez, even he was surprised that the company was purchased so early in its development. Under the terms of the agreement, Novartis agreed to acquire Protez for up to \$400 million in cash. The first \$100 million was paid at closing. Novartis tied the remaining \$300 million investment in Protez to meeting certain clinical milestones, regulatory approvals, and commercial targets. Protez became a stand-alone subsidiary of Novartis, maintaining its operations in Pennsylvania. The sale of Protez was Robin Hood Venture's biggest exit to date. Robin Hood investors could have ultimately reaped as much as 15 times their investment if the entire \$400 million was paid out. Cashman's optimism soared.

Just two years later, however, Novartis made a stunning announcement about Protez. Officials at Novartis said that the company discontinued the development of Compound Y (now known as PZ-601) after observing a "high rate of adverse events" in testing the drug for patients with skin infections. Novartis closed Protez's headquarters and laid off its 16 employees. The former owners of Protez Pharmaceuticals never saw the \$400 million payday they hoped for when Novartis bought the company. "There has not been, and there will be, no milestone payments made from the previously announced \$300 million in potential milestones," says Sarah Kestenbaum of Novartis. Even without the additional \$300 million, the company's former owners received a fourfold return on their investment from the \$100 million in cash paid at the time of the acquisition.

"The [PZ-601] program termination is a reminder of how difficult the drug-development business is," says Barbara S. Schilberg, CEO of BioAdvance. "We look forward to seeing the members of the team find new opportunities in the region where they can use their entrepreneurial talent." They did find new opportunities as well. Three former Protez executives quickly moved on to launch a life sciences company called VenatoRx Pharmaceuticals, which began work on new antibacterial compounds to treat infections funded by a three-year, multi-million-dollar grant from the National Institutes of Health. Christopher Cashman was named to the board of directors of JDP Therapeutics, Inc., a specialty pharmaceutical company.

1. How typical is Protez's success in raising capital? How typical is the eventual demise of Protez even after it had been successful raising funds and negotiated an exit through its sale to Novartis? Explain.
2. Venture capitalists often view failure in previous deals to be at least as valuable as success when looking to invest in the teams that are leading entrepreneurial start-ups. Do you agree with this perspective? Explain. Discuss why the former Protez executives were able to move on so quickly to new endeavors after Protez was shut down.
3. Do you consider the demise of Protez to be a failure? Explain.

Sources: Jim Melloan, "Mr. Cashman, You're On," *Inc.*, July 1, 2005, www.inc.com/magazine/20050701/cashman.html; "Protez Pharmaceuticals to Be Acquired by Novartis," *Drugs.com*, June 4, 2008, www.drugs.com/news/protez-pharmaceuticals-acquired-novartis-8264.html; John George, "Novartis shuts Protez," *Philadelphia Business*, September 20, 2010, www.bizjournals.com/philadelphia/stories/2010/09/20/story2.html?page=all; "JDP Therapeutics, Inc. Appoints Christopher M. Cashman to Board of Directors," *Prweb.com*, June 18, 2010, www.prweb.com/releases/JDP_Therapeutics/Pharmaceuticals/prweb4159384.htm.

Venture Capital Companies

Venture capital companies (VCs) are private, for-profit organizations that raise money from investors to purchase equity positions in young businesses that they believe have high growth and high profit potential, producing annual returns of 500 to 1,000 percent over five to seven years. More than 400 active venture capital firms operate across the United States today, investing in promising small companies in a variety of industries (see Figure 16.4). Companies in California's Silicon Valley and Boston's high-tech corridor attract 38 percent of all venture capital investments.⁴³ Some colleges and universities across the nation have created venture funds designated to invest in promising businesses started by their students, alumni, faculty, and others. Business schools at the University of Michigan, the University of Maryland, the University of North Dakota, Cornell University, and, in a joint venture called the University Venture Fund, the University of Pennsylvania, Brigham Young University, the University of Utah, and Westminster College operate venture capital funds that are comanaged by students, faculty, and sometimes professional venture capitalists.⁴⁴

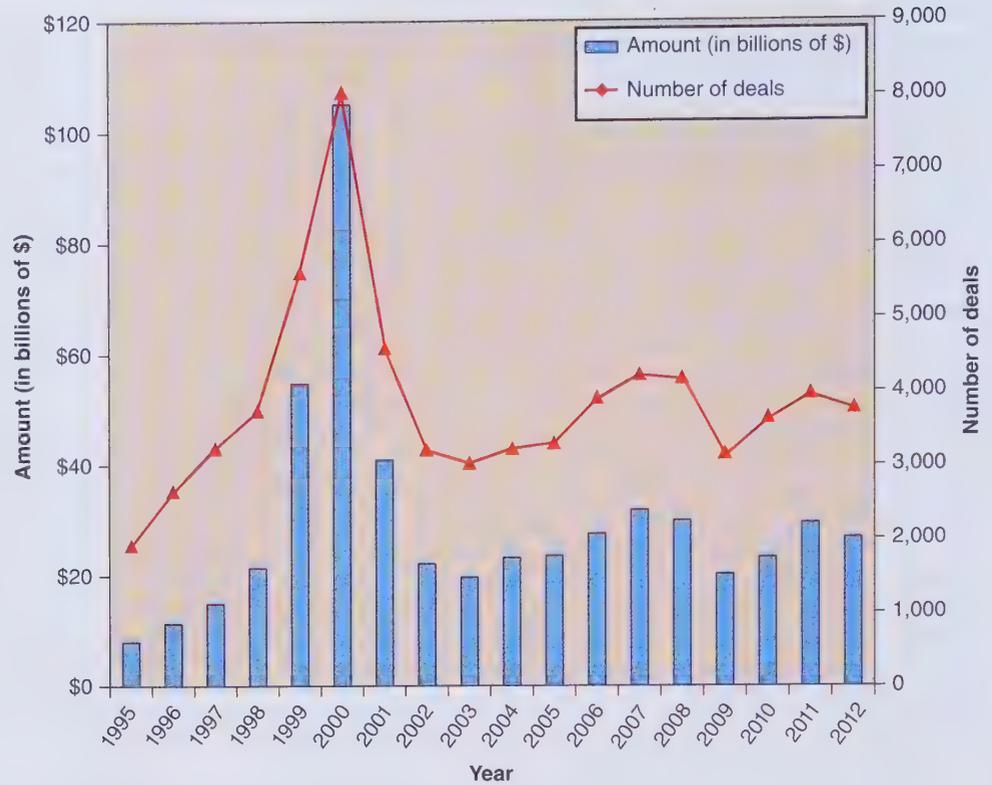
Venture capital firms, which provide funding for only 38 out of 100,000 of all start-up companies in the United States, have invested billions of dollars in high-potential small companies over the years, including notable businesses such as Apple Computer, Microsoft Inc., Intel, and Outback Steakhouse.⁴⁵ Although companies in high-tech industries such as communications, computer software, energy, medical care, and biotechnology are the most popular targets of venture capital, a company with extraordinary growth prospects has the potential to attract venture capital, whatever its industry.

4.

Describe the types of businesses that attract venture capital financing and explain the criteria that venture capitalists use to decide on their investments.

FIGURE 16.4
Venture Capital Funding

Source: Based on PriceWaterhouse-Coopers Money Tree Report.



The opinions of entrepreneurs and venture capitalists often differ when it comes to the growth potential for their start-up businesses. The typical venture capital firm receives about 1,100 business plans each year. “It’s rare that an unsolicited business plan shows up on the doorstep and becomes funded,” says Bryan Stolle with Mohr Davidow Ventures. “We have large networks of trusted colleagues and advisors, and we have more brought to us through those networks than we can handle or deal with.”⁴⁶ For every 100 business plans that the average venture capital firm receives, 90 of them are rejected immediately because they do not match the firm’s investment criteria or requirements. The firm conducts a thorough due diligence investigation of the remaining 10 companies and typically invests in only one of them. That is only 1 percent of the deals they consider! Undoubtedly, every entrepreneur who submits a business plan to venture capitalists is convinced that their business was worthy of funding, but very few ever see any investment. Table 16.2 offers a humorous look at how venture capitalists decipher the language of sometimes overly optimistic entrepreneurs.

A traditional venture capital firm seeks funding for several separate funds managed within the firm. Investment in the venture funds comes from wealthy individuals, corporations, pension funds, endowments, foundations, and insurance companies. Each fund has a cap for the amount of investment and a defined period of time that the fund will invest in high-potential businesses. As each fund nears the end of its defined time of operation, the venture capital management team seeks to liquidate all investments made from that fund so that the investors in the fund can be paid and realize a return on their initial investment. A few venture capital firms, known as evergreen funds, do not put a defined life on their funds and simply pay out returns to their investors over time as companies they invest in reach an exit event, such as an acquisition or public offering.

Policies and Investment Strategies

Venture capital firms usually establish stringent policies to govern their overall investment strategies.

INVESTMENT SIZE AND SCREENING The average venture capital firm’s investment in a small company is \$7.2 million. Depending on the size of the venture capital company and its cost structure, minimum investments range from \$100,000 to \$5 million. Investment ceilings, in effect, do not exist. Most firms seek investments in the \$5 million to \$25 million range to justify the cost of screening the large number of proposals they receive.

TABLE 16.2 Deciphering the Language of the Venture Capital Industry

By nature, entrepreneurs tend to be optimistic. When screening business plans, venture capitalists must make an allowance for entrepreneurial enthusiasm. Here's a dictionary of phrases commonly found in business plans and their accompanying venture capital translations.

Exploring an acquisition strategy—Our current products have no market.

We're on a clear P2P (pathway to profitability)—We're still years away from earning a profit.

Basically on plan—We're expecting a revenue shortfall of 25 percent.

A challenging year—Competitors are eating our lunch.

Considerably ahead of plan—Hit our plan in one of the last three months.

Company's underlying strength and resilience—We still lost money, but look how we cut our losses.

Core business—Our product line is obsolete.

Currently revising budget—The financial plan is in total chaos.

Cyclical industry—We posted a huge loss last year.

Entrepreneurial CEO—He is totally uncontrollable, bordering on maniacal.

Facing challenges—Our sales continue to slide, and we have no idea why.

Facing unprecedented economic, political, and structural shifts—It's a tough world out there, but we're coping the best we can.

Going to market with a freemium model—We don't know how we are going to make money, but we are going to start by giving our products away.

Highly leverageable network—No longer works but has friends who do.

Ingredients are there—Given two years, we might find a workable strategy.

Investing heavily in research and development—We're trying desperately to catch the competition.

Limited downside—Things can't get much worse.

Long sales cycle—Yet to find a customer who likes the product enough to buy it.

Major opportunity—It's our last chance.

Niche strategy—A small-time player.

On a manufacturing learning curve—We can't make the product with positive margins.

Passive investor—Someone who phones once a year to see if we're still in business.

Positive results—Our losses were less than last year.

Refocus our efforts—We've blown our chance, and now we have to fire most of our employees.

Repositioning the business—We've recently written off a multi-million-dollar investment.

Selective investment strategy—The board is spending more time on yachts than on planes.

Solid operating performance in a difficult year—Yes, we lost money and market share, but look how hard we tried.

Somewhat below plan—We expect a revenue shortfall of 75 percent.

Expenses were unexpectedly high—We grossly overestimated our profit margins.

Strategic investor—One who will pay a preposterous price for an equity share in the business.

Strongest fourth quarter ever—Don't quibble over the losses in the first three quarters.

Sufficient opportunity to market this product no longer exists—Nobody will buy the thing.

Too early to tell—Results to date have been grim.

A team of skilled, motivated, and dedicated people—We've laid off most of our staff, and those who are left should be glad they still have jobs.

Turnaround opportunity—It's a lost cause.

Unique—We have no more than six strong competitors.

Volume sensitive—Our company has massive fixed costs.

We don't measure our success by financial results—We are not sure whether this business model will ever result in profits.

We're iterating like crazy right now—We are no closer to a real product now than we were six months ago.

Window of opportunity—Without more money fast, this company is dead.

Work closely with the management—We talk to them on the phone once a month.

A year in which we confronted challenges—At least we know the questions even if we haven't got the answers.

Sources: Based on Scott Herhold, "When CEOs Blow Smoke," *e-company*, May 2001, pp. 125–127; Suzanne McGee, "A Devil's Dictionary of Financing," *Wall Street Journal*, June 12, 2000, p. C13; John F. Budd Jr., "Cracking the CEO's Code," *Wall Street Journal*, March 27, 1995, p. A20; "Venture-Speak Defined," *Teleconnect*, October 1990, p. 42; Cynthia E. Griffin, "Figuratively Speaking," *Entrepreneur*, August 1999, p. 26; "The Most Pervasive Pernicious Offense," *Wall Street Journal*, July 10, 2013, <http://blogs.wsj.com/accelerators/2013/07/10/thom-rube-the-most-pervasive-pernicious-offense/>; Kevin Rouse, "Actual Things That Came Out of Humans Mouths at Day One of TechCrunch's Disrupt SF Conference," *New York*, September 9, 2012, <http://nymag.com/daily/intelligencer/2012/09/techcrunch-jargon.html>.

In a normal year, VCs invest in only 3,700 of the nearly 28 million small businesses in the United States! The venture capital screening process is *extremely* rigorous. The typical venture capital company invests in less than 1 percent of the business plans it receives. According to the Global Entrepreneurship Monitor, only about one in 1,000 businesses in the United States attract venture capital during its existence.⁴⁷ The average time required to close a venture capital deal is 80 days, slightly longer than the time required to complete angel financing.⁴⁸

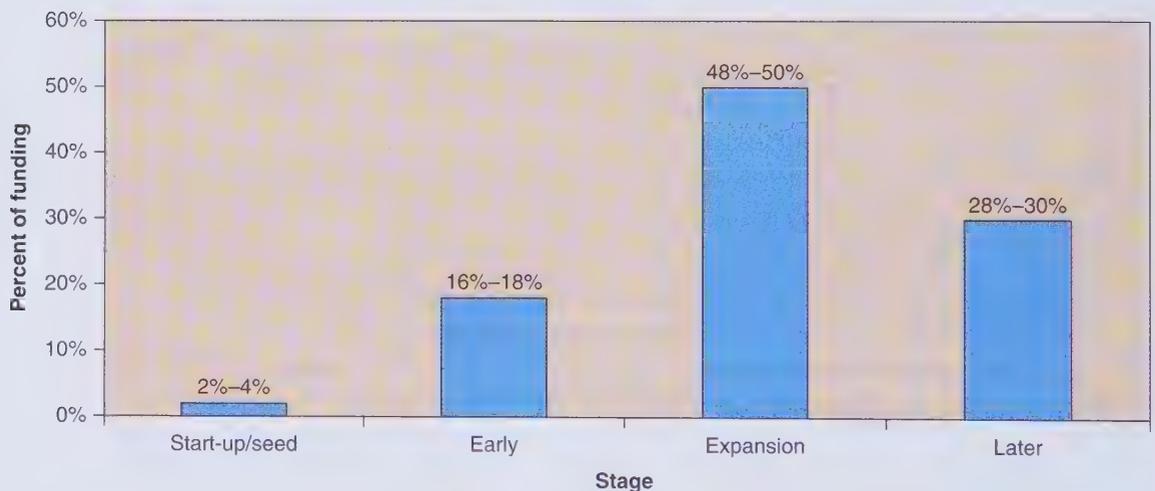
OWNERSHIP Most venture capitalists prefer to purchase ownership in a small business through common stock or convertible preferred stock. Although some venture capital firms purchase less than 50 percent of a company's stock, it is not uncommon for others to buy a controlling share of a company, leaving its founders with a minority share of ownership. Entrepreneurs must weigh the positive aspects of receiving needed financing against the disadvantages of owning a smaller share of the business. "Would you rather have 80 percent of a company worth zero or 50 percent of a company worth \$500 million?" asks a partner at one venture capital firm.⁴⁹

STAGE OF INVESTMENT Most venture capital firms invest in companies that are either in the early stages of development (called early-stage investing) or in the rapid-growth phase (called expansion-stage investing); few invest in businesses that are only in the start-up phase (see Figure 16.5). According to the Global Entrepreneurship Monitor, only one in 10,000 entrepreneurs worldwide receive venture capital funding at start-up.⁵⁰ About 97 percent of all venture capital goes to businesses in the early, expansion, and later stages.⁵¹ Most venture capital firms do not make just a single investment in a company. Instead, they invest in a company over time across several stages, where their investments often total \$10 to \$25 million or more.



ENTREPRENEURIAL PROFILE: Bismarck Lepe, Belsasar Lepe, and Sean Knapp: Ooyala

Ooyala allows creators of video content to deliver their content across all types of formats and devices. Founded by a group of former Google employees, Bismarck Lepe, Belsasar Lepe, and Sean Knapp, Ooyala received \$77 million in funding from venture capitalists over five major rounds of



Start-up/seed – This is the initial stage in which companies are just beginning to develop their ideas into products or services. Typically, these businesses have been in existence less than 18 months and are not yet fully operational.

Early stage – These companies are refining their initial products or services in pilot tests or in the market. Even though the product or service is available commercially, it typically generates little or no revenue. These companies have been in business less than three years.

Expansion stage – These companies' products or services are commercially available and are producing strong revenue growth. Businesses at this stage may not be generating a profit yet, however.

Later stage – These companies' products or services are widely available and are producing ongoing revenue and, in most cases, positive cash flow. Businesses at this stage are more likely to be generating a profit. Sometimes these businesses are spin-offs of already established successful private companies.

financing. Sierra Ventures, a California venture capital firm, was the first venture capital firm to invest in Ooyala and was the only investor in Ooyala's Series B investment round of financing. Sierra Ventures also participated with other venture capital firms in all three subsequent rounds of fund-raising that followed its initial investment. Mark Fernandes, managing director of Sierra Ventures, serves on the board of Ooyala as a representative of Sierra's sizable investment in the company.

ADVICE AND CONTACTS In addition to the money they invest, venture capital companies provide the small companies in their portfolios with management advice and access to valuable networks of contacts of suppliers, employees, customers, and other sources of capital. One of their goals in doing so is to strengthen the companies in which they have invested, thereby increasing their value. Former National Basketball Association star David Robinson's company, Admiral Capital Group, recently invested in Centerplate, an event catering business that focuses on sports venues, and plans to use his network of contacts to help the company expand, particularly into professional basketball events.⁵²

CONTROL In exchange for the financing they receive from venture capitalists, entrepreneurs must give up a portion of their businesses, sometimes surrendering a majority interest and control of its operations. Most venture capitalists prefer to let the founding team of managers employ its skills to operate a business *if* they are capable of managing its growth. However, most venture capitalists join the boards of directors of the companies they invest in or send in new managers or a new management team to protect their investments. The term sheets they negotiate often include the right to determine the CEO. In other words, venture capitalists are *not* passive investors! A study of new business ventures by Harvard professor Noam Wasserman reports that only half of the companies' founders were in the CEO position after three years and that the likelihood of a founder being replaced increases significantly after a company receives capital from outside investors, especially venture capitalists.⁵³

Some venture capitalists serve only as financial and managerial advisers, whereas others take an active role managing the company—recruiting employees, providing sales leads, choosing attorneys and advertising agencies, and making daily decisions—which can cause friction with the founding entrepreneur(s). The majority of these active venture capitalists say they are forced to step in because the existing management team lacked the talent and experience to achieve growth targets.



ENTREPRENEURIAL PROFILE: Jason Brown: Cotton Comfort Jason Brown was just 26 years old when a group of venture capitalists offered to invest \$5 million in Cotton Comfort, a small chain of clothing stores he had launched at age 20. He gave up 46 percent of his company in exchange for the capital investment and the investors' experience. Brown says that the venture capitalists pushed him to grow the company too fast, and when the economy slowed, Cotton Comfort ran out of cash and folded. "I was too young to know that my job was to listen to what the VCs had to say but to know that they had only a chapter out of the novel of understanding about my business," says Brown, who went on to launch two more successful businesses.⁵⁴

As Jason Brown learned, a common complaint among entrepreneurs who accept venture capital is that their investors push too hard for too much growth too soon.

INVESTMENT PREFERENCES Venture capital funds are larger, more professional, and more specialized than they were 20 years ago. As the industry grows, more venture capital funds are focusing their investments in niches—everything from information technology services to biotechnology. Most venture capital firms also focus their investments within a specific geographic region. Some will invest in almost any industry but prefer companies in particular stages, including the start-up phase. Traditionally, however, only about 2 to 4 percent of the companies receiving venture capital financing are in the start-up (seed) stage, when entrepreneurs are forming a company or developing a product or service. Most of the start-up businesses that attract venture capital today are in the biotechnology, software, energy, and medical device industries.

COMPETENT MANAGEMENT Attracting venture capital takes more than just a good idea; it requires a management team that can transform an idea into a viable business. Venture capitalists believe in the adage "Money follows management." To them, the most important ingredient in the success of a business is the ability of the management team. They are looking for a team of managers who share the same vision for the company and have the experience and the

ability to make that vision a reality. “The team is more important than the idea,” says Jason Mendelson of the venture capital firm The Foundry Group. “Always has been, always will be. So you can have the cure for cancer but a crummy team, and it will fail. If you have a great team and kind of a medium idea, you can usually do OK.”⁵⁵ From a venture capitalist’s perspective, the ideal management team has experience, managerial skills, commitment, and the ability to build effective teams.

COMPETITIVE EDGE Investors are searching for some factor that will enable a small business to set itself apart from its competitors. This distinctive competence may range from an innovative product or service that satisfies unmet customer needs to a unique marketing or research-and-development approach. It must be something with the potential to make the business a leader in its field.

GROWTH INDUSTRY Hot industries attract profits—and venture capital. Most venture capital funds focus their searches for prospects in rapidly expanding fields because they believe the profit potential is greater in these areas. Venture capital firms are most interested in young companies in industries that have enough growth potential to become at least \$100 million businesses within three to five years. Venture capitalists know that most of the businesses they invest in will flop, so their winners have to be *big* winners.

VIABLE EXIT STRATEGY Venture capitalists not only look for promising companies with the ability to dominate a market, but they also want to see a plan for a feasible exit strategy, ideally to be executed within three to five years. A recent study by the National Venture Capital Association reports that the number one factor that venture capitalists say creates a nonfavorable environment for venture capital is difficulty achieving successful exits.⁵⁶ Venture capital firms realize the return on their investments when the companies they invest in either make an initial public offering or sell out to a larger business. For instance, Dell recently purchased Equallogic, a company that developed highly efficient network data storage solutions for businesses, for \$1.4 billion, creating a handsome payout for Equallogic’s three founders and the venture capital companies that had invested in it. Paula Long, Peter Haden, and Paul Koning started Equallogic in the Haden’s attic in 2003, and within three years, its sales had increased from \$492,000 to more than \$100 million.⁵⁷ “If your vision is to run a company and hand it over to your kids, VC funding is out of the question,” says Mike Simon, CEO of LogMeIn, Inc., a remote software company that has raised \$20 million in capital, half of it from venture capital firms.⁵⁸

INTANGIBLE FACTORS Some other important factors considered in the screening process are not easily measured; they are the intuitive, intangible factors the venture capitalist detects by gut feeling. This feeling might be the result of the small firm’s solid sense of direction, its strategic planning process, the experience and chemistry of its management team, or a number of other factors.



ENTREPRENEURIAL PROFILE: Ofer Raz and Hod Fleishman: GreenRoad In 2003, Ofer Raz and Hod Fleishman launched GreenRoad, a company whose software helps companies and individuals improve driving habits, reduce collisions, improve fuel economy, and reduce vehicle operating costs, and quickly realized that their company would require a significant investment to capitalize on the market opportunity that lay before it. The duo estimates that the cost of vehicle crashes in the United States alone is \$235 billion and that 90 percent of all crashes are the result of driver behavior. Their subscription-based service provides real-time feedback and driver coaching and is designed to reduce those costs and save lives by improving drivers’ behavior. Customers who use the company’s technology (including Ryder, Ericsson, T-Mobile, LeFleur Transportation, and others) typically reduce the number of crashes by 50 percent and fuel consumption and emissions by up to 10 percent. After pitching their idea to many venture capital firms, Raz and Fleishman have received \$42.5 million in financing across three rounds. Venture capitalists were impressed with the experience of the management team that Raz and Fleishman had assembled, the company’s fast growth, and the size of the potential market. Representatives from the venture capital firms hold five of GreenRoad’s board seats, but the company has the capital it needs to support continued research and development, product innovation, and a more concentrated sales and marketing effort.⁵⁹

Despite its many benefits, venture capital is not suitable for every entrepreneur. “VC money comes at a price,” warns one entrepreneur. “Before boarding a one-way money train, ask yourself if this is the best route for your business and personal desires, because investors are like department stores the day after Christmas—they expect a lot of returns in a short period of time.”⁶⁰

Public Stock Sale ("Going Public")

In an **initial public offering (IPO)**, a company raises capital by selling shares of its stock to the general public for the first time. A public offering is an effective method of raising large amounts of capital, but it can be an expensive and time-consuming process filled with regulatory nightmares (see Table 16.3). In the past, "going public" was a more common strategy for small businesses seeking to raise capital than it is today. However, since 2001, there has been a significant drop in the number of public offerings. This is because of the dot-com crash in 2000 and the enactment of the Sarbanes-Oxley Act in 2002, which imposed much tighter regulatory control over and increased costs for publicly held companies. "The big VC companies now sort of have a chokehold on the distribution and they're not letting companies go public unless they have very, very large revenues and prospects for big market caps," explains Frank Quattrone, cofounder and CEO of Qatalyst Partners, a technology-focused investment bank.⁶¹ Figure 16.6 shows the trend in the number of IPOs and the amount of capital raised.

Once a company makes an IPO, *nothing* will ever be the same again. The company is no longer under the exclusive ownership and control of the entrepreneur. The entrepreneur typically retains some ownership and may play a significant management role. However, responsibility and control rests in the hands of the board and the management team they put in place to represent the interests of *all* the stockholders of the company.



ENTREPRENEURIAL PROFILE: Paymaxx and CompuPay The high cost of regulatory compliance dissuades many potential companies from going public. Paymaxx, founded in 1991, became one of the largest payroll provider companies in the United States, and the fast-growing company was considering an IPO to acquire the capital necessary to fuel its growth. Its founders made an abrupt U-turn in their plans when they discovered the cost of complying with the Sarbanes-Oxley Act, choosing instead to sell the company to a larger payroll processing company, CompuPay.⁶²

5. Explain the process, advantages, and challenges of making an initial public offering.

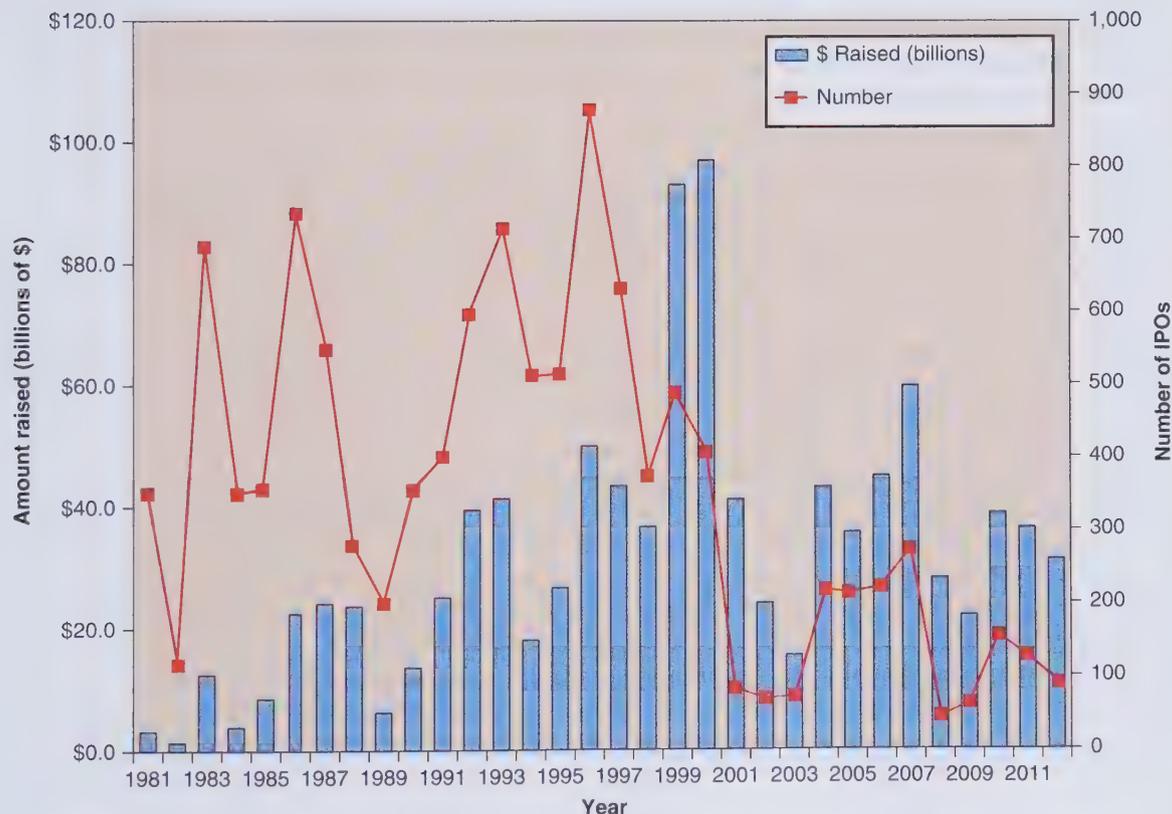


FIGURE 16.6

IPOs
STUDENTS-HUB.com

Source: Based on Renaissance Capital's IPO Home, www.ipohome.com.

TABLE 16.3 The IPO Process

Taking a company public is a complicated, bureaucratic process that usually takes several months to complete. Many experts compare the IPO process to running a corporate marathon, and both the company and its management team must be in shape and up to the grueling task. Making an IPO requires a coordinated effort from a team of professionals, including company executives, an accountant, a securities attorney, a financial printer, and at least one underwriter. Typically, the entire process of going public takes from 60 to 180 days, but it can take much longer if the issuing company is not properly prepared for the process. The key steps in taking a company public follow:

- **Choose the underwriter.** The single most important ingredient in making a successful IPO is selecting a capable **underwriter** (or **investment banker**). The underwriter serves two primary roles: helping to prepare the registration statement for the issue and promoting the company's stock to potential investors. The underwriter works with company managers as an adviser to prepare the registration statement that must be filed with the Securities and Exchange Commission (SEC), promoting the issue in a road show, pricing the stock, and providing after-market support. Once the registration statement is finished, the underwriter's primary job is selling the company's stock through an underwriting syndicate of other investment bankers it develops.
- **Negotiate a letter of intent.** To begin an offering, the entrepreneur and the underwriter must negotiate a **letter of intent**, which outlines the details of the deal. The letter of intent covers a variety of important issues, including the type of underwriting, its size and price range (usually between \$10 and \$20 per share), the underwriter's commission, and any warrants and options included. The underwriter establishes an estimated price range for the company's IPO in the letter of intent but does not set the final price until the day before the offering takes place. Depending on demand for the company's shares, the condition of the market, and other factors, the actual price may be outside the estimated range. Since 2001, 65 percent of IPOs have sold within or above the estimated ranges listed in their SEC filings.⁶³

There are two types of underwriting agreements: firm commitment and best effort. In a **firm commitment agreement**, the underwriter agrees to purchase all of the shares in the offering and then resells them to investors. This agreement *guarantees* that the company will receive the required funds, and most large underwriters use it. In a **best efforts agreement**, the underwriter merely agrees to use its best efforts to sell the company's shares and does not guarantee the company will receive the needed financing. The managing underwriter acts as an agent, selling as many shares as possible through the syndicate. Most letters of intent include a **lock-up agreement** that prevents the sale of insider shares, those owned by directors, managers, founders, employees, and other insiders, for 12 to 36 months. The sale of these shares early in a company's public life could send negative signals to investors, eroding their confidence in the stock and pushing its price downward.

- **Prepare the registration statement.** After a company signs the letter of intent, the next task is to prepare the **registration statement** to be filed with the SEC and the prospectus to be distributed to potential investors. These documents describe both the company and the stock offering and disclose information about the risks of investing. It includes information on the use of the proceeds, the company's history, its financial position, its capital structure, the risks it faces, its managers, and many other details. The statements are extremely comprehensive and may take months to develop.
- **File with the SEC.** When the registration statement is finished (with the exception of pricing the shares, proceeds, and commissions, which cannot be determined until just before the issue goes to market), the company officially files the statement with the SEC and awaits the review of the Division of Corporate Finance. The division sends notice of any deficiencies in the registration statement to the company's attorney in a comment letter. The company and its team of professionals must address all of the deficiencies noted in the comment letter and prepare an amended registration statement. Finally, the company files the revised registration statement, along with a pricing amendment (giving the price of the shares, the proceeds, and the underwriter's commission).
- **Wait to go effective.** While waiting for the SEC's approval, the managers and the underwriters are busy. The underwriters are building a syndicate of other underwriters who will market the company's stock. (No sales can be made prior to the effective date of the offering, however.) The SEC also limits the publicity and information a company may release during this quiet period (which officially starts when the company reaches a preliminary agreement with the managing underwriter and ends 90 days after the effective date).
- **Road show.** The purpose of the **road show** is to promote interest among potential underwriters in the IPO by featuring the company, its management, and the proposed deal. The managing underwriter and key company officials barnstorm major cities such as New York, Boston, San Francisco, Chicago, Los Angeles, and sometimes foreign cities such as London and Hong Kong at a grueling pace. Company executives often make presentations to stockbrokers and institutional investors in two or three cities a day for two to four weeks.
- **Sign a formal underwriting agreement.** On the last day before the registration statement becomes effective, the company signs the formal underwriting agreement. The final settlement, or closing, takes place a few days after the effective date for the issue. At this meeting, the underwriters receive their shares to sell and the company receives the proceeds of the offering.
- **Meet state requirements.** In addition to satisfying the SEC's requirements, a company also must meet the securities laws in all states in which the issue is sold. These state laws (or "blue sky" laws) vary drastically from one state to another, and the company must comply with them.

Few companies with less than \$25 million in annual sales manage to go public successfully. It is extremely difficult for a start-up company with no track record of success to raise money with a public offering. Instead, investment bankers who underwrite public stock offerings usually look for established companies with the following characteristics:

- Consistently high growth rates.
- Scalability. Institutional investors want proof that a company can maintain or improve its efficiency as it experiences the strain that rapid growth imposes.
- High profit potential. Strangely enough, profitability at the time of the IPO is not essential; since 2001, 47 percent of companies making IPOs have had negative earnings.⁶⁴
- Three to five years of audited financial statements that meet or exceed SEC standards. After the Enron and WorldCom scandals, investors are demanding impeccable financial statements.
- A solid position in a rapidly growing industry. In 1999, the median age of companies making IPOs was four years; today, it is twelve years.⁶⁵
- A sound management team with experience and a strong board of directors.

The biggest advantage of an IPO is the capital infusion that the company receives. Since 2001, the average IPO has raised \$310 million for the issuing company.



ENTREPRENEURIAL PROFILE: Robin Chase: Zipcar Zipcar cofounder and CEO Robin Chase developed a sound business model for new kind of car rental company. Zipcar offers a fleet of Mini Coopers, Beetles, and Priuses, which are popular with the company's target market of young customers. Zipcar's rental cars are parked at various reserved locations in the urban areas and college campuses where it operates. Zipcar follows a membership model that allows its customers to reserve cars by the hour or day with gas, parking, maintenance, and insurance included. Members have automated access to Zipcars using an access card that enables them to unlock the door where the keys are already inside. Although cofounder Chase was strong on the initial vision for the company, she was unable to get Zipcar to profitability and was unsuccessful in raising badly needed financing. Thus, the board, which was made up of Chase and four outside investors, decided it was time to find a new CEO. "While we all think Robin did a fabulous job starting the company, the sense at the board level was that we needed a different type of manager for the next stage," explains Jill Preotle, a board member. The board hired Scott Griffith as the new CEO. Griffith had experience with two start-up ventures—one very successful and one that failed. Over the next seven years, Griffith led Zipcar through several rounds of venture capital financing totaling \$56 million. In June 2010, Zipcar announced that it had filed a registration statement with the SEC relating to a proposed IPO. In April 2011, Zipcar announced that it raised \$174.3 million through its IPO, which was 27 percent higher than its most optimistic forecast.⁶⁶



Zipcar.

Source: © B Christopher/Alamy.

Securing capital to launch or to expand a small business is no easy task. However, entrepreneurs who understand the equity funding options that are available and are prepared to go after them stand a much better chance of getting the financing they seek than those who don't.

Chapter Review

1. Explain the differences between the two types of capital small businesses require: fixed and working.
 - Capital is any form of wealth employed to produce more wealth. Two forms of capital are commonly identified: fixed capital and working capital.
 - Seed capital is used for the start of a new business. Growth capital is money used to fund the significant expansion or change in the business model of an existing business. Both seed and growth capital can be used to fund fixed and working capital needs.
 - Fixed capital is used to purchase a company's permanent or fixed assets. Working capital represents the business's normal short-term operations.
2. Describe the seven sources of funding that the founders can contribute to their new businesses.
 - Funding from the founding entrepreneur is the most common sources of funding for a new business.
 - The founders of a new business rely on a variety of forms of self-funding to finance the launch: (1) using personal savings to fund the business and to support the living expenses of the entrepreneur as the business gets started, (2) contributing personal assets to the business such as computers and vehicles, (3) taking out unsecured personal loans, (4) taking out a second mortgage on the entrepreneur's home, (5) pledging personal assets such as investments to secure a business loan, (6) working a second job while starting the business, and (7) using various

types of bootstrapping to help reduce the need for funding.

- An entrepreneur may choose to start a business alone or may bring in partners as cofounders to help with financing and to bring in skills and experience the entrepreneur does not possess.
3. Describe the various sources of outside equity capital available to entrepreneurs, including, friends and relatives, crowdfunding, accelerators, angels, corporations, venture capital, and public stock offerings.
 - After emptying their own pockets, the next place entrepreneurs turn for capital is family members and friends. Crowdfunding and accelerators are two relatively new forms of funding used by entrepreneurs. Angels are private investors who not only invest their money in small companies but also offer valuable advice and counsel to them. Some business owners have success financing their companies by forming an alliance with a corporation (often a larger company in their industry), a customer, or a supplier. Venture capital companies are for-profit, professional investors looking for fast-growing companies in “hot” industries. When screening prospects, venture capital firms look for competent management, a competitive edge, a growth industry, and important intangibles that will make a business successful. Some owners choose to attract capital by taking their companies public, which requires registering the public offering with the SEC.
 4. Describe the types of businesses that attract venture capital financing. Explain the criteria that venture capitalists use to decide on their investments.
 - Businesses that have high potential for growth and a competitive edge attract the interest of venture capital investment. Most venture capital firms seek investments in the \$5 million to \$25 million range to justify the cost of screening the large number of proposals they receive. Most venture capitalists prefer to purchase ownership in a small business through common stock or convertible preferred stock. Venture capital firms invest in companies that are either in the early stages of development or in the rapid-growth phase; few invest in businesses that are only in the start-up phase. Two factors make a deal attractive to venture capitalists: high returns and a clear exit strategy. They are looking for a team of managers who share the same vision for the company and have the experience and the ability to make that vision a reality.
 5. Explain the process, advantages, and challenges of making an initial public offering.
 - Going public is a difficult form of financing for smaller businesses in the current regulatory climate. It is most often used for entrepreneurial firms that have already achieved significant size through rapid growth.
 - Going public offers the advantages of raising large amounts of capital, improved access to future financing, improved corporate image, and gaining listing on a stock exchange. The disadvantages include dilution of the founder’s ownership, loss of privacy, reporting to the SEC, filing expenses, and accountability to shareholders.

Discussion Questions

- 16-1. Why is it so difficult for most small business owners to raise the capital needed to start, operate, or expand their ventures?
- 16-2. What guidelines should an entrepreneur follow for successfully financing his business?
- 16-3. Define equity financing. What advantage does it offer over debt financing?
- 16-4. What is the most common source of equity funds in a typical small business? If an owner lacks sufficient equity capital to invest in the firm, what options are available for raising it?
- 16-5. What are the seven sources of funding that the founders can tap for their new businesses?
- 16-6. What is crowdfunding? How has the JOBS Act changed and entrepreneur’s ability to use crowdfunding?
- 16-7. What are the advantages offered by starting a business in an accelerator program?
- 16-8. What is an angel investor? Assemble a brief profile of the typical private investor. How can entrepreneurs locate potential angels to invest in their businesses?
- 16-9. Explain corporate venture capital with suitable examples.
- 16-10. What types of businesses are most likely to attract venture capital? What investment criteria do venture capitalists use when screening potential businesses? How do these compare to the typical angel’s criteria?
- 16-11. How do venture capital firms operate? Describe their procedure for screening investment proposals.
- 16-12. Summarize the major challenges of “going public” for a small business.

CHAPTER 17

Sources of Debt Financing

Learning Objectives

On completion of this chapter, you will be able to:

1. Describe the various sources of debt capital and the advantages and disadvantages of each.
2. Explain the types of financing available from nonbank sources of credit.
3. Identify the sources of government financial assistance and the loan programs these agencies offer.
4. Describe the various loan programs available from the Small Business Administration.
5. Discuss state and local economic development programs.
6. Discuss other possible methods of financing growth.
7. Explain how to avoid becoming a victim of a loan scam.



One of the greatest disservices you can do a man is to lend him money that he can't pay back.

—Jesse Holman Jones

Live within your means, never be in debt, and by husbanding your money you can always lay it out well.

—Andrew Jackson

Rather than adding another owner to a business, as happens with an equity investment, **debt financing** is a temporary supply of funding with a contractual obligation to repay with interest. Debt financing, particularly from institutional lenders, is not a source of funding that is available to most start-ups. Most new entrepreneurs must rely on their own funding sources and on the business itself to generate capital internally. As a business begins to grow, its retained earnings, the portion of its profits that the owner keeps in the company, is the least expensive source of capital. Funding a growing business by its own cash flow is known as **organic funding**.

Small companies in the United States that are beyond the start-up phase rely heavily on debt capital to feed their growing businesses when internally generated cash flow is insufficient. The Small Business Administration estimates that lenders make \$600 billion worth of loans of less than \$1 million to small companies each year. Add to that amount loans from family members and friends and credit card borrowing, and total small business borrowing approaches \$1 trillion a year. Lenders of capital are more numerous than investors, but small business loans can be just as difficult (if not more difficult) to obtain, especially given the recent turbulence in the financial markets. The amount that banks lend to small businesses has decreased by more than \$100 billion since the credit crunch began in 2008.¹ A recent survey by the National Federation of Independent Businesses (NFIB) reports that small business owners have adjusted to the tighter lending conditions that began in 2008. Only 7 percent of small business owners say that their credit needs are not being met. However, the survey also found that 64 percent of small business owners did not apply for a loan of any kind. The NFIB also reports that small business owners continue to be cautious about capital spending, building up inventory, and hiring.² A survey by the New York Federal Reserve reports that entrepreneurs seeking small loans have had the hardest time finding banks willing to lend to them since 2008.³ When entrepreneurs are not making capital investments, building inventory, and hiring, their companies do not grow, and the entire economy suffers. Table 17.1 displays the increase in small business debt leading up to the fiscal crisis that began in 2008 and decrease in small business debt during the subsequent years.



ENTREPRENEURIAL PROFILE: Summit Kumar: Summit Telecom Summit Kumar, president of Summit Telecom, a telecommunications company in Hicksville, New York, had success in the past getting credit for his business, but that changed when the economy entered a prolonged recession in 2008. “The banks are not lending. They claim they are, but they’re not,” says Kumar. “I got a line of credit from a bank five years ago, and I paid it back. Now the same bank says I’m ‘high-risk business’ and turns me away.” Because of the weak economy and the resulting tightening of

TABLE 17.1 Value of Small Business Loans

	2006	2007	2008	2009	2010	2011	2012
Commercial real estate							
\$100,000 or less	\$28.7	\$28.4	\$28.5	\$26.4	\$22.1	\$19.8	\$18.0
\$100,000 to \$250,000	\$65.0	\$68.8	\$68.6	\$67.1	\$59.6	\$56.4	\$53.1
\$250,000 to \$1 million	\$244.2	\$262.8	\$277.9	\$278.4	\$260.5	\$247.8	\$236.7
Total commercial real estate	\$337.9	\$360.1	\$375.0	\$372.0	\$342.3	\$323.9	\$307.8
Commercial and industrial							
\$100,000 or less	\$117.0	\$131.2	\$141.7	\$134.5	\$137.2	\$119.8	\$120.2
\$100,000 to \$250,000	\$54.7	\$57.5	\$57.3	\$55.1	\$51.2	\$47.3	\$46.3
\$250,000 to \$1 million	\$124.6	\$138.0	\$137.4	\$133.6	\$121.6	\$116.0	\$113.5
Total commercial and industrial	\$296.3	\$326.7	\$336.4	\$323.2	\$309.9	\$283.0	\$280.1
Total small							
Business loans (\$1 million or less)	\$634.2	\$686.8	\$711.5	\$695.2	\$652.2	\$606.9	\$587.8

Source: Federal Deposit Insurance Corporation, Statistics on Depository Institutions.

credit by the banking industry, Kumar's business has suffered. Because he was unable to secure bank financing, Kumar had to turn to a cash advance company that would give him \$50,000 but expected him to pay back \$75,000 six months later.⁴

Although entrepreneurs who borrow capital maintain complete ownership of their businesses, they must carry the debt as a liability on the balance sheet and repay it with interest at some point in the future. In addition, because lenders consider small businesses to be greater risks than bigger corporate customers, small companies must pay higher interest rates because of the risk-return trade-off—the higher the risk, the greater the return demanded. Most small firms pay the **prime rate**, the interest rate banks charge their most creditworthy customers, *plus* two or more percentage points. Still, the cost of debt financing often is lower than that of equity financing because debt financing does not require entrepreneurs to dilute their ownership interest in the company.

The need for debt capital can arise from a number of sources, but financial experts identify the following reasons business owners should consider borrowing money:⁵

- **Increasing the company's workforce and/or inventory to boost sales.** Sufficient working capital is the fuel that feeds a company's growth.
- **Gaining market share.** Businesses often need extra capital as their customer bases expand and they incur the added expense of extending credit to customers.
- **Purchasing new equipment.** Financing new equipment that can improve productivity, increase quality, and lower operating expenses often takes more capital than a growing company can generate internally.
- **Refinancing existing debt.** As companies become more established, they can negotiate more favorable borrowing terms compared to their start-up days, when entrepreneurs take whatever money they can get at whatever rate they can get. Replacing high-interest loans with loans carrying lower interest rates can improve cash flow significantly.
- **Taking advantage of cash discounts.** Suppliers sometimes offer discounts to customers who pay their invoices early. As you will learn in Chapter 19, business owners should take advantage of cash discounts in most cases.
- **Buying the building in which the business is located.** Many entrepreneurs start out renting the buildings that house their businesses; however, if location is crucial to their success, it may be wise to purchase the location.
- **Establishing a relationship with a lender.** If a business has never borrowed money, taking out a loan and developing a good repayment and credit history can pave the way for future financing. Smart business owners know that bankers who understand their businesses play an integral role in their companies' ultimate success.
- **Retiring debt held by a "nonrelationship" creditor.** Entrepreneurs find that lenders who have no real interest in their companies' long-term success or do not understand their businesses can be extremely difficult to work with. They prefer to borrow money from lenders who are willing to help them achieve their business mission and goals.
- **Foreseeing a downturn in business.** Establishing access to financing before a business slowdown hits insulates a company from a serious cash crisis and protects it from failure.

Entrepreneurs seeking debt capital face an astounding range of credit options varying greatly in complexity, availability, and flexibility. Not all of these sources of debt capital are equally favorable, however. By understanding the various sources of capital—both commercial and government lenders—and their characteristics, entrepreneurs can greatly increase the chances of obtaining a loan.

Figure 17.1 shows the financing strategies that small business owners use for their companies. We now turn to the various sources of debt capital.

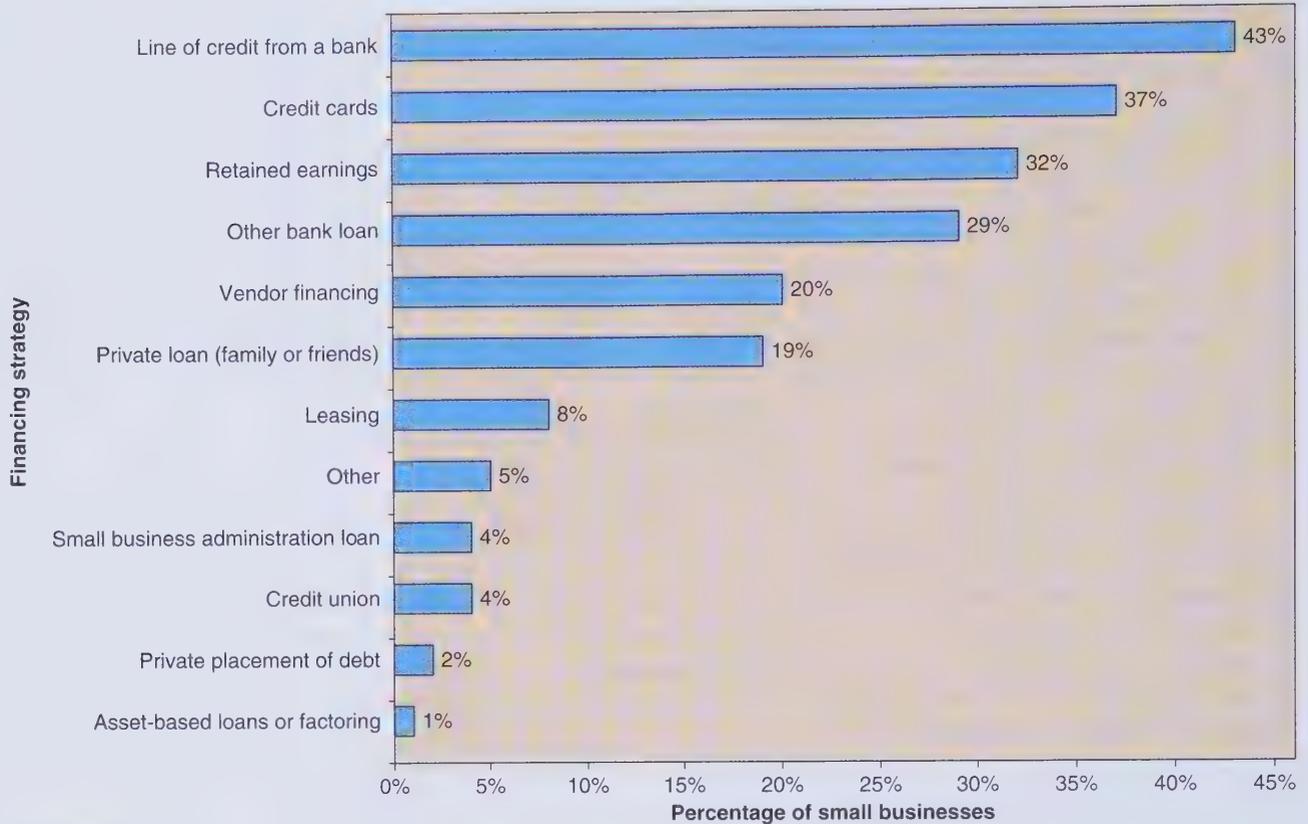


FIGURE 17.1
Small Business Financing Strategies

Source: Based on National Small Business Association, 2012 Small Business Access to Capital Survey, p. 4.



In the Entrepreneurial Spotlight

A Tale of Two Borrowers

Busboys and Poets

Andy Shallal has been able to succeed in a market where most competitors are failing. Shallal owns several popular Busboys and Poets bookstore cafés in the Washington metropolitan area.

Shallal emigrated from Iraq at the age of 11 when Saddam Hussein assumed power. His experiences early in life led him to be a social activist and to bring his values into his business. Shallal was inspired to keep neighborhood development true to the history of an area. His vision was to make Busboys and Poets a neighborhood gathering place where people of different incomes, races, and identities could come together to exchange ideas. His first restaurant proved to be highly successful and allowed him to open two additional locations, each with its own identity tied to the local neighborhood.

Busboys and Poets cafés generate revenue of more than \$14 million a year, but when Shallal wanted to borrow money to expand two of his highly successful stores, he could not find a bank that would lend him the money. One bank said that it would lend him the money personally if he used his house as

collateral. Shallal wanted a true business loan that uses the assets of the business as collateral. All of the banks he talked to turned him down, saying that they are not giving these types of business loans due to weak economic conditions.

Unless he secures some form of financing, he will be unable to expand his business to accommodate the growing demand for his concept.

All American Real Estate

James and Sonia Conlin opened All American Real Estate NNY LLC after James had retired from the army after 21 years of service. James had been working in real estate on nights and weekends for a few years leading up to his retirement. The Conlins needed funding to help renovate the office space for the new real estate firm they founded. The building, which had been built in 1850, had not been updated since the 1950s. They decided to try to take out a loan to update the decor, straighten a few of the walls, and put up new windows. The Conlins had estimated start-up cost to be about \$120,000. The Conlins' loan request

fit within the limits of the Small Business Administration's (SBA's) Patriot Express program, which they qualified for because of James's service in the army. The couple developed a business plan with the help of their local Small Business Development Center and submitted it to Community Bank.

"It's the fastest turnaround time for SBA approval because the loans are given preference," says Jennifer L. Huttemann-Kall, vice president at Community Bank, who was the loan officer for the loan. "SBA's pipeline has been so full that it is a huge help."

Patriot Express loans generally offer the lowest interest rates available for business loans and are guaranteed by the SBA for 85 percent for a loan the size that the Conlins were seeking for their new business.

"The fact that he is a retired military officer said a lot to me," says Huttemann-Kall. "And when I asked them for things, they were on it instantly—that says a lot about their business ethic. They have immediate access to soldiers and contacts at other bases."

The bank approved the loan, and the Conlins now operate their successful firm, along with two agents they have added to

the company's staff, out of the renovated space made possible by the Patriot Express loan.

1. One of these businesses received a bank loan, and the other did not. Describe the differences between the two companies that led to one entrepreneur's receiving the financing he needed and the other one's failing to qualify for a loan.
2. What steps would you have recommended to Andy Shallal to increase the probability of qualifying for a loan?
3. Suppose that Shallal had approached you for help after being turned down by three banks. What other sources of capital would you have suggested he use?

Sources: Based on "Thriving Small Businesses Still Struggling to Get Loans," *CNN.com*, December 12, 2009, www.cnn.com/2009/POLITICS/12/12/obama.bank.lenders/index.html; "Andy Shallal: Restaurateur, Busboys and Poets," *Washington Business Journal*, April 6, 2009, www.bizjournals.com/washington/stories/2009/04/06/tidbits21.html; Nancy Madsen, "Two Catch 'Patriot Express,'" *Watertown Daily Times*, December 19, 2010, www.watertowndailytimes.com/article/20101219/NEWS03/312199981.

Sources of Debt Capital

Commercial Banks

Commercial banks are the very heart of the financial market, providing the greatest number and variety of loans to small businesses. Commercial banks provide 50 percent of the dollar value of all loans to small businesses.⁶ For small business owners, banks are lenders of *first* resort, especially as their companies grow. The typical loan amount is small; more than 88 percent of all small business bank loans are for less than \$100,000. The average micro-business loan (those less than \$100,000) is \$6,820, and the average small business loan (those between \$100,000 and \$1 million) is \$245,775.⁷



ENTREPRENEURIAL PROFILE: Allison O'Neill: Bundle Allison O'Neill, founder of an infant and toddler clothing and accessory store in Soho, New York, called Bundle, launched her business just as the banking crisis and resulting recession began in 2008. Bundle is the type of business that tends to do well in any economy, which was one of the reasons she started the business. "One of the things I found was that, of all of retail, children's clothing is the most recession proof," says O'Neill. In addition to having cash on hand, O'Neill made sure to bootstrap her business start-up. "Everyone who works here wears many hats . . . everyone who's here is a sales associate, and a social media manager, and a marketing manager, and an inventory specialist." However, even with her frugal management and healthy personal finances, O'Neill had trouble securing a business loan. "I had great credit," she says. "I had basically four times the amount of a loan I was looking for, in my brokerage account, and they didn't care. They were just like, we're not taking any risks on start-ups."⁸

As Allison O'Neill learned, banks tend to be conservative in their lending practices and prefer to make loans to established small businesses rather than to high-risk start-ups. Small companies that are less than three years old are as much as 50 percent less likely to receive loans or lines of credit than older, more established businesses.⁹ Because start-ups are so risky, bankers prefer to make loans to companies that have successful track records. Banks are concerned with a small company's operating past and scrutinize its records to project its position in the immediate future. They also want proof of a company's stability and its ability to generate adequate cash flow that ensures repayment of the loan. If they do make loans to a start-up venture, banks like to see significant investment from the owner, sufficient cash flow to repay the loan, personal guarantees by the entrepreneurs to repay the loan if the business cannot, and the ample collateral (such as compensating balances) to secure it. Bankers also prefer to see more than one source of repayment on loans to small businesses. An SBA guarantee to insure the business loan is another option. These are all business "bankable." Entrepreneurs should not overlook small community banks (those with less than \$10 billion in assets) for loans. These small banks, which make

1.

Describe the various sources of debt capital and the advantages and disadvantages of each.



Allison O'Neill, founder of Bundle, a children's clothing store in Soho, New York.

Source: Allison O'Neill.

up 98.7 percent of U.S. banking institutions, account for almost 52 percent of the dollar volume of all small business loans.¹⁰ They also tend to be “small business friendly” and are more likely than their larger counterparts to customize the terms of their loans to the particular needs of small businesses, offering, for example, flexible payment terms to match the seasonal pattern of a company’s cash flow or interest-only payments until a piece of equipment begins generating revenue. Small community banks approve 49.5 percent of small business loan requests, far higher than the small business loan approval rate of 17.3 percent at large banks.¹¹

When evaluating a loan application, banks focus on a company’s capacity to create positive cash flow because they know that’s where the money to repay their loans will come from. The first question in most bankers’ minds when reviewing an entrepreneur’s business plan is “Can this business generate sufficient cash to repay the loan?” Even though they rely on personal guarantees and collateral to secure their loans, the last thing banks want is for a borrower to default, forcing them to sell the collateral (often at “fire sale” prices) and use the proceeds to pay off the loan or seek repayment from the owners individually. That’s why bankers stress cash flow when analyzing a loan request, and that’s why it is so difficult for a business start-up to find bank financing. “Cash is more important than your mother,” jokes one experienced borrower.¹²

Banks, as well as many other lenders, also require that entrepreneurs sign personal guarantees for any loans they make to the small businesses. By making a personal loan guarantee, an entrepreneur pledges that he or she will be personally liable for repaying the loan in the event that the business itself cannot repay the loan. Recall from Chapter 5 that in the eyes of the law, a sole proprietor or a general partner and the business are one and the same; therefore, for them, personal loan guarantees are redundant. However, because the owners of S corporations, corporations, and limited liability companies are separate from their businesses, they are not automatically responsible for the company’s debts. Once the owners of these businesses sign personal loan guarantees, however, they become liable for their companies’ loans. (It is as if these individuals have “cosigned” the loan with the business.) Working with a partner, Rosalind Resnick launched NetCreations, an Internet marketing company, using money from various sources, including bank loans. The bank required the partners to provide personal guarantees of \$2 million for NetCreation’s line of credit and equipment leases. The personal guarantees remained in effect until the company went public.¹³

Short-Term Loans

Short-term loans, extended for less than one year, are the most common type of commercial loan banks make to small companies. These funds typically are used to replenish the working capital account to finance the purchase of inventory, finance credit sales to customers, take advantage of cash discounts, or handle other short-term needs. As a result, an owner repays the loan after converting inventory and receivables into cash. There are several types of short-term loans.

COMMERCIAL LOANS (OR TRADITIONAL BANK LOANS) The basic short-term loan is the commercial bank’s specialty. Business owners typically repay the loan, which often is unsecured because secured loans are much more expensive to administer and maintain, as a lump sum within three to six months. In other words, the bank grants a loan to the small business owner without requiring him or her to pledge any specific collateral to support the loan in case of default. The owner repays the total amount of the loan at maturity. Sometimes the interest due on the loan is prepaid—deducted from the total amount borrowed. Until a small business is able to prove its financial strength and liquidity (cash flow) to the bank’s satisfaction, it will probably not qualify for this kind of commercial loan.

LINES OF CREDIT One of the most common requests entrepreneurs make of banks is to establish a **line of credit**, a short-term loan with a preset limit that provides much-needed cash flow for day-to-day operations. With a commercial (or revolving) line of credit, business owners can borrow up to the predetermined ceiling at any time during the year quickly and conveniently by writing themselves a loan. Banks set up lines of credit that are renewable for anywhere from 90 days to several years, and they usually limit the open line of credit to 40 to 50 percent of a firm’s present working capital, although they may lend more for highly seasonal businesses. Bankers may require a company to rest its line of credit during the year, maintaining a zero balance, as proof that the line of credit is not a perpetual crutch. Like commercial loans, lines of credit can be secured or unsecured. Small lines of credit often are unsecured, and large ones usually are secured by accounts receivable, inventory, equipment, or other business assets.

TABLE 17.2 How Large Should Your Line of Credit Be?

Determining how large a small company’s line of credit should be is an important step for a growing business. As a company’s sales grow, so will its inventory and accounts receivable balances, both of which tie up valuable cash. To avoid experiencing a cash crisis, many growing companies rely on a line of credit. How large should that line of credit be? The following formulas will help you answer that question:

$$\text{Average collection period ratio} + \text{Average inventory turnover ratio} - \text{Average payable period ratio} = \text{Cash flow cycle}$$

Cash flow cycle × Average daily sales – Forecasted annual profit = Line of credit requirement

Example: Suppose that Laramie Corporation has an average collection period ratio of 49 days and an average inventory turnover ratio of 53 days. The company’s average payable period is 39 days, its annual sales are \$5,800,000, and its net profit margin is 6.5 percent. What size line of credit should Laramie seek?

Average collection period ratio	49 days
Average inventory turnover ratio	<u>53 days</u>
Total	102 days
Minus average payable period ratio	<u>39 days</u>
Cash flow cycle	63 days
Annual sales	\$5,800,000
Average daily sales (annual sales ÷ 365 days)	\$15,890
Cash flow cycle	63 days
Times average daily sales	\$15,890
Equals	\$1,001,096
Minus forecasted profit (annual sales × net profit margin)	<u>377,000</u>
Equals line of credit requirement	<u>\$624,096</u>

Laramie Corporation should seek a line of credit of \$624,000.

Source: Based on George M. Dawson, “It Figures,” *Entrepreneur Start-Ups*, December 2000, p. 27.

A business typically pays a small handling fee (1 to 2 percent of the maximum amount of credit) plus interest on the amount borrowed—usually at least prime plus one or more point. Because banks prefer the security of established businesses, securing a line of credit can be difficult for some small companies, especially new ones. A study by the National Federation of Independent Businesses reports that the most difficult type of loan for small business owners to obtain is a line of credit; only 37.6 percent of the small companies that applied received one.¹⁴ Table 17.2 shows one method for determining how large a line of credit a small company should seek.

ENTREPRENEURIAL PROFILE: David Meinert: Onto Entertainment, Big Mario’s New York Style Pizza, and The 5 Point Cafe

David Meinert has been a successful restaurateur in Seattle for many years. He owns Onto Entertainment, Big Mario’s New York Style Pizza, and The 5 Point Cafe. Meinert has strong credit and profitable businesses that generate \$2 million in annual revenue. Meinert recently switched to Chase Bank after 12 years banking with Bank of America. He chose large banks because of the convenience of their many locations. Meinert applied for a \$50,000 line of credit from Chase. However, the bank denied his loan application within 12 hours. “It was insulting and made no sense, even to the banker. And there was no one to even talk to about it,” Meinert says. After Chase Bank denied his request for the line of credit, Meinert decided to switch all of his business accounts to Seattle Bank, a small community bank. Meinert has been happy with his choice. “For one, I had a conversation with the executive vice president. That’s a huge difference in itself,” he said. “The higher-ups of the bank are able to come to my restaurant and have a meal. They are customers of my business, and I’m a customer of theirs. It’s also just the whole vibe of knowing people and knowing they’re decision makers of the bank. I’ve been able to meet board members of the bank. They’re local people who live here, work here—they’re going to be at this bank for a long time.”¹⁵

automobiles, recreational vehicles, boats, and major appliances. For example, Thrifty Car Sales makes a floor plan financing program available to the network of franchised dealers who sell the used cars that are taken out of service from its Thrifty Car Rental system. Bombadier Capital, the provider of the floor plan, finances Thrifty Car Sales dealers' purchases of automobiles from Thrifty Car Rental and maintains a security interest in each car in the order by holding its title as collateral.¹⁶ Dealers pay interest on the loan monthly and repay the principal as the cars are sold. The longer a floor-planned item sits in inventory, the more it costs a business owner in interest expense. Banks and other floor planners often discourage retailers from using their money without authorization by performing spot checks to verify prompt repayment of the principal as items are sold.

Intermediate- and Long-Term Loans

Banks primarily are lenders of short-term capital to small businesses, although they will make certain intermediate- and long-term loans. Intermediate- and long-term loans are extended for one year or longer and are normally used to increase fixed- and growth-capital balances. Commercial banks grant these loans for starting a business, constructing a plant, purchasing real estate and equipment, and other long-term investments. Loan repayments are normally made monthly or quarterly.

TERM LOANS Another common type of loan banks make to small businesses is a **term loan**. Typically unsecured, banks grant these loans to businesses whose past operating history suggests a high probability of repayment. Some banks make only secured term loans, however. Term loans impose restrictions (called **covenants**) on the business decisions an entrepreneur makes concerning the company's operations. For instance, a term loan may set limits on owners' salaries, prohibit further borrowing without the bank's approval, or maintain certain financial ratios. Term loans often have a balloon feature, which means that after three to five years, the full amount of principal is due before the amortized payments fully repay the loan. If the business is in good financial shape, the bank will renew the loan with the business, charging new loan fees and possibly changing the interest rate. An entrepreneur must understand all of the terms attached to a loan before accepting it.

INSTALLMENT LOANS These loans are made to small firms for purchasing equipment, facilities, real estate, and other fixed assets. When financing equipment, a bank usually lends the small business from 60 to 80 percent of the equipment's value in return for a security interest in the equipment. The loan's amortization schedule typically coincides with the length of the equipment's usable life. When financing real estate (commercial mortgages), banks typically lend up to 75 to 80 percent of the property's value and allow a lengthier repayment schedule of 10 to 30 years.

The accompanying "Lessons from the Street-Smart Entrepreneur" feature describes how small business owners can maintain positive relationships with their bankers.



Lessons from the Street-Smart Entrepreneur

How to Maintain a Positive Relationship with Your Banker

Too often, entrepreneurs communicate with their bankers only when they find themselves in a tight spot and needing money. Unfortunately, that's not the best way to manage a working relationship with a bank. "Businesspeople have a responsibility to train their bankers in their businesses," says one lending adviser. "A good banker will stay close to the business, and a good business will stay close to the banker." A good banking relationship has the power to influence in a significant way the success of a small business.

How can business owners develop and maintain a positive relationship with their bankers? The first step is picking the

right bank and the right banker. Some banks are not enthusiastic about making small business loans, and others target small businesses as their primary customers. It's a good idea to visit several banks—both small community banks and large national banks—and talk with a commercial loan officer about your banking needs and the bank's products and services. After finding the right banker, an entrepreneur must focus on maintaining effective *communication*. The best strategy is to keep bankers informed—of both good news and bad.

Jamey Bennett is CEO of LightWedge, which manufactures specialty reading lights. Bennett has always made it a practice

to keep his banker informed. For example, when Bennett decided to replace his CFO, he immediately let his banker know. A change in key personnel, especially one that deals with the finances of the business, is important to a banker. "I don't think anybody likes surprises, especially your banker," says Bennett. "If something material to the business changes significantly, I keep [my banker] abreast of it." Sometimes the news a business owner has to share with a banker is not good news. "Right now, we're feeling pretty good about where we are in respect to managing our cash, but some of our customers are not in such good shape," says Bennett. "We've got one of our biggest customers looking very, very sick right now." In this case, Bennett's banker was able to offer some advice that helped fend off a possible major problem later. His banker recommended that he purchase credit insurance to help protect against a loss resulting from a large accounts receivable becoming uncollectable. "I need him as a partner in what we're doing today and what I expect to be doing tomorrow," says Bennett.

What else can entrepreneurs do to manage their banking relationships?

Understand the factors that influence a banker's decision to lend money. Bankers want to lend money to businesses; that's how they generate a profit. However, they want to lend money to businesses they believe offer a very high probability of repaying their loans on time. Bankers look for companies that are good credit risks and that have clear plans for success.

Invite the banker to visit your company. An on-site visit gives the banker the chance to see exactly what a company does and how it does it. It's also a great opportunity to show the bank where and how the business puts the bank's money to use.

Make a good impression. A company's physical appearance can go a long way toward making either a positive or a negative impression on a banker. Lenders appreciate clean, safe, orderly work environments and view sloppily maintained facilities (such as spills, leaks, and unnecessary clutter) as negatives.

Send customer mailings to the banker as well. "Besides the numbers, we try to give our bankers a sense of our vision for the business," says Mitchell Goldstone, president of Thirty-Minute Photos Etc. Goldstone sends customer mailings to his bankers "so they know we're thinking about opportunities to generate money."

Send the banker samples of new products. "I try to make my banker feel as if he's a partner," says Drew Santin, president of a product development company. "Whenever we get a new machine, I go out of my way to show the banker what it does."

Show off your employees. Bankers know that one of the most important components of building a successful company is a dedicated team of capable employees. Giving bankers the opportunity to visit with employees and ask them questions while touring a company can help alleviate fears that they are pumping their money into a high-risk "one-person show."

Know your company's assets. Almost always interested in collateral, bankers want to judge the quality of your company's assets—property, equipment, inventory, accounts receivable, and others. Be sure to point them out. "As you walk the lender through your business," says one experienced banker, "it's always a good idea to identify assets the banker might not think of."

Be prepared to personally guarantee any loans the bank makes to your business. Even though many business owners choose the corporate or limited liability company forms of ownership for their limited liability benefits, some are surprised when a banker asks them to make personal guarantees on business loans. It's a common practice, especially on small business loans.

Keep your business plan up to date and make sure your banker gets a copy of it. Bankers lend money to companies that can demonstrate that they will use the money wisely and productively. They also want to make sure that the company offers a high probability of repayment. The best way to provide bankers with that assurance is with a solid business plan.

Know how much money you need and how you will repay it. When a banker asks, "How much money do you need?" the correct answer is not "How much can I get?"

1. What advantages do entrepreneurs gain by communicating openly with their bankers?
2. What are the consequences of an entrepreneur's failing to communicate effectively with a banker?

Sources: Based on Kasey Wehrum, "How to Get Chummy with Your Banker," *Inc.*, April 1, 2009, www.inc.com/magazine/20090401/finance-buddy-can-you-spare-a-loan.html; Emily Maltby, "Uptick Catches Entrepreneurs by Surprise," *Wall Street Journal*, December 8, 2009, p. B7; Keith Lowe, "Keep Your Banker Informed," *Entrepreneur*, April 1, 2002, www.entrepreneur.com/article/0,4621,298380,00.html; David Worrell, "Attacking a Loan," *Entrepreneur*, July 2002, www.entrepreneur.com/article/52678; Maggie Overfelt, "How to Raise Cash During Crunch Time," *FSB*, March 2001, pp. 35–36; Joan Pryde, "Lending a Hand with Financing," *Nation's Business*, January 1998, pp. 53–59; Joseph W. May, "Be Frank with Your Bank," *Profit*, November/December 1996, pp. 54–55; "They'll Up Your Credit If . . .," *Inc.*, April 1994, p. 99; Jane Easter Bahls, "Borrower Beware," *Entrepreneur*, April 1994, p. 97; Jacquelyn Lynn, "You Can Bank on It," *Business Start-Ups*, August 1996, pp. 56–61; Stephanie Barlow, "Buddy System," *Entrepreneur*, March 1997, pp. 121–125; Carlye Adler, "Secrets from the Vault," *FSB*, June 2001, p. 33.

Nonbank Sources of Debt Capital

Although they are usually the first stop for entrepreneurs in search of debt capital, banks are not the only lending game in town. We now turn our attention to other sources of debt capital that entrepreneurs can tap to feed their cash-hungry companies.

Asset-Based Lenders

Asset-based lenders, which are usually smaller commercial banks, commercial finance companies, and credit unions, allow small businesses to borrow money by pledging otherwise idle assets, such as accounts receivable, inventory, or purchase orders, as collateral. This form

2. Explain the types of financing available from nonbank sources of credit.

Source: CartoonStock.



"It's a mistake to borrow money from a friend."

of financing works especially well for manufacturers, wholesalers, distributors, and other companies with significant stocks of inventory, accounts receivable, equipment, real estate, or other assets. Even unprofitable companies whose income statements could not convince loan officers to make traditional loans can get asset-based loans. Because asset-based lenders focus more on collateral than on a company's credit rating, these cash-poor but asset-rich companies can use normally unproductive assets—accounts receivable, inventory, equipment, and purchase orders—to finance rapid growth and the cash crises that often accompany it.

Like banks, asset-based lenders consider a company's cash flow, but they are much more interested in the quality of the assets pledged as collateral. The amount a small business can borrow through asset-based lending depends on the **advance rate**, the percentage of an asset's value that a lender will lend. For example, a company pledging \$100,000 of accounts receivable might negotiate a 70 percent advance rate and qualify for a \$70,000 asset-based loan. Advance rates can vary dramatically depending on the quality of the assets pledged and the lender. Because inventory is an illiquid asset (i.e., hard to sell), the advance rate on inventory-based loans is quite low, usually 10 to 50 percent. Steven Melick, CEO of the Sycamore Group, an e-business software developer, gets an 85 percent advance rate on his company's loans from GE Capital by pledging high-quality accounts receivable as collateral.¹⁷ The most common types of asset-based financing are discounting accounts receivable and inventory financing.

DISCOUNTING ACCOUNTS RECEIVABLE The most common form of secured credit is accounts receivable financing. Under this arrangement, a small business pledges its accounts receivable as collateral; in return, the lender advances a loan against the value of approved accounts receivable. The amount of the loan tendered is not equal to the face value of the accounts receivable, however. Even though the lender screens the firm's accounts and accepts only qualified receivables, it makes an allowance for the risk involved because some receivables will be uncollectible. A small business usually can borrow an amount equal to 55 to 85 percent of its receivables, depending on their quality. Generally, lenders accept only accounts receivable that are current.



ENTREPRENEURIAL PROFILE: Robison Oil Robison Oil, of Elmsford, New York, sells and services heating, ventilating, and air-conditioning equipment and is a supplier of heating oil, natural gas, electricity, biofuel, and green energy alternatives to both residential and commercial customers. Robison Oil is a highly seasonal business, sometimes showing a loss at the end of the year. As a result, its bank was unable to provide the company with financing. Instead, Robison Oil turned to an asset-based lender, which was willing to extend an \$11 million term loan and \$18 million line of credit based on the strength of its long-term customer accounts. "We had to go back to a bank, but we have found this segment of lenders much more flexible," said Dan Singer,

copresident of Robison. The total financing costs of the asset-based lender were about one percent-age point more than the company would have gotten with a traditional bank loan.¹⁸

INVENTORY FINANCING A small business can use its inventory of raw materials, work in process, and finished goods to secure loan. If the business defaults on the loan, the lender claims the firm's inventory, sells it, and uses the proceeds to satisfy the loan (assuming that the bank's claim is superior to the claims of other creditors). Because inventory usually is not a highly liquid asset and its value can be difficult to determine, lenders are willing to lend only a portion of its worth, usually no more than 50 percent of the inventory's value. Most asset-based lenders avoid inventory-only deals; they prefer to make loans backed by inventory *and* more secure accounts receivable.

PURCHASE ORDER LOANS Small companies that receive orders from large customers can use those purchase orders as collateral for loans. The customer places an order with a small business that needs financing to fill the order. The small business pledges the future payment from the order as security for the loan, and the lender verifies the credit rating of the customer (not the small business) before granting the short-term loan, which often carries annual rates of 40 percent or more. Borrowers usually repay the loan within 60 days.



ENTREPRENEURIAL PROFILE: George Tarrab: Slider the UNScooter George Tarrab is the founder of Slider the UNScooter, which sells ride-on scooters out of its operation located in Simi Valley, California. When the economic downturn came in 2008, Tarrab was unable to convince banks to extend credit to his business. The Slider's sales were strong and growing faster than the company's cash flow could handle. Tarrab had several orders from major customers. To fulfill the orders, Tarrab turned to purchase order financing and was able to secure more than \$200,000 in funding to get the scooters made. Although the purchase order lender charged substantial fees, Tarrab was able to get his orders filled and keep his growing business moving ahead.¹⁹

Asset-based financing is a powerful tool. A small business that could obtain a \$1 million line of credit with a bank would be able to borrow as much as \$3 million by using accounts receivable as collateral. It is also an efficient method of borrowing because entrepreneurs borrow only the money they need when they need it. Asset-based borrowing is an excellent just-in-time method of borrowing, one that often is available within just hours. As bank credit has tightened in the aftermath of the financial crisis of 2008, the popularity of asset-based lending has increased.

Asset-based loans are more expensive than traditional bank loans because of the cost of originating and maintaining them and the higher risk involved. To ensure the quality of the assets supporting the loans they make, lenders often monitor borrowers' assets, perhaps as often as weekly, making paperwork requirements on these loans intimidating, especially to first-time borrowers. Rates usually run from two to eight percentage points (or more) above the prime rate. Because of this rate differential, small business owners should not use asset-based loans over the long term; their goal should be to establish their credit through asset-based financing and then to move up to a line of credit.

Trade Credit

Because of its ready availability, trade credit is an extremely important source of financing to most entrepreneurs. In fact, 60 percent of small businesses use trade credit as a source of financing.²⁰ Trade credit involves convincing vendors and suppliers to sell goods and services without requiring payment up front. When banks refuse to lend money to a small business because they see it as a poor credit risk, an entrepreneur may be able to turn to trade credit for capital. Getting vendors to extend credit in the form of delayed payments (e.g., "net 30" credit terms) usually is much easier for small businesses than obtaining bank financing. Essentially, a company receiving trade credit from a supplier gets a short-term, interest-free loan for the amount of the goods purchased.

Vendors and suppliers usually are willing to finance a small business owner's purchase of goods from 20 to 90 days, interest free. The key to maintaining trade credit as a source of funds is establishing a consistent and reliable payment history with every vendor.



ENTREPRENEURIAL PROFILE: Ed and Jennifer Foy: eFashion Solutions In 2000, Ed and Jennifer Foy started eFashion Solutions, a company that provides e-commerce solutions for well-known companies in the apparel, entertainment, and specialty retail industries, in Secaucus, New Jersey. The company provides a full range of services, including purchasing, merchandising,

Web site design, marketing, business intelligence, customer service, order management, and order fulfillment for its clients. As their company grew, the Foys raised \$24 million in equity capital and used a variety of traditional bank financing to support its operations. When the company's regular lender shut off access to credit because of the financial crisis, eFashion Solutions began using trade credit from its vendors. eFashions Solutions has been able to negotiate “net 60” credit terms with some vendors but takes advantage of cash discounts (more on these in Chapter 19) from other vendors that range from 1 to 10 percent for early payment.²¹

Equipment Suppliers

Most equipment suppliers encourage business owners to purchase their equipment by offering to finance the purchase over time. This method of financing is similar to trade credit but with slightly different terms. Usually, equipment vendors offer reasonable credit terms with only a modest down payment and the balance financed over the life of the equipment (often several years). In some cases, the vendor repurchases equipment for salvage value at the end of its useful life and offers the business owner another credit agreement on new equipment. Start-up companies often use trade credit from equipment suppliers to purchase equipment and fixtures such as counters, display cases, refrigeration units, machinery, and the like. It pays to scrutinize vendors' credit terms, however; they may be less attractive than those of other lenders.

Commercial Finance Companies

When denied bank loans, small business owners often look to commercial finance companies for the same types of loan. Commercial finance companies are second only to banks in making loans to small businesses and, unlike their conservative counterparts, are willing to tolerate more risk in their loan portfolios.²² For instance, Chris Lehnes, a top manager at CIT Small Business Lending, says that his company regularly makes loans to small businesses with debt to equity ratios of 10:1 (10 times as much debt as equity), a situation that would send most bankers scurrying back to their vaults.²³ Of course, like banks, finance companies' primary consideration is collecting their loans, but finance companies tend to rely more on obtaining a security interest in some type of collateral, given the higher risk loans that make up their portfolios. Because commercial finance companies depend on collateral to recover most of their losses, they do not always require a complete set of financial projections of future operations as most banks do. However, this does *not* mean that they neglect to evaluate carefully a company's financial position, especially its cash balance, before making a loan. “We're looking at the projected cash flow—the ability of the business to repay us,” says CIT's Lehnes. “We put a lot of weight on what the business has done in the past couple of years.”²⁴

Approximately 150 large commercial finance companies, such as UPS Capital, GE Capital Solutions, CIT Small Business Lending, and others, make a variety of loans to small companies, ranging from asset-based loans and business leases to construction and Small Business Administration-guaranteed loans. Dubbed “the Wal-Marts of finance,” commercial finance companies usually offer many of the same credit options as commercial banks do, including intermediate- and long-term loans for real estate and fixed assets as well as short-term loans and lines of credit. P.C. Richard & Son, one of the oldest private, family-owned appliance and consumer electronics retailers in the United States, uses GE Capital to provide inventory financing to offer a large selection of products to its customers. Based on inventory turnover and cash flow, GE Capital terms are often more flexible than those that a manufacturer can provide, allowing P.C. Richard to account for seasonal variation and to act quickly on new opportunities, such as the introduction of the new Apple iPad. In an era when many regional and national competitors have suffered, P.C. Richard has not just survived but thrived, generating robust Internet sales and expanding the number of its stores by 15 percent. Since 2009, P.C. Richard has opened 10 new showrooms.²⁵

Finance companies offer small business borrowers faster turnaround times, longer repayment schedules, and more flexible payment plans than traditional lenders, all valuable benefits to cash-hungry small companies. However, because their loans are subject to more risks, finance companies charge higher interest rates than commercial banks (usually at least prime plus 2 percent). Their most common methods of providing credit to small businesses are asset based—accounts receivable financing and inventory loans. Rates on loans from commercial finance companies are higher than those at banks—as high as 15 to 30 percent (including fees), depending on the risk a particular business presents and the quality of the assets involved. Because many of the loans they make are secured by collateral (usually the business equipment, vehicle, real estate, or inventory purchased with the loan), finance companies often impose more onerous reporting requirements, sometimes requiring weekly (or even daily) information on a small company's inventory levels

or accounts receivable balances. However, entrepreneurs who cannot secure financing from traditional lenders because of their short track records, less-than-perfect credit ratings, or fluctuating earnings often find the loans they need at commercial finance companies.

Stock Brokerage Houses

Stockbrokers also make loans, and many of them offer loans to their customers at lower interest rates than banks. These **margin loans** carry lower rates because the collateral supporting them—the stocks and bonds in the customer's portfolio—is of high quality and is highly liquid. Moreover, brokerage firms make it easy to borrow. Usually, brokers set up a line of credit for their customers when they open a brokerage account. To tap that line of credit, a customer simply writes a check or uses a debit card. Typically, there is no fixed repayment schedule for a margin loan; the debt can remain outstanding indefinitely as long as the market value of the borrower's portfolio of collateral meets minimum requirements. Aspiring entrepreneurs can borrow up to 50 percent of the value of their stock portfolios, up to 70 percent of their bond portfolios, and up to 90 percent of the value of their government securities.

There is risk involved in using stocks and bonds as collateral on a loan. Brokers typically require a 30 percent cushion on margin loans. If the value of the borrower's portfolio declines, the broker can make a **margin call**—that is, the broker can call the loan in and require the borrower to provide more cash and securities as collateral. Swings in the stock market may translate into margin calls for many entrepreneurs, requiring them to repay a significant portion of their loan balances within a matter of days—or hours. If an account lacks adequate collateral, the broker can sell off the customer's portfolio to pay off the loan.

Insurance Companies

For many small businesses, life insurance companies can be an important source of business capital. Insurance companies offer two basic types of loans: policy loans and mortgage loans. **Policy loans** are extended on the basis of the amount of money paid through premiums into the insurance policy; with a policy loan, a business owner serves as his or her own bank, borrowing against the money accumulated in the investment portion of an insurance policy. It usually takes about two years for an insurance policy to accumulate enough cash surrender value to justify a loan against it. Once he or she accumulates cash value in a policy, an entrepreneur may borrow up to 95 percent of that value for any length of time. Interest is levied annually, but the entrepreneur determines the repayment rate, or repayment may be deferred indefinitely. However, the amount of insurance coverage is reduced by the amount of the loan. Policy loans typically offer very favorable interest rates, sometimes below the prime rate. Only insurance policies that build cash value—that is, combine a savings plan with insurance coverage—offer the option of borrowing. These include whole life (permanent insurance), variable life, universal life, and many corporate-owned life insurance policies. Term life insurance, which offers only pure insurance coverage, provides no borrowing capacity.

Insurance companies make **mortgage loans** on a long-term basis on real property worth a minimum of \$500,000. They are based primarily on the value of the real property being purchased. The insurance company extends loans of up to 75 or 80 percent of the real estate's value and allows a lengthy repayment schedule over 25 or 30 years so that payments do not strain the firm's cash flows excessively. Many large real estate developments, such as shopping malls, office buildings, and theme parks, rely on mortgage loans from insurance companies.

Credit Unions

Credit unions, nonprofit financial cooperatives that promote saving and provide loans to their members, are best known for making consumer and car loans. However, many are also willing to lend money to their members to launch businesses, especially since many banks have restricted loans to higher-risk start-ups. The first credit union in the United States was chartered in New Hampshire in 1909.²⁶ Today, more than 7,500 federally and state-chartered credit unions operate in the United States, and many of them make business loans, usually in smaller amounts than commercial banks typically make. In fact, the average credit union business loan is \$217,000, but some credit unions have made business loans in the millions of dollars.²⁷ Because credit unions are exempt from federal income tax, they often charge lower interest rates than banks.

Credit unions make \$12 billion in small business loans to their members each year.²⁸ However, the small business loan approval rate at credit unions has slipped from 57.6 percent in 2014 to 45 percent today, which is slightly below the 49.5 percent small business loan approval rate at

small banks.²⁹ Lending practices at credit unions are very much like those at banks, but they are subject to constraints that banks are not. For instance, credit unions are prohibited from making business loans that total more than 12.25 percent of their assets (a cap that Congress is considering increasing to 27.5 percent). Recent changes in legislation, however, exempt certain business loans from that limitation. In another move that favors entrepreneurs, the SBA recently opened its 7(a) loan programs to credit unions, providing even more avenues for entrepreneurs seeking financing.

Increasingly, entrepreneurs are turning to credit unions to finance their businesses' capital needs.



ENTREPRENEURIAL PROFILE: Muhammad Abdullah: Legacy Business Group

Muhammad Abdullah, who owns Legacy Business Group in Des Moines, Iowa, needed a line of credit to fill large orders from customers of his safety and medical-supplies business. Abdullah's company took a \$60,000 order for fire extinguishers, fire extinguisher cabinets, whiteboards, bike racks, and other items needed for an Armed Forces Readiness Center in Middletown, Iowa. However, Abdullah was unable to get financing from a bank to fill the order, so he turned to a credit union where he was able to get a \$25,000 line of credit. "It's not the normal way, but I guess I've been doing business with credit unions personally for a good while," says Abdullah. "They said they want to work with small business, and so we called them."³⁰

Entrepreneurs searching for a credit union near them can use the online database at the Credit Union National Association's Web site at www.cuna.org.

Bonds

Bonds, which are corporate IOUs, have always been a popular source of debt financing for large companies, but few small business owners realize that they can also tap this valuable source of capital. Although the smallest businesses are not viable candidates for issuing bonds, a growing number of small companies are finding the funding they need through bonds when banks and other lenders say no. Because of the costs involved, issuing bonds usually is best suited for companies generating annual sales between \$5 million and \$30 million and having capital requirements between \$1.5 million and \$10 million. Although they can help small companies raise much needed capital, bonds have certain disadvantages. The issuing company must follow the same regulations that govern businesses selling stock to public investors. Even if the bond issue is private, the company must register the offering and file periodic reports with the Securities and Exchange Commission.

Convertible bonds, bonds that give the buyer the option of converting the debt to equity by purchasing the company's stock at a fixed price in the future, have become more popular for small companies. In exchange for offering the option to convert the bond into stock, the small company issuing the convertible bonds gets the benefit of paying a lower interest rate on the bond than on a traditional bond. The conversion feature is valuable only if the company is successful and the value of its stock increases over time.

Small manufacturers needing money for fixed assets with long repayment schedules have access to an attractive, relatively inexpensive source of funds in **industrial development revenue bonds (IDRBs)**. To issue IDRBs, a company must work with a local or state government agency that issues the bonds on the company's behalf. The company, not the government entity, is responsible for repaying both the principal and the interest on the bond issue. Typically, the amount of money companies that issue IDRBs seek to raise is at least \$2 million, but some small manufacturers have raised as little as \$500,000 using a mini-bond program that offers a simple application process and short closing times. Each government entity has its own criteria, such as job creation, expansion of the tax base, and others, that companies must meet to be eligible to issue mini-bonds. NGK Spark Plugs, a company founded in 1936 that produces spark plugs for automotive, marine, motorcycle, and small engines, issued \$15 million in industrial revenue bonds with the help of the West Virginia Economic Development Agency to build an 85,000-square-foot factory in Sissonville, West Virginia, that created 80 new jobs.³¹

To open IDRBs up to even smaller companies, some states pool the industrial bonds of several small companies too small to make an issue alone. By joining together to issue composite industrial bonds, companies can reduce their issuing fees and attract a greater number of investors. The issuing companies typically pay lower interest rates than they would on conventional bank loans.

Private Placements

A private placement involves selling debt to one or a small number of investors, such as insurance companies or pension funds. Private placement debt is a hybrid between a conventional

loan and a bond. At its heart, it is a bond, but its terms are tailored to the borrower's individual needs, as a loan would be.

Privately placed securities offer several advantages over standard bank loans. First, they usually carry fixed interest rates rather than the variable rates banks often charge. Second, the maturity of private placements is longer than most bank loans: 15 years rather than five. Private placements do not require hiring expensive investment bankers. Finally, because private investors can afford to take greater risks than banks, they are willing to finance deals for fledgling small companies.

Small Business Investment Companies

The Small Business Investment Company program was started after Russia's successful launch of the first space satellite, *Sputnik*, in 1958. Its goal was to accelerate the American position in the space race by funding high technology start-ups. Created by the 1958 Small Business Investment Act, **small business investment companies** (SBICs) are privately owned financial institutions that are licensed and regulated by the Small Business Administration. In a unique public-private partnership, the more than 300 SBICs operating across the United States use a combination of private capital and federally guaranteed debt to provide long-term venture capital to small businesses. In other words, SBICs operate like any other venture capital firm, but, unlike traditional venture capital firms, they use private capital and borrowed government funds to provide both debt and equity financing to small businesses.

In 2012, SBICs provided \$3.1 billion in financing to more than 1,000 small businesses, which was a 17 percent increase from 2011 and an 83 percent increase from 2010.³² Most SBICs prefer later-round financing to funding raw start-ups. Because of changes in their financial structure made a few years ago, however, SBICs now are better equipped to invest in start-up companies. On average, about 30 percent of SBIC investments go to companies that are less than two years old.³³ Funding from SBICs helped launch companies such as Apple, Costco, Intel, Federal Express, Whole Foods Market, Outback Steakhouse, and Build-a-Bear Workshop.

SBICs must be capitalized privately with a minimum of \$5 million, at which point they qualify for up to \$3 in long-term SBA loans for every dollar of private capital invested in small businesses up to the ceiling of \$150 million. As a general rule, SBICs may provide financial assistance only to small businesses with a net worth of less than \$18 million and average after-tax earnings of \$6 million during their past two years. However, employment and total annual sales standards vary from industry to industry. SBICs are limited to a maximum investment or loan amount of 30 percent of their private capital to a single client.

Operating as government-backed venture capitalists, SBICs provide both debt and equity financing to small businesses. Because of SBA regulations affecting the financing arrangements an SBIC can offer, many SBICs extend their investments as loans with an option to convert the debt instrument into an equity interest later. Most SBIC loans are between \$100,000 and \$5 million, and although interest rates can be higher than traditional bank loans, the loan term is longer than most banks allow. Borrowers typically do not make installment payments; instead, the loan is due at an agreed-on date. When they make equity investments, SBICs are prohibited from obtaining a controlling interest in the companies in which they invest (no more than 49 percent ownership). SBICs must invest at least 25 percent of their capital in smaller businesses, which are defined by the SBA as those with tangible net worth of less than \$6 million and an average of \$2 million in net income over the previous two years at the time of investment. The most common methods of SBIC financing are straight debt instruments (49 percent), debt instruments combined with equity features (35 percent), and equity-only investments (16 percent).³⁴



ENTREPRENEURIAL PROFILE: Terry, Barry and Mark Awalt: JSI Store Fixtures In 1991, brothers Terry and Barry Awalt started JSI Store Fixtures, a company that provides a wide range of attractive and functional fixtures to retail stores, in the family basement in Milo, Maine, with a single table saw. Brother Mark joined the family business in 1997. JSI grew quickly, and the Awalts moved the business into a nearby former shoe factory. In 2006, the Awalts had the opportunity to acquire a regional competitor and needed capital to invest in more efficient, more productive equipment. Champlain Capital Partners, an SBIC with offices in Boston and San Francisco, provided the necessary capital to fuel the company's growth. Since receiving equity financing from the SBIC, JSI Store Fixtures has tripled its customer base, more than doubled its workforce, and now generates nearly \$40 million in annual sales.³⁵

3.

Identify the sources of government financial assistance and the loan programs these agencies offer.

Federally Sponsored Programs

Federally sponsored lending programs have suffered from budget reductions in the past several years. Current trends suggest that the federal government is reducing its involvement in the lending business, but many programs are still active, and some are actually growing.

Economic Development Administration

The Economic Development Administration (EDA), a branch of the Commerce Department, offers a variety of grants, loan guarantees, and loans to create new businesses and to expand existing businesses in areas with below-average income and high unemployment. Focusing on economically distressed communities, the EDA finances long-term investment projects needed to stimulate economic growth and to create jobs by making loan guarantees. The EDA guarantees up to 80 percent of business loans between \$750,000 and \$10 million. Entrepreneurs apply for loans through private lenders for whom an EDA loan guarantee significantly reduces the risk of lending. Start-up companies must supply 15 percent of the guaranteed amount in the form of equity, and established businesses must make equity investments of at least 15 percent of the guaranteed amount. Small businesses can use the loan proceeds in a variety of ways, including supplementing working capital and purchasing equipment and buying land and renovating buildings.

EDA business loans are designed to help replenish economically distressed areas by creating or expanding small businesses that provide employment opportunities in local communities. To qualify for a loan, a business must be located in a disadvantaged area, and its presence must directly benefit local residents. Some communities experiencing high unemployment or suffering from the effects of devastating natural disasters have received EDA Revolving Loan Fund grants to create loan pools for local small businesses. The EDA provides grants to a state or local agency that makes loans at or below market rates to small companies that otherwise have difficulty borrowing money. Loan amounts range from as little as \$1,000 to more than \$1 million, but most fall between \$25,000 and \$175,000.



ENTREPRENEURIAL PROFILE: Jaswantiben Jamnadas Popat: Shri Mahila Griha Udyog Lijjat Papad (SMGULP)

Jaswantiben Jamnadas Popat co-founded SMGULP with six other women in 1959. The success of the cooperative organization, which manufactures popular edibles and household products, demonstrates the empowerment that women can achieve through entrepreneurship. SMGULP began with just seven semi-literate sister-members on the terrace of a building in Mumbai, India. The initial capital of just Rs 80 was borrowed from a local moneylender. From such a humble beginning, the SMGULP has grown so phenomenally that it now employs over 42,000 sister-members and has achieved sales of over Rs 8,290 million, including exports. It has a central office in Mumbai and 75 branches across India.³⁶

The EDA's Trade Adjustment Assistance for Firms (TAAF) program provides financial assistance to manufacturers and service companies that have been affected adversely by imports. Small companies work with one of 11 Trade Adjustment Assistance Centers to receive grants that cover 50 to 75 percent of the cost of projects (from market research and product development to e-commerce and inventory control) that are aimed at improving the company's competitive position. For instance, after Wayne and Mechelle Williams bought a struggling custom door manufacturing company, they used a variety of funding, including a TAAF grant, to bring the company out of bankruptcy and to achieve 700 percent growth in just four years by taking market share back from Chinese competitors.³⁷

Department of Housing and Urban Development

The Department of Housing and Urban Development (HUD) sponsors several loan programs to assist qualified entrepreneurs in raising needed capital. Community Development Block Grants (CDBGs) are extended to cities and towns that, in turn, lend or grant money to entrepreneurs to start small businesses that will strengthen the local economy. Grants are aimed at cities and towns in need of revitalization and economic stimulation. Some grants are used to construct buildings and plants to be leased to entrepreneurs, sometimes with an option to buy. Others are earmarked for revitalizing a crime-ridden area or making start-up loans to entrepreneurs or expansion loans to existing business owners. No ceilings or geographic limitations are placed on CDBG loans and grants, but projects must benefit low- and moderate-income families.

HUD also makes loan guarantees through its Section 108 provision of the Community Block Development Grant program. The agency has funded more than 100 projects since its inception in 1978. These loan guarantees allow a community to transform a portion of CDBG funds

into federally guaranteed loans large enough to pursue economic revitalization projects that can lead to the renewal of entire town. For instance, the city of Greenville, South Carolina, used Section 108 funds to renovate a public market designed to serve as an anchor in its West End section that was targeted for revitalization. Since its construction, 16 small businesses have located in the market, creating new jobs and stimulating economic growth in the area, and a new stadium modeled after Boston's Fenway Park is home to the local minor league baseball team.³⁸

U.S. Department of Agriculture's Rural Business and Cooperative Program and Business Program

The U.S. Department of Agriculture (USDA) provides financial assistance to certain small businesses through its Rural Business-Cooperative Service (RBS). The RBS program is open to all types of businesses (not just farms) and is designed to create nonfarm employment opportunities in rural areas—those with populations below 50,000 and not adjacent to a city where densities exceed 100 people per square mile. Entrepreneurs in many small towns, especially those with populations below 25,000, are eligible to apply for loans through the RBS program, which makes almost \$900 million in loan guarantees each year.

The RBS does make a limited number of direct loans to small businesses, but the majority of its activity is in loan guarantees. Through its Business and Industry Guaranteed Loan Program, the RBS will guarantee as much as 80 percent of a commercial lender's loan up to \$25 million (although actual guarantee amounts are almost always far less, usually between \$200,000 and \$1 million) for qualified applicants. Entrepreneurs apply for loans through private lenders, who view applicants with loan guarantees favorably than because the agency's guarantee reduces the lender's risk dramatically.

To make a loan guarantee, the RBS requires much of the same documentation as most banks and most other loan guarantee programs. Because of its emphasis on developing employment in rural areas, the RBS requires an environmental impact statement describing the jobs created and the effect the business has on the area. The RBS also makes grants available to businesses and communities for the purpose of encouraging small business development and growth.

Small Business Innovation Research Program

Started as a pilot program by the National Science Foundation in the 1970s, the Small Business Innovation Research (SBIR) program has expanded to 11 federal agencies, ranging from NASA to the Department of Defense. The total SBIR budget across all 11 agencies is more than \$2.1 billion annually. These agencies award cash grants or long-term contracts to small companies wanting to initiate or to expand their research-and-development (R&D) efforts. SBIR grants give innovative small companies the opportunity to attract early-stage capital investments *without* having to give up significant equity stakes or taking on burdensome levels of debt.

The SBIR process includes three phases. Phase I (project feasibility) grants, which determine the feasibility and commercial potential of a technology or product (called "proof of concept"), last for up to six months and have a ceiling of \$150,000. Phase II (prototype development) grants, designed to develop the concept into a specific technology or product, run for up to 24 months with a ceiling of \$1 million. Approximately 40 percent of all Phase II applicants receive funding. Phase III is the commercialization phase, in which the company pursues commercial applications of the R&D conducted in Phases I and II and must use private or non-SBIR federal funding to bring a product to market.

Competition for SBIR funding is intense; only 17 percent of the small companies that apply receive funding. So far, 112,500 SBIR awards totaling more than \$26.9 billion (26 percent in Phase I and 74 percent in Phase II) have gone to more than 15,000 small companies, which traditionally have had difficulty competing with big corporations for federal R&D dollars. The government's dollars have been well invested. Nearly 45 percent of small businesses receiving second-phase SBIR awards have achieved commercial success with their products.³⁹



ENTREPRENEURIAL PROFILE: Dr. Jim Stefansic: Pathfinder Therapeutics, Inc. Pathfinder Therapeutics, Inc., is a medical device company that developed an image-guided surgery system for abdominal surgery that works like a GPS for surgeons. Jim Stefansic, cofounder of Pathfinder Therapeutics, secured four SBIR grants totaling almost \$3.4 million from the U.S. Department of Health and Human Services to help support the development of the company's products and supporting software.



Entrepreneurship in Action

Where Do We Turn Now?

Tim Erven founded Custom Gaming in 2008 when he was 18 years old. Over the next five years, the company grew to become the leader in rapid-fire controllers for serious gamers. Custom Gaming was not Erven's first entrepreneurial endeavor, however. At the age of 10, Erven started an e-commerce company that sold strategy guides for video games, Pokemon cards, and custom-made skateboards. He was able to use the money from his various ventures to pay his way through college at Drew University in New Jersey.

After five years of operation, Custom Gaming had grown to about 250 orders a week through its Amazon storefront, which generated about \$300,000 in revenues. Although the business is profitable, like any small companies Erven has had to struggle with cash flow issues as the company grew. Erven tried to secure a \$10,000 loan to help pay for improvements to the Web site and to rent a warehouse to store products. He supplied the banks with tax returns that demonstrated the profitability of his business. However, each of the six banks that he approached for a loan rejected his application. His parents offered to put their home up as collateral for the loan, but banks still rejected his loan application. The bankers expressed concerns about Erven's age and the fact that his business had no credit record. Because he has not been able to get a bank loan, Erven has relied on several personal credits cards to fund cash flow in his business and support its growth.

Erven's loan requests were within the amount that banks typically approve for business loans. However, even though Erven

was willing to reduce the amount of the loan below conventional standards, he was unable to secure approval from the banks.

Desperate for funding, Erven has explored nontraditional financing. However, he is concerned about the costs of this type of funding when compared to a bank loan. He has even explored getting equity financing from Chinese investors who are interested in having him move his production to China.

"I'm either going to have to give up a portion of the company or pay a high [interest rate]," says Erven. "I'd be able to get a much lower rate [from a bank], but that's the reality of what I have to do to get the funding."

1. What other sources of financing do you recommend that Erven consider for the financing he needs for his business?
2. Erven had never borrowed money for his business before the opportunity to expand his business and rent warehouse space. What steps can entrepreneurs take to make sure that they have financing arrangements in place when opportunities such as this one arise?

Sources: Based on Nick Leiber, "Why Banks Won't Lend to This Guy's Profitable Business," *Bloomberg Businessweek*, February 27, 2012, www.businessweek.com/articles/2012-02-27/why-banks-wont-lend-to-this-guys-profitable-business; "Lack of Small Business Loans Driving US Entrepreneurs to China," *Personal Money Network*, May 1, 2012, personalmoneynetwork.com/moneyblog/2012/03/01/finding-small-business-loans; Tim Erven, "Tim Erven," *Huffington Post*, July 9, 2012, www.huffingtonpost.com/tim-erven.

The Small Business Technology Transfer Program

The Small Business Technology Transfer (STTR) program complements the SBIR program. Whereas the SBIR focuses on commercially promising ideas that originate in small businesses, the STTR allows small companies to exploit the Small Business Innovation Research (SBIR) program. While SBIR focuses on developing vast reservoir of commercially promising ideas that originate in universities, federally funded R&D centers, and nonprofit research institutions. Researchers at these institutions can join forces with small businesses and can spin off commercially promising ideas while remaining employed at their research institutions. Five federal agencies award grants in two of three phases (up to \$100,000 in Phase I and up to \$750,000 in Phase II) to these research partnerships. The STTR's annual award budget is approximately \$1 billion.

Small Business Administration

The Small Business Administration (SBA) has several programs designed to help finance both start-up and existing small companies that cannot qualify for traditional loans because of their thin asset bases and their high risk of failure. The SBA has come under recent criticism because of the diversion of funding to large corporations that was intended for small businesses. There also have been concerns about mismanagement and waste within the SBA. However, strong political support remains for the agency.

In 2012, the SBA guaranteed more than \$30 billion in lending to more than 47,000 small businesses. In the wake of the upheaval in the financial markets in 2008, banks maintain much tighter lending standards, and many small businesses cannot qualify for loans. Although SBA loan programs account for less than 10 percent of all small business lending, tight credit conditions make them all the more important for small companies in search of capital.⁴¹ "SBA programs

4.

Describe the various loan programs available from the Small Business Administration.

help newer businesses and businesses that don't have a lot of collateral," says an executive at a bank that makes SBA-guaranteed loans.⁴²

The SBA's \$102.6 billion loan portfolio makes it the largest single financial backer of small businesses in the nation.⁴³ The SBA does *not* actually lend money to entrepreneurs directly; instead, entrepreneurs borrow money from a traditional lender (about 4,500 lenders in the United States make SBA loans), and the SBA guarantees a percentage of the loan to the lender in case the borrower defaults. To be eligible for SBA backing, a business must be within the agency's criteria that define a small business. In addition, some types of businesses, such as those engaged in gambling, pyramid sales schemes, or real estate investment, among others, are ineligible for SBA loans. The loan application process can take from between three days to many months, depending on how well prepared the entrepreneur is and which bank is involved. To speed up processing times, the SBA created three "express" programs that give entrepreneurs responses to their loan applications within 36 hours. Table 17.3 summarizes the various SBA lending programs.

SBAExpress Loan Programs

THE SBAEXPRESS PROGRAM The **SBAExpress Program**, in which participating lenders use their own loan procedures and applications to make loans of up to \$350,000 to small businesses, streamlines the application process for SBA loan guarantees. Because the SBA guarantees up to 50 percent of the loan, banks are often more willing to make small loans to entrepreneurs who might otherwise have difficulty meeting lenders' standards. Lenders can charge up to 6.5 percent above the prime interest rate on SBAExpress loans below \$50,000 and up to 4.5 percent above prime on loans above \$50,000. Loan maturities on these loans typically are seven years. Mike Robillard, president of San Antonio Clippers in San Antonio, Texas, used an SBAExpress loan to add two locations to his Sports Clips hair salon franchise operation. Robillard needed growth capital quickly to secure the best locations, a key to success in his industry. "We had to start laying out money quickly to lock down those locations," he says.⁴⁴

PATRIOT EXPRESS PROGRAM The **Patriot Express loan program** is designed to assist some of the nation's 25 million veterans and their spouses who want to become entrepreneurs. The loan ceiling is \$500,000, and the SBA guarantees up to 90 percent (more than the normal 85 percent) of the loan amount in case the borrower defaults. The business must be at least 51 percent owned by an eligible veteran. Like SBAExpress loans, the turnaround time on loan applications is just 36 hours. Patriot Express loans carry interest rates that range from 2.25 to 4.75 percent above the prime interest rate.



ENTREPRENEURIAL PROFILE: Jason Kuhn and Evan Kranzley: J&E Technical Services

Jason Kuhn and Evan Kranzley are partners in J&E Technical Services located in Martinsburg, West Virginia. They needed a business loan to purchase a portable X-ray device for their business to perform nondestructive testing on aircraft. If they could not get financing to purchase the device, they would lose a huge opportunity to obtain a contract with Northrop Grumman Corporation. The business was able to secure an SBA Patriot Express Loan Program through its local BB&T branch bank. "Knowing Jason was a U.S. Navy veteran, and the SBA's Patriot Express program was designed for entrepreneurs with military experience, this was a good fit for J&E," says Matt Coffey, assistant vice president and business services officer for BB&T. "We could see the contract opportunities they had were real, they just needed funding to get started." Since receiving the loan, J&E Technical has expanded into other markets, including testing power-generating wind turbines, petrochemical plants, and pipelines.⁴⁵

SBA Loan Programs

SMALL LOAN ADVANTAGE PROGRAM The SBA Small Loan Advantage program was launched in 2011. This program expands access to capital for small businesses and entrepreneurs in specifically designated underserved communities. The Small Loan Advantage program allows for loans up to \$350,000 with SBA guarantees 85 percent for loans up to \$150,000 and 75 percent for those greater than \$150,000. Most Small Loan Advantage loans are approved in a matter of minutes through electronic submission.

COMMUNITY ADVANTAGE Community Advantage is a pilot program of the SBA that also is aimed at increasing the number loans in specifically designated underserved communities. This program partners with community-based, mission-focused financial institutions rather than banks and other traditional SBA lenders. Potential new SBA lending partners include Community Development Financial Institutions, SBA's Certified Development Companies, and SBA's nonprofit microlending intermediaries. The maximum loan size for this program is \$250,000,

TABLE 17.3 SBA Loan Program Overview

Program	Maximum Loan Amount	Guaranty Percentage	Use of Proceeds	Loan Maturity	Maximum Interest Rates
Standard 7(a)	\$5 million	85% on loans up to \$150,000; 75% on loans between \$151,000 and \$5 million	Term loan. Purchase land or buildings; expand or renovate existing buildings; acquire equipment and fixtures; make leasehold improvements; working capital; refinance existing debt (in special cases); purchase inventory; establish seasonal line of credit	Working capital, equipment—5 to 10 years; real estate—up to 25 years	Loans of 7 years or less: prime + 2.25%; loans longer than 7 years: prime + 2.75%; for loans of less than \$50,000, rates can be up to prime + 4.25%
SBAExpress	\$350,000	50%	Same as 7(a) loan purposes and revolving line of credit	Same as 7(a)	Loans of \$50,000 or less: prime + 6.5%; loans of greater than \$50,000: prime + 4.5%
Patriot Express	\$500,000	Same as 7(a)	Same as SBAExpress	Same as 7(a)	Same as 7(a)
Export Express	\$500,000	90% on loans of \$350,000 or less; 75% on loans greater than \$350,000	Proceeds for entering new export market or to expand and existing export market	Same as SBAExpress	Same as 7(a)
CAPLines	\$5 million	Same as 7(a)	Working capital needs that are associated with specific contracts	Up to 5 years	Same as 7(a)
International Trade	\$5 million	90% up to \$4.5 million maximum guarantee	Acquire long-term fixed assets	Up to 25 years	Same as 7(a)
Small Loan Advantage Program	\$250,000	Same as 7(a)	Same as 7(a)	Same as 7(a)	Same as 7(a)
Community Advantage Program	\$250,000	Same as 7(a)	Same as 7(a)	Same as 7(a)	Prime + 4%
Export Working Capital	\$5 million (may be combined with International Trade loan)	90% up to \$4.5 million maximum guarantee	Short-term working capital for exporting	Generally 1 year or a single transaction cycle (3-year maximum)	No cap
504 Loans	\$5 to \$5.5 million, depending on type of business	40% up to \$2.2 million maximum	Long-term, fixed-asset projects, such as constructing new buildings, purchasing and renovating existing buildings, and purchasing equipment and machinery	Equipment—up to 10 years; real estate—up to 20 years	Fixed rate depends on when SBA's debenture-backed loan is sold
Microloan	\$50,000	N/A	Purchase machinery and equipment, fixtures, leasehold improvements, financing receivables, or working capital; cannot be used to repay existing debt.	Up to 6 years	Variable; generally between 8% and 13%

Source: "Quick Reference to SBA Loan Guaranty Programs," U.S. Small Business Administration, Washington, DC, www.sba.gov/sites/default/files/Quick%20Reference%20Guide%20to%20SBA%20Loan%20Guaranty%20Programs.pdf.

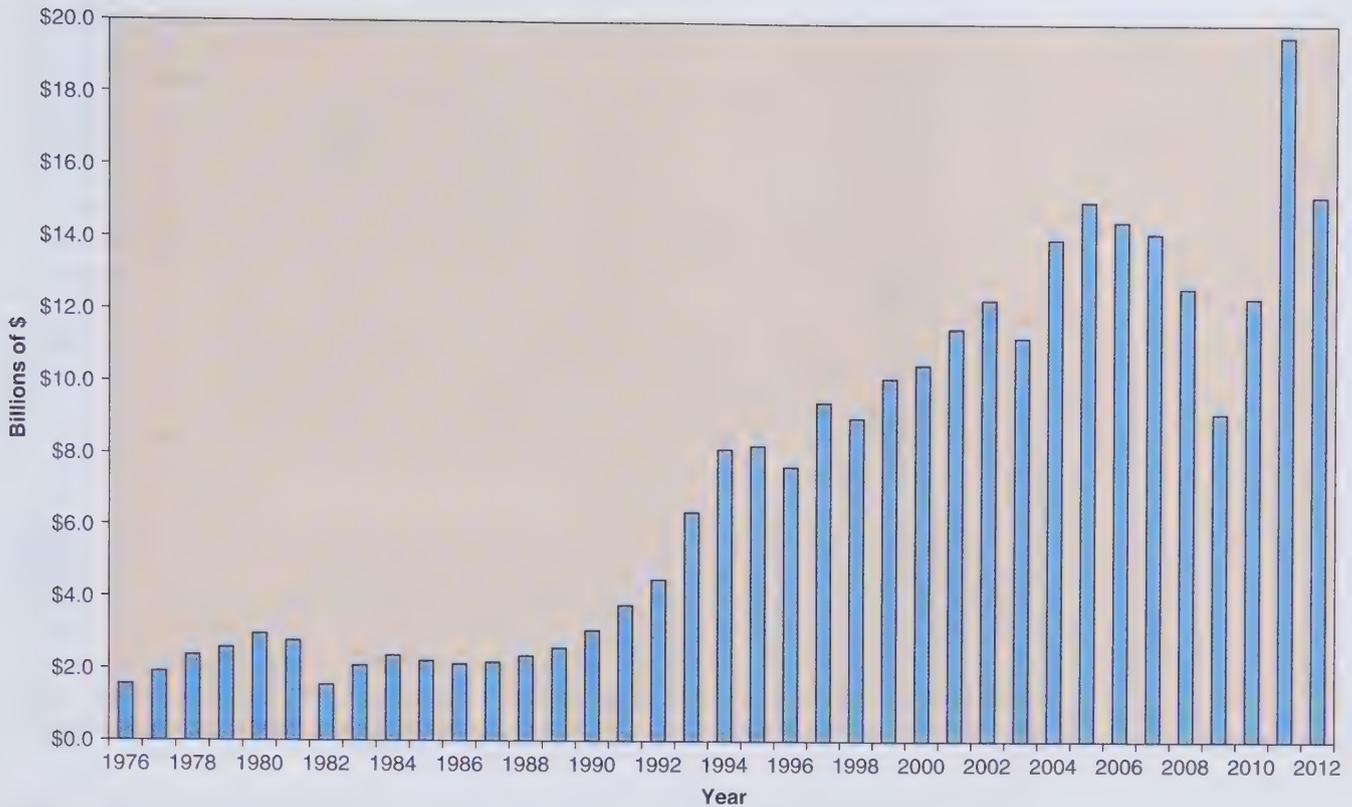


FIGURE 17.2

SBA 7(A) Guaranteed Loans

Source: Based on SBA, Quarterly Indicators and Summary of Performance and Financial Information.

with guarantees of 85 percent for loans up to \$150,000 and 75 percent for those greater than \$150,000. Approval times for most Community Advantage loans are within 5 to 10 days.

7(A) LOAN GUARANTY PROGRAM The SBA works with local lenders (both bank and nonbank) to offer a variety of loan programs designed to help entrepreneurs who cannot get capital from traditional sources to gain access to the financing they need to launch and grow their businesses. By far the most popular SBA loan program is the **7(A) loan guaranty program** (see Figure 17.2), which makes partial guarantees on loans up to \$5 million to small businesses. Private lenders actually extend these loans to companies, but the SBA guarantees them in case the borrower defaults. Normally, the SBA guarantees 85 percent of loans up to \$150,000 and 75 percent of loans above \$150,000 up to the loan guarantee ceiling of \$3,750,000. Sheila Tucker worked in chain pharmacies for more than twenty years before she secured a 7(a) loan guaranty to open her first pharmacy. Based on that store's success, she obtained a second 7(a) loan guaranty to open a second location.⁴⁶

The SBA does not actually lend any money to small businesses; it merely acts as an insurer, guaranteeing the lender a certain level of repayment in case the borrower defaults on the loan. Because the SBA assumes most of the credit risk, lenders are more willing to consider riskier deals that they normally would refuse.

ENTREPRENEURIAL PROFILE: Susan Nolte and Marissa Hanley: May Cookie Co. Susan Nolte founded May Cookie Co. based on her vision to start a business that would create a world of healthy people who eat well, live well, and smile a lot. While attending her first national trade show in 2009, she landed her first big retail account, a national home furnishings store. This account helped Nolte build steady cash flow for her business while pursuing regional distribution through Whole Foods and several other distribution outlets. However, May Cookie Co. needed access to capital to expand and to fulfill its growing orders. Nolte met with an SBA lending specialist at Connecticut Bank & Trust, who helped her secure a \$75,000 loan guaranteed by the SBA's 7(a) program to help get her company's natural cookie mixes produced, marketed, and distributed. May Cookie Co. built sales through independent and small-chain specialty stores, Whole Foods, and online. In 2010, Nolte decided to bring her daughter, Marissa Hanley, into the company to handle new business development in California. "I'm really trying to get the word out to the public at large," says Nolte, "But I don't want to grow too fast!"⁴⁷



Marissa Hanley and Susan Nolte

of May Cookie Co.

Source: May Cookie Co.

Qualifying for an SBA loan guarantee requires cooperation among the entrepreneur, the participating bank, and the SBA. The participating bank determines the loan's terms and sets the interest rate within SBA limits. Contrary to popular belief, SBA guaranteed loans do *not* carry special deals on interest rates. An entrepreneur negotiates interest rates with the participating bank, with a ceiling of prime plus 2.25 percent on loans of less than seven years and prime plus 2.75 percent on loans of seven to 25 years. Interest rates on loans of less than \$25,000 can go up to prime plus 4.75 percent. The average interest rate on SBA-guaranteed loans is prime plus 2 percent (compared to prime plus 1 percent on conventional bank loans). The SBA normally assesses a one-time guaranty fee of between 2.5 and 3.5 percent for all loan guarantees, depending on the loan amount.

In a recent five-year period, the SBA provided 7(a) guarantees on loans to an average of more than 51,000 small businesses that would have had difficulty getting loans without the help of the SBA guarantee. The average 7(a) loan is \$337,730 and the average duration of an SBA loan is 12 years—longer than the average commercial small business loan. In fact, longer loan terms are a distinct advantage of SBA loans. At least half of all bank business loans are for less than one year. By contrast, SBA real estate loans can extend for up to 25 years (compared to just 10 to 15 years for a conventional loan), and working capital loans have maturities of seven years (compared with two to five years at most banks). These longer terms translate into lower payments, which are better suited for young, fast-growing, cash-strapped companies. Craig Hartzell, a disabled U.S. Army Special Forces veteran, founded Azimuth, a company that specializes in engineering, fabrication and engineering services in support of the U.S. Department of Defense. At its start-up, Hartzell's company lacked the necessary capital to meet the financial challenges of successful contract bidding against much larger competitors, but Hartzell was able to receive an SBA 7(a) guaranteed loan secured through a local lender.⁴⁸

THE CAPLINE PROGRAM In addition to its basic 7(a) loan guarantee program (through which the SBA makes about 70 percent of its loans), the SBA provides guarantees on small business loans for start-up, real estate, machinery and equipment, fixtures, working capital, exporting, and restructuring debt through several other methods. About two-thirds of all of the SBA's loan guarantees are for machinery and equipment or working capital. The **CAPLine Program** offers short-term capital to growing companies needing to finance seasonal buildups in inventory or accounts receivable under five separate programs, each with maturities up to five years: seasonal line of credit (provides advances against inventory and accounts receivable to help businesses weather seasonal sales fluctuations), contract line of credit (finances the cost of direct labor and materials costs associated with performing contracts), builder's line of credit (helps small contractors and builders finance labor and materials costs), standard asset-based line of credit (an asset-based revolving line of credit for financing short-term needs), and small asset-based line of credit (an asset-based revolving line of credit up to \$200,000). CAPLine is aimed at helping cash-hungry small businesses by giving them a credit line to draw on when they need it. These loans built around lines of credit are what small companies need most because they are so flexible, efficient, and, unfortunately, so hard for small businesses to get from traditional lenders.

SECTION 504 CERTIFIED DEVELOPMENT COMPANY PROGRAM Established in 1980, the SBA's Section 504 program is designed to encourage small businesses to purchase fixed assets, expand their facilities, and create jobs (see Figure 17.3). Section 504 loans provide long-term financing at fixed rates to small companies to purchase land, buildings, or equipment. Because they are designated for fixed-asset purchases that provide basic business infrastructure to small companies that otherwise might not qualify, 504 loans are intended to serve as a catalyst for economic development. Three lenders play a role in every 504 loan: a bank, the SBA, and a **certified development company** (CDC). A CDC is a nonprofit organization licensed by the SBA and designed to promote economic growth in local communities. Some 270 CDCs now operate across the United States and make more than 9,000 504 loans in an average year. An entrepreneur generally is required to make a down payment of just 10 percent of the total project cost. The CDC puts up 40 percent at a low, long-term, fixed rate, supported by an SBA loan guarantee in case the entrepreneur defaults. The bank provides at market rates long-term financing for the remaining 50 percent, which also is supported by an SBA guarantee. The major advantages of Section 504 loans are their fixed rates and terms, their 10 percent down payment, and the 0 percent down payment required.

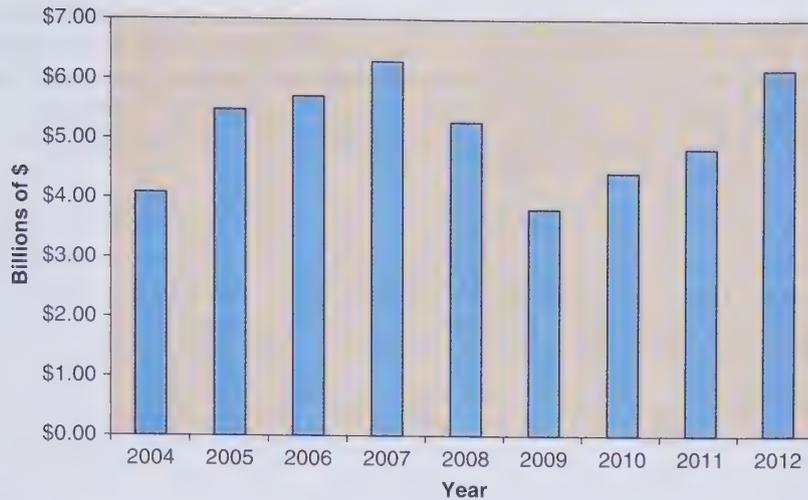


FIGURE 17.3
SBA 504 Loan Volume

Source: Based on SBA, Quarterly Indicators and SBA's Summary of Performance and Financial Information.



ENTREPRENEURIAL PROFILE: Jim Tankersley: Laser-Tronics Jim Tankersley owns and operates Laser-Tronics, a company in San Marcos, California that uses computer-guided machines to cut computer frames, auto parts, and other products out of raw-metal plates and bars. Tankersley needed an 18,000-square-foot building to house his business and was able to purchase a building for \$2.2 million with financing from Union Bank of California and CDC Small Business Finance, a local certified development company. "Union Bank suggested SBA 504 financing because of the low down payment, which allowed me to save my cash for the business," says Tankersley.⁴⁹

As attractive as they are, 504 loans are not for every business owner. The SBA imposes several restrictions on 504 loans:

- For every \$65,000 (\$100,000 for small manufacturers) that the SBA provides, the project must create or preserve at least one new job or achieve a public policy goal, such as rural development, expansion of exports, minority business development, and others.
- Machinery and equipment financed must have a useful life of at least 10 years.
- The borrower must occupy at least two-thirds of a building constructed with the loan, or the borrower must occupy at least half of a building purchased or remodeled with the loan.
- The borrower must qualify as a small business under the SBA's definition and must have neither a tangible net worth in excess of \$15 million nor an average net income in excess of \$5 million after taxes for the preceding two years.

Because of strict equity requirements, existing small businesses usually find it easier to qualify for 504 loans than do start-ups. The average 504 loan has ranged from \$500,000 to \$600,000 in recent years.

MICROLOAN PROGRAM Recall from the previous chapter that the majority of entrepreneurs require less than \$100,000 to launch their businesses. Indeed, research suggests that most entrepreneurs require less than \$50,000 to start their companies. Unfortunately, loans of that amount can be the most difficult to get, especially since the financial crisis of 2008. Lending these relatively small amounts to entrepreneurs starting businesses is the purpose of the SBA's microloan program. Called **microloans** because they range from just a hundred dollars to as much as \$50,000, these loans have helped thousands of people take their first steps toward entrepreneurship. Banks typically have shunned loans in such small amounts because they considered them to be unprofitable. In 1992, the SBA began funding microloan programs at 96 private nonprofit lenders in 44 states in an attempt to "fill the void" in small loans to start-up companies, and the program has expanded from there. In 2012, microloan lenders provided 3,973 microloans amounting to \$44.7 million. The average microloan was about \$11,250 and carried an 8.18 percent interest rate.⁵⁰



ENTREPRENEURIAL PROFILE: Mitesh and Chetna Parikh: Threads Mitesh and Chetna Parikh started a salon, called Threads, in a tiny start-up space in a Holiday Inn in Dublin, Ohio. The Parikhs were able to support their business's initial growth with cash flow that the business generated. However as word-of-mouth grew, they could not handle any new customers

within such a small space. The Parikhs found a larger space across the street that had great freeway access, but they needed \$100,000 in capital for tenant improvements and for purchasing additional salon equipment. Despite their strong personal credit, banks declined their loan request because the business had been open for only two years. The Parikhs were able to find funding through a micro-lender called Opportunity Fund, which approved a \$100,000 loan. Threads now generates several million in revenues and employs 26 people.⁵¹

Today, more than 170 authorized lenders make SBA-backed microloans. The average maturity of microloans is three years (the maximum term is six years) and interest rates range between 8 and 13 percent. Lenders' standards are less demanding than those on conventional loans. All microloans are made as installment loans through nonprofit intermediaries such as Opportunity Fund and ACCION International that are approved by the SBA. The typical microloan recipient is a small company with five or fewer employees and collateral that bankers shun for traditional loans, such as earthworms from a fish bait farmer in Ohio or a Minnesota grocery store's frozen fish inventory.⁵² Although microloans are available to anyone, the SBA hopes to target those entrepreneurs who have the greatest difficulty getting start-up and expansion capital: women, minorities, and people with low incomes.



ENTREPRENEURIAL PROFILE: Michael Golata: UPS Retailer Sam's Club, a division of Wal-Mart, works with a nonbank SBA lender, Superior Financial Group, to offer its small business members microloans up to \$25,000 through the SBA. "Access to capital is a major pain point for our [small business] members," says Catherine Corley, vice president of membership. Michael Golata, a contractor for UPS who delivers emergency medical equipment to hospitals, had the opportunity to expand his business by bringing other delivery drivers into his business. Golata found a used Sprinter van for \$12,500 and applied to two local banks for a loan, but both rejected his loan application. A commercial finance company offered to lend him the money, but Golata balked at the 21 percent interest rate and \$450 monthly payments. He learned about the microloans that Sam's Club offered with Superior Financial Group and applied online for a \$10,000 loan. The next day, Superior approved his loan with a 7.25 percent loan over 10 years. "I thought I was dreaming," says Golata, whose business with UPS immediately increased from \$3,000 a week to \$8,000.⁵³

LOANS INVOLVING INTERNATIONAL TRADE For small businesses going global, the SBA has the **Export Express Program**, which, like other express programs, offers quick turnaround times on applications for guarantees of 75 to 85 percent on loans up to \$500,000 to help small companies develop or expand their export initiatives. Loan maturities range from 5 to 25 years, depending on the purpose of the loan.

The SBA also offers the **Export Working Capital Program**, which is designed to provide working capital to small exporters by providing loan guarantees of 90 percent of the loan amount up to \$5 million. The SBA works in conjunction with the Export-Import Bank (Ex-Im Bank) to administer this loan guarantee program. Applicants file a one-page loan application, and the response time normally is 10 days or less. Small businesses must use loan proceeds to finance small business exports.



ENTREPRENEURIAL PROFILE: Mike Brown: American Aluminum International Mike Brown is the owner of American Aluminum International, a small Missouri company that wholesales aluminum sheet, coil, bar, and other metals that are used to make large trailers, gas tanks, and electrical transformers. The company exports all of its production output to companies in Mexico. Its customers typically take a long time to pay, causing a cash flow problem. To offset his company's high accounts receivables due to slow payments, Brown was able to secure a \$1.5 million credit line with Bank of America, guaranteed by the Export-Import Bank of the United States. "The funds were used to stock inventory and pay our vendors despite our customers often taking 90 to 120 days to pay," says Brown.⁵⁴

The **International Trade Loan Program** is for small businesses that are engaging in international trade or are adversely affected by competition from imports. The loan ceiling is \$5 million, and maturities run up to 25 years.

DISASTER ASSISTANCE LOANS As their name implies, **disaster assistance loans** are made to small businesses devastated by financial or physical losses from hurricanes, earthquakes, floods, tornadoes, and other disasters. Business physical disaster loans are designed to help companies

repair or replace damage to physical property (buildings, equipment, inventory, and so on) caused by the disaster, and economic injury loans provide working capital for businesses throughout the disaster period. For businesses, the maximum disaster loan usually is \$2 million, but Congress often raises that ceiling when circumstances warrant. Disaster loans carry low interest rates of 4 percent and long payback periods up to 30 years. After Hurricane Sandy slammed into the coastal region of the Northeast United States, shutting down thousands of businesses, the SBA granted \$260 million in disaster assistance loans to more than 2,500 small businesses that suffered financial losses.⁵⁵

State and Local Loan Development Programs

Just when many federally funded programs are facing cutbacks, state and local loan and development programs are becoming more active in providing funds for business start-ups and expansions. Many states have decided that their funds are better spent encouraging small business growth rather than “chasing smokestacks”—trying to entice large businesses to locate in their boundaries. These programs come in many forms, but they all tend to focus on developing small businesses that create the greatest number of jobs and economic benefits. Entrepreneurs who apply for state and local funding must have patience and must be willing to slog through some paperwork, however.

Although each state’s approach to economic development and job growth is unique, one common element is some kind of small business financing program: loans, loan guarantees, development grants, venture capital pools, and others. One approach many states have had success with is **Capital Access Programs (CAPs)**. First introduced in 1986 in Michigan, 22 states now offer CAPs that are designed to encourage lending institutions to make loans to businesses that do not qualify for traditional financing. Under a CAP, a bank and a borrower each pay an up-front fee (a portion of the loan amount) into a loan-loss reserve fund at the participating bank, and the state matches this amount. The reserve fund, which normally ranges from 6 to 14 percent of the loan amount, acts as an insurance policy against the potential loss a bank might experience on a loan and frees the bank to make loans that it otherwise might refuse. One study of CAPs found that 55 percent of the entrepreneurs who received loans under a CAP would not have been granted loans without the backing of the program.⁵⁶

Even cities and small towns have joined in the effort to develop small businesses and help them grow. More than 7,500 communities across the United States operate **revolving loan funds (RLFs)** that combine private and public funds to make loans to small businesses, often at below-market interest rates. As money is repaid into the funds, it is loaned back out to other entrepreneurs.

In addition to RLFs, more than 1,000 communities across the United States have created **community development financial institutions (CDFIs)** that designate at least some of their loan portfolios for entrepreneurs and small businesses. CDFIs operate through a variety of mechanisms, including microenterprise loan funds, community development loan funds, and others, and provide loans to people who do not meet traditional lenders’ criteria. Because the loans that they make are higher risk, the interest rates that CDFIs charge are higher than those charged by traditional lenders.

5.

Discuss state and local economic development programs.



In the Entrepreneurial Spotlight

Alternative Sources of Financing

Although banks tend to be lenders of first resort for small businesses, accounting for the greatest volume of loans to small businesses, they are not the only lending game in town, as the following profiles illustrate.

Take2Chic

Mari Alstin needed \$25,000 to open her women’s clothing boutique, Take2Chic, in Philadelphia. Although she had \$10,000 in savings and had found another source for the remaining

\$15,000. She had used the peer-to-peer lending site Prosper for personal loans in the past, so she decided to return to it to raise the money she needed for her new store. “I needed something that was quick, easy, and guaranteed,” says Alstin. “It was all about timing because I didn’t want the place that I wanted to lease to be given away.” Alstin posted a description of her entrepreneurial project at the Prosper Web site. She was able to quickly raise the full \$15,000. The loan came from a large number of people who each of whom loaned Alstin between \$1,000 and \$5,000.

In the Entrepreneurial Spotlight *(continued)*

Material Culture

George Jevremovic began importing and selling Turkish rugs in 1982. Because of the growth in his business, he eventually moved into a 60,000-square-foot storefront called Material Culture, where he sells imported rugs and furnishings imported from around the world to designers, homeowners, and collectors. Jevremovic wanted to refinance Material Culture's debt to accommodate a restructuring of the business. He knew that he could use the company's primary asset, its inventory, to secure a loan, but that asset-based loans typically carry high interest rates and fees. Instead, Jevremovic turned to MultiFunding, a Philadelphia-based loan broker. Loan brokers help entrepreneurs find a wide range of funding options, including merchant cash advances, accounts receivable and inventory financing, lease buybacks, purchase order financing, and conventional SBA loans. MultiFunding introduced Material Culture to a regional bank that provided two conventional loans—a line of credit and a term loan. Through this arrangement, Material Culture refinanced its debts at low rates and secured some working capital. MultiFunding's fee is typically between 1 and 2.5 percent of the total loan amount.

Able Planet

Kevin Semcken had been working with his current bank for almost three years. He had a \$2.5 million line of credit for his business, Able Planet, which manufactures audio headphones that it sells to big box retailers. Semcken had never missed a payment,

but one day he got an unexpected call from his banker. The bank would no longer allow Able Planet to use the line of credit for financing the cost of raw materials and manufacturing. Without that line of credit, Semcken would have no way to pay for inventory that he sold to retailers such as Wal-Mart and Costco. "They waited until the last minute and dropped it on us," says Semcken. The timing of the bank's decision came at the worst time. His business was approaching the busiest season. The time from back-to-school through Christmas was when his company sold 60 percent of its products each year. Semcken had invested a good deal of his own money into Able Planet and had gotten investments from family members. He was concerned about protecting all of the money his family had invested, but without funding, he would not be able to fill the orders for his retail customers.

1. What steps can business owners take when banks refuse their loan applications?
2. Assume the role of consultant to Kevin Semcken, owner of Able Planet. What advice can you offer him about getting the financing he needs to support his company?

Sources: Based on Michelle Goodman, "Anonymous Investors Offer a Lending Alternative," *Entrepreneur*, January 7, 2013, www.entrepreneur.com/article/225022; Jeremy Quittner, "How to Get a Loan? Let Us Count the Ways," *Inc.*, February 4, 2013, www.inc.com/jeremy-quittner/alternatives-to-banking.html; "Multifunding Success Stories: George Jevremovic," *Multifunding*, April 16, 2012, www.multifunding.com/success_stories/george-jevremovic; Nitasha Tiku, "When Your Bank Stops Lending," *Inc.*, July 1, 2009, www.inc.com/magazine/20090701/case-study-when-your-bank-stops-lending.html.

Other Methods of Financing

Small business owners do not have to rely solely on financial institutions and government agencies for capital.

Factoring Accounts Receivable

Rather than carry credit sales on its own books (some of which may never be collected), a small business can sell outright its accounts receivable to a factor. A **factor** buys a company's accounts receivable and pays for them in two parts. The first payment, which the factor makes immediately, is for 50 to 80 percent of the accounts' agreed-on value, which is typically discounted at a rate of 3 to 5 percent of the value of the invoice. The factor makes the second payment of 15 to 18 percent, which makes up the balance less the factor's service fees, when the original customer pays the invoice. Because factoring is a more expensive type of financing than loans from either banks or commercial finance companies, many entrepreneurs view factors as lenders of last resort. However, for businesses that cannot qualify for those loans, factoring may be the only choice!

Begun by American colonists to finance their cotton trade with England, factoring has become an important source of capital for many small businesses that depend on fast billing turnaround across a multitude of industries ranging from hardware stores and pharmacies to pest control firms and hiring agencies. Factoring deals are either with recourse or without recourse. Under deals arranged with recourse, a small business owner retains the responsibility for customers who fail to pay their accounts. The business owner must take back these uncollectible invoices. Under deals arranged without recourse, however, the owner is relieved of the responsibility of collecting them. If customers fail to pay their accounts, the factor bears the loss. Because

6.

Discuss other possible methods of financing growth.

the factoring company assumes the risk of collecting the accounts, it normally screens the firm's credit customers, accepts those judged to be creditworthy, and advances the small business owner a portion of the value of the accounts receivable. Factors will discount anywhere from 2 to 40 percent of the face value of a company's accounts receivable, depending on the following characteristics of a small company:

- Its customers' financial strength, credit ratings, and ability to pay invoices on time
- Its industry and its customers' industries because some industries have a reputation for slow payments
- Its history and financial strength, especially in deals arranged with recourse
- Its credit policies

The discount rate on deals without recourse usually is higher than on those with recourse because of the higher level of risk they carry for the factor.

Although factoring is more expensive than traditional bank loans (a 2 percent discount from the face value of an invoice due in 30 days amounts to an annual interest rate of 24.5 percent), it is a source of quick cash and is ideally suited for fast-growing companies, especially start-ups that cannot qualify for bank loans. "Factoring provides a business with immediate cash for accounts receivable because a business can sell receivables as soon as they are generated," explains the head of one factoring operation.⁵⁷ Small companies that sell to government agencies and large corporations, both famous for stretching out their payments for 60 to 90 days or more, also find factoring attractive because they collect the money from the sale (less the factor's discount) much faster.



ENTREPRENEURIAL PROFILE: Susan Brown: Boppy Co. Susan Brown created a pillow, called Boppy, that is used to help breast-feeding moms give their infants added support. She grew her company to about \$2 million in revenues, selling her product to 100 specialty children's stores, but as the business grew, cash was running low because of the company's growing accounts receivable. Brown couldn't secure a loan from a traditional bank, so she turned instead to a factoring agency. The factor gave her 80 percent of the value of her invoices so that she wouldn't have to wait the typical 30 days for payment. The business inched along until acquiring its first major retail account. Boppy Co. now generates \$40 million in retail sales annually.⁵⁸

Leasing

Leasing is another common alternative financing technique. Today, small businesses can lease virtually any kind of asset—from office space and telephones to computers and heavy equipment. By leasing expensive assets, a small business owner is able to use them without tying up valuable capital for an extended period of time. In other words, entrepreneurs can reduce the long-term capital requirements of their businesses by leasing equipment and facilities, and they are not investing capital in depreciating assets. In addition, because no down payment is required and because the cost of the asset is spread over a longer time (lowering monthly payments), the company's cash flow improves.

Cash Advances

Restaurants and other retailers often have difficulty finding financing because they do not have accounts receivable or invoices to borrow against. Lending companies such as AdvanceMe and RapidAdvance will provide businesses cash advances in the form of a lump sum. The lender then takes a percentage of the business's daily credit card receipts until the borrower repays the loan and a predetermined fee. Cash advances are a last resort source of debt financing because its cost is so high.



ENTREPRENEURIAL PROFILE: Dennis Sick: Mohegan Manor Dennis Sick, owner of the Mohegan Manor restaurant in Baldwinsville, New York, needed money to cover utilities and taxes during the slow winter months, so Sick took out an advance on credit card receipts. Using cash advance financing, his business received a lump sum of \$45,000 from the lender. In return, the lender took a percentage of the business's daily credit card receipts until Sick repaid the loan, plus a fixed fee. The lender took 13 to 18 percent of Mohegan Manor's daily credit card sales until Sick was able to repay the loan. Seven months later Sick had paid a total of \$64,000, giving the lender an annual

return of about 70 percent!⁵⁹



Susan Brown, founder of Boppy Company.

Source: Boppy Company.

Peer-to-Peer Loans

New online funding options are emerging to help small businesses with credit. **Peer-to-peer loans** are Web-based vetting platforms that create an online lending community of investors who provide funding to creditworthy small-business owners. Two of the most popular online vetting platforms are Lending Club and Prosper. Lending Club reports that it makes more than \$120 million in loans to small businesses *each month!* Interest rates can range from less than 7 percent to more than 25 percent. Lending Club has a maximum loan limit of \$35,000. Hannah Attwood wanted to raise money to open a cloth diaper supply and cleaning service called Adore Diaper Service. She first tried to secure bank financing. “They just laughed at me,” she says. Attwood then applied to Lending Club, and within a week, more than 60 investors had jointly given her a three-year, \$6,000 loan at 11.36 percent. She combined the loan with an equal amount of savings to buy industrial washers and dryers and cloth diapers for her business.⁶⁰

Credit Cards

Unable to find financing elsewhere, some entrepreneurs have launched their companies using the fastest and most convenient source of debt capital available: credit cards. It is a common financing technique for start-ups. However, credit cards are expensive, and if the business fails, the entrepreneur is left with a mountain of unpaid credit card bills to pay personally. Although it is sometimes part of the mythology of entrepreneurship, experts do not recommend using credit cards to finance a new business. Putting business start-up costs on credit cards charging 20 percent or more in annual interest is expensive and risky and can lead to severe financial woes, however. A study by Robert Scott of Monmouth University and the Kauffman Foundation reports that taking on credit card debt reduces the likelihood that a start-up company will survive its first three years of operation. Every \$1,000 increase in credit card debt results in a 2.2 percent increase in the probability that a company will fail.⁶¹

Where *Not* to Seek Funds

Entrepreneurs searching for capital must be wary of con artists whose targets frequently include financially strapped small businesses. The swindle usually begins when the con artist scours an area for “DEs”—desperate entrepreneurs in search of quick cash injections to keep their businesses going. Usually, the scam involves advance fees and follows one of two patterns (although a number of variations exist). Under one scheme, scammers guarantee a small business owner a loan from a nonexistent bank with false credentials. The con artist tells the owner that loan processing will take time and that in the meantime the owner must pay a percentage of the loan amount as an advance fee. Of course, the loan never materializes, and the small business owner loses the deposit, sometimes several thousands of dollars.

Another common scam begins with a loan broker who promises a capital-hungry small business owner an SBA loan if the owner pays a small processing fee. Again, the loan never appears, and the small business owner loses his or her deposit. Other scammers charge entrepreneurs excessive fees to help them apply for SBA loan guarantees.

Unfortunately, schemes by con artists preying on unsuspecting business owners who are in need of capital are more common when credit tightens. Scams most commonly involve the SBA’s smallest loan programs, such as the *SBAExpress* and Microloan programs. The Internet has made crooks’ jobs easier. On the Web, they can establish a legitimate-looking presence, approach their targets anonymously, and vanish instantly—all while avoiding mail fraud charges if they happen to get caught. These con artists move fast, cover their trails well, and are extremely smooth. The best protection against such scams is common sense and remembering the adage “If it sounds too good to be true, it probably is.” Experts offer the following advice to business owners:

- Be suspicious of anyone who approaches you—unsolicited—with an offer for “guaranteed financing.”
- Watch out for red flags that indicate a scam: “guaranteed” loans, up-front fees, and unsolicited pitches over the Web.
- Conduct a thorough background check on any lenders, brokers, or financiers with whom you intend to do business. Is the lender registered to do business in your state? Does the Better Business Bureau have a record of complaints against the company?

7.

Explain how to avoid becoming a victim of a loan scam.

- Make sure you have an attorney review all loan agreements before you sign them.
- *Never* pay advance fees for financing, especially on the Web, unless you have verified the lender's credibility.

Chapter Review

1. Describe the various sources of debt capital and the advantages and disadvantages of each.
 - Commercial banks offer the greatest variety of loans, although they are conservative lenders. Typical short-term bank loans include commercial loans, lines of credit, discounting accounts receivable, inventory financing, floor planning, and character loans.
2. Explain the types of financing available from nonbank sources of credit.
 - Asset-based lenders allow small businesses to borrow money by pledging otherwise idle assets, such as accounts receivable, inventory, or purchase orders, as collateral.
 - Trade credit is used extensively by small businesses as a source of financing. Vendors and suppliers commonly finance sales to businesses for 30, 60, or even 90 days.
 - Equipment suppliers offer small businesses financing similar to trade credit but with slightly different terms.
 - Commercial finance companies offer many of the same types of loans that banks do, but they are more risk oriented in their lending practices. They emphasize accounts receivable financing and inventory loans.
 - Stock-brokerage houses offer loans to prospective entrepreneurs at lower interest rates than banks because they have high-quality, liquid collateral—stocks and bonds in the borrower's portfolio.
 - Insurance companies provide financing through policy loans and mortgage loans. Policy loans are extended to the owner against the cash surrender value of insurance policies. Mortgage loans are made for large amounts and are based on the value of the land being purchased.
 - SBICs are privately owned companies licensed and regulated by the SBA that qualify for SBA loans to be invested in or loaned to small businesses.
3. Identify the various federal loan programs aimed at small businesses.
 - The EDA, a branch of the Commerce Department, makes loan guarantees to create and expand small businesses in economically depressed areas.
 - HUD extends grants (such as CDBGs) to cities that, in turn, lend and grant money to small businesses in an attempt to strengthen the local economy.
 - The USDA's RBS loan program is designed to create nonfarm employment opportunities in rural areas through loans and loan guarantees.
 - The SBIR program involves 11 federal agencies that award cash grants or long-term contracts to small companies wanting to initiate or to expand their R&D efforts.
 - The STTR program allows researchers at universities, federally funded R&D centers, and nonprofit research institutions to join forces with small businesses and develop commercially promising ideas.
4. Describe the various loan programs available from the SBA.
 - SBA loan activity is in the form of loan guarantees rather than direct loans. Popular SBA programs include the SBAExpress Program, Patriot Express Program, Small Loan Advantage program, Community Advantage program, the 7(a) loan guaranty program, the CAPLine Program, the Microloan program, the 504 Certified Development Company Program, several export loan programs, and the disaster loan program.
5. Discuss state and local economic development programs.
 - In an attempt to develop businesses that create jobs and economic growth, most states offer small business financing programs, usually in the form of loans, loan guarantees, and venture capital pools.
 - Many state and local loan and development programs, such as CAPs and RLFs, complement those sponsored by federal agencies.
6. Discuss other possible methods of financing growth.
 - By factoring accounts receivable, leasing equipment instead of buying it, cash advances on credit card receipts, peer-to-peer lending, and using credit cards, owners can stretch their supplies of capital.
7. Explain how to avoid becoming a victim of a loan scam.
 - Entrepreneurs hungry for capital for their growing businesses can be easy targets for con artists running loan scams. Entrepreneurs should watch out for promises of "guaranteed" loans, up-front fees, and offers that seem too good to be true.

Discussion Questions

- 17-1. What role do commercial banks play in providing debt financing to small businesses? Outline and briefly describe the major types of short-, intermediate-, and long-term loans commercial banks offer.
- 17-2. Explain the various factors that the entrepreneurs should consider for debt financing.
- 17-3. Explain how asset-based financing works. What is the most common method of asset-based financing? What are the advantages and disadvantages of using this method of financing?
- 17-4. What function do SBICs serve? How does an SBIC operate? What methods of financing do SBICs rely on most heavily?
- 17-5. Briefly describe the loan programs offered by the following:
 - a. EDA
 - b. HUD
 - c. USDA
 - d. Local development companies.
- 17-6. Describe the various sources of debt capital and the advantages and disadvantages of each.
- 17-7. Which of the SBA's loan programs accounts for the majority of its loan activity? How does the program work?
- 17-8. Explain the purpose and the operation of the SBA's microloan program.
- 17-9. Explain how to avoid becoming a victim of a loan scam.

CHAPTER 18

Location, Layout, and Physical Facilities



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain the stages in the location decision.
2. Describe the location criteria for retail and service businesses.
3. Outline the basic location options for retail and service businesses.
4. Explain the site selection process for manufacturers.
5. Discuss the benefits of locating a start-up company in a business incubator.
6. Describe the criteria used to analyze the layout and design considerations of a building, including the Americans with Disabilities Act.
7. Explain the principles of effective layouts for retailers, service businesses, and manufacturers.

It is not the strongest of the species that survive, nor the most intelligent, but the ones most responsive to change.

—Charles Darwin

It is choice—not chance—that determines your destiny.

—Jean Nidetch

Stages in the Location Decision

1.

Explain the stages in the location decision.

Few decisions that entrepreneurs make have as lasting and as dramatic an impact on their businesses as the choice of a location. Entrepreneurs who choose their locations wisely—with their customers' preferences and their companies' needs in mind—can establish an important competitive advantage over rivals who choose their locations haphazardly. Because the availability of qualified workers, tax rates, quality of infrastructure, traffic patterns, quality of life, and many other factors vary from one site to another, the location decision is an important one that can influence the growth rate and the ultimate success of a company. Thanks to widespread digital connectivity, mobile computing, extensive cellular coverage, and affordable air travel, entrepreneurs have more flexibility when choosing a business location than ever before.

The characteristics that make for an ideal location often vary dramatically from one company to another because of the nature of the business. In the early twentieth century, companies looked for ready supplies of water, raw materials, or access to railroads. For instance, West Virginia once was home to a thriving glass-making industry because it provided entrepreneurs with ample supplies of quality sand (a key raw material), natural gas for heating glass furnaces, and inexpensive river transportation to get finished products to market.¹ Today, businesses are more likely to look for sites that are close to universities and offer high-speed Internet access and accessible interstate highways and airports. In fact, one study concluded that the factors that make an area most suitable for starting and growing small companies include access to dynamic universities, an ample supply of skilled workers, a nearby airport, a temperate climate, and a high quality of life.²

The key to finding a suitable location is identifying the characteristics that can give a company a competitive edge and then searching out potential sites that meet those criteria. For example, businesses that depend on face-to-face contact with customers must identify locations that attract high volumes of well-qualified walk-in customers. Although online sales continue to increase steadily, brick-and-mortar businesses still dominate consumer sales, accounting for 92 percent of all retail sales.³ One reason for the staying power of physical locations is the appeal of their real-world presence. An inviting physical location enables people to touch, feel, and experience the products and services a business offers. Potential buyers can pick up merchandise, try it on, and compare it side by side with other items. An optimal location also provides a gathering place where people can share experiences and one-on-one interactions. The ability to look someone in the eye and ask questions or watch a demonstration appeals to human nature and provides a powerful sales tool for the business. Investing time collecting and analyzing the data relevant to choosing a location pays off in customer traffic, higher sales, and greater efficiencies.



ENTREPRENEURIAL PROFILE: Steve Kuhnau: Smoothie King Smoothie King, a company started in 1973 when founder Steve Kuhnau began blending fresh fruit, nutrients, and proteins to combat his allergies, is one of the leading retailers of nutritional smoothies, diet supplements, and healthy snacks. Headquartered in New Orleans, Louisiana, the company has grown to 639 franchised locations (103 of them outside the United States) and is one of the top-performing and fastest-growing companies in the industry. With 21 years of experience, Richard Leveille, a senior vice president whose main responsibility is location analysis for new outlets, knows that choosing the right location is a key element to Smoothie King's success. The company has three primary criteria for selecting a site for a new outlet: high visibility, maximum customer convenience, and successful businesses in the surrounding area that complement Smoothie King's products. Managers and franchisees know from experience that the most important factor in selecting a site is its visibility, a location with high traffic counts that customers can easily see. Convenient locations translate into more frequent visits from customers, which is why the chain looks for locations that allow the installation of drive-through windows. The final criterion is a location that supports other successful businesses whose products complement Smoothie King's or that attract the same customer base. Smoothie King works with Buxton, a company that specializes in site selection for restaurants and retailers, to find its locations. Buxton's analytical tools allow Smoothie King to identify those locations that provide the best match for its target customers and to make projections about which areas offer the greatest potential to support large numbers of outlets.⁴

The location decision process resembles an inverted pyramid. The first level of the decision is the broadest, requiring an entrepreneur to select a particular region of the country. Then an entrepreneur must choose the right state, then the right city, and, finally, the right site within the city (see Figure 18.1). The "secret" to selecting the ideal location is to identify the areas that

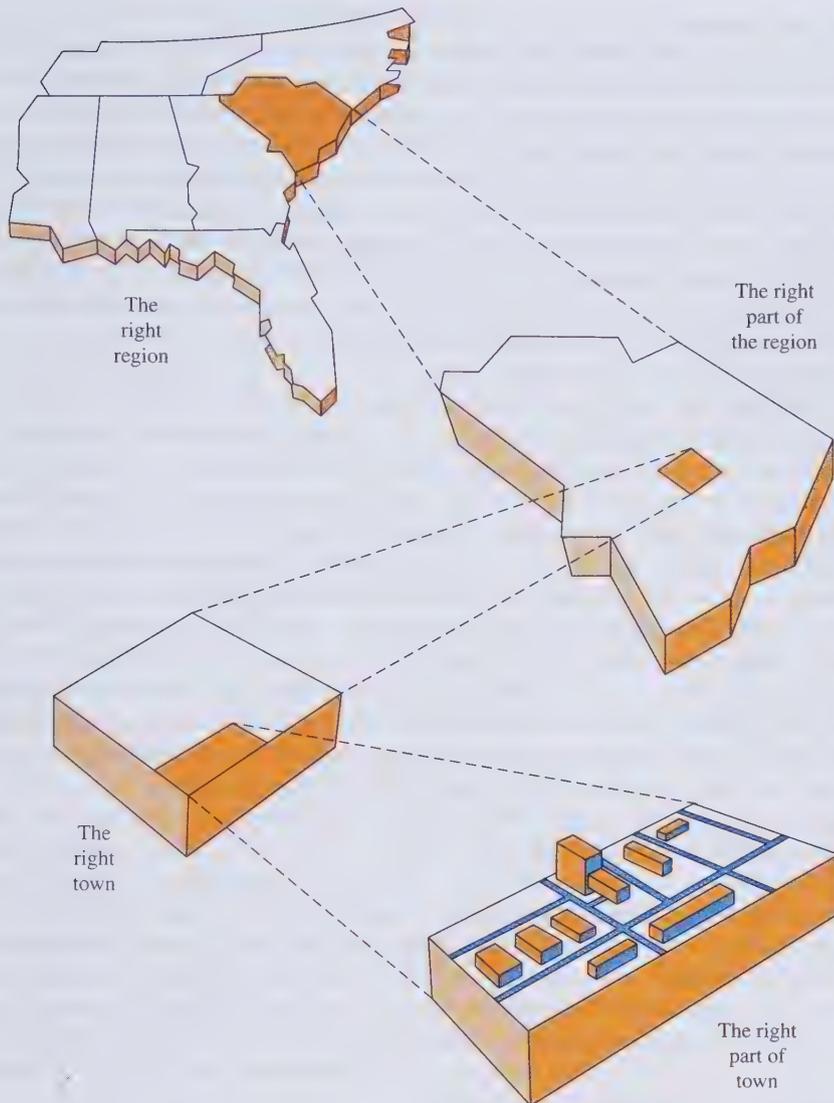


FIGURE 18.1
The Location Decision

Source: From Dale M. Lewison and M. Wayne DeLozier, *Retailing* (Columbus, OH: Merrill/Macmillan Publishing, 1984), p. 341.

most important to a company's success and then finding a location that satisfies as many of them as possible, particularly those that are most critical. For instance, one of the most important location factors for high-tech companies is the availability of a skilled labor force, and their choice of location reflects this.



ENTREPRENEURIAL PROFILE: Terry Golding: Amethyst Research, Inc. Terry Golding, president of Amethyst Research, Inc., a small company that has developed an advanced semiconductor technology used to manufacture infrared night-vision imagers, chose a location in the Technology Transfer Center in Ardmore, Oklahoma, that provides both office and lab space for the company's 10 employees, five of whom have PhDs. Although Ardmore is a small town (just 25,000 residents), it has attracted numerous small high-tech companies, such as Amethyst Research, with its specialized technology parks and a technology incubator that will soon be in operation. Ardmore also offers start-up companies the advantage of low costs and easy access to major markets, such as nearby Dallas and Oklahoma City. The support of local government officials and a pro-business climate clinched the deal for Golding. "We wouldn't be nearly as far along with our business had we not located here," he says.⁵

Selecting the Region

The first step in selecting the best location is to focus on selecting the right region. This requires entrepreneurs to look at the location decision from the "30,000-foot level," as if he or she were in an airplane looking down. In fact, in the early days of their companies, Sam Walton, founder of

retail giant Wal-Mart, and Ray Kroc, who built McDonald's into a fast-food giant, actually used private planes to survey the countryside for prime locations for their stores.

Which region of the country has the characteristics necessary for a new business to succeed? Above all, entrepreneurs must place their customers first when considering a location. As Smoothie King's experience suggests, facts and statistics, not speculation, lead entrepreneurs to the best locations for their businesses. Common criteria include rapid population growth, rising disposable incomes, the existence of necessary infrastructure, a nonunion environment, and low operating costs. At the broadest level of the location decision, entrepreneurs prefer to locate in regions of the country that are experiencing substantial growth. Since the 1950s, the U.S. population has shifted to the South and the West and from rural areas to urban and suburban communities.⁶ Studying these shifts in population and the resulting economic growth gives entrepreneurs an idea of where the action is—and isn't.

One of the first stops entrepreneurs should make when conducting a regional evaluation is the U.S. Census Bureau (www.census.gov). There entrepreneurs can access for specific locations vital demographic information, such as age, income, educational level, employment level, occupation, ancestry, commuting times, housing data (house value, number of rooms, mortgage or rent status, number of vehicles owned, and so on), and many other characteristics. With a little practice, entrepreneurs can prepare customized reports on the potential sites they are considering. These Web-based resources give entrepreneurs instant access to important site-location information that only a few years ago would have taken many hours of intense research to compile! In 2012, the Census Bureau ceased publication of the *U.S. Statistical Abstract* (published annually since 1878), which contained about 1,400 useful data sets about the United States, ranging from basic population characteristics and leisure activity expenditures to poverty rates and energy consumption. However, ProQuest, an information gateway company founded in 1943, now publishes in both print and online formats the *ProQuest Statistical Abstract of the United States* (http://cisupa.proquest.com/ws_display.asp?filter=Statistical%20Abstract), which closely resembles the discontinued Census Bureau publication.

The Census Bureau's American FactFinder site (<http://factfinder.census.gov>) provides easily accessible demographic fact sheets and maps on nearly every community in the United States, including small towns. The Census Bureau's American Community Survey provides annual updates on the demographic and economic characteristics of areas with populations of at least 65,000, three-year updates on areas with populations between 20,000 and 65,000, and five-year updates on areas with populations of less than 20,000. Both the American FactFinder and the American Community Survey allow entrepreneurs to produce easy-to-read, customizable maps of the information they generate in their searches.

ZoomProspector is a useful Web site that gives entrepreneurs access to much of the same information that large companies use when selecting locations and allows them to search for the ideal location using a multitude of factors, including population size, job growth rate, number of patents issued, venture capital invested, education level, household incomes, and proximity to interstate highways, railroads, and airports. Once entrepreneurs locate a city that matches their customer profiles, they find other cities across the United States that have similar profiles with a single mouse click! Entrepreneurs who are considering a particular region can display "heat maps" that visually display the areas that have the highest concentrations of people who have a particular characteristic, such as a bachelor's degree or the highest household incomes.



ENTREPRENEURIAL PROFILE: Steve Sarowitz: Paylocity Steve Sarowitz, CEO of Paylocity, a provider of human resources and payroll services to small and medium-size businesses, uses ZoomProspector to find the best locations across the United States for the rapidly expanding company's new offices. Sarowitz says that ZoomProspector helps his company answer the important question: Would this be a good market for us? "What's great about ZoomProspector is that we can get so much information about each individual market we are considering—market demographics, which industries are strongest, education levels, and more," says Sarowitz. Founded in 1997, Paylocity, which is based in Arlington Heights, Illinois, and has appeared on *Inc.*'s list of the 5,000 fastest-growing companies seven times, now has 14 locations and, with ZoomProspector's help, is looking to add more.⁷

ePodunk, a Web site that provides in-depth Census-based information about more than 46,000 towns and cities of all sizes around the United States, is another useful tool for entrepreneurs. Zipskinny is a Web site that provides Census profiles for communities using ZIP codes.

The Population Reference Bureau (www.prb.org) provides a detailed breakdown of the most relevant data collected from the most recent census reports. Its DataFinder is a database that includes 244 variables for the United States and 132 variables for 210 other nations. The site also includes helpful articles that discuss the implications of the changing demographic and economic profile of the nation's (and the world's) population, such as the impact of aging Baby Boomers on business and the composition of the U.S. workforce.

Other helpful resources merit mention as well. *Lifestyle Market Analyst*, a four-part annual publication, matches population demographics with lifestyle interests. Section 1 provides demographics and lifestyle information for 210 "Designated Market Areas" across the United States. Section 2 gives demographic and geographic profiles of 77 lifestyle interests that range from avid readers and dieters to wine aficionados and pet owners. Section 3 describes the dominant lifestyle interests for each of the 210 market areas. Section 4 provides comparisons of other activities that correspond with each lifestyle interests. Entrepreneurs can use *Lifestyle Market Analyst* to determine, for example, how likely members of a particular market segment are to own a dog, collect antiques, play golf, own a vacation home, engage in extreme sports, invest in stocks or bonds, or participate in a host of other activities.

Other sources of demographic data include Nielsen Marketplace, *Editor and Publisher Market Guide*, *The American Marketplace: Demographics and Spending Patterns*, and *Zip Code Atlas and Market Planner*. Nielsen Marketplace provides a comprehensive tool for market analysis, allowing customers to generate customized reports and maps that show basic demographics, lifestyle patterns, and purchasing behavior for almost any market in the United States. The site also includes several unique statistics. Effective buying income (EBI) is a measure of disposable income, and the buying power index (BPI) is a unique measure of spending power that takes population, EBI, and retail sales into account to determine a market's ability to buy goods and services.

The *Editor and Publisher Market Guide* includes detailed economic and demographic information, ranging from population and income statistics to information on climate and transportation networks for all 3,096 counties in the United States and more than 1,600 key cities in both the United States and Canada.

The American Marketplace: Demographics and Spending Patterns provides useful demographic information in eight areas: education, health, income, labor force, living arrangements, population, race and ethnicity, and spending and wealth. Most of the tables in the book are derived from government statistics, but *The American Marketplace* also includes a discussion of the data in each table as well as a forecast of future trends. Many users say the primary advantage of *The American Marketplace* is its ease of use.

The U.S. Census Bureau also offers the ZIP Code Tabulation Areas (ZCTA) Web site (www.census.gov/geo/ZCTA/zcta.html) that organizes the wealth of census data by zip code. The database of 33,120 ZCTAs across the United States allows users to create tables and plot maps of census data by ZIP code.

Site Selection magazine (www.siteselection.com) is another useful resource that helps entrepreneurs determine the ideal location for their companies. Issues contain articles that summarize the incentive programs that states offer, profiles of each region of the country, and the benefits of locating in different states.

The task of analyzing various potential locations—gathering and synthesizing data on a wide variety of demographic and geographic variables—has become much easier and less expensive because much of the data required to determine the ideal location are available online. Many states and counties across the United States now provide geographic information systems (GIS) files online that allow entrepreneurs to identify sites that meet certain location criteria for their businesses. GIS packages allow users to search through virtually any database containing a wealth of information and plot the results on a map of the country, an individual state, a specific city, or even a single city block. The visual display highlights what otherwise would be indiscernible business trends. For instance, using GIS programs, entrepreneurs can plot their existing customer base on a map with various colors representing the different population densities. Then they can zoom in on those areas with the greatest concentration of customers, mapping a detailed view of ZIP code borders or even city streets. GIS street files originate in the U.S. Census Department's TIGER (Topographically Integrated Geographic Encoding Referencing) file, which contains map information broken down for every square foot of Metropolitan Statistical Areas (MSAs). MSAs contain the name and location of every street in the country and detailed block statistics for the 345 largest urban areas. In essence, TIGER is a massive database

of geographic features such as roads, railways, and political boundaries across the entire United States that, when linked with mapping programs and demographic databases, gives entrepreneurs incredible power to pinpoint existing and potential customers on easy-to-read digital maps.

The Small Business Administration's (SBA's) Small Business Development Center (SBDC) program also offers location analysis assistance to entrepreneurs. These centers, numbering more than 900 nationwide, provide training, counseling, research and other specialized assistance to entrepreneurs and existing business owners on a wide variety of subjects—all at no charge! They are an important resource, especially for those entrepreneurs who may not have access to a computer. (To locate the SBDC nearest you, contact the SBA office in your state or go to the SBA's SBDC locator page at www.sba.gov/local-assistance.)

For entrepreneurs interested in demographic and statistical profiles of international cities, Euromonitor International (www.euromonitor.com) and the Organization for Economic Development and Cooperation (www.oecd.org) are excellent resources.

Once an entrepreneur has identified the best region of the country, the next step is to evaluate the individual states in that region.

Selecting the State

Every state has a business development office working to recruit new businesses. Although the publications produced by these offices will be biased in favor of locating in that state, they still are excellent sources of information and can help entrepreneurs assess the business climate in each state. Some of the key issues to explore include the laws, regulations, and taxes that govern businesses and incentives or investment credits the state may offer to businesses locating there. Other factors to consider include proximity to markets, proximity to raw materials, wage rates, quantity and quality of the labor supply, general business climate, and tax rates. Table 18.1 shows the most friendly and least friendly states for small businesses, a ranking based on a survey conducted by the Kauffman Foundation and Thumbtack that asked more than 6,000 small business owners to evaluate the states in which they operated on multiple factors, including the ease of starting a business, hiring costs, the regulatory burden that states impose, worker training programs that are available, and others.

PROXIMITY TO MARKETS Locating close to the markets they plan to serve is critical to manufacturers, especially when the cost of transporting finished goods is high relative to their value. Locations near customers offer a competitive advantage. Service firms often find that

TABLE 18.1 Most and Least Small Business Friendly States

Ranking (A+ [Most Friendly] to F [Least Friendly])	States
A+	Arkansas, Idaho, Oklahoma, Utah
A	Georgia, Louisiana, New Hampshire, Texas
A-	Kansas, Oregon, South Carolina, Virginia
B+	Alabama, Colorado, Indiana, Nebraska
B	Missouri, Nevada, Tennessee
B-	Arizona, Minnesota, Washington
C+	Maryland, Pennsylvania, Kentucky, Wisconsin
C	Connecticut, Florida, Illinois, North Carolina
C-	Iowa, Louisiana, Montana, New Jersey
D+	Delaware, Massachusetts, Michigan, Ohio
D	Alaska, California, Maine, New Mexico, New York
F	Hawaii, Vermont, Rhode Island
Not rated	North Dakota, South Dakota, West Virginia, Wyoming

Source: Based on "Which State Is Best for Small Business?" *Entrepreneur*, November 12, 2012, <http://www.entrepreneur.com/article/224704>; "United States Small Business Friendliness," Thumbtack and Kauffman Foundation, 2012, <http://www.thumbtack.com/survey>.

proximity to their clients is essential. If a business is involved in repairing equipment used in a specific industry, it should be located where that industry is concentrated. The more specialized a business or the greater the relative cost of transporting the product to the customer, the more likely it is that proximity to the market will be of importance in the location decision. Many quick-service restaurants prefer locations near college and university campuses because of the high concentration of their target customers. One disadvantage of a college town location is that sales decline when college students leave for Christmas and summer breaks; however, many chains report that, despite the predictable decrease in sales when students are away, their college town locations are among their highest-performing units.



ENTREPRENEURIAL PROFILE: Scott Gittrich: Toppers Pizza Toppers Pizza, founded in 1991 by Scott Gittrich and based in Whitewater, Wisconsin, has expanded to 50 locations by focusing primarily on cities that are home to at least one college or university. Toppers Pizza's outlets feature an unusual menu—the Potato Topper pizza (potato chunks, bacon, and onions), the Hang-over Helper (Canadian bacon, onions, bell peppers, and potatoes), and the Mac' N Cheese—and stay open until 3 A.M., features that are popular with its college-age target market. Gittrich says that stores that are located near college campuses generate 50 percent of their sales after 9 P.M. "It's not easy to do," he admits, "but our stores are buzzing with activity after our competitors have closed." Annual sales at Toppers Pizza outlets average \$930,000, well above the industry average.⁸

PROXIMITY TO NEEDED RAW MATERIALS A business that requires raw materials that are difficult or expensive to transport may need a location near the source of those raw materials. For example, fish-processing plants benefit from locating close to ports. Some companies locate close to the source of raw materials because of the cost of transporting heavy low-value materials over long distances. Bel Brands USA, maker of Mini Babybel cheese, selected Brookings, South Dakota, as the location for its newest manufacturing plant in the United States. Managers included 40 criteria in the selection process, including labor supply and costs, utilities cost, land price and availability, and operating costs, but the most important factor was the availability of an essential raw material, milk, in the area to support the company's annual production of 40 million pounds of cheese. Other factors that made Brookings an ideal choice include South Dakota State University, which has a renowned dairy science program, a friendly business climate, and a low cost of living.⁹ For products in which bulk or weight is not a factor, locating close to suppliers can facilitate quick deliveries and reduce inventory holding costs. The value of products and materials, their cost of transportation, and their unique functions all interact to determine how close a business should be to its suppliers.

WAGE RATES Existing and anticipated wage rates provide another measure for comparing states. Wages vary from one state or region to another, significantly affecting a company's cost of doing business. For instance, according to the Bureau of Labor Statistics, the average hourly compensation for workers (including wages and benefits) ranges from a low of \$26.32 in the South to a high of \$33.18 in the Northeast. (The average hourly compensation for the nation is \$28.95.¹⁰) Wage rate differentials within geographic regions can be even more drastic. When reviewing wage rates, entrepreneurs must be sure to measure the wage rates for jobs that relate to their particular industries or companies. In addition to surveys by the Bureau of Labor Statistics (www.bls.gov), local newspaper ads can give entrepreneurs an idea of the pay scale in an area. In addition, entrepreneurs can obtain the latest wage and salary surveys with an e-mail or telephone call to the local chambers of commerce for cities in the region under consideration. Entrepreneurs should study not only prevailing wage rates but also *trends* in rates. How does the rate of increase in wage rates compare to those in other states? Another factor influencing wage rates is the level of union activity in a state. How much union organizing activity has the state seen within the last two years? Is it increasing or decreasing? Which industries have unions targeted in the recent past?

LABOR SUPPLY For many businesses, especially technology-driven companies, one of the most important characteristics of a potential location is the composition of the local workforce. The number of workers available in an area and their levels of education, training, and experience determine a company's ability to fill jobs with qualified workers at reasonable wages. According to a recent survey by *Site Selection* magazine, site selection consultants ranked workforce availability as the most important location factor.¹¹



ENTREPRENEURIAL PROFILE: Andy Lim: Lavu Inc. Andy Lim, who spoke no English when he emigrated to the United States in 2000, started Lavu Inc., a company that makes a simple iPad- and iPhone-based tableside ordering and restaurant management software system, from his kitchen table in Albuquerque, New Mexico, in 2010. The groundbreaking system has proved to be so effective that restaurants all across the nation have adopted it, and celebrity chef Gordon Ramsay has featured it on his television show, *Kitchen Nightmares*. For Lavu, Albuquerque is the ideal location, mainly because of an ample supply of highly educated, talented workers. “We are going head-to-head against Silicon Valley,” says Lim, “but we are staying in Albuquerque. We are very efficient here. The living costs are cheaper, and we have been able to hire the best and brightest employees, many of whom are graduates of the nearby University of New Mexico.”¹²

Entrepreneurs should know how many qualified people are available in the area to do the work required in the business. Some states attempt to attract industry with the promise of cheap labor. Unfortunately, businesses locating in those states may find unskilled, low-wage labor and unskilled laborers who can be difficult to train. The size of an area’s labor pool and the education, skills, and ability of its members determine a company’s ability to fill jobs with qualified workers at reasonable wages. “The single biggest reason why anyone is moving companies is access to talent,” says Tim Nitti, co-owner of location strategy company KLG.¹³

Knowing the exact nature of the labor force needed and preparing job descriptions and job specifications in advance help business owners determine whether there is a good match between their companies and the available labor pool. Checking educational statistics in the state to determine the number of graduates in relevant fields of study provides an idea of the local supply of qualified workers. Drawn by the strength of a technology cluster and the presence of 17 colleges and universities near Boston with 221,000 students, a thriving video game industry that is comprised mainly of small companies such as Harmonix (“Guitar Hero” and “Rock Band”), Turbine (“Lord of the Rings”), Tilted Mill Entertainment (“SimCity”), and others has made Massachusetts home. Becker College in Worcester, Massachusetts, houses the Digital Game Institute, which provides a reservoir of young talent for these fast-growing high-tech companies.¹⁴

BUSINESS CLIMATE According to a recent survey by *Site Selection* magazine, 87 percent of site consultants say that a state’s business climate is very or somewhat important in companies’ location decisions.¹⁵ A state’s business climate is its overall attitude toward businesses; some states have created environments that are more “entrepreneur friendly” than others. Has the state passed laws that place restrictions on the way a company can operate? Does the state impose a corporate income tax? (Four states do not.) Does it support education at all levels so that a supply of qualified employees is available? Does the state offer small business support programs or financial assistance to entrepreneurs?



ENTREPRENEURIAL PROFILE: John and Tullaya Akins: Bangkok Cuisine Thai Restaurant John and Tullaya Akins, owners of the Bangkok Cuisine Thai Restaurant in Sandpoint, Idaho, wanted to open a second Mediterranean-themed restaurant. The copreneurs had selected a brick building in Sandpoint’s downtown district that had housed a bicycle shop but changed their minds when they learned that the city would impose an impact fee (to tap into the city’s water and sewer systems and to cover fire and police protection) of \$26,000 to convert the building into a 45-seat restaurant. “That’s make or break for us,” says John. “We are shopping for a location in Ponderay (a nearby town with minimal impact fees) and the surrounding area that is more business friendly. It’s too bad. We love this community.”¹⁶

TAX RATES Another important factor entrepreneurs must consider is the tax burden that states impose on businesses and individuals. Income taxes may be the most obvious tax states impose on both business and individual residents, but entrepreneurs also must evaluate the impact of payroll taxes, sales taxes, property taxes, and specialized taxes on their cost of operations. Currently, seven states impose no income tax on their residents, but state governments always impose taxes of some sort on businesses and individuals.¹⁷ In some cases, states offer special tax rates or are willing to negotiate fees in lieu of taxes (FILOT) for companies that create jobs and stimulate the local economy.



ENTREPRENEURIAL PROFILE: Peter Farrell: ResMed Inc. When California passed Proposition 30, a proposal that raised taxes on its wealthiest citizens, many entrepreneurs began making plans to relocate their businesses to states where the tax burden is significantly lower. “There are states with no personal income tax,” says David Kline, vice president of a taxpayers advocacy

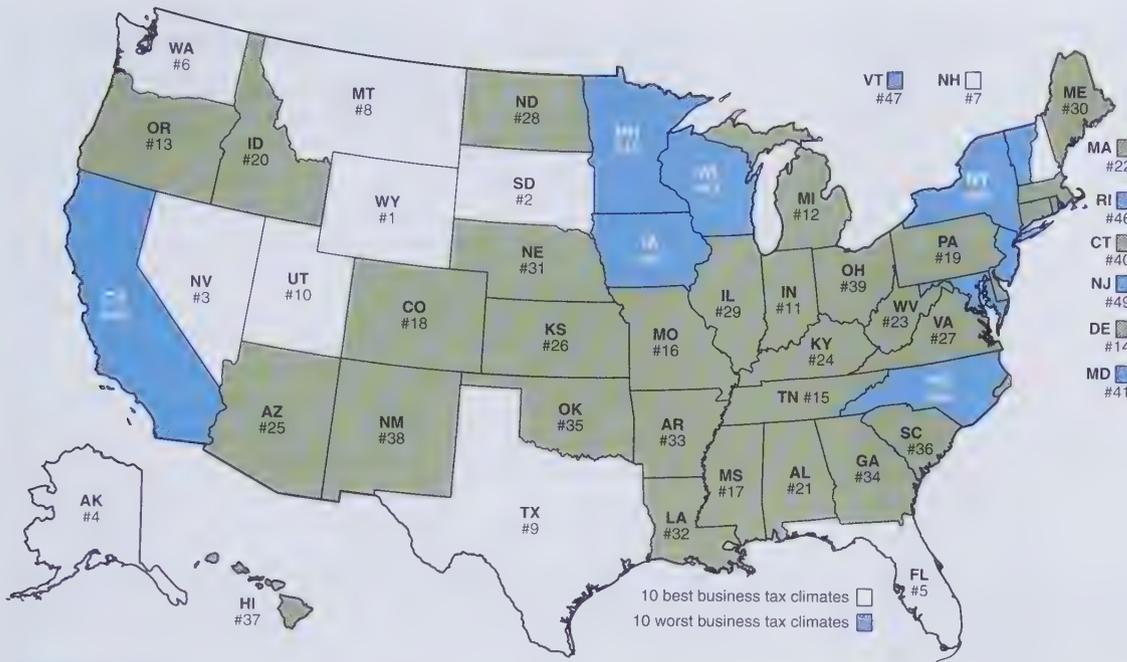


FIGURE 18.2
State Business Tax Climate Index

Source: Scott Drenkard and Joseph Henhman, *2013 State Business Climate Index*, Tax Foundation, October 9, 2012, p. 2.

group. "If you move from California to Florida, and you are in a high-income bracket, you are automatically giving yourself a 13.3 percent raise." Peter Farrell, who founded ResMed, a company that makes medical devices designed to manage breathing problems due to sleep disorders, in San Diego, California, began making plans to relocate his company, which employs 600 people, when voters passed Proposition 30. "California has become an unfriendly business environment," he says.¹⁸

Figure 18.2 shows the Tax Foundation's State Business Tax Climate Index, which ranks states' tax climates from best (no. 1) to worst (no. 50).

INTERNET ACCESS Fast and reliable Internet access is another important factor in the location decision. Internet access through high-speed cable or DSL lines is essential for high-tech companies and those engaging in e-commerce. Even companies that may not do business over the Web use the Internet as a daily business tool for e-mail and information access. Companies that fall behind in high-tech communications find themselves at a severe competitive disadvantage. A recent study by the SBA reports that 48 percent of small business owners in rural areas and 37 percent of business owners in metropolitan areas are dissatisfied with the speed of their Internet connections.¹⁹

TOTAL OPERATING COSTS When scouting a state in which to locate a company, an entrepreneur must consider the total cost of operating a business there. For instance, a state may offer low utility rates, but its labor costs and tax rates may be among the highest in the nation. To select the ideal location, entrepreneurs must consider the impact of a state's total cost of operation on their business ventures. The state evaluation matrix in Table 18.2 provides a handy tool designed to help entrepreneurs determine which states best suit the most important location criteria for their companies. This same matrix can be adapted to analyze individual cities as well.

Entrepreneurial activity in the United States follows distinct geographic patterns; states in the West and the South exhibit the highest rates of entrepreneurial activity (see Figure 18.3). The next phase of the location selection process concentrates on selecting the best city.

Selecting the City

A company's location should match the market for its products or services, and assembling a demographic profile of a city tells an entrepreneur how well it measures up to his or her target market's profile.

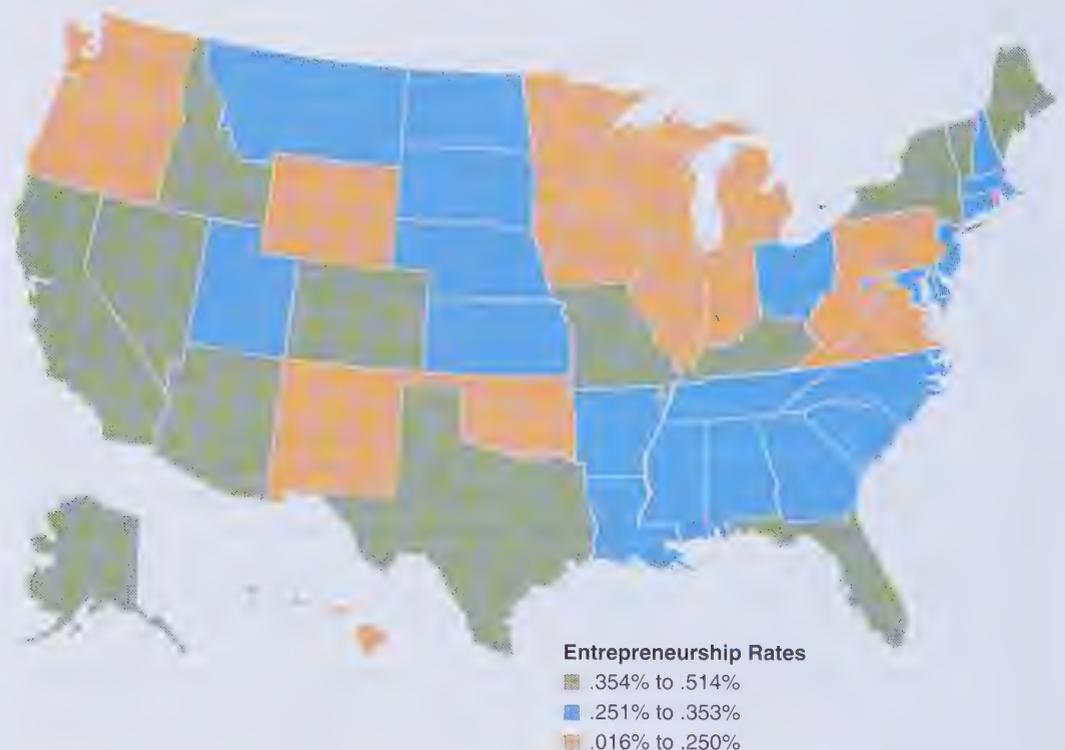
TABLE 18.2 State Evaluation Matrix

Location Criterion	Weight 10—High, 1—Low	Score 5—High, 1—Low	State-Weighted Score (Weight × Score)		
			Florida	Georgia	South Carolina
State and local tax burden		1 2 3 4 5			
Transportation infrastructure		1 2 3 4 5			
Utility rates		1 2 3 4 5			
Land and building prices		1 2 3 4 5			
Regulatory burden		1 2 3 4 5			
Quality of workforce		1 2 3 4 5			
Raw material availability		1 2 3 4 5			
Legal climate		1 2 3 4 5			
Educational and training opportunities		1 2 3 4 5			
Availability of incentives		1 2 3 4 5			
Other		1 2 3 4 5			
Total score					

*Assign to each location criterion a weight that reflects its relative importance (10—high to 1—low). Then score each state on a scale of 1 (low) to 5 (high). Calculate the weighted score (weight × score) for each state. Finally, add up the total weighted score for each state. The state with the highest total weighted score is the best location for your business.

FIGURE 18.3 Entrepreneurial Activity by State

Source: Robert M. Fairlie, Entrepreneurial Activity, Kauffman Foundation, March 2012, p. 16.



ENTREPRENEURIAL PROFILE: Larry Reinstein: Fresh City Fresh City, a Needham, Massachusetts-based chain of 16 fast-casual restaurants that features a fresh, healthy menu, considers the population density and the education and income levels of an area when scouting potential locations. “We find that the better educated the consumer is, the more apt they are to be our kind of guest,” says CEO Larry Reinstein. Fresh City has located its restaurants in communities with high concentrations of well-educated, high-income people in and around Boston and plans to open restaurants in Herndon, Virginia, just outside of Washington, D.C., which recently was named one of the healthiest cities in the United States.²⁰

Factors that entrepreneurs should consider when selecting a city are discussed in the following sections.

POPULATION TRENDS Analyzing over time the lists of “best cities for business” compiled annually by many magazines reveals one consistent trend: Successful small companies in a city tend to track a city’s population growth. In other words, more potential customers mean that a small business has a better chance of success. Detroit, Michigan, once home to a thriving automotive industry, has seen its population shrink from a peak of 1.85 million in 1950 to just 706,000 people. Vacant commercial and residential properties account for 37 square miles of the city’s total area of 139 square miles. Since 1999, median household income has declined 15 percent to just \$25,200 (half that of the entire United States), creating a difficult environment for entrepreneurs.²¹ Provo, Utah, on the other hand, is home to a large and growing population of highly educated young people; nearly 52 percent of the city’s population is between the ages of 20 and 44, the prime time for entrepreneurial activity. The city’s diverse high-tech and software sectors, convenient access to some of the most beautiful natural areas anywhere, availability of venture capital, low crime rate, pro-business policies, low corporate tax rate, and two large universities make it a magnet for entrepreneurs. “It’s the up-and-coming version of Silicon Valley—with better skiing,” says Governor Gary Herbert. For several years, *Forbes* has ranked Provo, which is one of the fastest-growing cities in the United States (see Table 18.3), as one of the best cities for business and for raising a family.²²

By analyzing population trends and other demographic data, an entrepreneur can examine a city in detail, and the location decision becomes more than “a shot in the dark.” Studying the characteristics of a city’s residents, including population sizes and density, growth trends, family size, age breakdowns, education, income levels, job categories, gender, religion, race, and nationality, gives entrepreneurs the facts they need to make an informed location decision. For example, with basic census data, entrepreneurs can determine the value of the homes in an area, how many rooms they contain, how many bedrooms they contain, what percentage of the population own their homes, and the amount of residents’ monthly rental or mortgage payments. Imagine how useful such information would be to someone about to launch a home accessories store! Figure 18.4 shows the 11 megaregions in the United States, large population centers that are linked by interlocking economic systems, shared natural resources and ecosystems, and common transportation systems. Experts expect most of the nation’s rapid population growth—and an even larger share of its economic expansion—to occur in these emerging megaregions over the next several decades.²³

POPULATION DENSITY Population density, the number of residents per square mile, can be another important factor in determining the optimal business location. In many cities in the United States, people live and work in very high-density areas that provide a sizable base of potential customers for local businesses. Businesses that require high-traffic volume, such as restaurants and retail shops, benefit by locating in these high-density areas.

Knowing the population density within a few miles of a potential location gives entrepreneurs a clear picture of whether a city can support their businesses. Fitness club owners have discovered that population density is one of the most important factors in selecting a suitable location. Selecting the right locations is crucial for Anytime Fitness, a chain of fast-growing

TABLE 18.3 Fastest-Growing Metropolitan Areas, 2012–2017

Metropolitan Area	Projected Growth Rate, 2012–2017
1. Provo–Orem, Utah	7.4%
2. Austin–Round Rock, Texas	7.4%
3. Killeen–Temple–Fort Hood, Texas	7.2%
4. Raleigh–Cary, North Carolina	7.2%
5. San Antonio–New Braunfels, Texas	7.1%
6. Ocala, Florida	6.9%
7. Houston–Sugar Land–Baytown, Texas	6.7%
8. Jacksonville, Florida	6.6%
9. Charlotte–Gastonia–Rock Hill, North/South Carolina	6.6%
10. McAllen–Edinburg–Mission, Texas	6.6%

Source: “Household Names,” *Site Selection*, January 2013, p. 24.



FIGURE 18.4
Megaregions in the United States in 2050

Source: “Maps,” America 2050, <http://www.america2050.org/maps/>.

24-hour fitness clubs, because most of its franchisees’ customers live or work within a three-mile radius of a club.²⁴ Information on population density and other important demographic characteristics is available from the publications and online resources described earlier in this chapter.

COMPETITION For some retailers, locating near competitors makes sense because similar businesses located near one another may serve to increase traffic flow to both. This location strategy works well for products for which customers are most likely to comparison shop. For instance, in many cities, auto dealers locate next to one another in a “motor mile,” trying to create a shopping magnet for customers. The convenience of being able to shop for dozens of brands of cars all within a few hundred yards of one another draws customers from a sizable trading area. Of course, the strategy of locating near competitors has limits. Oversaturating an area with businesses of the same type dilutes sales and profits of every competing business.

Studying the size of the market for a product or service and the number of existing competitors helps an entrepreneur determine whether he or she can capture a sufficiently large market share to earn a profit. Again, census reports can be a valuable source of information. *County Business Patterns* gives a breakdown of businesses in manufacturing, wholesale, retail, and service categories and estimates companies’ annual payrolls and number of employees broken down by county. *Zip Code Business Patterns* provides the same data as *County Business Patterns* except that it organizes the data by ZIP code. The *Economic Census*, which is produced for years that end in “2” and “7,” gives an overview of the businesses in an area—their sales (or other measure of output), employment, payroll, and form of organization. It covers eight industry categories—including retail, wholesale, service, manufacturing, construction, and others—and gives statistics not only at the national level but also by state, MSA, county, places with 2,500 or more inhabitants, and ZIP code. The *Economic Census* is a useful tool for helping entrepreneurs determine whether the areas they are considering are competitive with competitors.

CLUSTERING Some cities have characteristics that attract certain industries, and, as a result, companies tend to cluster there. **Clusters** are geographic concentrations of interconnected companies, specialized suppliers, distribution networks, and service providers that are present in a region.²⁵ According to Harvard professor Michael Porter, clusters are important because they allow companies in them to increase their productivity and to gain a competitive edge. For instance, with its highly trained, well-educated, and technologically literate workforce, Austin, Texas, has become a draw for high-tech companies. Home to Dell Inc. and Hewlett-Packard, Austin offers many small technology companies exactly what they need to succeed.

When the concentration of companies in a city reaches the tipping point, other businesses in those industries tend to spring up there as well, drawn by the concentration of skilled workers, specialized service providers, and infrastructure of industry-concentrated resources. Los Angeles is home to a cluster of entertainment companies, New York City hosts publishers and financial companies, Seattle is known for its software cluster, and Raleigh–Durham is renowned for medical research companies.²⁶ Statesville–Mooresville, North Carolina, the leading micropolitan area in the United States (micropolitan areas are the 526 rural counties in which the population of the largest city is less than 50,000 people), houses a cluster of companies in the motorsports industry, which provides more than 25,000 jobs and generates an economic impact of \$6 billion annually. Ninety percent of the teams that race on the NASCAR circuit are based in Statesville–Mooresville, and the area is home to NASCAR’s corporate office, the NASCAR Hall of Fame, numerous race venues, and nine colleges or universities with motorsports-related programs.

ENTREPRENEURIAL PROFILE: Rob Kauffman and Joseph Carroll: RK Motors Drawn by the cluster’s automotive resources, RK Motors, a company founded by Rob Kauffman and Joseph Carroll that restores and sells vintage muscle cars, recently relocated its shop and showroom, the RKM Performance Showroom, to Mooresville (known as “Race City USA”). “Our new shop is close to a lot of our partners,” says Jamie Wiehe, the company’s marketing director. “Many of the people we employ here are the best of the best. Our new location is perfect for us.”²⁷



RK Motors Performance Showroom is located in Mooresville, North Carolina, also known as “Race City USA.”

Source: RK Motors.

COMPATIBILITY WITH THE COMMUNITY One of the intangibles that can be determined only by a visit to an area is the degree of compatibility that a business has with the surrounding community. In other words, a small company’s image must fit in with the character of a town and the needs and wants of its residents.

ENTREPRENEURIAL PROFILE: Joe Masher: Bow Tie Cinemas Bow Tie Cinemas, a fourth-generation family-owned business, recently opened a 17-screen multiplex theater in Richmond, Virginia, the largest theater complex the company has ever opened. When selecting locations for its theaters, Bow Tie looks for communities that are consistent with its image, which involves bringing style and elegance back to the theater experience and providing patrons with superb movie presentations and service. COO Joe Masher says that the chain looks for cities with active arts, medical, and educational communities. “Richmond was a perfect storm for all three,” he says.²⁸

LOCAL LAWS AND REGULATIONS Before settling on a city, entrepreneurs must consider the regulatory burden local government will impose. Government regulations affect many aspects of a small business’s operation, from acquiring business licenses and building permits to erecting business signs and dumping trash. Some cities are regulatory activists, creating so many rules that they discourage business creation; others take a more laissez-faire approach, imposing few restrictions on businesses. One recent survey reports that 29 percent of small business owners across the United States cite layers of overly complicated state and local regulations and licensing requirements as obstacles to their success.²⁹

ENTREPRENEURIAL PROFILE: Juliet Pries: The Ice Cream Bar Entrepreneur Juliet Pries battled a regulatory bureaucracy for two years before she was able to acquire all of the permits, approvals, and licenses required to start her vintage ice cream shop, The Ice Cream Bar, in San Francisco. At one point, the reams of paperwork that she was required to submit (along with thousands of dollars in fees) sat unprocessed in an office for months while Pries continued to pay rent and other expenses so that she would not lose her desired location. Pries persevered, and her shop, which employs 14 people, has become a popular attraction in the Cole Valley neighborhood for both residents and visitors. Inspired by Pries’s story, employees of the city’s planning department made a convoluted approval process that discourages entrepreneurs from launching food-related businesses in San Francisco.³⁰

Zoning laws can have a major impact on an entrepreneur's location decision. New York City passed the first comprehensive zoning laws in 1916, and most cities now have **zoning laws** that divide a city or county into cells or districts to control the use of land, buildings, and sites.³¹ Their purpose is to contain similar activities in suitable locations. For instance, one section of a city may be zoned residential, whereas the primary retail district is zoned commercial and another is zoned industrial to house manufacturing operations. Before selecting a particular site within a city, entrepreneurs must explore local zoning laws to determine whether there are any ordinances that would place restrictions on business activity or that would prohibit establishing a business altogether. Zoning regulations may make a particular location out of bounds. In some cases, an entrepreneur may appeal to the local zoning commission to rezone a site or to grant a **variance** (a special exception to a zoning ordinance), but this is risky and could be devastating if the board disallows the variance. For 23 years, David Donald operated a bar next to a post office near downtown Greenville, South Carolina, before closing it so that he could reopen with a new design and concept. However, when he applied for a business license, the city denied his application twice, pointing out that city council had rezoned the area from "commercial" to "redeveloped." Donald appealed the ruling to the Board of Zoning Appeals, but the board denied his request.³²

As the number of home-based businesses has increased in the last several years, more entrepreneurs have found themselves at odds with zoning regulations. The problem is particularly acute in New York City, where storefront rents can be astronomically high and impossible for most start-up businesses to pay. Entrepreneurs often start home-based businesses even though they are in violation of zoning regulations and are subject to fines.



ENTREPRENEURIAL PROFILE: Lauren Levy: Magnificent Baby When Lauren Levy started Magnificent Baby, an online baby clothing and accessory business, the fifth-floor apartment on New York City's West End Avenue that she shared with her husband served as company headquarters, warehouse, and distribution center. To mollify her neighbors, Levy used their babies as models and allowed them to purchase items at a discount. Magnificent Baby grew quickly, and Levy relocated to an official office in Midtown, paying \$2,500 in monthly rent. In retrospect, Levy says that launching the company from her apartment was the right choice because the start-up could not have survived if she had to pay rent for an office or warehouse space at the outset.³³

APPROPRIATE INFRASTRUCTURE Business owners must consider the quality of the infrastructure in a potential location. Is an airport located nearby? Are flights available to the necessary cities, and are the schedules convenient? If a company needs access to a railroad spur, is one available in the city? How convenient is the area's access to major highways? What about travel distances to major customers? How long will it take to deliver shipments to them? Are the transportation rates reasonable? In some situations, double or triple handling of merchandise and inventory causes transportation costs to skyrocket. For many businesses, the availability of loading zones is an important feature of a suitable location. Some downtown locations suffer from a lack of sufficient space for carriers to load and unload deliveries of merchandise.

TOTAL OPERATING COSTS Just like states, cities vary in the total operating costs that they impose on businesses. When screening cities as potential locations for their businesses, entrepreneurs should examine utility rates, taxes, licenses, real estate prices, transportation costs, and others to gauge their impact on their companies' total operating costs. Table 18.4 shows the 10 largest and the 10 midsize cities in the United States that offer the lowest cost structures for businesses using 26 different cost components as measurements.

INCENTIVES Some cities and counties offer financial and other incentives to encourage businesses that will create jobs to locate within their borders. These incentives range from job training for workers and reduced tax rates to financial grants and loans. "Incentives are a pricing tool that is designed to make a location more cost-competitive for a project," says one site selection consultant.³⁴



ENTREPRENEURIAL PROFILE: Andrew Peykoff: Niagara Bottling LLC Launched in 1963 by Andrew Peykoff, Niagara Bottling LLC, a family-owned producer of private-label bottled water based in Ontario, California, with bottling operations in eight states, recently opened a 256,000-square-foot bottling plant in Missouri City, Texas. Brian Hess, vice president of operations and legal affairs, says that the company "conducted comprehensive research" on several potential

TABLE 18.4 Ten Lowest Cost Large and Midsize Cities in the United States

Rank	Large Cities*	Cost Index**
1	Cincinnati, OH	95.9
2	Atlanta, GA	96.2
3	Orlando, FL	96.3
4	Tampa, FL	96.4
5	Dallas–Fort Worth	96.5
6	Baltimore, MD	97.0
7	St. Louis, MO	97.1
8	Cleveland, OH	97.1
9	Pittsburgh, PA	97.2
10	Phoenix, AZ	97.6
Rank	Midsize Cities***	Cost Index
1	Oklahoma City, OK	95.5
2	Nashville, TN	95.7
3	New Orleans, LA	96.0
4	Indianapolis, IN	96.3
5	Raleigh, NC	96.6
6	Austin, TX	97.0
7	Salt Lake City, UT	97.2
8	Buffalo, NY	97.8
9	Wilmington, DE	98.0
10	Providence, RI	98.0

*U.S. cities with populations of more than 2 million.

**Baseline cost index = 100, which represents the average cost of doing business in the four largest metropolitan areas in the United States: New York, Los Angeles, Chicago, and Dallas–Fort Worth.

***U.S. cities with populations between 1 million and 2 million.

Sources: "Cincinnati Ranked Lowest-Cost Business Location Among Large U.S. Cities; Atlanta at Second: KPMG Study," KPMG, March 22, 2012, www.kpmg.com/us/en/issuesandinsights/articlespublications/press-releases/pages/cincinnati-ranked-lowest-cost-business-location-among-large-us-cities-atlanta-close-at-second-kpmg-study.aspx; "Oklahoma City, Nashville Ranked Most Cost-Attractive Business Locations Among Mid-Sized U.S. Cities: KPMG Study," KPMG, March 22, 2012, www.kpmg.com/us/en/issuesandinsights/articlespublications/press-releases/pages/oklahoma-city-nashville-ranked-most-cost-attractive-business-locations-among-mid-sized-us-cities-kpmg-study.aspx.

locations before selecting Missouri City because it offered an ample water supply, low start-up and operating costs, a pro-business environment, and an attractive incentive package. The city and the local water commission offered Niagara Bottling a 60 percent tax abatement over 10 years, a streamlined permitting process, and workforce training through local community colleges. The new plant operates three bottling lines and employs 96 people.³⁵

QUALITY OF LIFE A final consideration when selecting a city is the quality of life it offers. Entrepreneurs have the freedom and the flexibility to locate their companies in cities that suit not only their business needs but also their personal preferences. When choosing locations for their companies, entrepreneurs often consider factors such as cultural events, outdoor activities, entertainment opportunities, safety, and the city's "personality." Cities that offer comfortable weather, cultural events, colleges and universities, museums, funky music venues, outdoor activities, concerts, unique restaurants, and an interesting nightlife have become magnets for entrepreneurs looking to start companies. The cultural infrastructure of cities such as Austin, Boston, Seattle, San Francisco, Washington, Dallas, Minneapolis, Portland, Boulder, and others have made them incubators for creativity and entrepreneurship as educated young people drawn by the cities' quality of life have moved in. RelocateAmerica recently named Greenville, South

Atlanta, Georgia, as one of the best places to live in America because its low cost of living, mild climate, affordable housing, exceptional health care, and award-winning school systems create an overall quality of life that is unmatched by many other cities.



ENTREPRENEURIAL PROFILE: Krish Patel: Wireless Communications Krish Patel chose thriving downtown Greenville, South Carolina, as the location for the headquarters for his company, Wireless Communications, a chain of 35 Verizon Wireless retail stores. Patel and the 15 employees who work in the downtown office enjoy the ability to stroll the quaint, tree-lined downtown streets; eat lunch at one of the many local restaurants; watch the Reedy River flow by in nearby Falls Park; and ride their bikes on or hike the nearby Swamp Rabbit Trail. “I enjoy the community and the business energy,” says Patel. “You can’t lose being in downtown Greenville.”³⁶

Not only can a location in a city offering a high quality of life away from the workplace be attractive to an entrepreneur, but it also allows businesses to attract and retain a quality workforce. According to a study of the importance of location on recruiting employees conducted by the Human Capital Institute, the three most important factors in attracting talent are job opportunities, a clean and safe community, and an affordable cost of living.³⁷

The Final Site Selection

Successful entrepreneurs develop a site evaluation system that is both detailed and methodical. Each type of business has its own unique set of location criteria, and entrepreneurs must use them to screen potential locations to find the best possible site. Manufacturers must consider access to customers, raw material, suppliers, labor, and suitable transportation. Service companies require ready access to their customers but usually can operate in lower-rent areas, whereas retailers’

Entrepreneurship in Action

The Ideal Spot

Mark McCausland, president of Ultramain Systems, a company that produces software that monitors the maintenance and logistics schedules for jets, transport trucks, and other assets, was so pleased with his company’s location in Albuquerque, New Mexico, that when it was time to expand, he never considered moving anywhere else. The high-tech company, whose primary customers are the major airlines, recently moved its 100 employees into a new 30,000-square-foot headquarters just one-half mile from its original location. “We could be located virtually anywhere, but the attractions of Albuquerque are very compelling,” he says. McCausland says that the nearby airport, Albuquerque International Sunport, is an important benefit. “Our customers are located all over the world—Hong Kong, Dubai, London, and Amsterdam,” he says. “I can catch a direct flight to these locations or reach them with just one connection.”

For a company such as Ultramain Systems, Albuquerque offers many other benefits. “New Mexico has a technology R&D credit,” says McCausland. “That is what we do—high tech R&D. That tax credit is very attractive to a technology company like ours.” In addition to tax benefits, Ultramain Systems enjoys the benefit of low operating costs in the Southwest and a sound business infrastructure. “There is very good fiber and Internet connectivity here,” according to McCausland, who often hires graduates from both the University of New Mexico located in

Albuquerque and the New Mexico Institute of Mining and Technology located in nearby Socorro. “There are good computer science programs here. Nanotechnology and plasma research are being done here. Microchip manufacturing is done here. This may not be Silicon Valley, but it is still a great location for technology companies.”

Albuquerque’s quality of life also is an advantage, especially when it comes to recruiting employees. “The traffic here is very easy,” says McCausland. “The weather here is stellar, and the amenities are very good. [Albuquerque] is a big enough town that you have all the cultural and social amenities that you could want.”

1. What criteria do high-tech companies such as Ultramain Systems seek when selecting a location?
2. What factors make Albuquerque, New Mexico, a good location for Ultramain Systems?
3. Use one of the Web sites described earlier in this chapter, such as the U.S. Census Bureau, ZoomProspector, and others, to develop a demographic profile of Albuquerque. Is your profile consistent with the criteria you identified in question 1?

Source: Based on Ron Stamer, “Back to School,” *Site Selection*, November 2012, pp. 142–149.

prime consideration is a sufficient flow of customer traffic. The one element common to all three is the need to locate where customers want to do business.



ENTREPRENEURIAL PROFILE: Tom Jednorowicz: Meatheads Burgers and Fries

Tom Jednorowicz, founder of Meatheads Burgers and Fries, a small chain of premium hamburger restaurants with 11 locations in Illinois, recently opened the chain's first outlet in urban Chicago, a significant departure from its normal locations in suburban neighborhoods, where concentrations of its target customers are highest. The restaurant is in Chicago's Roscoe Village neighborhood, which has a population of more than 15,000, on a site that is next to an upscale grocery store and a large high school. The area has a high concentration of Meatheads's target customers. "Meatheads is a family concept," says Jednorowicz. "Whether the location is urban or suburban, we're looking first and foremost to appeal to that Mom, Dad, school-age kids unit. That's why we're here in Roscoe Village."³⁸

The site location decision draws on the most precise information available on the makeup of the area. Using the sources of published statistics described earlier in this chapter, an entrepreneur can develop valuable insights into the characteristics of people and businesses in the immediate community. After narrowing the list of potential locations using statistics, entrepreneurs must visit each site for a firsthand view of its suitability. Many sites that look good "on paper" may be unsuitable because of other factors. On-site visits to potential locations are essential because they allow entrepreneurs to evaluate each site's intangible aspects.

Rental or lease rates are an important factor when choosing a site. The location with the lowest rental rate may not be the best deal, however. "Cheap" rental rates often indicate second-class locations (and the resulting poor revenues they generate). Locations along New York City's Fifth Avenue command some of the highest rental rates in the nation. Between 42nd and 49th Streets, retail stores pay an average of \$800 *per square foot* per year, double the average rent for retail space on Los Angeles's tony Rodeo Drive. Locations north of 49th Street charge up to \$3,000 *per square foot* per year. The high-volume locations pay off, however; many stores, such as high-end retailers Cartier, Tiffany & Co., and Bergdorf Goodman and mid-priced stores such as H&M and Zara, generate annual sales of more than \$15,000 per square foot per year. (By comparison, stores in the most productive malls, such as the Forum Shops at Caesars in Las Vegas, generate annual sales of \$1,400 per square foot.³⁹)

Of course, entrepreneurs must be sure that the rent or lease payments for a particular location fit comfortably into their companies' financial structure.



ENTREPRENEURIAL PROFILE: George Madeckas: The Clock

George Madeckas, owner of The Clock, an iconic restaurant that opened in 1953 at a busy intersection in Greenville, South Carolina, recently closed the popular eatery after the landlord raised the rent on the location from \$2,400 per month to \$3,900 per month. Madeckas says that the higher rent means that the restaurant, revered by generations of locals for its delicious burgers and fries, could no longer operate profitably at the location. After 60 years in the same location, "it's time to move on," says Madeckas, who hopes to reopen in a location that his business can afford.⁴⁰

Many businesses are downsizing their outlets to lower their start-up and operating costs and to allow for a greater number of location options that are not available to full-size stores. Many quick-service restaurants are placing smaller, less expensive outlets in locations that cannot support a full-size store and are finding that sales per square foot exceed those of traditional franchise outlets.⁴¹ Freshens, an Atlanta, Georgia-based chain of frozen yogurt and smoothie shops, is experimenting with kiosks that are just 400 square feet, much smaller than the company's traditional outlets. The compact stores, which attract attention with their bold graphics, bright colors, and contemporary design, allow the company to get its products in front of more customers by placing them in convenient locations, such as high-profile regional malls, and in high-traffic locations that are not capable of housing larger, traditional stores, such as airports and college campuses.⁴² Retailers and restaurateurs have discovered that these nontraditional locations can generate three to five times more traffic than shopping centers and malls.

Finally, an entrepreneur must be careful to select a site that creates the right impression for a business in customers' eyes. A company's location speaks volumes about a company's "personality."

Source: CartoonStock.



"The best thing about Ann's Aerobics is its location."

Location Criteria for Retail and Service Businesses

2.

Describe the location criteria for retail and service businesses.

Few decisions are as important for retailers and service firms as the choice of a location. Because their success depends on a steady flow of customers, these businesses must locate their businesses with their target customers' convenience and preferences in mind. The following are important considerations.

Trade Area Size

Every retail and service business should determine the extent of its **trade area**, the region from which a business can expect to draw customers. The primary variables that influence the scope of the trading area are the type and the size of the business. If a retail store specializes in a particular product line and offers a wide selection and knowledgeable sales people, it may draw customers from a great distance. The stores of outdoor outfitter Cabela's, many of which contain 200,000 square feet of retail space, are "destination stores" that feature museum-quality taxidermy displays, 55,000-gallon aquariums stocked with fish, restaurants, and an extensive product line of camping, hunting, fishing, hiking, and other outdoor gear. Although most of Cabela's 42 stores are in rural locations, they draw customers from hundreds of miles away and are popular destinations for tourists. In contrast, a convenience store with a general line of merchandise has a small trading area because it is unlikely that customers will drive across town to purchase items that are available within blocks of their homes or businesses. As a rule, the larger the store, the greater its selection, and the better its service, the broader is its trading area. Businesses that offer a narrow selection of products and services tend to have smaller trading areas. For instance, the majority of a massage therapist's clients live within three to five miles of the location with a secondary tier of clients who live within 5 to 10 miles. Clients who are willing to travel more than 15 minutes for a session are rare.⁴³

The following environmental factors also influence trade area size.

RETAIL COMPATIBILITY Shoppers tend to be drawn to clusters of related businesses. That is one reason that shopping malls, lifestyle centers, and outlet shopping centers are popular destinations for shoppers and attractive locations for retailers. The concentration of businesses pulls customers from a larger trading area than a single freestanding business does. **Retail compatibility** describes the benefits a company receives by locating near other businesses selling complementary products and services or that generate a high volume of foot traffic. Clever retailers choose their locations with an eye on the surrounding mix of businesses. For instance, grocery store operators prefer not to locate in shopping centers with movie theaters, offices, and fitness centers, businesses whose customers occupy parking spaces for extended time periods. Drugstores, nail salons, and ice cream parlors have proved to be much better shopping center neighbors for grocers.

DEGREE OF COMPETITION The size, location, and activity of competing businesses also influence the size of the trading area. If a business is the first of its kind in a location, its trading area might be extensive. However, if the area already has multiple stores nearby that are direct competitors, its trade area is diminished significantly. Market saturation is a problem for businesses in many industries, ranging from fast-food restaurants to convenience stores.

TRANSPORTATION NETWORK The transportation networks are the highways, roads, and public service routes that presently exist or are planned. An inconvenient location reduces the business's trading area. Entrepreneurs should check to see whether the transportation system works smoothly and is free of barriers that might prevent customers from reaching their stores. Can customers traveling on the opposite side of the road have easy access to the store's entrance? Do signs and traffic lights allow traffic to flow smoothly?

PHYSICAL AND PSYCHOLOGICAL BARRIERS Physical barriers may be parks, rivers, lakes, or any other obstruction that hinders customers' access to an area. Locating on one side of a large park may reduce the number of customers who will drive around it to get to the store. In urban areas, new immigrants tend to cluster together, sharing a common culture and language. These trading areas are defined by cultural barriers, where inhabitants are loyal patrons of the businesses in their neighborhoods. The Little Havana section of Miami or the Chinatown sections of San Francisco, New York, and Los Angeles are examples. One powerful emotional barrier is safety. If high-crime areas exist around a site, potential customers are likely to avoid business located there.

Entrepreneurs should evaluate the characteristics of a trade area thoroughly, and the matrix in Table 18.5 is a helpful tool for conducting an analysis. Once entrepreneurs rank each factor in relative importance and assign a score on the 1-to-5 scale, they simply multiply the two values to get a score for each characteristic. Adding up the scores produces a total score. (Higher is better.)

Customer Traffic

Perhaps the most important screening criterion for a potential retail and a service location is the number of potential customers passing by the site during business hours. To be successful, a business must be able to generate sufficient sales to surpass its break-even point, and that requires an ample volume of traffic. The key success factor for many retail stores is a high-volume location with easy accessibility. Entrepreneurs should use traffic counts (pedestrian and/or auto) and traffic pattern studies to confirm that the sites they are considering as potential locations are capable of generating sufficient sales volume.

Adequate Parking

If customers cannot find convenient and safe parking, they are not likely to stop in the area. Because of the limited space available, some downtown areas suffer from inadequate parking.

TABLE 18.5 Retail Trading Area Analysis

Characteristics	Relative Importance										Trading Area Score					Weighted Score Area A		Weighted Score Area B	
	1—Low, 10—High										1—Major Disadvantage, 5—Major Advantage					(Importance × Score)		(Importance × Score)	
	1	2	3	4	5	6	7	8	9	10	1	2	3	4	5				
Population size																			
Population density																			
Per capita disposable income																			
Buying power																			
Education level																			
Age distribution																			
Number of existing competitors																			
Strength of existing competitors																			
Level of market saturation																			
Population growth projections																			
Available parking																			
Visibility																			
Ease of access																			
Other:																			

Although shopping malls typically average five parking spaces per 1,000 square feet of shopping space, many central business districts get by with 3.5 spaces per 1,000 square feet. Even when a business provides free parking, some potential customers may not feel safe on the streets, especially after dark. Many large city business districts become virtual ghost towns at the end of the business day. A location where traffic vanishes after 6 P.M. may not be as valuable as mall and shopping center locations that mark the beginning of the prime sales at 6 P.M.

Reputation

Like people, a site can have a bad reputation. Sites in which businesses have failed repeatedly create negative impressions in customers' minds; many people view the business as just another that soon will be gone. Sometimes previous failures are indicative of a fundamental problem with the location itself; in other cases, the cause of the previous failure was the result not of a poor location but of a poorly managed business. When entrepreneurs decide to conduct business in a location that has housed previous failures, it is essential that they make many highly visible changes to the site so that customers perceive the company as a "fresh start."

Visibility

No matter what a retailer sells or how well it serves customers' needs, it cannot survive without visibility. Highly visible locations simply make it easy for customers to find the business and make purchases. A site lacking visibility puts a company at a major disadvantage before it even opens its doors. In a competitive marketplace, customers seldom search for a business when equally attractive alternatives are easy to locate.

Some service businesses, however, can select sites with less visibility if the majority of their customer contacts are by telephone, fax, or the Internet. For example, customers usually contact plumbers by telephone, so, rather than locating close to their customer bases, plumbers have flexibility in choosing their locations. Similarly, businesses that work at their customers' homes, such as swimming pool services, can operate from their homes and service vehicles.

The Index of Retail Saturation

The index of retail saturation (IRS) is a measure of the potential sales per square foot of store space for a given product within a specific trading area. This measure combines the number of customers in a trading area, their purchasing power, and the level of competition. The index is the ratio of a trading area's sales potential for a particular product or service to its sales capacity:

$$IRS = \frac{C \times RE}{RF}$$

where

C = number of customers in the trading area

RE = retail expenditures (the average expenditure per person [\$] for the product in the trading area)

RF = retail facilities (the total square feet of selling space allocated to the product in the trading area)

This computation is an important one for any retailer to make. Locating in an area already saturated with competitors results in dismal sales volume and often leads to failure.

To illustrate the index of retail saturation, suppose that an entrepreneur looking at two sites for a sports store finds that he needs sales of \$175 per square foot to be profitable. Site 1 has a trading area with 25,875 potential customers, each of whom spends an average of \$42 on sports annually; the only competitor in the trading area has 6,000 square feet of selling space. Site 2 has 27,750 potential customers spending an average of \$43.50 on sports annually; two competitors occupy 8,400 square feet of space. The IRS of site 1 is as follows:

$$IRS = \frac{25,875 \times 42}{6,000}$$

$$= \$181.12 \text{ sales potential per square foot}$$

The IRS of site 2 is as follows:

$$\begin{aligned} IRS &= \frac{27,750 \times 43.50}{8,400} \\ &= \$143.71 \text{ sales potential per square foot} \end{aligned}$$

Although site 2 appears to be more favorable on the surface, site 1 is supported by the index; site 2 fails to meet the minimum standard of \$175 per square foot.

Reilly's Law of Retail Gravitation

Reilly's Law of Retail Gravitation, a classic work in market analysis published in 1931 by William J. Reilly, uses the analogy of gravity to estimate the attractiveness of a particular business to potential customers. The ability to draw customers is directly related to the extent to which customers see it as a "destination" and is inversely related to the distance that customers must travel to reach the business. Reilly's model also provides a way to estimate the trade boundary between two market areas by calculating the "break point" between them. The break point between two primary market areas is the boundary between the two where customers become indifferent about shopping at one or the other. The key factor in determining this point of indifference is the size of the communities. If two nearby cities have the same population sizes, then the break point lies halfway between them. The following is the equation for Reilly's Law:⁴⁴

$$BP = \frac{d}{1 + \sqrt{P_b/P_a}}$$

where

BP = distance in miles from location A to the break point

d = distance in miles between locations A and B

P_a = population surrounding location A

P_b = population surrounding location B

For example, if city A and city B are 22 miles apart and city A has a population of 22,500 and city B has a population of 42,900, the break point according to Reilly's law is as follows:

$$BP = \frac{22}{1 + \sqrt{42,900/22,500}} = 9.2 \text{ miles}$$

The outer edge of city A's trading area lies about nine miles between city A and city B. Although only a rough estimate, this simple calculation using readily available data can be useful for screening potential locations.



In the Entrepreneurial Spotlight

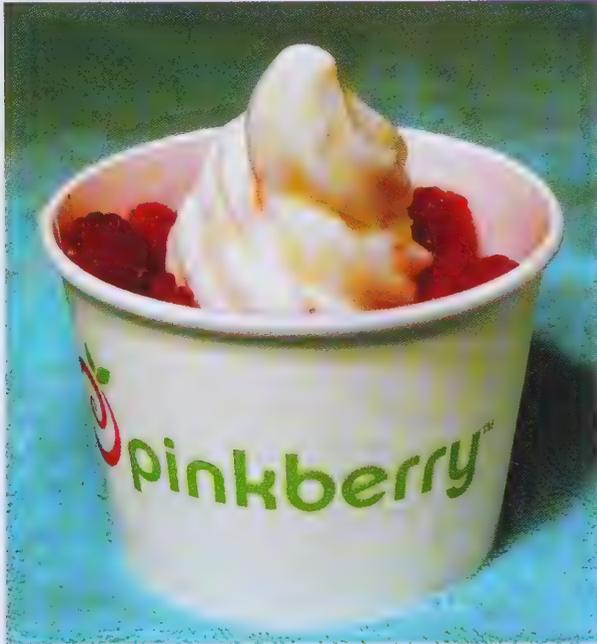
Transformed Locations

Entrepreneurs, by their nature, are risk takers, but the most successful entrepreneurs take the necessary steps to minimize the risks they face in their businesses. Rob Stumm, who operates three Pinkberry Frozen Yogurt franchises with his daughters Courtney and Celie, and John Jeter, founder of The Handlebar, a pub/café/concert venue in Greenville, South Carolina, personify the dogged persistence and willingness to step out and take a chance when they are confident that they have made the right decisions. Stumm opened his first Pinkberry franchise in an ideal location in the center of New Orleans, an area he had researched thoroughly and, as a New Orleans native, knew quite well. "With

a Whole Foods and other similar stores across the street, we knew our customers would be there," he says. "We knew our second location had to yield the same results."

With his first franchise outlet operating successfully, Stumm began to focus on finding the location for his second franchise. The location that Stumm selected, however, caused some observers to doubt. "Before we came in, the site of our second store was not what you would consider ideal," he admits. Located on an odd-shaped lot in what was then a rough section of the French Quarter, the site was home to an old gazebo where employees of a neighboring hotel took their smoke breaks, yet Stumm, a

In the Entrepreneurial Spotlight *(continued)*



Pinkberry Frozen yogurt.

Source: Jonathan Alcorn/Newscom.

licensed architect, saw the site as a diamond in the rough. Retail shops thrived less than a block away, and the historic French Quarter drew millions of tourists and potential customers annually. Undeterred, Stumm convinced Pinkberry officials that the location would be successful and purchased it. “Franchisees should never compromise on real estate,” advises Stumm. “We knew our target market going into our second location and didn’t want to settle on a location that might be easier to set up but would be farther away from our customers.” Stumm says that the second outlet was the most expensive to build, in part because of the need to customize the building to fit onto the odd-shaped lot. The location also has proved to be the most successful of the three (soon to be four) outlets that Stumm owns. In fact, the French Quarter location is one of the most successful units in the entire Pinkberry chain.

John Jeter faced a similar issue when he decided to open The Handlebar, which he bills as a “listening room, pub, and café,” in a former Oldsmobile dealership in Greenville’s North End. The city has won numerous awards and has become a model of downtown revitalization, but none of the revitalization efforts had reached the North End when Jeter opened for business in 2001. However, Jeter looked around at the crumbled buildings, weed-choked sidewalks, and tattered strip of gas stations and

miscellaneous businesses and envisioned a city gem—a “cultural anchor,” a place with a bohemian attitude that would house a village of creative ventures. “People thought we were nuts,” recalls Jeter. “Everybody said we should move to the West End (the thriving sector of the city that was the first to benefit from its revitalization efforts), but the real estate was exorbitant.”

Jeter’s risk paid off. By booking up-and-coming musicians such as John Mayer, Jennifer Nettles, Corey Smith, Indigo Girl Amy Ray, Zac Brown, and others, The Handlebar began attracting a loyal following of customers. “That’s what an entertainment venue does,” he says. “It brings people into a part of town after hours. There’s life on the street. Everybody feels safer, and things take off from there.” Soon, entrepreneur Gene Burger transformed a nearby former Amoco gas station into Horizon Records, and Mike Goe opened the Wood and Wire Guitar Shop. Other businesses, including a florist, an antique store, and a bevy of artists, quickly followed, and the North End began to look like the thriving cultural anchor that Jeter had envisioned all along. “[It was] a ghost town around there in the evenings, but now a whole cluster of entertainment activities and businesses have come in and more are coming,” says a city economic development official. “Something like The Handlebar makes all the difference in revitalizing a neighborhood.”

The Handlebar is an integral part of Greenville’s cultural infrastructure and was the key component in the revitalization of the city’s North End. A new master plan for the area calls for a \$200,000 streetscape project that includes pocket parks, bike paths, flower beds, and wider sidewalks that are designed to draw more shoppers. Many merchants say it is the tipping point that will allow their unique cultural village to become the gem that Jeter envisioned many years ago. “We’re marching out of the mainstream,” he jokes, “but we’ve been doing that since we started.”

1. What risks did Rob Stumm and John Jeter take by choosing what many people considered less-than-ideal locations for their businesses?
2. Work with several of your classmates to select an area of your community that suffers from some of the maladies that Stumm and Jeter faced and develop a plan for revitalizing it. What steps would you have to take first to make the area attractive to potential entrepreneurs? What could local government do to encourage entrepreneurs to locate there?

Sources: Based on Robert Thomas, “Finding the Real Estate Diamond in the Rough,” *QSR Magazine*, May 2012, www.qsrmagazine.com/growth/finding-real-estate-diamond-rough; Anna Lee, “The Handlebar’s Song,” *Greenville News*, May 19, 2012, pp. 1A, 3A.

Location Options for Retail and Service Businesses

Retail and service business owners can locate in nine basic areas: the central business district, neighborhoods, shopping centers and malls, near competitors, shared spaces, inside large retail stores, nontraditional locations, at home, and on the road. According to Reis Inc., the average cost to lease space in a shopping center is about \$19 per square foot, and at malls, lease rates average \$39 per square foot. In central business locations, the average cost is between \$22 and \$45 per square foot (rental rates vary significantly, depending on the city).⁴⁵ Of course, cost is just one factor a business owner must consider when choosing a location.

3.

Outline the basic location options for retail and service businesses.

Central Business District

The central business district (CBD) is the traditional center of town—the downtown concentration of businesses established early in the development of most towns and cities. Entrepreneurs derive several advantages from a downtown location. Because businesses are centrally located, they attract customers from the entire trading area of the city. In addition, small businesses benefit from the traffic generated by other stores clustered in the downtown district. However, locating in a CBD does have certain disadvantages. Intense competition, high rental rates, traffic congestion, and inadequate parking facilities characterize some CBDs. In addition, many cities have experienced difficulty in preventing the decay of their older downtown business districts. Downtown districts withered as residents moved to the suburbs and began shopping at newer, more convenient shopping centers and malls.

Today, however, many of these CBDs are experiencing rebirth as cities restore them to their former splendor and shoppers return. Many customers find irresistible the charming atmosphere that traditional downtown districts offer with their rich mix of stores, their unique architecture and streetscapes, and their historic character. Cities have begun to reverse the urban decay of their downtown business districts through proactive revitalization programs designed to attract visitors and residents alike to cultural events by locating theaters and museums, hosting festivals, and sponsoring special events such as ice skating in the downtown area. In addition, many cities are providing economic incentives to real estate developers to build apartment and condominium complexes in the heart of their downtown districts. Vitality is returning as residents live and shop in the once nearly abandoned downtown areas. The “ghost-town” image is being replaced by both younger and older residents who love the convenience and excitement of life at the center of the city.



ENTREPRENEURIAL PROFILE: Casey Karnes: B1 Bicycles Columbus, Ohio’s, CBD suffered from many of the same maladies as other cities, but city officials have focused their efforts on refurbishing it. A study that the city conducted concludes that a \$375 million retail gap exists in downtown Columbus. “There is a huge unmet demand for goods and services downtown,” says one city official. “It’s one of the largest untapped retail markets in central Ohio.” The 100,000 employees who work downtown make up the largest potential customer base, but more than 39,000 students who attend classes at four locations in the CBD are also a significant market. More than 6,200 people live downtown, and neighborhoods that are within two miles of the CBD are home to 65,000 residents. Casey Karnes, who opened B1 Bicycles, a full-service bicycle shop in the CBD in 2007, in the early stages of the downtown revitalization effort, is pleased with his downtown location and says that his company’s sales are growing fast. “There’s still a lot of room for expansion, a lot of room for people to be part of downtown retail, but having more restaurants and more people moving downtown is helping.”⁴⁶

Neighborhood Locations

Small businesses that locate near residential areas rely heavily on the local trading areas for business. For example, many grocers and convenience stores located just outside residential subdivisions count on local customers for successful operation. One study of food stores reports that the majority of the typical grocers’ customers live within a five-mile radius. The primary advantages of a neighborhood location include relatively low operating costs and rents and close contact with customers.



ENTREPRENEURIAL PROFILE: Danny Meyer: Shake Shack Danny Meyer, founder of Union Square Hospitality Group, owns three of the *Zagat Guide*’s top five fine-dining restaurants in Manhattan. Meyer also operates Shake Shack, an upscale hamburger restaurant (plus wine, beer, and ShackMeister Ale) with nine locations in major urban areas or in sports venues. Meyer recently opened the first Shake Shack outlet in suburbia, choosing a location in affluent West Port, Connecticut, as the site for his experiment to determine whether the business model will succeed outside of densely populated urban areas. Unlike the typical fast-food chains, Shake Shack uses soft, muted colors that fit into the upscale neighborhood. “Our customer is the person who says, ‘I don’t eat at fast-food restaurants, but when I choose to eat a burger and fries or a shake, I want a good one, and that’s why I’m coming to Shake Shack,’” says Randy Garutti, Shake Shack’s CEO.⁴⁷

Shopping Centers and Malls

Until the early twentieth century, CBDs were the primary shopping venues in the United States. As cars and transportation networks became more popular in the 1920s, shopping centers began popping up outside the CBDs. Then in October 1956, the nation’s first shopping mall, Southdale,

opened in the Minneapolis, Minnesota, suburb of Edina. Designed by Victor Gruen, the fully enclosed mall featured 72 shops anchored by two competing department stores (a radical concept at the time), a garden courtyard with a goldfish pond, an aviary, hanging plants, and artificial trees. With its multilevel layout and parking garage, Southdale was a huge success and forever changed the way Americans would shop.⁴⁸ Today, the nation's nearly 113,000 shopping centers and malls, which encompass more than 8.8 billion square feet of retail space, have become a mainstay of the American landscape. Because many different types of stores operate under one roof, shopping malls give meaning to the term "one-stop shopping." In a typical month, nearly 187 million adults visit malls or shopping centers, generating \$2.4 trillion in annual sales, representing 55 percent of all retail sales.⁴⁹ There are eight types of shopping centers (see Table 18.6):

- **Neighborhood shopping centers.** The typical neighborhood shopping center is relatively small, containing from 3 to 12 stores and serving a population of up to 40,000 people who live within a 10-minute drive. The anchor store in these centers is usually a supermarket or a drugstore. Neighborhood shopping centers typically are straight-line strip malls with parking available in front and primarily serve the daily shopping needs of customers in the surrounding area.
- **Community shopping centers.** A community shopping center contains from 12 to 50 stores and serves a population ranging from 40,000 to 150,000 people. The leading tenant often is a large department or variety store, a super drugstore, or a supermarket. Community shopping centers sell more clothing and other soft goods than do neighborhood shopping centers. Of the eight types of shopping centers, community shopping centers take on the greatest variety of shapes, designs, and tenants.
- **Power centers.** A power center combines the drawing strength of a large regional mall with the convenience of a neighborhood shopping center. Anchored by several large specialty retailers, such as warehouse clubs, discount department stores, or large specialty stores, these centers target older, wealthier Baby Boomers, who want selection and convenience. Anchor stores usually account for 80 percent of power center space, compared with 50 percent in the typical community shopping center. Just as in a shopping mall, small businesses can benefit from the traffic generated by anchor stores, but they must choose their locations carefully so that they are not overshadowed by their larger neighbors.
- **Theme or festival centers.** Festival shopping centers employ a unifying theme that individual stores display in their decor and sometimes in the merchandise they sell. Entertainment is a common theme for these shopping centers, which often target tourists. Many festival shopping centers are located in urban areas and are housed in older, sometimes historic buildings that have been renovated to serve as shopping centers.
- **Outlet centers.** As their name suggests, outlet centers feature manufacturers' and retailers' outlet stores selling name-brand goods at a discount. Unlike most other types of shopping centers, outlet centers typically have no anchor stores; the discounted merchandise they offer draws sufficient traffic. Most outlet centers are open-air and are laid out in strips or in clusters, creating small "villages" of shops.
- **Lifestyle (or town) centers.** Typically located near affluent residential neighborhoods where their target customers live, lifestyle centers are designed to look less like shopping centers and malls and more like the busy streets in the CBDs that existed in towns and cities in their heyday. Occupied by many upscale national chain specialty stores, such as Williams Sonoma, Talbot's, Pottery Barn, Pier 1 Imports, Jos. A. Bank Clothiers, and others, these centers combine shopping convenience, dining, and entertainment, ranging from movie theaters and open-air concerts to art galleries and people watching. Some centers also include residential space, often located above the ground-level retail shops. "Lifestyle centers create a shopping-leisure destination that's an extension of customers' personal lifestyles," says one industry expert. The typical lifestyle center generates between \$400 and \$500 in sales per square foot compared to \$350 to \$375 in sales per square foot in traditional malls.⁵⁰ Lifestyle centers are among the most popular types of shopping centers being built today. The first lifestyle center, The Shops of Saddle Creek, opened in Germantown, Tennessee, in 1987. Today, more than 400 lifestyle centers operate across the United States.⁵¹
- **Regional shopping malls.** The regional shopping mall is a large shopping area, usually from 5 to 15 miles or more in all directions. These enclosed malls contain from 50 to

TABLE 18.6 Types of Shopping Centers

Type of Shopping Center	Concept	Square Footage (including anchors)	Acreage	Typical Anchor		Anchor Ratio (%) ^a	Primary Trade Area (miles) ^b
				Number	Type		
Malls							
Regional center	General and fashion merchandise; mall (typically enclosed)	480,000–800,000	40–100	2 or more	Full-line department store; junior department store; mass merchant; discount department store; fashion apparel	50–70	5–15
Super-regional center	Similar to regional center but offers more variety	>800,000	60–120	3 or more	Full-line department store; junior department store; mass merchant; fashion apparel	50–70	5–25
Open-air centers							
Neighborhood center	Convenience	30,000–150,000	3–15	1 or more	Supermarket	30–50	3
Community center	General merchandise; convenience	100,000–350,000	10–40	2 or more	Discount department store; supermarket; drug; home improvement; large specialty or discount apparel	40–60	3–6
Lifestyle center	Upscale national chain specialty stores, dining, and entertainment in an outdoor setting	150,000–500,000 but can be larger or smaller	10–40	0–2	Not usually anchored in the traditional sense but may include bookstore; large specialty retailers; multiplex cinema; small department store	0–50	8–12
Power center	Category-dominant anchors; few small business tenants	250,000–600,000	25–80	3 or more	Category killer; home improvement; discount; department store; warehouse club; off-price	75–90	5–10
Theme/festival center	Leisure; tourist oriented; retail and service	80,000–250,000	5–20	Unspecified	Restaurants; entertainment	N/A	25–75
Outlet center	Manufacturers' outlet stores	50,000–400,000	10–50	N/A	Manufacturers' outlet stores	N/A	25–75

^aThe share of a center's total square footage that is occupied by its anchors.

^bThe area from which 60% to 80% of the center's sales originate.

Source: International Council of Shopping Centers, New York.

100 stores and serve a population of 150,000 or more living within a 20- to 40-minute drive. The anchor is typically one or more major department stores with smaller specialty stores occupying the spaces between the anchors. Clothing is the most popular item sold in regional shopping malls.

- **Super-regional shopping malls.** A super-regional mall is similar to a regional mall but is bigger, containing more anchor stores and a greater variety of shops selling deeper lines of merchandise. Its trade area stretches up to 25 or more miles. Canada's West Edmonton Mall, the largest mall in North America, with more than 800 stores and 100 restaurants in 5.3 million square feet, is one of the most famous super-regional malls in the world. In addition to its abundance of retail shops, the mall contains an ice skating rink, a water park, two hotels, an amusement park, a luge tower, miniature golf courses, and a 21-screen movie complex. Currently, more than 1,500 regional and super-regional shopping malls operate in the United States.

When evaluating a mall or shopping center location, an entrepreneur should consider the following questions:

- Is there a good fit with other products and brands sold in the mall or center?
- Who are the other tenants? Which stores are the anchors that will bring people into the mall or center?
- Demographically, is the center a good fit for your products or services? What are its customer demographics?
- How much foot traffic does the mall or center generate? How much traffic passes the specific site you are considering?
- How much vehicle traffic does the mall or center generate? Check its proximity to major population centers, the volume of tourists it draws, and the volume of drive-by freeway traffic. A mall or center that scores well on all three is more likely to be a winner.
- What is the mall's vacancy rate? What is the turnover rate of its tenants?
- How much is the rent, and how is it calculated? Most mall tenants pay a base amount of rent plus a small percentage of their sales above a specified level.
- Is the mall or center successful? How much does it generate in sales per square foot? (Experts say that if a mall's sales per square foot slips below \$300, it is doomed.⁵²) The International Council of Shopping Centers in New York (www.icsc.org) is a good source of industry information.

A mall location is no guarantee of business success, however. Malls have been under pressure lately. About one-third of the malls in the United States are thriving, and many weaker ones (known as “greyfields”) have been demolished or redeveloped. The basic problem is an oversupply of mall space; there is 22.5 square feet of mall retail space for every person in the United States! The last new enclosed mall in the United States opened in 2006.⁵³ In addition, the demographic makeup of an area's shoppers often changes over time, creating a new socioeconomic customer base that may or may not be compatible with a small company's target customer profile. As a result, many malls have undergone extensive renovations to emphasize “entertailing,” adding entertainment features to their existing retail space in an attempt to generate more traffic. For instance, in addition to its 520 retail shops and 60 restaurants, Minneapolis's Mall of America, the largest mall in the United States (located only a few miles from Southdale, the nation's first mall), includes a Nickelodeon Universe amusement park at its center, a 1.2-million-gallon aquarium, a flight simulator, and a 14-screen movie complex in its 4.2 million square feet of space. The Mall of America, which attracts 40 million visitors per year, could hold seven Yankee Stadiums but does not make the top 10 list of largest malls in the world.⁵⁴

Near Competitors

One of the most important factors in choosing a retail or service location is the compatibility of nearby stores with the retail or service customer. For example, stores selling high-priced goods such as cars or merchandise that requires comparisons, such as antiques, find it advantageous to locate near competitors to facilitate comparison shopping. Locating near competitors might be a key factor for success in businesses that sell goods that customers compare on the basis of price, quality, color, and other factors.

Although some business owners avoid locations near direct competitors, others see locating near rivals as an advantage. For instance, restaurateurs know that successful restaurants attract other restaurants, which, in turn, attract more customers. Many cities have at least one “restaurant row,” where restaurants cluster together; each restaurant feeds customers to the others. In Worcester, Massachusetts, more than 40 restaurants coexist on Shrewsbury Street's Restaurant Row. Entrepreneur Greg Califano, who studied in Naples, Italy, to become certified to make authentic Neapolitan pizzas, chose Restaurant Row for the location of his pizza wood-fired pizza restaurant, Volturno. Califano found a historic building that fits the “Old World” ambiance of the restaurant, which includes two special pizza ovens flown in from Naples.⁵⁵

Locating near competitors has its limits, however. Clustering too many businesses of a single type into a small area ultimately erodes their sales once the market reaches the saturation point. As the number of gourmet coffee shops has exploded in top metropolitan areas, many have remain profitable, often competing with three or four similar shops, all within easy walking

distance of one another. When an area becomes saturated with competitors, the stores cannibalize sales from one another, making it difficult for them to survive.

Shared Spaces

Because outstanding locations can be expensive or hard to find, some small companies are sharing spaces with other small businesses. Entrepreneurs can reduce their rent and maintenance costs (and, therefore, their financial risk) by operating in a joint space. Entrepreneurs often find that sharing space with other businesses sparks creativity because their employees have the opportunity to interact with people outside of their industries. Others who share space with businesses that sell complementary products often see their sales increase.



ENTREPRENEURIAL PROFILE: Jessica Swiggum Goldman, Emmy Rigali, and Trisha Reynolds: All About Dance, Go Cycle, and Free to Be

When Jessica Swiggum Goldman, owner of a dance studio, All About Dance, decided to expand her business, she moved into a 15,000-square-foot building in Chicago's Old Town section and struck a deal with Emmy Rigali, owner of a fitness studio, to rent a portion of the building. The location gave Rigali the opportunity to offer a spin class that her customers had been requesting. She invested in 26 stationary bikes and a sound system and opened Go Cycle. Goldman also rented a portion of her building to a third complementary business, Free to Be, which sells dance and fitness apparel. "I have a built-in customer base," says owner Trisha Reynolds. "They're here every day." The three entrepreneurs not only share the building's rent expense but also benefit from sharing a common front desk and receptionist, studio space, and locker rooms. They also have discovered intangible benefits of their shared space. "There's an energy here, a buzz," says Rigali. "In shared space, I was successful more quickly and with less stress."⁵⁶

Inside Large Retail Stores

Rather than compete against giant retailers, some small business owners are cooperating with them, locating their businesses inside the larger company's stores. These small companies offer products that the large retailers do not and benefit from the large volume of customer traffic that the large stores attract. Large retailers, including Wal-Mart, Target, and others, are hosts to small businesses, including franchisees of fast-food chains Subway, McDonald's, and Checkers and medical clinics and banks. Checkers, a quick-service hamburger chain that operates 770 drive-through outlets in the United States, recently opened restaurants inside Wal-Mart stores. "It has to be the right type of partnership," says Jennifer Durham, who is in charge of franchise development. "We wouldn't go into a Neiman-Marcus because that's not where our customers are."⁵⁷ These stores within a store reap the benefits of the large volume of traffic from the more than 100 million people who shop at Wal-Mart each week.

Nontraditional Locations

Rather than select a location and try to draw customers to it, many small businesses are setting up locations where their customers already are. Many of these are nontraditional locations, such as airports, museums, office buildings, churches, casinos, college and university campuses, athletic arenas, and others, that offer high concentrations of potential customers. In many cases, these locations are smaller and less expensive to build but generate more sales per square foot than traditional, full-size stores. Dunkin' Donuts has more than 500 nontraditional locations out of 6,800 outlets in the United States, including locations in theme parks, military bases, universities, travel centers on interstate highways, and others. More than 8,000 of Subway's 35,000 restaurants worldwide are in nontraditional locations, including a high school in Detroit in which students operate the outlet, and account for 20 percent of the chain's total sales. Subway also has an outlet in a Jeep assembly plant and in a church in Buffalo, New York, where the pastor is a franchisee.⁵⁸

Home-Based Businesses

For more than 15 million entrepreneurs, home is where the business is, and their numbers are swelling. One recent study from the SBA reports that 52 percent of all small companies are home based and that more than 21 percent of home-based businesses generate more than \$100,000 in annual revenue.⁵⁹ Many service businesses operate from entrepreneurs' homes. Because many of these companies do not rely on customers to come to their places of business, incurring the expense of an office location is unnecessary. For instance, customers typically contact plumbers

or exterminators by telephone, and the work is performed in customers' homes. Internet-based and catalog retailers also operate from their homes.



ENTREPRENEURIAL PROFILE: Kelly Lester: EasyLunchboxes Kelly Lester founded EasyLunchboxes from her living room. The enterprise was born out of Kelly's unique ability to do things efficiently on a shoestring budget, and her desire to send her kids to school with simple, healthy food at optimum cost. So she developed a slick, easily washable lunchbox set that compartmentalized containers and cooler bags, allowing one to pack lunches fast, without wasting time, money, and paper or plastic. Kelly managed to introduce EasyLunchboxes right in the middle of the "bento" craze. In the United States, bento-style lunches have become hugely popular with parents. The container sets are the best-selling lunchboxes on amazon.com.

Choosing a home location has disadvantages. It may affect family life, interruptions are more frequent, the refrigerator is all too handy, work is always just a few steps away, and isolation can be a problem. Another difficulty that some home-based entrepreneurs face involves zoning laws. As their businesses grow and become more successful, entrepreneurs' neighbors often begin to complain about the increased traffic, noise, and disruptions from deliveries, employees, and customers who drive through their residential neighborhoods to conduct business.

On the Road

Some entrepreneurs are finding that the best location is not a permanent location but a mobile business that takes products and services to its customers. Veterinarians, dentists, restaurants, and others are outfitting mobile units and taking their businesses on the road. Although mobile entrepreneurs avoid the costs of building or renovating permanent locations, they must incur the expense of setting up their mobile businesses. They also face other obstacles, such as finding suitable parking spaces in high-traffic areas, complaints from owners of nearby businesses, and securing the necessary permits to operate. In some cities, ordinances prohibit food truck entrepreneurs from operating within a set distance (often 200 to 300 feet, but some cities have established a minimum of 1,500 feet) of an existing restaurant.



Lessons from the Street-Smart Entrepreneur

How to Launch a Successful Pop-Up Shop

One of the hottest trends in the retail and restaurant industries is pop-up shops, temporary locations that are open for only a few hours, days, or weeks before shutting down. Many pop-up stores operate in the busy shopping period leading up to Christmas. Entrepreneurs are using pop-up stores to test ideas for new businesses, move excess inventory, explore the viability of new markets, and capitalize on a market opportunity. Sisters Christina Bartkus and Lisa Trifone, cofounders of Purefections, a chocolate shop in Quincy, Massachusetts, that makes delectable concoctions from fine Belgian chocolate, spotted an opportunity to reach customers in nearby Boston and in November opened a pop-up shop in an unused section of their brother's interior design business on Boston's busy Tremont Street. They posted an adhesive version of their business name and logo in large cocoa-colored letters on the space's white walls, put a sign outside announcing their shop, and began selling their chocolate goodies. "We have many customers who come to our Quincy store and beg us to open up more pop-ups," says Bartkus. "Pop-ups allow us to be more convenient for our existing customers and to reach a whole new customer base."

The Street-Smart Entrepreneur offers business owners the following lessons learned by studying the factors behind successful pop-up stores:

Decide what you want your pop-up shop to accomplish.

Entrepreneurs create pop-up shops for many reasons; be sure to identify the goals and objectives your shop should achieve. On a visit to New York City, Jason Revilla and Jim Grumbine, cofounders of Faith & Fortune, an online company that sells "socially conscious" T-shirts, sweatshirts, hoodies, and other apparel, noticed several successful pop-up shops and decided to open their own in their hometown of in Beverly, Massachusetts. Their goal was to raise awareness of their company among potential customers. "Because we're a Web-based business, we were looking to get more people to interact with our brand," says Grumbine. "[We want] people to come in and see our clothing because the materials we use are unique, soft, comfortable, and vintage-like."

Develop a unified plan for your concept. By definition, pop-up shops have only a limited time to accomplish

their purposes, and entrepreneurs must make the most of the brief opportunity they have. The best way to achieve that is to develop a plan to create a unique, one-of-a-kind shopping experience, an event that will attract customers and keep them talking for weeks about it. Every pop-up shop should have a unified theme that resonates with the company's target audience. Women's handbag retailer Kate Spade had success with an igloo-shaped pop-up shop set up next to a skating rink in New York City's Bryant Park for three weeks before Christmas that offered shoppers a selection of signature handbags, accessories, jewelry, and stocking stuffers in addition to free hot chocolate.

Select the right location for your pop-up store. Because a pop-up store is temporary, an entrepreneur must find the ideal location for it. Jason Revilla and Jim Grumbine worked with a friend who is a real estate agent to find an empty storefront on a street with a high volume of foot traffic for their Faith & Fortune pop-up store. Alfredo Sandoval, a restaurateur and managing partner of the Mercadito Hospitality Group in Chicago, opened a pop-up restaurant, PT, that operated during the Windy City's summer months on the spacious sidewalk patio at the Talbott Hotel, which is located in a prime spot in Chicago's upscale Gold Coast Historic District. The temporary restaurant set up 100 seats on the patio and 50 in a converted space inside the boutique hotel. PT was able to field test its drink and menu items on customers and generate a significant "buzz" for its brand, enabling the company to open a full-time, permanent restaurant in the Talbott Hotel several months later.

Manage your costs. Some entrepreneurs use pop-up stores to test their business ideas on a small scale before committing significant resources to them. Others see pop-up shops as a way to generate additional profits. Whatever purpose entrepreneurs have for their pop-up shops, they must manage their costs carefully. Entrepreneurs often can negotiate reasonable rental rates with landlords on properties that otherwise would remain vacant. At Faith & Fortune, the landlord allowed Revilla and Grumbine to use the storefront in exchange for a few T-shirts. They also spent \$150 to purchase business signs (which they can reuse), office supplies, and food and, as they promised, donated 20 percent of their sales to charitable causes.

Get the word out. One key to a successful pop-up event is promotion, and social media marketing tools are ideal for reaching potential customers. Cheri Caso, owner of Merchant No. 4, an online shop that sells modern housewares, opened a pop-up shop in an unused loft in her friend's architecture firm in New York City. Because of the fourth-floor location, Caso knew that promoting her pop-up store would be essential. To generate traffic, she announced the event on Facebook and Twitter and sent press releases to local publications and design blogs that were popular with her target customers. She also placed a sidewalk sign outside the building. In just four days, she covered her costs (just \$1,000), sold a lot of slow-moving merchandise, generated a small profit, and promoted her company to the nearly 300 people who went through the shop. Other entrepreneurs have been successful by hosting a wine and cheese grand opening, inviting shoppers to a VIP blogger night, or offering discounts to customers who sign in on Foursquare.

Use mobile technology to make the checkout process seamless for customers. One practical issue that pop-up entrepreneurs must deal with is making sure that the checkout process works smoothly and efficiently. Greg Turner, owner of Fringe Outfitters, an online retailer of men's and women's clothing, uses Square, a mobile credit card reader that allows merchants to accept credit cards on any smart phone or tablet device that operates on either iOS or Android operating systems, when he launches a pop-up store. Entrepreneurs can set up an account at Squareup.com and receive a free Square card reader that plugs into the headphone jack of their phones or tablets. Square charges a processing fee of 2.75 percent for credit card swipe transactions and 3.5 percent plus 15 cents for keyed-in transactions.

Pop-up shops are useful tools for entrepreneurs who want to create a lean start-up. Rather than build a business model or full-featured product in secrecy and then launch it with great fanfare, a lean start-up launches a "minimum viable product," one that includes just enough features to get meaningful feedback from customers. In a customer-focused, iterative process, entrepreneurs observe customers' purchasing behavior and use the feedback they get from the minimum viable product to revise and improve the original product or business model before going back to the market to get more feedback from customers. The idea is to get to market much faster with a product or business model whose features reflect just what customers want and to reduce the probability of wasting time incorporating features that customers don't want. One business writer who has watched pop-up shops lead to successful permanent small businesses says,

Why does this pop-up storefront option work so well? It lowers the barriers to entry for a person interested in starting a business, creates a temporary timeline to test out the businesses potential, and mitigates the risk associated with a traditional start-up. It also does away with the tedium, and minutia associated with filing endless permits, developing long-range accounting forecasts, reviewing costly insurance packages, multi-year leases, navigating bureaucracy, and more. In the end, it's the Lemonade Stand philosophy: All it takes to start one is a stand and lemonade. The other pieces are necessary but can be added and enhanced as the business grows.

Sources: Based on Kathleen Pierce, "The Anatomy of a Pop-Up Store," *Boston Globe*, December 5, 2012, www.bostonglobe.com/lifestyle/style/2012/12/05/the-anatomy-pop-store/cy2daeKoRS1gy5jmus0GVL/story.html; Matt Robinson, "Purefections Brings the Sweet to the Street Starting November 17," *Exhale*, November 2, 2012, <http://exhalelifestyle.com/main/index.php/purefections-brings-the-sweet-to-the-street-starting-november-17>; Jason Del Rey, "How to Open a Pop-Up Store," *Inc.*, July 1, 2010, www.inc.com/magazine/20100701/how-to-open-a-pop-up-store.html; "Tips for Starting a Pop-Up Shop," *Fox Small Business Center*, April 18, 2012, <http://smallbusiness.foxbusiness.com/sbc/2012/04/02/how-to-start-pop-up-shop>; Bob Krummert, "How Pop-Up Restaurants Can Help You Expand," *Restaurant Hospitality*, May 31, 2012, <http://restaurant-hospitality.com/new-restaurant-concepts/how-pop-restaurants-can-help-you-expand>; Charlie Duerr, "Summer Pop-Up Restaurant Craze Hits Chicago," *Nation's Restaurant News*, June 27, 2012, <http://nrn.com/latest-headlines/summer-pop-restaurant-craze-hits-chicago>; Melanie McIntyre, "How to Open a Pop-Up Retail Shop," *Metropreneur Columbus*, April 1, 2011, www.themetropreneur.com/columbus/open-pop-up-shop; Alyson Shontell, "18 Amazing Pop-Up Stores That Stopped Shoppers in Their Tracks," *Business Insider*, May 3, 2011, www.businessinsider.com/17-most-creative-pop-up-stores?op=1; Robert Wilonsky, "The Power of the Pop-up Shop," *Dallas Observer*, June 10, 2011, http://blogs.dallasobserver.com/unfairpark/2011/06/the_power_of_the_pop-up_shop.php.

The Location Decision for Manufacturers

4. Explain the site selection process for manufacturers.

The criteria for the location decision for manufacturers are very different from those of retailers and service businesses; however, the decision can have just as much impact on the company's success. In some cases, a manufacturer has special needs that influence the choice of a location. When one manufacturer of photographic plates and film was searching for a location for a new plant, it had to limit its search to those sites with a large supply of available freshwater, a necessary part of its process. In other cases, zoning ordinances dictate a company's location decision. If a manufacturer's process creates offensive odors or excessive noise, it may be even further restricted in its choices.

The type of transportation facilities required dictates the location of a factory in some cases. Some manufacturers may require a location on a railroad siding, whereas others may need only access to interstate highways. Some companies ship bulk materials by ship or barge and consequently require a facility near a navigable body of water. Developers are building the 6,700-acre Americas Gateway Logistics Center, a mixed-use industrial park in Florida's heartland that will minimize the transportation costs of its tenants by providing ready access to interstate highways, railways, seaports, and international air cargo airports. "International access is tremendous through the ports, and we are criss-crossed with highways and Class 1 railroads," says one official.⁶⁰

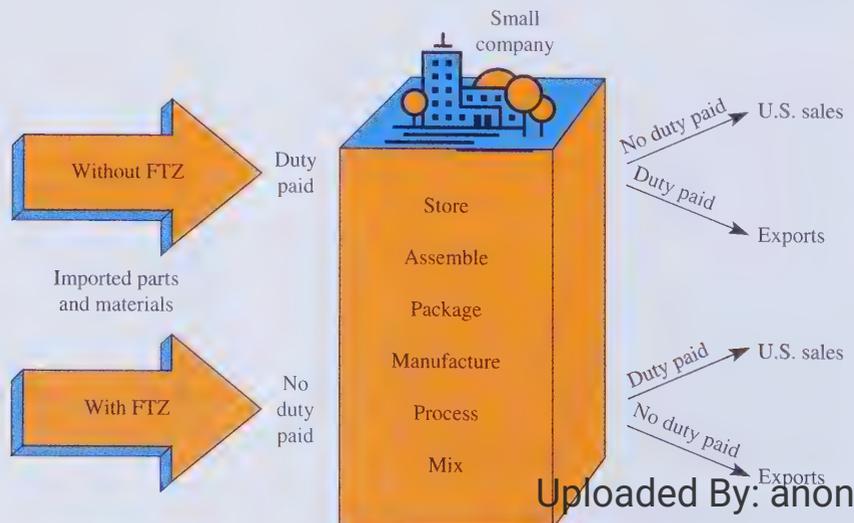
As fuel costs escalate, the cost of shipping finished products to customers also influences the location decision for many manufacturers, forcing them to open factories or warehouses in locations that are close to their primary markets to reduce transportation costs.

ENTREPRENEURIAL PROFILE: Mickey Walker: Viking Air Movers Mickey Walker, founder of Viking Air Movers, a small, family-owned business that makes pressurized drying systems, recently opened a factory in Hesperia in southern California's San Bernardino County. Walker cites the area's inexpensive land, reasonable wage rates, and sizable, qualified workforce as benefits of locating there, but low transportation costs were the primary driver of the company's decision. "We ship our products worldwide from our plant," says Walker. "The transportation assets of this area are outstanding. The major railroad hubs and Interstate 15 give us access to our [West Coast and Asian] customers." Viking Air Movers also operates a distribution center in Fairfield, Ohio. "We ship products east of the Mississippi out of Fairfield," he says.⁶¹

Foreign Trade Zones

Created in 1934, foreign trade zones can be an attractive location for small manufacturers that engage in global trade and are looking to reduce or eliminate the tariffs, duties, and excise taxes they pay on the materials and parts they import and the goods they export. A **foreign trade zone** (see Figure 18.5) is a specially designated area in or near a U.S. customs port of entry that allows resident companies to import materials and components from foreign countries; assemble, process, manufacture, or package them and then ship the finished product back out while either deferring, reducing, or eliminating completely tariffs and duties. As far as tariffs and duties are concerned,

FIGURE 18.5
How a Foreign Trade Zone (FTZ) Works



a company located in a foreign trade zone is treated as if it is located outside the United States. For instance, a maker of speakers can import components from around the world and assemble them at its plant located in a foreign trade zone. The company pays no duties on the components it imports or on the speakers it exports to other foreign markets. The only duties the manufacturer pays are on the speakers it sells in the United States. There are 257 foreign trade zones and 514 subzones, which are special foreign trade zones that are established for limited purposes, operating in the United States. (The International Trade Administration provides a list of foreign trade zones by state at <http://ia.ita.doc.gov/ftzpage/letters/ftzlist-map.html>.) More than 12 percent of foreign goods enter the United States through foreign trade zones.⁶² The value of shipments into foreign trade zones has increased from \$147 billion in 1998 to nearly \$534 billion today; foreign trade zone tenants export nearly \$35 billion worth of goods annually.⁶³

Business Incubators

For many start-up companies, a business incubator may make the ideal initial location. A **business incubator or accelerator** is an organization that combines low-cost, flexible rental space with a multitude of support services for its small business residents. The primary reason that communities establish incubators is to enhance economic development, create jobs, and diversify the local economy. The strategy works; 84 percent of the companies that graduate from incubators stay in the local community.⁶⁴



ENTREPRENEURIAL PROFILE: Andrew Torba and Charles Szymanski: Kuhcoon Andrew Torba and Charles Szymanski recently moved their start-up, Kuhcoon, a company that builds, maintains, and manages social networking accounts for businesses into the Scranton Enterprise Center, a business incubator created in 2003 in downtown Scranton, Pennsylvania. “The incubator really gave us the legitimacy and credibility we needed as young entrepreneurs,” says Torba, who is just 21 years old. “Before this, we were operating out of a shed in my parents’ backyard.” Kuhcoon moved into the incubator after Torba and Szymanski won the annual Great Valley Technology Alliance business plan competition. Since entering the incubator, Kuhcoon has grown from four employees to 10 and now has clients around the world for its social media services platform.⁶⁵

An incubator’s goal is to nurture young companies during the volatile start-up period and to help them survive until they are strong enough to go out on their own (see Figure 18.6). Three types of incubators exist: mixed-use incubators host start-up companies from a variety of industries, technology incubators target companies that are creating or commercializing new technologies, and empowerment incubators are mixed-use facilities that focus on businesses whose founders are underserved, such as minority or women entrepreneurs.⁶⁶ Deborah Jackson, Kelly Hoey, and Veronika Sonsev founded New York City based startup accelerator Women Innovative Mobile (WIM) Accelerator. WIM Accelerator targets and invests in mobile technology ventures with gender diverse founding

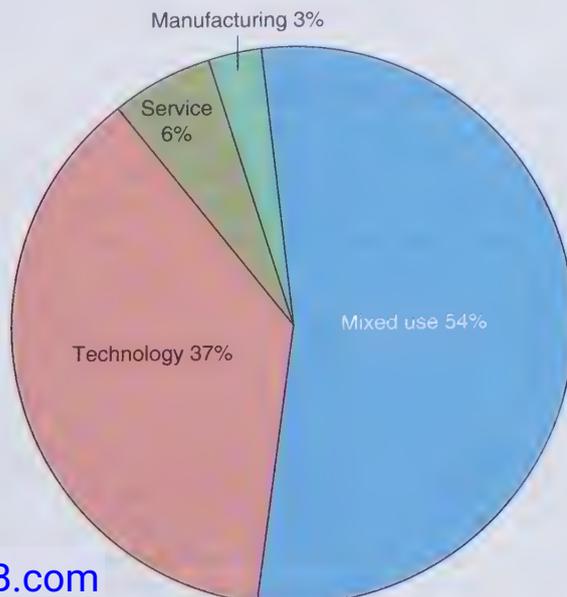


FIGURE 18.6
Business Incubators
by Industry Focus

Source: Based on National Business Incubation Association, Athens, OH, 2012.

Veronika Sonsev, Deborah Jackson, and Kelly Hoey, cofounders of Women Innovative Mobile, a business accelerator.

Source: Lisa Tanner Photography.



teams. Companies accepted into the WIM Accelerator receive access to expert mentors and advisors, services and perks such as free office space plus a seed-capital investment from WIM Accelerator, in exchange for which WIM Accelerator takes an 8% equity stake in the ventures.⁶⁷

The shared resources that accelerators and incubators typically provide their tenants include secretarial services, a telephone system, computers and software, high-speed Internet connections, audiovisual equipment, meeting space, and, sometimes, access to mentors, management consulting services, and financing. Not only do these services save young companies money (reducing a small company's start-up costs in some cases by 40 to 50 percent), but they also save them valuable time. Entrepreneurs can focus on getting their products and services to market rather than searching for the resources they need to build their companies. Many business incubators help their tenants gain access to capital by providing access to angel investors and venture capital firms; a survey by the National Business Incubation Association reports that 83 percent of incubators provide some kind of access to seed capital, ranging from help with obtaining federal grants to making connections with angel investors.⁶⁸

The typical incubator has entry requirements that prospective residents must meet. Incubators also have criteria that establish the conditions a business must maintain to remain in the facility as well as the expectations for "graduation" into the business community. The typical start-up that lives in an incubator stays for an average of three years. More than 1,250 incubators operate across the United States, up from just 12 in 1980. Perhaps the greatest advantage of choosing to locate a start-up company in an incubator is a greater chance for success. The National Business Incubation Association reports that graduates from business incubators have an 87 percent survival rate. Each year, business incubators help an estimated 49,000 start-up companies that provide full-time employment for more than 200,000 workers and generate annual revenue of almost \$15 billion.⁶⁹

Layout and Design Considerations

Once an entrepreneur chooses the best location for his or her business, the next issue to address is designing the proper layout for the space to maximize sales (retail) or productivity (manufacturing or service). **Layout** is the logical arrangement of the physical facilities in a business that contributes to efficient operations, increased productivity, and higher sales. Planning for the most effective and efficient layout in a business environment can produce dramatic improvements in a company's operating effectiveness and efficiency. An attractive, effective layout can help a company's recruiting efforts, reduce absenteeism, and improve employee productivity and satisfaction. A recent *U.S. Workplace Survey* by global design firm Gensler reports that 90 percent of employees believe that better workplace design and layout improves their performance and productivity and the company's competitiveness. Yet only 50 percent of workers say that their work environment encourages innovation.⁷⁰ The changing nature of work demands that work space design also changes. Although many jobs require the ability to focus on "heads down," individual tasks, collaboration with coworkers is becoming a more significant component of work even when workers are scattered across the globe and "meet" virtually. Increasingly, work is becoming

6.

Describe the criteria used to analyze the layout and design considerations of a building, including the Americans with Disabilities Act.

more complex, team based, technology dependent, and mobile, and work spaces must change to accommodate these characteristics. The study by Gensler concludes that top-performing companies have work spaces that are more effective than those of average companies, particularly for collaboration. Gensler also reports that employees at top-performing companies spend 23 percent more time collaborating with their coworkers than do employees at average companies.⁷¹

When creating a layout, managers must consider its impact on space itself (comfort, flexibility, size, and ergonomics), the people who occupy it (type of work, special requirements, need for interaction, and tasks performed), and the technology they use (communication, Internet access, and equipment).⁷² The following factors have a significant impact on a space's layout and design.

Size and Adaptability

A building must offer adequate space and be adaptable to accommodate a business's daily operations. If space is restrictive at the outset of operations, efficiency will suffer. There must be room enough for customers' movement, inventory, displays, storage, work areas, offices, and restrooms. Haphazard layouts undermine employee productivity and create organizational chaos. Businesses that launch in locations that are too small at the outset must make premature and costly moves to larger spaces, interfering with their ability to maintain a loyal customer base. Although entrepreneurs want locations capable of accommodating their companies' growth, they should avoid spaces that are too big because they waste valuable resources in the form of higher rent and unused space. "Don't take on more space than you need," advises Bill Armstrong, an experienced commercial real estate broker.⁷³ In fact, many businesses are reducing the space they allocate for their office workers because technology allows some people to work from almost anywhere rather than from a traditional office. In 1985, the average amount office space per employee was 400 square feet; today, it is 250 square feet, and experts predict that by 2021, the average office employee will work in just 150 square feet.⁷⁴ Companies are moving away from private offices and even cubicles to unassigned work spaces, communal tables or desks that workers share and that can be rearranged easily, depending on the task at hand. The result is a fluid layout that changes during the day. Studies show that employees utilize just 50 percent of a traditional office space because of meetings, travel, vacation, and sick days.



ENTREPRENEURIAL PROFILE: Rob Watts: Traction Systems, LLC

Rob Watts, founder of Traction Systems, LLC, a Web site development company in West Sacramento, California, created an office that includes L-shaped desks for each of the company's four employees in a single 30-square-foot room. Web designer Vitaly Zavortny says that the open space makes interaction and collaboration on projects easy; when he has to concentrate on "heads-down" work, he uses noise-canceling headphones. "We constantly collaborate on different projects and discuss different solutions for various problems so we love this environment," he says.⁷⁵

A start-up often requires the founder to customize a location to fit the company's specific layout needs. These upgrades to a rental space are known as **tenant improvements**, and sometimes landlords will contribute toward the cost of the improvements if an entrepreneur signs a long-term lease (typically at least three years). Entrepreneurs who lease buildings must consider other costs associated with the property in addition to the lease rate, which usually is expressed as a dollar amount per square foot. Additional costs include a fee for common area maintenance (CAM) (which covers the expense of maintaining the property), for property taxes, and for insurance; a lease agreement in which the tenant pays all three of these expenses is called a **triple net lease**.

External Appearance

The physical appearance of a building determines the first impression that customers have of a business and contributes significantly to establishing its identity in customers' minds. Therefore, a building's appearance must be consistent with the entrepreneur's desired image for the business. Retailers, in particular, must recognize the importance of creating the proper image for their stores and how their shop's layout and physical facility influence this image. In many ways, the building's appearance sets the tone for the customer's quality and service expectations. The appearance should reflect the "personality" of the business. Should the building project an exclusive image or an economical one? Is the atmosphere informal and relaxed, or it is formal and businesslike? Externally, the storefront—its architectural style and color, signs, entrances, and general appearance—provides important clues to customers about a business's image.

Communicating the right signals through layout and physical facilities is an important step in attracting a steady stream of customers. Retail consultant Paco Underhill advises merchants to “seduce” passersby with their storefronts. “The seduction process should start a minimum of 10 paces away,” he says.⁷⁶ A building’s exterior should have “curb appeal” to entice shoppers, and one of the best ways to create curb appeal is to emphasize cleanliness. Trash in the parking area, fingerprints on glass doors and windows, peeling exterior paint, and stained, sticky floors send a negative message to potential customers and discourage them from shopping. Bojangles, the chicken and biscuits restaurant, emphasizes cleanliness in its restaurants, requiring managers to patrol their units at least once an hour to make sure that they measure up to the chain’s standards.⁷⁷



ENTREPRENEURIAL PROFILE: Huddle House Huddle House, an Atlanta, Georgia-based chain of family restaurants with 400 locations in 20 states, recently redesigned its restaurants to include a contemporary look with a unique tower entrance, subdued earth-tone color palette, and plush seating. Outlets sporting the new look have seen sales increase of at least 30 percent. “Our plans call for 90 percent of our system to be reimaged by 2017,” says Michael Abt, the company’s CEO.⁷⁸

A store’s window display can be a powerful selling tool if used properly. Often, a store’s display window is an afterthought, and many business owners neglect to change their displays often enough. The following tips help entrepreneurs create displays that sell:

- **Keep displays simple.** Simple, uncluttered arrangements of merchandise draw the most attention and have the greatest impact on potential customers.
- **Keep displays clean and up to date.** Dusty, dingy displays or designs that are outdated send the wrong message to customers.
- **Promote local events.** Small companies can show their support of the community by devoting part of the display window to promote local events.
- **Change displays frequently.** Customers don’t want to see the same merchandise every time they visit a store. Experts recommend changing window displays at least quarterly. Businesses that sell fashionable items, however, should change their displays at least twice a month, if not weekly.
- **Get expert help, if necessary.** Some business owners have no aptitude for design! In that case, their best bet is to hire a professional to design window and in-store displays. If a company cannot afford a professional designer’s fees, the entrepreneur should check with the design departments at local colleges and universities. There might be a faculty member or a talented student willing to work on a freelance basis.
- **Appeal to all of a customer’s senses.** Effective displays engage more than one of a customer’s senses. Who can pass up a bakery case of freshly baked, gooey cinnamon buns with their mouth-watering aroma wafting up to greet passersby?
- **Contact the companies whose products you sell to see whether they offer design props and assistance.** These vendors may offer additional insight and are aware of industry trends and competitor tactics.

Entrances

All entrances to a business should *invite* customers in. Wide entryways and attractive merchandise displays that are set back from the doorway can draw customers into a business. A store’s entrance should catch passing customers attention and draw them inside. “That’s where you want somebody to slam on the brakes and realize they’re going someplace new,” says retail consultant Paco Underhill.⁷⁹ Retailers with heavy traffic flows, such as supermarkets or drugstores, often install automatic doors to ensure a smooth traffic flow into and out of their stores. Retailers should remove any barriers that interfere with customers’ easy access to the storefront. Broken sidewalks, sagging steps, mud puddles, and sticking or heavy doors not only create obstacles that might discourage potential customers but also create legal hazards for a business if they cause customers to be injured.

The Americans with Disabilities Act

Approximately 18.7 percent of people in the United States are disabled.⁸⁰ The Americans with Disabilities Act (ADA), passed in July 1990, requires that businesses make their facilities available to physically challenged customers and employees. In addition, the law requires

businesses with 25 or more employees to accommodate physically challenged candidates in their hiring practices. Most states have similar laws, many of them more stringent than the ADA, that apply to smaller companies as well. The rules of these state laws and the ADA's Title III are designed to ensure that mentally and physically challenged customers have equal access to a firm's goods or services. For instance, the act requires business owners to remove architectural and communication barriers when "readily achievable" (accomplished without much difficulty or expense). The ADA allows flexibility in how a business achieves this equal access, however. For example, a restaurant could either provide menus in Braille or offer to have a staff member read the menu to blind customers. A small dry cleaner might not be able to add a wheelchair ramp to its storefront without incurring significant expense, but the owner could comply with the ADA by offering curbside pickup and delivery services for disabled customers at no extra charge.

The Department of Justice revised the ADA in 2010, and all newly constructed or renovated buildings that are open to the public and were occupied after March 15, 2012, must comply with the 2010 requirements. For example, in retail stores, checkout aisles must be wide enough—at least 36 inches—to accommodate wheelchairs. Restaurants must have at least 5 percent of their tables accessible to wheelchair-bound patrons. Miniature golf courses must make at least 50 percent of the holes on the course accessible to disabled customers.

Complying with the ADA does not necessarily require businesses to spend large amounts of money. The Department of Justice estimates that more than 20 percent of the cases that customers have filed under Title III involved changes that the business owners could have made at no cost, and another 60 percent would have cost less than \$1,000!⁸¹ In addition, companies with \$1 million or less in annual sales or with 30 or fewer full-time employees that invest in making their locations more accessible to everyone qualify for a tax credit. The credit is 50 percent of their expenses between \$250 and \$10,250. Businesses that remove physical, structural, and transportation barriers for disabled employees and customers also qualify for a tax deduction of up to \$15,000.

The ADA also prohibits any kind of employment discrimination against anyone with a physical or mental disability. A physically challenged person is considered to be "qualified" if he or she can perform the essential functions of the job. The employer must make "reasonable accommodation" for a physically challenged candidate or employee without causing "undue hardship" to the business. Most businesses have found that making these reasonable accommodations for customers and employees has created a more pleasant environment and offers additional conveniences for all.

Signs

One of the lowest-cost and most effective methods of communicating with customers is a business sign. Signs communicate what a business does, where it is, and what it is selling. The United States is a highly mobile society, and a well-designed, well-placed sign can be a powerful vehicle for reaching potential customers.

A sign should be large enough for passersby to read from a distance, taking into consideration the location and speed of surrounding traffic arteries. To be most effective, the message should be short, simple, and clear. A sign should be legible both in daylight and at night; proper illumination is a must. Contrasting colors and simple typefaces are best. Signs that customers can read or understand at a glance are most effective. The most common problems with business signs are that they are illegible, poorly designed, improperly located, and poorly maintained and have color schemes that are unattractive or hard to read.

Before investing in a sign, an entrepreneur should investigate the local community's sign ordinance. In some cities and towns, local regulations impose restrictions on the size, location, height, and construction materials used in business signs.

Interiors

Designing a functional, efficient interior layout demands research, planning, and attention to detail. Successful retailers recognize that their stores' interior layouts influence their customers' buying behavior. "A store's interior architecture is fundamental to the customer's experience—the stage upon which a retail company functions," says retail consultant Paco Underhill.⁸² Retailers such as Cabela's, Barnes & Noble, and Starbucks use layouts that encourage customers to linger and spend time (and money). Others, such as Lowe's, Aldi, and Wal-Mart, reinforce their discount images with layouts that communicate a warehouse environment, often complete

pallets, to shoppers. Luxury retailers such as Tiffany & Company, Coach, and Nordstrom create opulent layouts in which their upscale customers feel comfortable.

Technology has changed drastically the way employees, customers, and the environment interact with one another, but smart entrepreneurs realize that they can influence the effectiveness of those interactions with well-designed layouts. The result can be a boost to a company's sales and profits. For instance, as their customers' needs and expectations have changed, retailers have modified the layouts of their stores to meet those needs. Because shoppers are busier than ever and want an efficient shopping experience (particularly men), many retail stores have moved away from the traditional departments (e.g., shoes, cosmetics, and men's suits) and are organizing their merchandise by "lifestyle categories," such as sports, women's contemporary, men's business casual, and others. These displays expose customers to merchandise that they otherwise might have missed and make it easier for them to, say, put together an entire outfit without having to roam from one department to another.

Designing an effective layout is an art and a science. **Ergonomics**, the science of adapting work and the work environment to complement employees' strengths and to suit customers' needs, is an integral part of a successful design. For example, chairs, desks, and table heights that allow people to work comfortably can help employees perform their jobs faster and more easily. Design experts claim that improved lighting, better acoustics, and proper climate control benefit the company as well as employees. An ergonomically designed workplace can improve a company's ability to recruit new workers, increase workers' productivity significantly, and lower days lost due to injuries and accidents. A study for the Commission of Architecture and the Built Environment and the British Council for Offices reports that simple ergonomic features, such as proper lighting and seating, reduce absenteeism by 15 percent and increase productivity between 2.8 and 20 percent.⁸³

Unfortunately, many businesses fail to incorporate ergonomic design principles into their layouts, and the result is costly. The most frequent and most expensive workplace injuries are repetitive strain injuries (RSIs), which cost U.S. businesses \$20 billion in workers' compensation claims and \$600 million in lost productivity each year. According to the Bureau of Labor Statistics, RSIs are responsible for 33 percent of all workplace injuries and cause an injured worker to miss an average of 11 days of work per year, 38 percent more than the time missed for the average injury. RSIs also are a major driver of workers' compensation claims.⁸⁴ Workers who spend their days staring at computer monitors (a significant and growing proportion of the workforce) often are victims of RSIs.

The most common RSI is carpal tunnel syndrome, which occurs when repetitive motion causes swelling in the wrist that pinches the nerves in the arm and hand. The good news for employers, however, is that preventing injuries, accidents, and lost days does *not* require spending thousands of dollars on ergonomically correct solutions. Most of the solutions to RSIs are actually quite simple and inexpensive, ranging from installing equipment that eliminates workers' repetitive motions to introducing breaks during which workers engage in exercises designed by occupational therapists to combat RSIs.

Drive-Through Windows

For many businesses, a drive-through window adds another dimension to the concept of customer convenience and is a relatively inexpensive way to increase sales. In the quick-service restaurant business, drive-through windows are an essential design component, accounting for 70 percent of sales, an increase from 60 percent in 2002.⁸⁵ Although drive-through windows are staples at fast-food restaurants and banks, they can add value for customers in other businesses as well, including drugstores, convenience stores, hardware stores, and even wedding chapels. Archaeologists have found evidence of a "drive-through" window in an ancient building in Godin Tepe, a 5,000-year-old village in the mountains of Iran, through which residents distributed food and weapons to soldiers.⁸⁶

Seattle's Best Coffee recently opened 15 drive-through-only locations in the Dallas–Fort Worth market. With a footprint of only 600 square feet, the outlets can fit in almost any high-volume location and sell coffee, other beverages, and "dashboard friendly" food to busy customers who are too pressed for time to get out of their cars. The company selected Dallas–Fort Worth as the location for the first outlets because people there dine out 70 percent more than the national average.⁸⁷

Sight, Sound, Scent, and Lighting

Retailers can increase sales by sending important subconscious signals to customers using what design experts call “symbolics.” For instance, when shoppers enter a Whole Foods supermarket, the first items they see are displays of fresh flowers. Not only are the flowers’ colors and the smells pleasing, but they also send a clear message to customers: “You are embarking on an adventure in freshness in our store—flowers, produce, meats, seafood, *everything*.”⁸⁸ Layouts that engage all of customers’ senses also increase sales. Retail behavioral expert Paco Underhill, founder of Envirosell, a market research company, says that most of customers’ unplanned purchases come after they touch, taste, smell, or hear something in a store. For example, stores that sell fresh food see sales increase if they offer free samples to customers. One study reports that offering shoppers free samples increases not only the sales of the item offered but the sales of other products as well.⁸⁹ Research also shows that customers are willing to pay more for products they can see, touch, taste, or try.⁹⁰ “If somebody doesn’t try ‘em, they’re not going to buy ‘em,” quips Underhill.⁹¹ Sight, sound, scent, and lighting are particularly important aspects of retail layout.

SIGHT A business can use colors and visual cues in its interior designs to support its brand and image in subtle yet effective ways. For instance, many high-tech companies use bright, bold colors in their designs because they appeal to their young employees. On the other hand, more conservative companies, such as accounting firms and law offices, decorate with more subtle, subdued tones because they convey an image of trustworthiness and honesty. Upscale restaurants that want their patrons to linger over dinner use deep, luxurious tones and soft lighting to create the proper ambiance. Fast-food restaurants, on the other hand, use strong, vibrant colors and bright lighting to encourage customers to get in and out quickly, ensuring the fast table turnover they require to be successful. Table 18.7 shows how businesses can use colors to target specific groups of customers or elicit particular emotions among customers.

At the Vermont Country Deli in Brattleboro, Vermont, wooden bookshelves and odd tables filled with colorful displays of jams, jellies, and desserts greet customers as they enter the store. The mismatched tables and shelves give the store an authentic, down-home look, and signs such as “Life is short. Eat cookies” entice customers to make purchases. At Whole Foods, prices for fresh fruits and vegetables appear to be hand scrawled on fragments of black slate, a tradition in outdoor markets in Europe—as if a farmer had pulled up that morning, unloaded the produce, and posted the price before heading back to the farm. Some of the produce also is sprinkled with water droplets. When customers at the restaurant Tallulah on the Thames in Newport, Rhode Island, are seated, waiters hand them a rustic clipboard with a handwritten list of the daily “farm-to-table menu.”⁹² The subtle message these symbolics send to customers is *freshness*.⁹³

TABLE 18.7 The Power of Color

Colors can be used to target different demographics or create certain emotions in consumers					
Pinks/Reds	Oranges	Yellows	Greens	Blues	Purples
Activating, exciting, powerful	A balanced color, vibrant, energetic, friendly	Brightest and most energizing, warm, happy, stimulating	Calming, balancing, cool	Dependability, trust, stability, security	Abundance, dignity, creativity, imagination
Used minimally as an accent to draw attention or create sense of urgency	Used to give an inviting impression or to show movement and energy	Used in design focused on kids and to express happiness	Used to bring harmony and stability, often used in residential application to denote verdant or modern sustainable environment	Conservative dark hues used for business and lighter hues used for more social environments	Used to show wealth and luxury

Source: Based on Yellow Duck Marketing, cited in Regina Wood, “85 Percent of Consumers Buy Products Based on Color,” *Ragan*, June 13, 2012, www.ragan.com/Main/Articles/85_percent_of_consumers_buy_based_on_color.aspx#.

SCENT Research shows that scents can have a powerful effect in retail stores. The Sense of Smell Institute reports that the average human being can recognize 10,000 different aromas and can recall scents with 65 percent accuracy after one year, a much higher recall rate than visual and aural stimuli produce. Studies show that introducing the proper scent into a retail environment can increase sales from 20 to 90 percent. In one experiment, when Eric Spangenberg of Washington State University diffused a subtle scent of vanilla into the women's department of a store and rose maroc into the men's department, he discovered that sales nearly doubled. He also discovered that if he switched the scents, sales in both departments fell well below their normal average. Scents also enhance customers' perceptions of product quality and value.⁹⁴ Spangenberg's research suggests that simple scents, such as orange and vanilla, are more effective than complex scents that combine multiple fragrances.⁹⁵

Many companies—from casinos to retail stores—are beginning to understand the power of using scent as a marketing tool to evoke customers' emotions. Almost every bakery uses a fan to push the smell of fresh-baked breads and sweets into pedestrian traffic lanes, tempting them to sample some of their delectable goodies. Stores selling swimsuits see sales increase when they introduce a coconut scent, and in intimate apparel shops, a soft lilac scent increases sales.⁹⁶ "Smell has a greater impact on purchasing than everything else combined," says Alan Hirsch of the Smell & Taste Treatment & Research Foundation. "If something smells good, the product is perceived as good."⁹⁷ Lavender, vanilla, and chamomile scents encourage shoppers to relax and slow down; floral and citrus scents encourage them to browse longer and spend more.⁹⁸ Sony infuses its Style Stores with a blend of vanilla, orange, and cedar that is designed to make women shoppers feel more at ease.⁹⁹

SOUND Retailers that use the right sounds to "decorate the silence" can increase sales as well.¹⁰⁰ Background music can be an effective marketing tool if the type of music playing in a store matches the demographics of its target customers. "[Music] sets the tone for the whole place," says Jonathan Schoen, manager of Basso, an Italian restaurant in St. Louis, Missouri. "People walk in and can immediately hear what you're about."¹⁰¹ Abercrombie and Fitch plays loud, upbeat music with a rhythmic beat that creates a nightclub-like atmosphere for its youthful customers, but Victoria's Secret uses classical music in its stores to reinforce an upscale image for its brand.¹⁰² Many restaurants invest considerable time selecting just the right play lists for different day parts that reflect the image they want to create, increase food and bar sales, and encourage customers to "eat to the beat." Studies show that playing slow-tempo music during dinner increases bar sales by more than 40 percent and that playing music with a fast beat increases lunch sales. "We are a rock 'n' roll pizza joint, and we want music that reflects that," says Frank Uible, owner of Pi, a four-unit pizza chain in St. Louis, Missouri. "The music may be a little softer when we are not as busy and more up-tempo at peak hours."¹⁰³

Research shows that music is a stimulant to sales because it reduces resistance; warps the sense of time, allowing shoppers to stay longer in the store; and helps to produce a positive mental association between the music and the intended image of the store.¹⁰⁴ One audible rule seems clear for retail soundscapes: Slow is good. Because people's biorhythms often mirror the sounds around them, a gently meandering mix of classical music or soothing ambient noise encourages shoppers to slow down and relax. Classical music, in particular, makes shoppers feel affluent and boosts sales more than other types of music.¹⁰⁵ "If customers are moving less quickly," says shopping psychologist Tim Dennison, "they're more likely to engage with a product and make a purchase." The growing competition for the attention of time-pressed shoppers forces businesses to focus more on the total sensory experience they provide. "Retailers will have to make their stores more stimulating" says Dennison.¹⁰⁶

LIGHTING Good lighting allows employees to work at maximum efficiency. Proper lighting is measured by the amount of light required to do a job properly with the greatest lighting efficiency. In a retail environment, proper lighting should highlight featured products and encourage customers to stop and look at them. "The lighting and the atmosphere created with the lighting really makes your store more spectacular," says the president of a design firm that specializes in restaurants and retail stores.¹⁰⁷ Efficiency also is essential because lighting consumes 25 percent of the total energy used in the typical commercial building.¹⁰⁸ Traditional incandescent lighting is least efficient. Only 10 percent of the energy it generates is light; the remaining 90 percent is heat. Although incandescent bulbs are the cheapest to purchase, they have the longest life span, averaging only 750 and 1,200 hours. Compact fluorescent lights (CFLs) generate far less heat, use 75 percent less

energy, and last 8 to 10 times longer than traditional incandescent lights. Technology advances are increasing the popularity of light-emitting diode (LED) lighting. Although still more expensive to purchase, LEDs use just 20 percent of the electricity of incandescent lights and 50 percent of CFLs. They also last five times longer than CFLs and 45 times longer than incandescent lights. LEDs generate the least amount of heat, reducing business's cooling costs. The estimated total costs of operating each type of bulb over 50,000 hours are \$352.50 (incandescent), \$89.75 (CFL), and \$85.75 (LED).¹⁰⁹ Mike Hardin, owner of Hodad's, a hamburger restaurant in San Diego, California, worked with a local utility to convert all of the outlet's incandescent lights to LEDs. Hardin saw immediate results; Hodad's energy bill decreased by more than 50 percent. Now an LED convert, Hardin says, "It doesn't make sense to me anymore to screw in a light bulb that is going to cost me and our world a lot more energy."¹¹⁰

Lighting provides a good return on investment given its overall impact on a business. Few people seek out businesses that are dimly lit because they convey an image of untrustworthiness. The use of natural gives a business an open and cheerful look and actually can boost sales. A series of studies by energy research firm Heschong Mahone Group reports that stores using natural light experience sales that are 40 percent higher than those of similar stores using fluorescent lighting.¹¹¹ Similarly, a study by office furniture maker Haworth reports that employees who work in more natural environments (with natural light and external views) exhibit less job stress, more job satisfaction, and fewer ailments.¹¹²

Sustainability and Environmentally Friendly Design

Businesses are designing their buildings in more environmentally friendly ways not only because it is the right thing to do but also because it saves money. In addition to saving energy (and the planet), companies that create well-planned, environmentally friendly designs see employee productivity increase by 3.5 to 10 percent.¹¹³ Companies are using recycled materials; installing high-efficiency lighting, fixtures, and appliances; and using LEED (Leadership in Energy and Environmental Design) principles in construction and renovation.



ENTREPRENEURIAL PROFILE: Chipotle Mexican Grill Chipotle Mexican Grill, a chain of Mexican restaurants that Steve Ells started in 1993 in Denver, Colorado, recently built three LEED-certified restaurants. The outlet in Gurnee Mills, Illinois, uses 43 percent less water than the typical restaurant by including in its design a 2,500-gallon underground cistern that captures rainwater that is used for landscape irrigation, high-efficiency water fixtures, tankless water heaters, and waterless urinals. The restaurant, which was built mainly with recycled materials, features plenty of windows that let in natural light, and low-E glazing on the windows repels heat during the summer and cold during the winter. It also uses highly efficient LED lighting and Energy Star-rated kitchen equipment. An on-site wind turbine produces 10 percent of the restaurant's energy, and a computerized energy management system monitors all of the building's systems. Chipotle says that the restaurant's energy usage is 33 percent below that of a typical outlet and plans to build more LEED-certified outlets.¹¹⁴

Businesses that have not yet implemented LEED principles into the design of their buildings can lower the cost of and increase the efficiency of their operations by conducting energy audits, reducing the impact of "energy hogs" on their business expenses. Many local utilities conduct energy audits for free, and implementing their suggestions can produce significant savings. The U.S. Department of Energy offers simple checklists (www1.eere.energy.gov/femp/services/energy_aware.html) that serve as good starting points for defining an energy-savings plan.

Layout: Maximizing Revenues, Increasing Efficiency, and Reducing Costs

The ideal layout depends on the type of business and on the entrepreneur's strategy for gaining a competitive edge. Retailers design their layouts with the goal of maximizing sales revenue; manufacturers design their layouts to increase efficiency and productivity and to lower costs.

Layout for Retailers

Retail layout is the arrangement of merchandise in a store. A retailer's success depends, in part, on well-designed floor displays. The displays should pull customers into the store and make it easy for them to locate merchandise, compare price, quality, and features; and ultimately make a purchase.

7.

Explain the principles of effective layouts for retailers, service businesses, and manufacturers.

Paco Underhill, retail consultant and author of *Why We Buy: The Science of Shopping*, calls a store's interior design "the stage on which a retail company functions."¹¹⁵ Unfortunately, according to Underhill, most retail shopping spaces do not include what customers want to experience.¹¹⁶

Research shows that 66 percent of all buying decisions are made once a customer enters a store, meaning that the right layout can boost sales significantly.¹¹⁷ A retail layout should pull customers into the store and make it easy for them to locate merchandise; compare price, quality, and features; and ultimately make a purchase. An effective layout also should take customers past displays of other items that they may buy on impulse. One of the most comprehensive studies of impulse purchases found that one-third of shoppers made impulse purchases. The median impulse purchase amount was \$30 but varied by product category, ranging from \$6 for food items to \$60 for jewelry and sporting goods. Although the urge to take advantage of discounts was the most common driver of unplanned buying decisions, the location and attractiveness of the display also were important factors.¹¹⁸ Research shows that shoppers are influenced by in-store displays, especially end-cap displays—those at the ends of aisles.¹¹⁹

Retailers have always recognized that some locations within a store are superior to others. Customer traffic patterns give the owner a clue to the best location for the highest gross margin items. Merchandise purchased on impulse and convenience goods should be located near the front of the store. Items that people shop around for before buying and specialty goods attract their own customers and should not be placed in prime space. Prime selling space should be restricted to products that carry the highest markups.

Retail store layout evolves from a clear understanding of customers' buying habits. If customers come into the store for specific products and have a tendency to walk directly to those items, placing complementary products in their path increases sales. Observing customer behavior helps business owners identify "hot spots," where merchandise sells briskly, and "cold spots," where it may sit indefinitely. By experimenting with factors such as traffic flow, lighting, aisle size, music type and audio levels, signs, and colors, an owner can discover the most productive store layout. For instance, one of the hot spots in a Barnes & Noble bookstore during the busy holiday season is the "Christmas table" at the front of the children's department. The table, which holds between 75 and 125 titles, draws consistent traffic and is the most desired spot for a book aimed at children.¹²⁰

Business owners should display merchandise as attractively as their budgets will allow. Customers' eyes focus on displays, which tell them the type of merchandise the business sells. It is easier for customers to relate to one display than to a rack or shelf of merchandise. Open displays of merchandise can surround the focal display, creating an attractive selling area. Retailers can boost sales by displaying together items that complement each other. For example, displaying ties near dress shirts or handbags next to shoes often leads to multiple sales.

When planning in-store displays, retailers should remember the following:

- ***Make products easy to reach.*** The average man is 69.3 inches tall, and the average woman is 63.8 inches tall. The average person's normal reach is 16 inches, and the extended reach is 24 inches. The average person's standing eye level is 63.1 inches from the floor.¹²¹ Placing merchandise on very low or very high shelves discourages customers from making purchases. For example, putting hearing aid batteries on bottom shelves where the elderly have trouble getting to them or placing popular children's toys on top shelves where little ones cannot reach them hurts sales of these items.
- ***Shoppers prefer wide aisles.*** One study found that shoppers, especially women, are reluctant to enter narrow aisles in a store. Narrow aisles force customers to jostle past one another, creating what experts call the "butt-brush factor." Open aisles allow customers to shop comfortably and encourage them to spend more time in a store.
- ***Placing shopping baskets in several areas around a store increases sales.*** Seventy-five percent of shoppers who pick up a basket buy something, compared to just 34 percent of customers who do not pick up a basket.¹²² Smart retailers make shopping baskets available to customers throughout the store, not just at the entrance.
- ***A store's layout should enable customers to easily locate the items they want.*** Easy-to-read signs, clearly marked aisles, and displays of popular items located near the entrance make it easy for shoppers to find their way around a store.
- ***Whenever possible, allow customers to touch the merchandise.*** Customers are much more likely to buy items if they can pick them up. The probability that customers who are

shopping for clothing will make purchases increase if they try on the garments. Shoppers who use fitting rooms to try on garments make purchases 67 percent of the time, compared to a 10 percent purchase rate for shoppers who do not use a fitting room.¹²³

Retailers should separate the selling and nonselling areas of a store and should never waste prime selling space with nonselling functions, such as storage, receiving, office, and fitting areas. Although nonselling activities are necessary for a successful retail operation, they should not take precedence and occupy valuable selling and merchandising space. Many retailers place their nonselling departments in the rear of the building, recognizing the value of each foot of space in a retail store and locating their most profitable items in the best-selling areas. Entrepreneurs should use at least 80 percent of available retail space for selling and merchandising.

One nonselling activity, the checkout process, is a particularly important ingredient in customer satisfaction and often ranks as a sore spot with shoppers. Research shows that shoppers tend to be impatient, willing to wait only about four minutes in a checkout line before becoming exasperated. One study reports that 43 percent of customers say that long checkout lines make them less likely to shop at a store.¹²⁴ Retailers are discovering that simplifying and speeding up the checkout process increases customer convenience, lowers shoppers' stress levels, and makes them more likely to come back. Some retailers use roving clerks equipped with handheld credit card swiping devices, especially during peak hours, to hasten the checkout process.

The various areas within a small store's interior space are not equal in generating sales revenue. Certain areas contribute more to revenue than others. The value of store space depends on floor location in a multistory building, location with respect to aisles and walkways, and proximity to entrances. Space values decrease as distance from the main entry-level floor increases. Selling areas on the main level contribute a greater portion to sales than do those on other floors because they offer greater exposure to customers than either basement or higher-level locations. Therefore, main-level locations carry a greater share of rent than other levels.



In the Entrepreneurial Spotlight

The Secrets of Successful Retail Layouts

Fraser Ross, owner of Kitson, a 10-store retail chain in southern California that sells pop culture fashions, accessories, books, and gift items and novelties, plans the layout for his stores strategically, using his many years of retail experience and keen observation of shoppers and their buying habits. Ross frequently changes the displays and the layout of his stores, but he relies on one underlying principle: lure shoppers into the store with attractive displays of lower-priced gifts, entice them with a flashy jewelry counter in the center, and guide them toward the back, where eye-catching shelves of colorful, expensive handbags and shoes and orderly racks of the latest fashions await. Ross starts seducing customers before they enter his store with unusual, attention-grabbing window displays that might use a popular movie or book as its theme. In Ross's eclectic stores, which are well-known destinations for celebrity shoppers, including the Kardashians, Alicia Keys, Channing Tatum, Heidi Klum, Jessica Alba, Lenny Kravitz, Taylor Swift, and others, round tables in the gift area along one wall steer customers back into the heart of the store, where they continue to fill their shopping baskets.

During the all-important holiday season, which accounts for half of Kitson's \$30 million in annual sales, layout takes on even more importance. Ross plots a very intentional path for shoppers to follow through the store. He places unusual gift items at the front of the store and uses displays of jewelry and accessories to draw shoppers to the rear of the store, which is home to the

most expensive items. He puts carefully selected impulse items from inexpensive bracelets to pricier colognes and perfumes near cash registers. Ross also carefully selects his stores' play lists of background music. Beginning on the first Saturday before Thanksgiving, every fourth song on the track is a Christmas song. As Christmas draws closer, he increases the frequency of holiday music until every song is a Christmas song, but the choices, like the stores' merchandise, is eclectic, including classics such as Bing Crosby's "White Christmas" and modern songs such as "Christmas Tree" by Lady Gaga and Space Cowboy. Ross also changes in-store displays more frequently during the holidays. "You've got to feed customers today," he explains. The men's shop and a selection of about 400 books priced between \$10 and \$30 are located upstairs.

Like Fraser Ross, David DeMattei, CEO of Lucky Brand, a retailer of casual apparel, shoes, jewelry, and accessories with 209 stores in the United States, understands the importance of an effective layout to his company's sales and profits. "Retail is in the details," quips DeMattei. Lucky Brand, a division of Fifth & Pacific, recently engaged in a methodical revamp of its stores, doing away with a cluttered look that often displayed merchandise out of customers' reach and appeared outdated. Replacing it is an orderly layout with a clean look, lighter colors, and displays positioned to allow shoppers to create complete outfits easily. Although a great deal of research went into the design, DeMattei says that

In the Entrepreneurial Spotlight *(continued)*

"we don't want it to look like a science. We just want it to look relaxed." The goal of the newly designed stores, whose signature item is Lucky Brand jeans (which contain the message "Lucky You" stitched inside the fly), is to "romance" shoppers. "It starts with the [display] windows," says Patrick Wade, the company's creative director, gazing at a window mannequin wearing a carefully coordinated casual outfit. Just behind the mannequin inside the store are tables displaying the items in the same outfit and in other color variations of the outfit. "The idea is to get shoppers thinking, 'I could buy it just the way it is in the window—or make the look my own with the red blouse,'" he says.

Lucky Brand has been conducting experiments to determine whether putting menswear or womenswear at the front of its stores increases sales. A yearlong study has proved inconclusive, so DeMattei decided to leave women's clothing up front and to put men's clothing at the back of the store.

Inspired by the success of cosmetics retailer Sephora, makeup and skin care retailers have switched from "don't touch" layouts to "open layouts" that allow customers to browse through open shelves and experiment without interference from a salesperson. Launched in 1993 as a French perfume chain, Sephora stormed the makeup market in the United States and forced other makeup retailers to change their tactics. For years, women shopping for makeup had two choices: drugstores that offered products in tightly sealed packages or department stores that required a hovering salesperson whose sales commission was tied to particular brands. Spotting an opportunity, managers at Sephora decided to break out of the traditional mold for

marketing makeup and offer more than 13,000 products in one store and give customers the freedom to explore and sample various types of makeup. In the company's open sell environment, women can try lipsticks, eyeliners, blushes, and other products from more than 250 brands on their own, or they can ask for assistance from one of Sephora's highly trained sales associates.

An open sell strategy with minimal involvement from trained beauty consultants means that proper layout is more important than ever before. Despite stocking more than 13,000 products, Sephora stores are always neat and orderly. The unspoken message they send to customers is clear: We offer a large selection of products, but they are always easy to find. Displays organize fragrances in alphabetic order and cosmetics by brand. Large storefront windows allow passersby to have a bird's-eye view of the store instantly and to see the breadth and depth of its product line, both of which have proved to be effective at drawing in shoppers.

1. Identify at least two layout principles that the three retailers described here utilize.
2. Work with a team of your classmates to identify a local business and use the layout principles that you have learned in this chapter to develop a more effective layout. How would you test your layout to determine whether it actually is more effective?

Sources: Based on Christina Binkley, "How Stores Lead You to Spend," *Wall Street Journal*, December 2, 2010, pp. D1, D8; Christina Binkley, "The Shopping Science Behind Lucky's Revamp," *Wall Street Journal*, January 19, 2012, p. D8; Elizabeth Holmes, "Leave Me Alone, I'm Shopping," *Wall Street Journal*, June 28, 2012, pp. D1, D4.

The layout of aisles in the store has a major impact on the customer exposure that merchandise receives. Items located on primary walkways should be assigned a higher share of rental costs and should contribute a greater portion to sales revenue than those displayed along secondary aisles. Space values also depend on the spaces' relative position to the store entrance, which serves as the "landing strip" for shoppers. A critical moment occurs when shoppers walk into a store as they slow down, try to orient themselves, and expand their peripheral vision to get a panoramic view of the retail spaces. An effective layout allows them to familiarize themselves with the retail landscape as quickly as possible.



ENTREPRENEURIAL PROFILE: Old Navy Clothing retailer Old Navy recently created a new look for its stores using a "racetrack" layout in which the primary aisle starts at the store's entrance and loops through the entire store in a circular, square, or rectangular pattern. The goal of a racetrack layout is to expose customers to as much merchandise as possible and to encourage them to browse through other merchandise displayed on smaller "rabbit trails" that branch off of the main aisle. The new Old Navy layout also includes dressing rooms, a children's play area, and cash registers located in the center of the store and a "fundamentals" wall that displays low-priced items.¹²⁵

Most American shoppers turn to the right when entering a store and will move around it counterclockwise.¹²⁶ That makes the front right-hand section of a retail store the "retail sweet spot." Retailers should put their best-selling and highest-profit-margin items in this prime area. Only about one-fourth of a store's customers will go more than halfway into the store. Therefore, the farther away an area is from the entrance, the lower its value. Using these characteristics, Figure 18.7 illustrates space values for a typical small-store layout.

Layout for Manufacturers

Manufacturing layout decisions take into consideration the placement of equipment, workstations, machines, and stock-holding points within a production facility. The objective is to

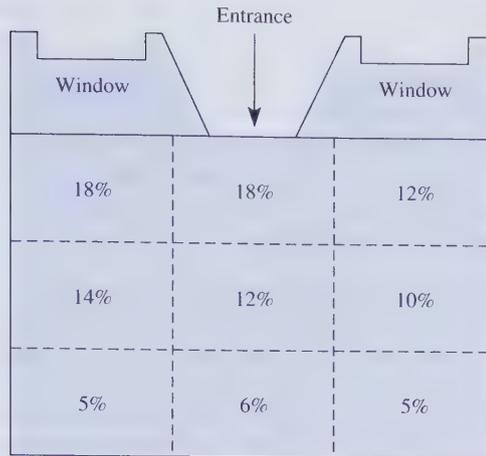


FIGURE 18.7
The Space Value
for a Small Store

arrange these elements to ensure a smooth work flow (in a production area) or a particular traffic pattern (in a service area). Manufacturing facilities have come under increased scrutiny as firms attempt to improve quality, reduce inventories, and increase productivity through facilities that are integrated, flexible, and controlled. Facility layout has a dramatic effect on product mix, product processing, materials handling, storage, control, and production volume and quality.

FACTORS IN MANUFACTURING LAYOUT The ideal layout for a manufacturing operation depends on several factors, including the following:

- **Type of product.** Product design and quality standards, whether the product is produced for inventory or for order, and physical properties, such as the size of materials and products special handling requirements, susceptibility to damage, and perishability
- **Type of production process.** Technology used types of materials handled, means of providing a service, and processing requirements in terms of number of operations involved and amount of interaction between departments and work centers
- **Ergonomic considerations.** To ensure worker safety, to avoid unnecessary injuries and accidents, and to increase productivity
- **Economic considerations.** Volume of production; costs of materials, machines, work stations, and labor; pattern and variability of demand; and length of permissible delays
- **Space availability within facility itself.** Ensure that the space will adequately meet current and future manufacturing needs

TYPES OF MANUFACTURING LAYOUTS Manufacturing layouts are categorized either by the work flow in a plant or by the production system's function. There are three basic types of layouts that manufacturers can use separately or in combination—product, process, and fixed position—and they differ in their applicability of different levels of manufacturing volume.

Product Layouts In a **product (or line) layout**, a manufacturer arranges workers and equipment according to the sequence of operations performed on the product. Conceptually, the flow is an unbroken line from raw materials input to finished goods. This type of layout is applicable to rigid-flow, high-volume, continuous or mass-production operations or when the product is highly standardized. Automobile assembly plants, paper mills, and oil refineries are examples of product layouts. Product layouts offer the advantages of lower materials handling costs; simplified tasks that can be done with low cost, lower-skilled labor; reduced amounts of work-in-process inventory; and relatively simplified production control activities. All units are routed along the same fixed path, and scheduling consists primarily of setting a production rate.

Disadvantages of product layouts include their inflexibility, monotony of job tasks, high fixed investment in specialized equipment, and heavy interdependence of all operations. A breakdown in one machine or at one work station can idle the entire line. Such a layout also requires the owner to duplicate many pieces of equipment in the manufacturing facility; duplication can be cost prohibitive for a small business. German automaker BMW, in which the heirs of Herbert

Quandt (who acquired majority ownership of the company in 1960) own a controlling interest, recently expanded its factory in Greer, South Carolina. Borrowing the layout of a factory in Leipzig, Germany, BMW redesigned the Greer factory in a “hand-and-finger” concept. “The plant has a main [manufacturing] line that goes through the middle of the building, and there are ‘fingers’ that branch off in different directions,” says communications director Max Metcalf. The fingers are corridors where employees perform various subassembly and installation activities that are then fed into the main manufacturing line. Each finger has its own receiving docks so that components from suppliers can arrive just in time.¹²⁷

Process Layouts In a **process layout**, a manufacturer groups workers and equipment according to the general function they perform without regard to any particular product. Process layouts are appropriate when production runs are short, when demand shows considerable variation and the costs of holding finished goods inventory are high, or when the product is customized. Process layouts have the advantages of being flexible for doing customer work and promoting job satisfaction by offering employees diverse and challenging tasks. Its disadvantages are the higher costs of materials handling, more skilled labor, lower productivity, and more complex production control. Because the work flow is intermittent, each job must be individually routed through the system and scheduled at the various work centers, and its status must be monitored individually.

Fixed-Position Layouts In a **fixed position layout**, materials do not move down a line as in a product layout. Because of the bulk or weight of the final product, workers go to the materials and assemble them into finished products in one spot. Aircraft assembly shops and shipyards typify this kind of layout.

DESIGNING LAYOUTS The starting point in layout design is determining how and in what sequence product parts or service tasks flow together. One of the most effective techniques is to create an overall picture of the manufacturing process using assembly charts and process flowcharts. Given the tasks and their sequence, in addition to a knowledge of the volume of products that can be produced, an entrepreneur can analyze space and equipment needs. Two important criteria for selecting and designing a layout are worker productivity and materials handling costs.

Worker Productivity Designing layouts ergonomically so that they maximize workers’ strengths is especially important for manufacturers. Creating an environment that is comfortable and pleasant for workers pays big benefits over time in the form of higher productivity, lower absenteeism and tardiness, and fewer injuries. Designers must be sure that they match the environment they create to workers’ needs rather than trying to force workers to adapt to the environment.

Materials Handling Costs Manufacturers can lower materials handling costs by using layouts designed to automate product flow whenever possible and to minimize flow distances and times. The extent of automation depends on the level of technology and amount of capital available as well as behavioral considerations of employees. Flow distances and times are usually minimized by locating sequential processing activities or interrelated departments in adjacent areas. The following features are important to a good manufacturing layout:

- Smooth materials flow pattern
- Straight-line layout where possible
- Straight, clearly marked aisles
- Backtracking kept to a minimum
- Related operations close together
- Minimum of in-process inventory
- Easy adjustment to changing conditions
- Minimum materials handling distances
- Minimum of manual handling
- No unnecessary rehandling of material

- Minimum handling between operations
- Materials delivered to production employees quickly
- Use of gravity to move materials whenever possible
- Materials efficiently removed from the work area
- Materials handling done by indirect labor
- Orderly materials handling and storage
- Good housekeeping

Chapter Review

1. Explain the stages in the location decision.
 - The location decision is one of the most important decisions an entrepreneur will make, given its long-term effects on the company. An entrepreneur should look at the choice as a series of increasingly narrow decisions: Which region of the country? Which state? Which city? Which site?
 - Demographic statistics are available from a wide variety of sources, but government agencies such as the Census Bureau have a wealth of detailed data that can guide an entrepreneur in her location decision.
2. Describe the location criteria for retail and service businesses.
 - For retailers and many service businesses, the location decision is especially crucial. They must consider the size of the trade area, the volume of customer traffic, the number of parking spots, the availability of room for expansion, and the visibility of a site.
3. Outline the basic location options for retail and service businesses.
 - Retail and service businesses have six basic location options: CBDs, neighborhoods, shopping centers and malls, near competitors, outlying areas, and at home.
4. Explain the site selection process for manufacturers.
 - A manufacturer's location decision is strongly influenced by local zoning ordinances. Some areas offer industrial parks designed specifically to attract manufacturers. Two crucial factors for most manufacturers are the accessibility to (and the cost of transporting) raw materials and the quality and quantity of available labor.
5. Discuss the benefits of locating a start-up company in a business incubator.
 - Business incubators are locations that offer flexible, low-cost rental space to their tenants as well as business and consulting services. Their goal is to nurture small companies until they are ready to "graduate" into the larger business community. Many government agencies and universities offer incubator locations.
6. Describe the criteria used to analyze the layout and design considerations of a building, including the Americans with Disabilities Act.
 - When evaluating the suitability of a particular building, an entrepreneur should consider several factors:
 - **Size.** Is the structure large enough to accommodate the business with some room for growth?
 - **Construction and external appearance.** Is the building structurally sound, and does it create the right impression for the business?
 - **Entrances.** Are they inviting?
 - **Legal issues.** Does the building comply with the ADA, and, if not, how much will it cost to bring it up to standard?
 - **Signs.** Are they legible, well located, and easy to see?
 - **Interior.** Does the interior design contribute to your ability to make sales, and is it ergonomically designed?
 - **Lights and fixtures.** Is the lighting adequate to the tasks workers will be performing, and what is the estimated cost of lighting?
7. Explain the principles of effective layout for retailers, service businesses, and manufacturers.
 - Layout for retail store and service businesses depends on the owner's understanding of customers' buying habits. Retailers have three basic layout options from which to choose: grid, free-form, and boutique layouts. Some areas of a retail store generate more sales per square foot and are, therefore, more valuable than others.
 - The goal of a manufacturer's layout is to create a smooth, efficient work flow. Three basic options exist: product layout, process layout, and fixed-position layout. Two key considerations are worker productivity and materials handling costs.

Discussion Questions

- 18-1. How do most small business owners choose a location? Is this wise?
- 18-2. What factors should a manager consider when evaluating a region in which to locate a business? Where are such data available?
- 18-3. Outline the factors entrepreneurs should consider when selecting a state in which to locate a business.
- 18-4. What factors should a seafood-processing plant, a beauty shop, and an exclusive jewelry store consider in choosing a location? List factors for each type of business.
- 18-5. What intangible factors might enter into the entrepreneur's location decision?
- 18-6. Explain the relevance of "business clusters" with suitable examples.
- 18-7. What are the factors an entrepreneur should consider when evaluating a mall or shopping centre location to set up his business?
- 18-8. Explain how a foreign trade zone works.
- 18-9. Outline the benefits of locating a start-up company in a business incubator.
- 18-10. Why may a cheap location not be the best location?
- 18-11. What function does a small firm's sign serve? What are the characteristics of an effective business sign?
- 18-12. Explain the following statement: "The portions of a small store's interior space are not of equal value in generating sales revenue." What are some of the major features that are important to a good manufacturing layout?

CHAPTER 19

Supply Chain Management

Learning Objectives

On completion of this chapter, you will be able to:

1. Understand the components of a purchasing plan.
2. Explain the principles of total quality management, including Lean, 5S, and Six Sigma, and their impact on quality.
3. Conduct economic order quantity analysis to determine the proper level of inventory.
4. Differentiate among the three types of purchase discounts that vendors offer.
5. Calculate a company's reorder point.
6. Develop a vendor rating scale.
7. Describe the legal implications of the purchasing function.



We are too busy mopping the floor to turn off the faucet.

—Anonymous

Continuous improvement is not about the things you do well—that's work. Continuous improvement is about removing the things that get in the way of your work. The headaches, the things that slow you down, that's what continuous improvement is all about.

—Bruce Hamilton

This chapter discusses the activities involved in managing a small company's supply chain—purchasing, quality management, and vendor analysis. Although none of these is the most glamorous or exciting job that an entrepreneur undertakes, they form an important part of the foundation that supports every small business. When entrepreneurs begin producing products or providing services, they quickly learn how much their products or services depend on the quality of the components and services they purchase from their suppliers. Success today depends on higher levels of collaboration among the businesses that make up a company's supply chain. "Many businesses still regard the supply chain as the back end of their businesses, but the modern supply chain has a much bigger contribution to make," concludes a study of supply chain management. "It can help companies differentiate themselves from the competition and achieve greater sustainable growth."¹ Today, thriving companies operate as part of seamless network of alliances and partnerships with customers, suppliers, and distributors. For many businesses, the quality of the supply chain determines their ability to satisfy their customers and to compete effectively. "Competition is not really company vs. company," says one expert, "but supply chain vs. supply chain."² In other words, supply chain management has become an important strategic issue rather than merely a tactical matter for companies. Several studies have found that companies that utilize best-practice supply chain management tools outperform those with average supply chains. They not only have faster delivery times, lower costs, and higher levels of customer service but also achieve superior financial performance, producing 30 percent higher profit margins than companies with average supply chains. Top-performing companies also have on-time delivery rates of 96 percent (compared to 89 percent for average performing companies) and generate 15.3 inventory turns per year (compared to just 8.2 turns for average performing companies)—all while carrying less inventory.³

Supply chain management (SCM) is the process by which a company forecasts, plans for, and acquires the materials and goods it purchases from vendors and suppliers to maximize the value it provides to its customers at minimum cost. Proper SCM requires transparency, a smooth flow of information up and down the chain, and collaboration among a company and its supply chain partners. Managing the supply chain has become more challenging, however, because the globalization of business makes supply chains longer and adds layers of complexity to supply chain activities. The Outsourcing World Summit reports that 58 percent of medium-size companies and 43 percent of small companies engage in global sourcing for at least some of their purchases. Nearly 75 percent of these companies also say that they plan to expand their global purchases over the next three years.⁴ According to a recent study by PriceWaterhouseCoopers, 85 percent of managers say that their companies' global purchasing patterns have increased the level of complexity in their supply chains.⁵ Figure 19.1 shows the greatest pressures that companies face in managing their supply chains. Purchasing goods and services from companies scattered across the globe means that entrepreneurs must manage the elements of their supply chains more closely to avoid disruptions, inventory shortages, and quality problems.

Selecting the right vendors and designing a fast and efficient supply chain influences a small company's ability to produce and sell quality products and services at competitive prices. These decisions have far-reaching effects for a business as well as a significant impact on its bottom line.

Most shoppers give little thought to the path that the goods they buy in stores took to get there. However, entrepreneurs know that a flexible, reliable supply chain is essential to business success.

Source: © Patti McConville/Alamy.



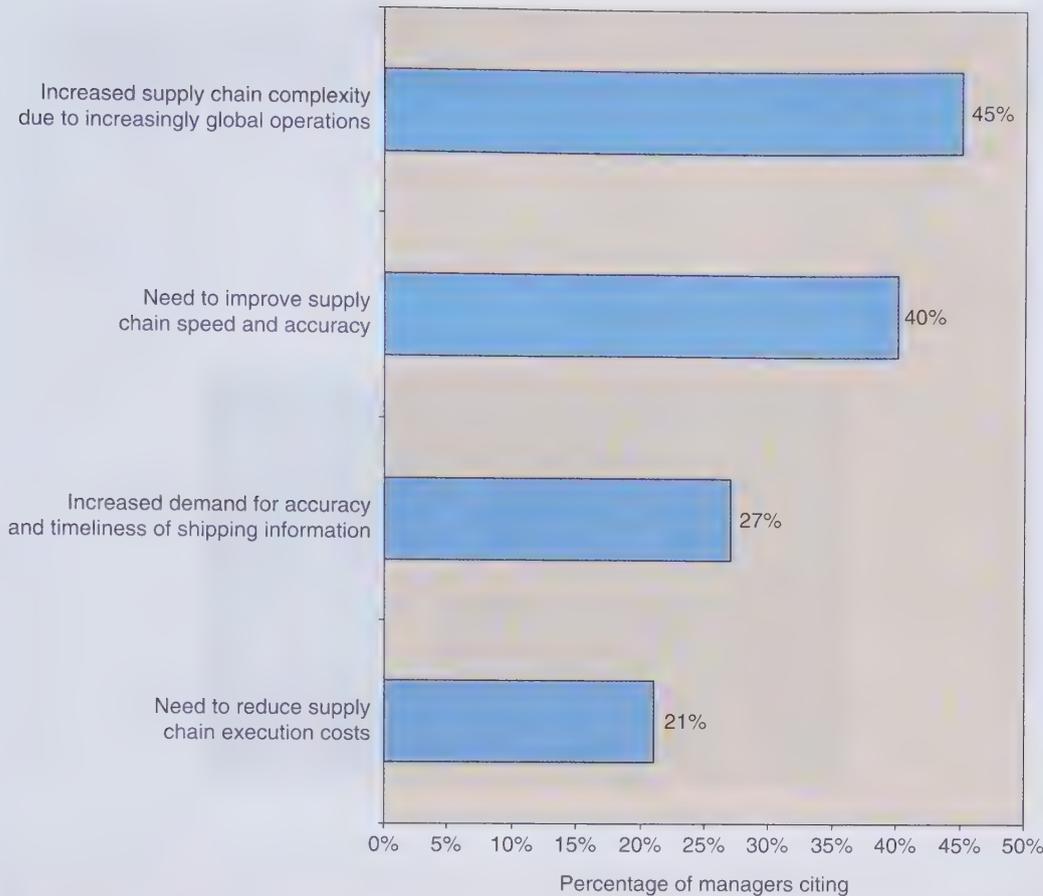


FIGURE 19.1
Top Supply Chain Pressures

Source: Bob Heaney, "Supply Chain Visibility in Consumer Markets," Aberdeen Group, March 2013, p. 2.

Depending on the type of business involved, the purchasing function can consume anywhere from 25 to 85 percent of each dollar of sales. By shaving just 2 percent off of its cost of goods sold, a typical small company can increase its net income by more than 25 percent! One classic study of various industries by IBM determined that to match the bottom-line impact of a \$1 savings in purchasing, a company must increase its sales revenue by an average of 19.7 percent.⁶ To realize these savings, however, entrepreneurs must create a purchasing plan, establish well-defined measures of product or service quality, and select vendors and suppliers using a set of relevant, objective criteria.

When a company's supply chain breaks down, the result can be devastating in both immediate and future costs, such as recalling dangerous or defective products and lost sales from customers who turn to substitute products. Some of those lost customers never return, and, worse yet, the company's name and reputation are tarnished forever. For instance, Yum! Brands, owner of the KFC, Taco Bell, and Pizza Hut brands, saw sales at its restaurants in China decline 25 percent in the months after news reports revealed excessive levels of antibiotics in samples of chicken that the company purchased from some of its Chinese suppliers. Yum! Brands, with more than 39,000 restaurants in 125 countries, quickly realigned its supply chain in China, eliminating more than 1,000 small poultry producers (where almost all of the problems originated) and reinforced its quality control standards. Despite the company's quick response to the supply problems, overcoming the negative publicity from the incident took many months.⁷

A company's supply chain is an integral part of its operations, and managers must identify the primary risks that their supply chains face (see Figure 19.2) and develop contingency plans for managing them. A survey by the World Economic Forum reports that 93 percent of managers around the globe say that managing supply chain risks has become a higher priority in their companies over the last five years.⁸ Both man-made and natural disasters pose a threat to companies' supply chains. Massive floods in Thailand that left 900 factories in seven industrial parks under 15 feet of water disrupted the supply chains of companies around the world in a variety of industries. The personal computer industry was especially hard hit because factories located near Bangkok produce one-third of the world's hard drives and up to 80 percent of other computer components. Because of the interconnected nature of supply chains, computer makers around the world faced shortages of hard drives and other parts for more than a year after the floods. Just a

few months before the floods, makers of computers and other electronic devices had experienced major supply chain disruptions when a devastating earthquake and resulting tsunamis shut down factories in Japan, which accounts for 60 percent of the world’s production of silicon chips and 90 percent of BT resin, a substance used to make printed circuit boards, both of which are vital components in almost every electronic device. Companies around the world faced manufacturing and shipping delays because they could not acquire enough silicon chips to produce personal computers, tablets, smart phones, television sets, home appliances, and other electronic devices.⁹ The affected companies incurred millions of dollars in lost revenue. Minimizing problems from disruptions in a company’s supply chains as a result of disasters and unexpected events requires proper SCM and a sound purchasing plan.

Massive floods in Thailand disrupted the supply chains of companies around the globe.

Source: Pornchai Kittiwongsakul/ Getty Images.

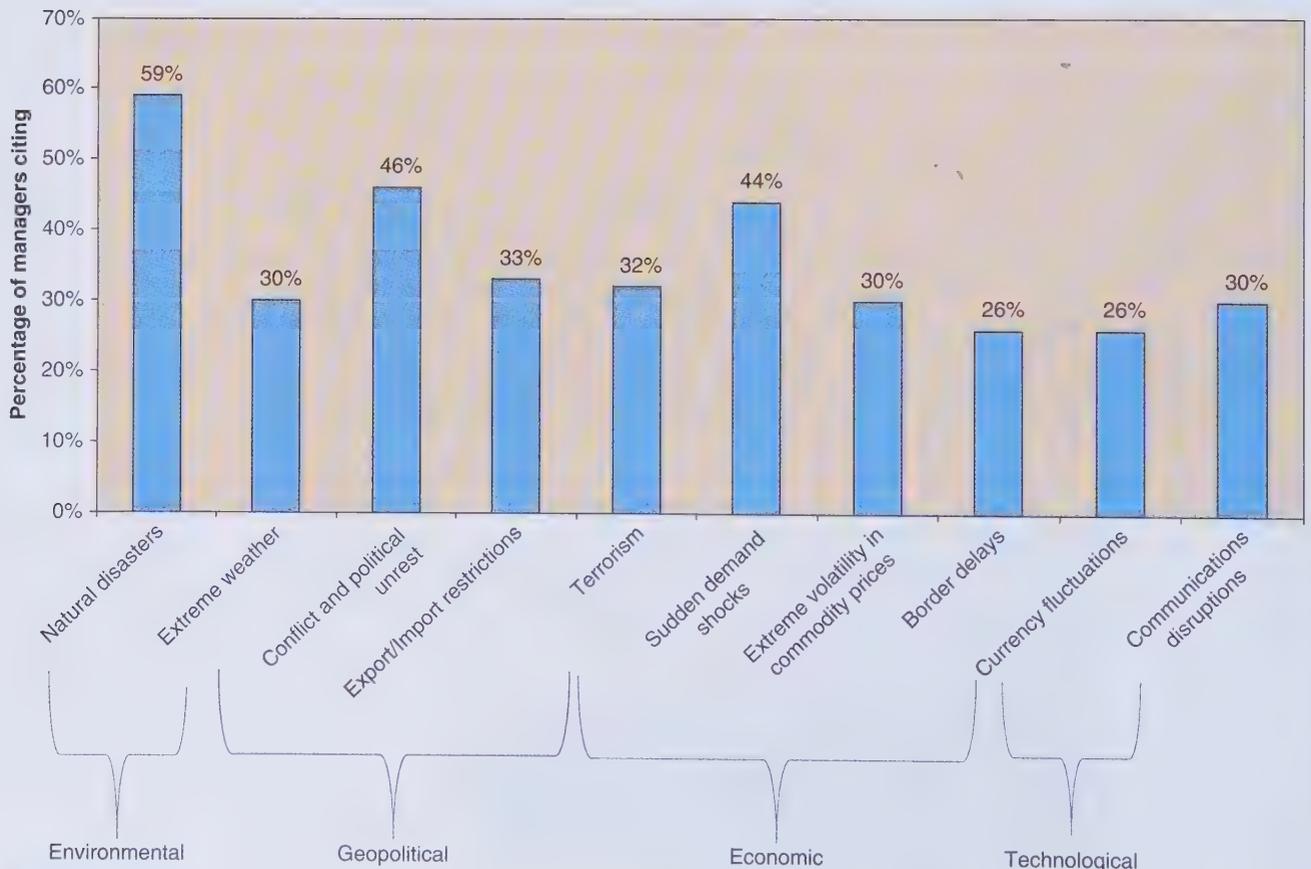


FIGURE 19.2

Greatest Threats to Supply Chains



Lessons from the Street-Smart Entrepreneur

How to Manage Supply Chain Risk

Many small businesses pay prices for goods and services that are too high, and they find that their options are limited by the lack of competent suppliers. The broader the base of potential suppliers a business has, the more supply flexibility and security it has and the greater is its ability to get the best prices on its purchases. Use the following tips from the Street-Smart Entrepreneur to build meaningful, long-term relationships with the best suppliers.

1. **Establish your company's critical criteria for selecting a vendor.** What characteristics would the ideal vendor have? You must know up front what you are looking for in a vendor.
2. **Research thoroughly prospective vendors before you purchase anything from them.** The Internet is a useful tool for conducting a preliminary screening analysis.
3. **Interview prospective vendors with the same level of intensity that you interview prospective employees.** Both relationships influence how successful a company is at achieving quality objectives. "It's not easy to put aside the time," says James Walker, president of Octagon Research Solutions, a 60-person software company, "but for us, it's all about whether we can have a good relationship with [our vendors.]" Use the criteria you established in step 1 to establish a list of questions to ask potential vendors.
4. **Be assertive.** Ask tough questions and be a knowledgeable buyer. Don't allow suppliers to do their typical "sales pitches" before you have time to ask your questions.
5. **Check potential vendors' credit ratings.** Judging a potential vendor's financial strength and stability is important. Dealing with a vendor that is undergoing financial woes creates unnecessary complications for business owners.
6. **Get referrals.** Ask all potential vendors to supply a list of referrals of businesses that they have served over the past five years or more. Then make the necessary contacts.
7. **Visit potential vendors' businesses.** The best way to judge a vendor's ability to meet your company's needs is to see the operation firsthand. Nancy Connolly, president of Lasertone Corporation, a maker of copier and laser toner, insists on "a personal meeting between me and the president of the company," she says, before establishing a relationship with a vendor. The goal is to judge the level of the potential vendor's commitment to meeting Lasertone's needs.
8. **Evaluate potential suppliers' plans for dealing with risks and interruptions in their own supply chains.** Remember that if your vendor's supply of materials is interrupted, your supply also will be interrupted.
9. **Don't fixate on price.** Look for value in what they sell. If your only concern is lowest price, vendors will push their lowest-priced (and often lowest-quality) product lines.
10. **Ask "What if?"** The real test of a strong vendor–customer relationship occurs when problems arise. Smart entrepreneurs ask vendors how they will handle particular types of problems when they arise.
11. **Attend trade shows.** Work the room. A visit to a trade show is not a vacation; it's business. Find out whether the next booth has a valuable new vendor who has the potential to increase your company's profits!
12. **Don't forget about local vendors.** Because of their proximity, local vendors can sometimes provide the fastest service. Solving problems often is easier because local vendors can make on-site service calls.
13. **Test a vendor before committing completely.** Susan Gilbert, owner of Café in the Park, a restaurant in San Diego, says, "Inventory is cash flow. When I'm dealing with a vendor, I need to know how quickly they can deliver, how quickly I can turn over the inventory, and keep it all tight." Rather than place an order for 100 dozen Danish pastries with a new vendor, for instance, Gilbert starts with an order of several dozen pastries to judge the vendor's performance.
14. **Find an appropriate balance between sole sourcing, which reduces economies of scale, and multisourcing, which reduces the risk of interrupted supplies.** Recall that a common strategy uses Pareto's Law, the 80-20 Rule.
15. **Work with the vendors.** Tell your suppliers what you like and don't like about their products and service. In many cases, they can resolve your concerns. Most vendors want to build long-term relationships with their customers. Give them a chance to do so.
16. **Do unto others . . .** Treat your vendors well. Be selective but pay on time and treat them with respect.
 1. Why do so many firms focus solely on selecting vendors that offer the lowest prices? What are the dangers of doing so?
 2. Develop a list of 10 questions you would ask a potential vendor on a product you select.

Sources: Based on Nancy Germond, "Supply Chain Risk Management a Must as Global Sourcing Intensifies," *All Business*, June 11, 2010, www.allbusiness.com/company-activities-management/risk-management/14609006-1.html; Kelly L. Frey, "Selecting a Vendor: RFPs and Responses to RFPs," Baker, Donelson, Bearman, Caldwell, and Berkowitz, www.bakerdonelson.com/Documents/Selecting%20a%20Vendor.pdf; Allison Stein Wellner, "Finding the Right Vendor," *Inc.*, July 2003, pp. 88–95; Jan Norman, "How to Find Suppliers," *Business Start-Ups*, October 1998, pp. 44–47; *Physical Risks to the Supply Chain: A View from Finance*, CFO Research Services and FM Global, February 2009, pp. 6–7.

Creating a Purchasing Plan

1. Understand the components of a purchasing plan.



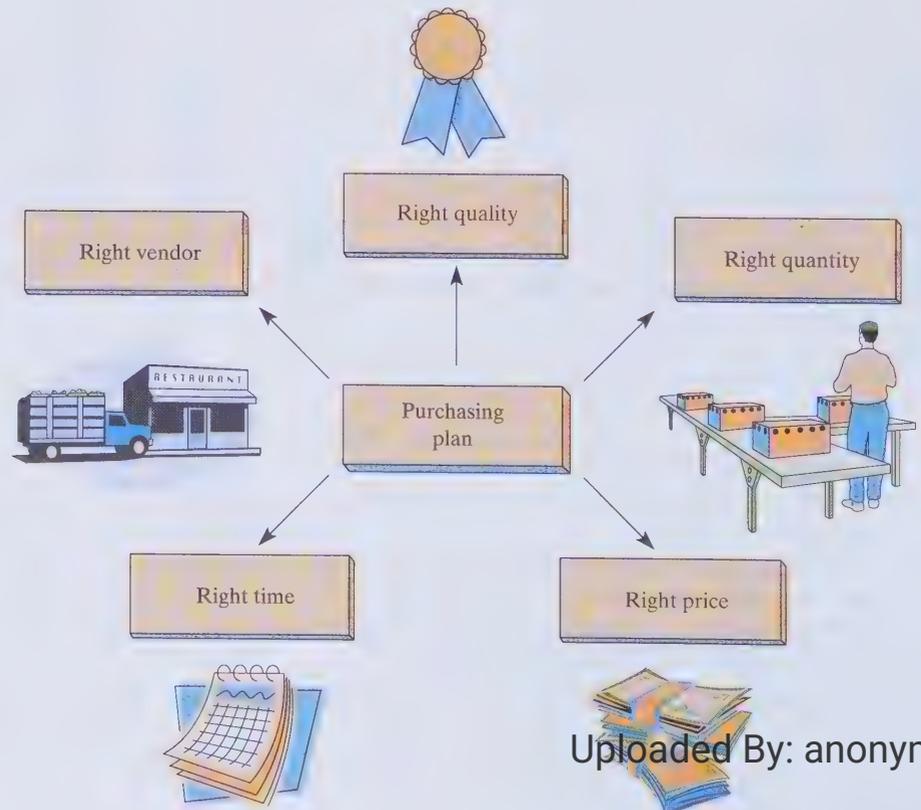
McCormick and Company purchases its spices from suppliers in 24 countries.
Source: Kesu/Shutterstock.

A **purchasing plan** involves planning for the acquisition of needed materials, supplies, services, and equipment of the right quality, in the proper quantities, for reasonable prices, at the appropriate time, and from the right vendor. A major objective of creating a purchasing plan is to establish a reliable, efficient supply chain through which a business acquires enough (but not too much) inventory to generate smooth, uninterrupted production or sales and ensures that finished goods are delivered on time to customers. “A more responsive supply chain is required to improve customer service levels,” says Stephanie Ranada, manager of supply and logistics at Tropical Retail Company. “It is the foundation of fulfilling the mandate of ‘right product at the right place at the right time.’”¹⁰ Companies are purchasing goods and supplies across the globe, making their supply chains longer and more challenging to manage. Coordinating the many pieces of the global puzzle requires a comprehensive purchasing plan. The plan must identify a company’s quality requirements, its cost targets, and the criteria for determining the best supplier, considering such factors as reliability, service, delivery, and cooperation.

ENTREPRENEURIAL PROFILE: McCormick and Company McCormick and Company, a business based in Sparks, Maryland, that sells spices ranging from allspice to turmeric, manages a global supply chain that stretches back more than 2,000 years to when the Nabataeans established a hub-and-spoke network of suppliers on the Arabian Peninsula. McCormick’s supply chain literally spans the globe (see Table 19.1), reaching into 50 locations in 24 countries to purchase from hundreds of suppliers the raw materials it requires for its product line. Since 1889, company buyers have traveled to Uganda and Madagascar for vanilla, to China and Nigeria for ginger, to Yugoslavia and Albania for sage, and to India, Turkey, Pakistan, and Syria for cumin seed. McCormick makes significant investments to find suppliers that can deliver quality materials in a timely manner and engages in extensive testing and security practices to ensure the quality and the safety of the raw materials it purchases. Recently, McCormick was put to the test when in the span of a matter of months, its supply chain was disrupted by a revolution in Egypt, devastating floods in Thailand, and computer system and shipping problems with a key vendor in Peru.¹¹

A purchasing plan is closely linked to the other functional areas of managing a small business: production, marketing, sales, engineering, accounting, finance, and others. A purchasing plan should recognize this interaction and help integrate the purchasing function into the total organization. A small company’s purchasing plan should focus on the five key elements of purchasing: quality, quantity, price, timing, and vendor selection (see Figure 19.3).

FIGURE 19.3
Components of a Purchasing Plan



2.

Explain the principles of total quality management, including Lean, 5S, and Six Sigma, and their impact on quality.

Quality

Not long ago, businesses saw quality products and services as luxuries for customers who could afford them. Many companies mistakenly believed that producing or purchasing high-quality products and services was too costly. Business owners understand that quality goods and services are absolutely *essential* to remaining competitive. The benefits that companies earn by creating quality products, services, and processes come not only in the form of fewer defects but also in lower costs, higher productivity, and higher customer retention rates. W. Edwards Deming, one of the founding fathers of the modern quality movement, always claimed that higher quality resulted in lower costs. Internally, companies with a quality focus report significant improvements in work-related factors such as increased employee morale, lower employee turnover, and enhanced quality of work life. Benefits such as these can result in earning a significant competitive advantage over rivals of *any* size.

Total quality companies believe in and manage with the attitude of continuous improvement, a concept the Japanese call *kaizen*. The *kaizen* philosophy holds that small improvements made continuously over time accumulate into a radically reshaped and improved process. When defective items do occur, managers and employees who are engaged in continuous improvement do not simply rework or repair them. Instead, they see defectives as an opportunity to improve the entire process. Their goal is to identify the root cause of the defects and to change the entire process so that the same problem does not occur again. *Kaizen* also encourages managers to focus on improving the entire system, not just its individual components. World-class organizations in the twenty-first century have made continuous improvement a fundamental element of their competitive strategies.

Quality has an impact on both costs and revenues. Improved quality leads to less scrap and rework time, lower warranty costs, and increased worker productivity. On the revenue side of the equation, quality improves the firm's reputation, attracts customers, and often gives a firm the opportunity to charge higher prices. The bottom-line impact of quality is increased profitability.

TOOLS FOR ENSURING QUALITY: LEAN PRINCIPLES, 5S PRINCIPLES, SIX SIGMA, AND TOTAL QUALITY MANAGEMENT No matter which industry they are in, small companies have at their disposal four basic tools to improve quality in their operations: lean principles, 5S principles, six sigma, and total quality management.

Lean Principles Originally applied to manufacturing, Lean principles also have produced significant quality improvements in both the retail and service sectors. The fundamental idea behind the Lean philosophy is to eliminate waste in a company's activities, whether they are in manufacturing, distribution, inventory control, customer service, human resources, or other areas, and to make a company lean (and efficient) in its operation. Lean is built on five principles:

- **Value.** Companies must create products and services that add value from the customer's perspective.
- **Value stream.** Businesses must identify the essential steps that allow them to create an efficient production or service work flow.
- **Flow.** Companies must eliminate every step in the value stream that adds no value or creates delays, bottlenecks, and wasted effort. The goal is to create a smoothly flowing, efficient process that produces value for customers.
- **Pull.** Companies produce only when customer demand pulls products and services through the system. Attempting to push them through the system results in inefficiency in the form of excess inventory, costs, and waste. Customer demand, the "pull" in the system, drives the entire supply chain.

Source: Bob Thaves, Tom Thaves/
Cartoonistgroup.com



- **Perfection.** Companies should strive for perfection by eliminating waste and inefficiency everywhere it arises and by providing exactly the products and services customers want.

The principles of Lean are aimed at eliminating seven wastes. Figure 19.4a shows the seven wastes in a manufacturing environment, and Figure 19.4b shows the seven wastes in a service operation. Some experts have added an eighth waste to both lists: the underutilization of people. Some companies treat their workers as if they know very little. World-class companies see their employees as a valuable source of ideas, creativity, and solutions, and they create systems that capture their employees' knowledge and apply it to the process of continuous improvement.

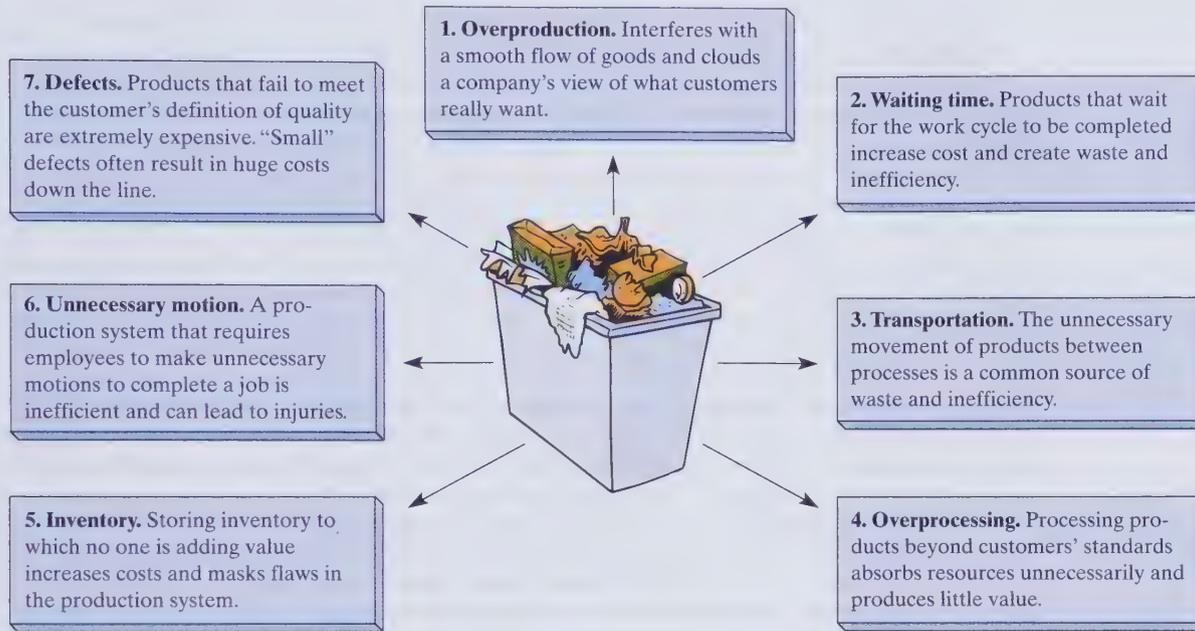
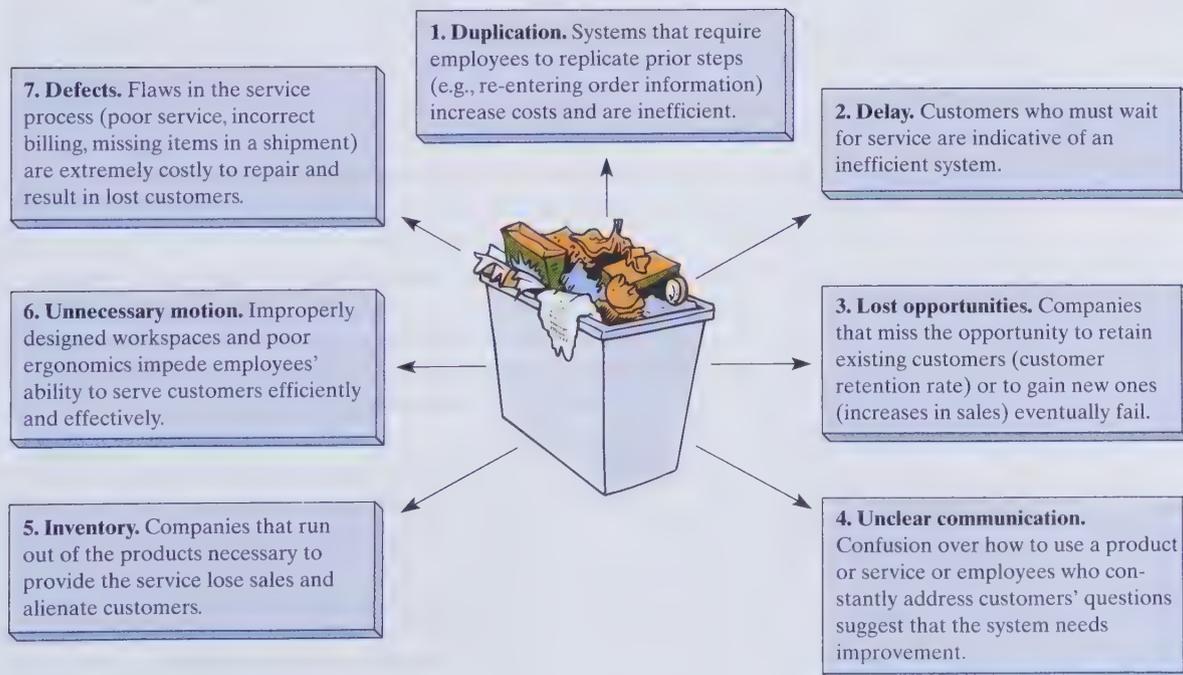


FIGURE 19.4a
Seven Wastes of Manufacturing



5S Principles Often used in conjunction with lean principles, the 5Ss are simple but effective ways to improve quality by organizing employees' work environment:

- **Sort.** Companies sort items in the workplace into two categories—necessary and unnecessary—and eliminate everything that is unnecessary.
- **Straighten.** Companies arrange the tools, equipment, and materials employees need to do their jobs in the most efficient manner that minimizes wasted motion and effort.
- **Shine.** Once organized, employees keep their work spaces neat and clean.
- **Systematize.** Businesses strive for continuous improvement in sorting, straightening, and shining by standardizing best-practice processes.
- **Sustain.** Companies sustain their drive toward continuous improvement by encouraging the involvement of all employees, self-discipline, and creating a performance measurement system.



ENTREPRENEURIAL PROFILE: Bill Vogel: Vogel Wood Products Bill Vogel, CEO of Vogel

Wood Products, a Monona, Wisconsin-based maker of wood and laminate cabinetry, fixtures, and office systems for home and commercial use, knew that his 15-employee company was operating well below peak efficiency. "We were putting in tons of overtime to get orders out the door," he says. Vogel knew that competition in the industry was becoming more fierce and that his company had to undergo dramatic changes to gain a competitive edge. With the help of the Wisconsin Manufacturing Extension Partnership, Vogel and his employees embarked on a quality improvement journey using lean manufacturing and 5S principles. The goal was to get every employee involved and to create a culture in which the customer comes first. Their first step was to map the company's existing processes, including those in manufacturing, assembly, and the front office, so that they could identify areas of inefficiency and waste. Employees then focused on using 5S principles to create a clean, organized, and efficient workplace. "With lean and 5S, the goal is to work more effectively, not harder," says Vogel. One team of employees came up with the idea of placing tools on carts that employees could move from one work station to another, reducing time wasted searching for the right tool. The changes allowed employees to identify and eliminate bottlenecks in the production process that Vogel says "unlocked the flow" of work. The company has reaped many benefits from the changes. In addition to improved employee morale, Vogel Wood Products has cut its cycle time (the time from receiving an order to delivering it to the customer) in half, reduced its work-in-process inventory by 70 percent, reduced overtime and labor costs by more than 6 percent, and increased its profits by 4 percent. "The principles of lean are simple," says sales manager Denita Ward. "The trick is to step back to see where basic changes can be made that result in real improvements."¹²

Six Sigma Six Sigma relies on data-driven statistical techniques to improve the quality and the efficiency of any process and to increase customer satisfaction. The quality threshold that Six Sigma programs set is high: an average of only 3.4 defects per 1 million opportunities! Although initially used by large corporations, Six Sigma can be adapted to work in small businesses as well. The four key tenets of Six Sigma are the following:

1. **Delight customers with quality and speed.** Six Sigma recognizes that the customer's needs come first. The goal is to produce products that are of the highest quality in a process that is efficient and fast.
2. **Constantly improve the process.** Six Sigma builds on the concept of continuous improvement. According to W. Edwards Deming, most quality problems are the result of the *process* (which management creates) rather than the *employees* (who work within the process that management builds). The goal is to reduce the variation of the process, which is measured by the standard deviation (denoted by the Greek letter sigma, σ).
3. **Use teamwork to improve the process.** Six Sigma counts on teams of employees working together to improve a process. People working together to share their knowledge can generate better solutions to quality problems than individuals can.
4. **Make changes to the process based on facts, not guesses.** To improve a process, employees must have quantifiable measures of results (e.g., quality of output) and of the process itself (e.g., how the process operated to produce those results).¹³

Table 19.2 explains the DMAIC process (Define, Measure, Analyze, Improve, Control) on which the Six Sigma approach is built. For small companies, the goal of the process is to understand their core business processes better so that managers and employees can work together to make significant improvements to them over time.

TABLE 19.2 The Six Sigma DMAIC Approach

Principle	Process Improvement Technique
Define	Identify the problem. Define the requirements. Set the goal for improvement.
Measure	Validate the process problem by mapping the process and gathering data about it. Refine the problem statement and the goal. Measure current performance by examining the relevant process inputs, steps, and output to establish a baseline.
Analyze	Develop a list of potential root causes. Identify the vital few. Use data analysis tools to validate the cause and effect connections between root causes and the quality problem.
Improve	Develop potential solutions to remove root causes by making changes to the process. Test potential solutions and develop a plan for implementing those that are successful. Measure the results of the improved process.
Control	Establish standard measures for the new process. Establish standard procedures for the new process. Review performance periodically and make adjustments as needed.

Source: Adapted from Andrew Spanyi and Marvin Wurtzel, "Six Sigma for the Rest of Us," *Quality Digest*, July 2003, www.qualitydigest.com/july03/articles/01_article.shtml.



ENTREPRENEURIAL PROFILE: Phil Parduhn: Pelco Products Pelco Products, a family-owned company founded in 1985 and based in Edmond, Oklahoma, has achieved success in a unique niche—manufacturing traffic signal hardware—by producing high-quality products and providing superior customer service. For Pelco, which sells its products in all 50 states as well as in international markets, speedy delivery is essential, especially when a city has experienced a natural disaster such as a hurricane or a tornado and must have replacement traffic lights, parts, and hardware quickly. Phil Parduhn, president of Pelco, implemented Lean principles in the company years ago and recently introduced Six Sigma methodology to continue the company's emphasis on continuous improvement. An analysis showed Parduhn that one of the areas in which the company needed to improve was its on-time delivery record. A team of employees studied the problem, identified the primary causes of "stuck" orders (those that were held up in the manufacturing process), and implemented a series of Lean- and Six Sigma-based techniques to resolve them. In less than four months, Pelco saw the volume of "stuck" orders decrease by 88 percent and the number of late deliveries to customers decline by 73 percent. Increased productivity that resulted from the streamlined process totaled more than \$15,500, but the higher level of customer satisfaction that the company experienced is priceless.¹⁴

Total Quality Management Under the total quality management (TQM) philosophy, companies define a quality product as one that conforms to predetermined standards that satisfy customers' demands. That means getting *everything* from delivery and invoicing to installation and follow-up right the first time. Although these companies know that they may never reach their targets of perfect quality, they never stop striving for perfection, recognizing that even a 99.9 percent level of quality is not good enough (see Table 19.3). The businesses that have effectively implemented these programs understand that the process involves a total commitment from strategy to practice and from the top of the organization to the bottom.

Rather than trying to inspect quality into products and services after they are completed, TQM instills the philosophy of doing the job right the first time. Although the concept is simple, implementing such a process is a challenge that requires a very different kind of thinking and very different culture than most organizations are comfortable with. Because the changes TQM requires are so significant, patience is a must for companies adopting the philosophy. Consistent quality improvements rarely occur over night, yet too many small business managers think, "We'll implement TQM today and tomorrow our quality will soar." TQM is *not* a "quick-fix," short-term program that can magically push a company to world-class-quality status overnight. Because it requires such fundamental, often drastic changes in the way a company does business, TQM takes time both to implement and to produce results. Although some small businesses that use TQM begin to see some improvements within just a matter of weeks, the *real* benefits take longer to realize. It takes at least two to four years before TQM principles gain acceptance among employees and as much as eight years are necessary to fully implement TQM in a company.

TABLE 19.3 Why 99.9 Percent Quality Isn't Good Enough

Most companies willingly accept a certain percentage of errors and defects. For many businesses, an acceptable range of defects is from 1 to 5 percent. In some companies, defects are regarded as a normal part of daily operations. However, quality consultants say that even 99.9 percent quality isn't good enough.

- To improve quality, many companies are limiting the number of suppliers they use for their raw materials and components, sometimes to just one or two.
- Partnering with suppliers so closely means that those suppliers must strive for 100 percent quality and performance.

What would be the result if some things were done right only 99.9 percent of the time? Consider the implications in the United States:

- 102,740 cell phone calls dropped per hour
- 2,283 credit card transactions charged to the wrong accounts every hour
- 3 unsafe landings at Atlanta's Hartsfield-Jackson Airport per day
- 18,265 pieces of mail in the postal system lost per hour
- 8,555 incorrectly filled drug prescriptions per day
- 15,800 packages misdelivered or lost by UPS each day
- 922 incorrect surgical procedures performed each week
- 4,326 debit card transactions deducted from the wrong accounts every hour
- 11 babies delivered to the wrong parents each day
- 251,142 text messages delivered to the wrong people every hour

If you are in the unlucky one-tenth of 1 percent, the error affects you 100 percent. In addition, unless a company strives for 100 percent product or service quality, there is little chance that it will ever achieve 99.9 percent quality.

To implement TQM successfully, a small business owner must rely on these fundamental principles:

- **Employ benchmarking to achieve quality outcomes.** Benchmarking is the process of identifying world-class processes or procedures that other companies (often in other industries) currently are using and building higher-quality standards around these for your business. This search for best practices is ongoing. As part of their quality initiative, employees at Scotsman Ice Systems, a small company in Fairfax, South Carolina, that makes high-end commercial and residential ice machines and refrigerators, benchmark the production processes of other manufacturing companies. To make sure that employee teams do not miss anything, teams have developed a benchmarking booklet that contains a list of key questions to take with them on benchmarking trips.¹⁵
- **Shift from a management-driven culture to a participative, team-based one.** Two basic tenets of TQM are employee involvement and teamwork. Business owners must be willing to push decision-making authority down the organization to where the real experts are. Teams of employees working together to identify and solve problems can be a powerful force in an organization of any size. Experience with TQM has taught entrepreneurs that the combined knowledge and experience of workers is much greater than that of only one person. Tapping into the problem-solving capabilities of the team produces profitable results.
- **Modify the reward system to encourage teamwork and innovation.** Because the team, not the individual, is the building block of TQM, companies often have to modify their compensation systems to reflect team performance. Traditional compensation methods pit one employee against another, undermining any sense of cooperation. Often they are based on seniority rather than on how much an employee contributes to the company. Compensation systems under TQM usually rely on incentives, linking pay to performance. However, rather than tying pay to individual performance, these systems focus on team-based incentives. Each person's pay depends on whether the entire team (or, sometimes, the entire company) meets a clearly defined, measurable set of performance objectives.
- **Train workers constantly to give them the tools they need to produce quality and to upgrade the company's knowledge base.** One of the most important factors in making long-term, constant improvements in a company's processes is teaching workers the philosophy and the tools of TQM. Admonishing employees to "produce quality" or offering them rewards for high quality is futile unless a company gives them the tools and knows how to achieve that end. Managers must be dedicated to making their companies "learning organizations" that encourage people to upgrade their skills and give them the opportunities and

incentives to do so. The most successful companies spend anywhere from 1 to 5 percent of their employees' time on training, most of it invested in workers, not managers. To give employees a sense of how the quality of their job fits into the big picture, many TQM companies engage in **cross training**, teaching workers to do other jobs in the company.

- **Train employees to measure quality with the tools of statistical process control (SPC).** The only way to ensure gains in quality is to measure results objectively and to trace the company's progress toward its quality objectives. That requires teaching employees how to use statistical process control techniques such as fishbone charts, Pareto charts, control charts, and measures of process capability. Without knowledgeable workers using these quantitative tools, TQM cannot produce the intended results.
- **Use Pareto's Law to focus TQM efforts.** One of the toughest questions managers face in companies embarking on TQM for the first time is "Where do we start?" The best way to answer that fundamental question is to use Pareto's Law (also called the 80/20 Rule), which states that 80 percent of a company's quality problems arise from just 20 percent of all causes. By identifying this small percentage of causes and focusing quality improvement efforts on them, a company gets maximum return for its efforts. This simple yet powerful rule forces workers to concentrate resources on the most significant problems first, where payoffs are likely to be biggest, and helps build momentum for successful TQM effort.
- **Share information with everyone in the organization.** Asking employees to make decisions and to assume responsibility for creating quality necessitates that the owner share information with them. Employees cannot make sound decisions consistent with the company's initiative if managers are unwilling to give them the information they need to make those decisions.
- **Focus quality improvements on astonishing the customer.** The heart of TQM is customer satisfaction—better yet, customer astonishment. Unfortunately, some companies focus their quality improvement efforts on areas that never benefit the customer. Quality improvements with no customer focus (either internal or external customers) are wasted.
- **Don't rely on inspection to produce quality products and services.** The traditional approach to achieving quality was to create a product or service and then to rely on an army of inspectors to "weed out" all of the defects. Not only is such a system a terrible waste of resources (consider the cost of scrap, rework, and no-value-added inspections), but it gives managers no opportunity for continuous improvement. The only way to improve a process is to discover the cause of poor quality, fix it (the sooner, the better), and learn from it so that workers can *avoid* the problem in the future. Using the statistical tools of the TQM approach allows a company to learn from its mistakes with a consistent approach to constantly improving quality.
- **Avoid using TQM to place blame on those who make mistakes.** In many firms, the only reason managers seek out mistakes is to find someone to blame for them. The result is a culture based on fear and the unwillingness of workers to take chances to innovate. The goal of TQM is to improve the processes in which people work, *not* to lay blame on workers. Searching out "the guilty party" doesn't solve the problem. The TQM philosophy sees each problem that arises as an opportunity for improving the company's system.
- **Strive for continuous improvement in processes as well as in products and services.** There is no finish line in the race for quality. A company's goal must be to improve the quality of its processes, products, and services constantly, no matter how high it currently stands!

Many of these principles are evident in quality guru W. Edwards Deming's 14 points, a capsulized version of how to build a successful TQM approach (see Table 19.4).

Implementing a TQM program successfully begins at the top. If the owner or chief executive of a company doesn't actively and visibly support the initiative, the employees who must make it happen will never accept it. TQM requires change: change in the way a company defines quality, in the way it sees its customers, in the way it treats employees, and in the way it sees itself. Successful implementation involves modification in an organization's culture as much as in its work processes.

Quantity: The Economic Order Quantity

The typical small business has its largest investment in inventory. However, an investment in inventory is not profitable because dollars spent return nothing until the inventory is sold. In a sense, a small company's inventory is its largest non-interest-bearing investment. Entrepreneurs must focus on controlling this investment and on maintaining proper inventory levels. A primary objective of

3.

Conduct economic order quantity analysis to determine the proper level of inventory.

TABLE 19.4 Deming's 14 Points

TQM cannot succeed as a piecemeal program or without true commitment to its philosophy. W. Edwards Deming, the man most visibly connected to TQM, drove home these concepts with his 14 points, the essential elements for integrating TQM successfully into a company. Deming's message was straightforward. Companies must transform themselves into customer-oriented, quality-focused organizations in which teams of employees have the training, the resources, and the freedom to pursue quality on a daily basis. The goal is to track the performance of a process, whether manufacturing a clock or serving a bank customer, and to develop ways to minimize variation in the system, eliminate defects, and spur innovation. The 14 points are as follows:

1. **Constantly strive to improve products and services.** This requires total dedication to improving quality, productivity, and service—continuously.
2. **Adopt a total quality philosophy.** There are no shortcuts to quality improvement; it requires a completely new way of thinking and managing.
3. **Correct defects as they happen.** Rather than relying on mass inspection of end products, companies should correct defects as they happen. Real quality comes from improving the process, not from inspecting finished products and services. At that point, it's too late. Statistical process control charts can help workers detect when a process is producing poor-quality goods or services. Then they can stop it, make corrections, and get the process back on target.
4. **Don't award business on price alone.** Rather than choosing the lowest-cost vendor, businesses should work toward establishing close relationships with the vendors who offer the highest quality.
5. **Constantly improve the system of production and service.** Managers must focus the entire company on customer satisfaction, measure results, and make adjustments as necessary.
6. **Institute training.** Workers cannot improve quality and lower costs without proper training to erase old ways of doing things.
7. **Institute leadership.** The supervisor's job is not to boss workers around; it is to lead. The nature of the work is more like coaching than controlling.
8. **Drive out fear.** People often are afraid to point out problems because they fear the repercussions. Managers must encourage and reward employee suggestions.
9. **Break down barriers among staff areas.** Departments within organizations often erect needless barriers to protect their own turf. Total quality requires a spirit of teamwork and cooperation across the entire organization.
10. **Eliminate superficial slogans and goals.** These only offend employees because they imply that workers could do a better job if only they would try.
11. **Eliminate standard quotas.** They emphasize quantity over quality. Not everyone can move at the same rate and still produce quality.
12. **Remove barriers to pride of workmanship.** Most workers want to do quality work. Eliminating "demotivators" frees them to achieve quality results.
13. **Institute vigorous education and retraining.** Managers must teach employees the new methods of continuous improvement, including statistical process control techniques.
14. **Take demonstrated management action to achieve the transformation.** Although success requires involvement of all levels of the organization, the impetus for change must come from the top.

These 14 interrelated elements contribute to a chain reaction effect. As a company improves its quality, costs decline, productivity increases, the company gains additional market share because of its ability to provide high-quality products at competitive prices, and the company and its employees prosper.

Source: Based on the W. Edwards Deming Institute, www.deming.org/deminghtml/wedi.html.

this part of the purchasing plan is to generate an adequate turnover of merchandise by purchasing proper quantities. Tying up capital in extra inventory limits a company's working capital and exerts unnecessary pressure on its cash flow. In addition, a business runs the risk of being stuck with obsolete or spoiled merchandise, an extremely serious problem for many small businesses. Excess inventory also takes up valuable storage or selling space that could be used for items with higher turnover rates and more profit potential. On the other hand, maintaining too little inventory can be extremely costly. An owner may be forced to reorder merchandise too frequently, escalating total inventory costs. In addition, inventory stockouts occur when customer demand exceeds a company's supply of merchandise, causing customer ill will. Persistent stockouts are inconvenient for customers, and many customers eventually abandon the store to shop elsewhere. Because many companies now employ lean and just-in-time inventory practices, interruptions in their supply chains can cause them to shut down temporarily and incur huge costs. "The very flexibility that provides the supply chain with its cost advantages has also caused its inherent vulnerability," says Paul Carter, head of global risk consulting for financial services company Allianz.¹⁶ After an explosion at Evonik Industries AG, an auto parts supplier in Marl, Germany, incapacitated one of the few factories in the world that makes nylon-12, a special resin used to manufacture automotive fuel and brake lines, carmakers around the world faced shortages and plant shutdowns. Up to 25 percent of the global supply of nylon-12, and its closure forced automakers to scramble to find substitute resins and alternative sources of supply.¹⁷ A recent survey by Deloitte Consulting reports

that 53 percent of executives say that interruptions in their companies' supply chains such as the one caused by the explosion have become more expensive over the last three years.¹⁸

Carrying either too much or too little inventory are expensive mistakes that lead to serious problems in other areas of the business, particularly cash management. The goal is to maintain enough inventory to meet customer orders and to satisfy production needs but not so much that storage costs and inventory investments are excessive. The analytical techniques used to determine **economic order quantities** (EOQs) help business owners determine the amount of inventory to purchase in an order or to produce in a production run to minimize total inventory costs. To compute the EOQ, an entrepreneur must first determine the three principal elements of total inventory costs: the cost of the units, the holding (or carrying) cost, and the setup (or ordering) cost.

Cost of Units

The cost of the units is simply the number of units demanded for a particular time period multiplied by the cost per unit. Suppose that a small manufacturer of lawn mowers forecasts demand for the upcoming year to be 100,000 mowers. He must order enough wheels at \$1.55 each to supply the production department. He computes the following:

$$\text{Total annual cost of units} = D \times C$$

where

$$D = \text{Annual demand (in units)}$$

$$C = \text{Cost of a single unit (\$)}$$

In this example,

$$D = 100,000 \text{ mowers} \times 4 \text{ wheels per mower} = 400,000 \text{ wheels}$$

$$C = \$4.15/\text{wheel}$$

$$\text{Total annual cost of units} = D \times C$$

$$= 400,000 \text{ wheels} \times \$4.15$$

$$= \$1,660,000$$

Holding (Carrying) Costs

An excessive inventory investment ties up a large amount of a company's cash unproductively in the form of holding costs. The typical costs of holding inventory include the costs of storage, insurance, taxes, interest, depreciation, damage or spoilage, obsolescence, and pilferage. The expense involved in physically storing the items in inventory is usually substantial, especially if the inventories are large. An entrepreneur may have to rent or build additional warehousing facilities, pushing the cost of storing the inventory even higher. The company also may incur expenses in transferring items into and out of inventory. The cost of storage also includes the expense of operating the facility (e.g., heating, lighting, and refrigeration) as well as the depreciation, taxes, and interest on the building. Most small business owners purchase insurance on their inventories to shift the risk of fire, theft, flood, and other disasters to an insurer. The premiums paid for this coverage also are included in the cost of holding inventory. In general, the larger a company's average inventory, the greater is its storage cost. For most companies, holding costs for an item range from 15 to 35 percent of its actual cost.

Depreciation costs represent the reduced value of inventory over time. Some businesses are strongly influenced by the depreciation of inventory. For example, an auto dealer's inventory is subject to depreciation because he or she must sell models left over from the previous year at reduced prices.

Spoilage, obsolescence, and pilferage also add to the costs of holding inventory. Some small firms, especially those that deal in trendy merchandise, assume an extremely high risk of obsolescence. For example, a fashion merchandiser with a large inventory of the latest styles may be left with worthless merchandise when styles change. In addition, unless the entrepreneur establishes sound inventory control procedures, the business will suffer losses from employee theft and shoplifting.

Let us return to the lawn mower manufacturer example to illustrate the cost of holding inventory:

$$\text{Total annual holding (carrying) costs} = \frac{Q}{2} \times H$$

Q = Quantity of inventory ordered

H = Holding cost per unit per year

TABLE 19.5 Holding (Carrying) Costs

If Q Is	$Q/2$, Average Inventory, Is	$Q/2 \times H$, Holding Cost, Is
500	250	\$312.50
1,000	500	625.00
2,000	1,000	1,250.00
3,000	1,500	1,875.00
4,000	2,000	2,500.00
5,000	2,500	3,125.00
6,000	3,000	3,750.00
7,000	3,500	4,375.00
8,000	4,000	5,000.00
9,000	4,500	5,625.00
10,000	5,000	6,250.00

The greater the quantity ordered, the greater is the inventory carrying costs. This relationship is shown in Table 19.5, assuming that the cost of carrying a single lawn mower wheel for one year is \$1.25.

Setup (Ordering) Costs

The various expenses incurred in actually ordering materials and inventory or in setting up the production line to manufacture them determine the level of setup or ordering costs of a product. The costs of obtaining materials and inventory typically include preparing purchase orders; analyzing and choosing vendors; processing, handling, and expending orders; receiving and inspecting items; and performing all of the required accounting and clerical functions. Even if the small company produces its own supply of goods, it encounters most of these same expenses. Ordering costs are usually relatively fixed, regardless of the quantity ordered.

Setup or ordering costs are found by multiplying the number of orders made in a year (or the number of production runs in a year) by the cost of placing a single order (or the cost of setting up a single production run). In the lawn mower manufacturing example, the annual requirement is 400,000 wheels per year, the cost to place an order is \$9.00, and the ordering costs are as follows:

$$\text{Total annual setup (ordering) costs} = \frac{D}{Q} \times S$$

where

D = Annual demand

Q = Quantity of inventory ordered

S = Setup (ordering) costs for a single run (or order)

The greater the quantity ordered, the smaller the number of orders placed. This relationship is shown in Table 19.6, assuming an ordering cost of \$9.00 per order.

Solving for EOQ

If carrying costs were the only expense involved in obtaining inventory, the business owner would purchase the smallest number of units possible in each order to minimize the cost of holding the

TABLE 19.6 Setup Costs

If Q Is	D/Q , Number of Orders per Year, Is	$D/Q \times S$, Setup (Ordering) Cost, Is
500	800	\$7,200.00
1,000	400	3,600.00
5,000	80	720.00
10,000	40	360.00

inventory. For example, if the lawn mower manufacturer purchased just four wheels per order, carrying cost would be minimized:

$$\begin{aligned}\text{Carrying cost} &= \frac{Q}{2} \times H \\ &= \frac{4}{2} \times \$1.25 \\ &= \$2.50\end{aligned}$$

However, ordering cost would be outrageous:

$$\begin{aligned}\text{Ordering cost} &= \frac{D}{Q} \times S \\ &= \frac{400,000}{4} \times \$9 \\ &= \$900,000\end{aligned}$$

Obviously this is not the small manufacturer's ideal inventory solution.

Similarly, if ordering costs were the only expense involved in procuring inventory, the business owner would purchase the largest number of units possible in order to minimize the ordering cost. In our example, if the lawn mower manufacturer purchased 400,000 wheels per order, ordering cost would be minimized:

$$\begin{aligned}\text{Ordering cost} &= \frac{D}{Q} \times S \\ &= \frac{400,000}{400,000} \times \$9 \\ &= \$9\end{aligned}$$

However, carrying cost would be tremendously high:

$$\begin{aligned}\text{Carrying cost} &= \frac{Q}{2} \times H \\ &= \frac{400,000}{2} \times \$1.25 \\ &= \$250,000\end{aligned}$$

A quick inspection shows that neither of those solutions minimizes the total cost of the manufacturer's inventory. Total cost is composed of the cost of the unit, carrying cost, and ordering costs:

$$\text{Total cost} = (D \times C) + \left(\frac{Q}{2} \times H\right) + \left(\frac{D}{Q} \times S\right)$$

These costs are illustrated in Figure 19.5. Notice that as the quantity ordered increases, the ordering costs decrease and the carrying costs increase.

The EOQ formula simply balances the ordering cost and the carrying cost of the small business owner's inventory so that total costs are minimized. Table 19.6 summarizes the total costs for various values of Q for our lawn mower manufacturer.

As Table 19.7 and Figure 19.3 illustrate, the EOQ formula locates the minimum point on the total cost curve, which occurs where the cost of carrying inventory ($Q/2 \times H$) equals the cost of ordering inventory ($D/Q \times S$). As we have seen, if a small business places the smallest number of orders possible each year, its ordering cost is minimized, but its carrying cost is maximized. Conversely, if the company orders the smallest number of units possible in each order, its carrying cost is minimized, but its ordering cost is maximized. Total inventory cost is minimized when carrying cost and ordering costs are balanced.

FIGURE 19.5
Economic Order Quantity

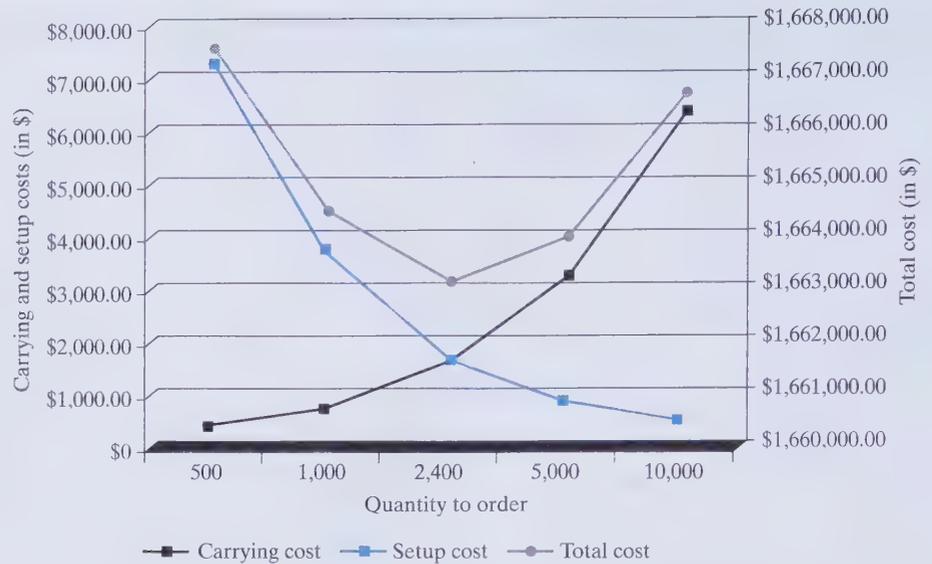


TABLE 19.7 EOQ and Total Cost

If Q Is	$D \times C$, Cost of Units, Is	$Q/2 \times H$, Carrying Cost, Is	$D/Q \times S$, Ordering Cost, Is	TC , Total Cost, Is
500	\$1,660,000	\$312.50	\$7,200.00	\$1,667,512.50
1,000	\$1,660,000	\$625.00	\$3,600.00	\$1,664,225.00
2,400	\$1,660,000	\$1,500.00	\$1,500.00	\$1,663,000.00
5,000	\$1,660,000	\$3,125.00	\$720.00	\$1,663,845.00
10,000	\$1,660,000	\$6,250.00	\$360.00	\$1,666,610.00

Let us return to our lawn mower manufacturer and compute its EOQ using the following formula:

$$\begin{aligned}
 \text{EOQ} &= \sqrt{\frac{2 \times D \times S}{H}} \\
 &= \sqrt{\frac{2 \times 400,000 \times \$9.00}{\$1.25}} \\
 &= 2,400 \text{ wheels}
 \end{aligned}$$

To minimize total inventory cost, the lawnmower manufacturer should order 2,400 wheels at a time. Furthermore,

$$\begin{aligned}
 \text{Number of orders per year} &= \frac{D}{Q} \\
 &= 400,000/2,400 \\
 &= 166.67 \text{ orders}
 \end{aligned}$$

This manufacturer will place approximately 167 orders this year at a minimum total cost of \$1,663,000, computed as follows:

$$\begin{aligned}
 \text{Total cost} &= (D \times C) + \left(\frac{Q}{2} \times H\right) + \left(\frac{D}{Q} \times S\right) \\
 &= (400,000 \times \$4.15) + (2,400/2 \times \$1.25) + (400,000/2,400 \times \$9.00) \\
 &= \$1,660,000 + \$1,500 + \$1,500 \\
 &= \$1,663,000
 \end{aligned}$$

EOQ with Usage

The preceding EOQ model assumes that orders are filled instantaneously; that is, fresh inventory arrives all at once. Because that assumption does not hold true for many small manufacturers, it is necessary to consider a variation of the basic EOQ model that allows inventory to be added over a period of time rather than instantaneously. In addition, a manufacturer is likely to be taking items from inventory for use in the assembly process over the same time period. For example, the lawn mower manufacturer may be producing blades to replenish his or her supply, but at the same time, assembly workers are reducing the supply of blades to make finished mowers. The key feature of this version of the EOQ model is that inventories are used while inventories are being added.

Using the lawn mower manufacturer as an example, we can compute the EOQ for the blades. To make the calculation, we need two additional pieces of information: the usage rate for the blades, U , and the factory's capacity to manufacture the blades, P . Suppose that the maximum number of lawn mower blades the company can manufacture is 480 per day. We know from the previous illustration that annual demand for mowers is 100,000 units (therefore, 100,000 blades). If the factory operates 5 days per week for 50 weeks (250 days), its usage rate is as follows:

$$U = \frac{100,000 \text{ units per year}}{250 \text{ days}} = 400 \text{ units per day}$$

It costs \$325 to set up the blade manufacturing line and \$8.71 to store one blade for one year. The cost of producing a blade is \$24.85. To compute EOQ with usage, we use the following formula:

$$\text{EOQ} = \sqrt{\frac{2 \times D \times S}{H \times \left(1 - \frac{U}{P}\right)}}$$

For the lawn mower manufacturer,

$$D = 100,000 \text{ blades}$$

$$S = \$325 \text{ per production run}$$

$$H = \$8.71 \text{ per blade per year}$$

$$U = 400 \text{ blades per day}$$

$$P = 480 \text{ blades per day}$$

$$\begin{aligned} \text{EOQ} &= \sqrt{\frac{2 \times 100,000 \times \$325}{8.71 \times \left(1 - \frac{400}{480}\right)}} \\ &= 6,691.50 \text{ blades} = 6,692 \text{ blades} \end{aligned}$$

Therefore, to minimize total inventory cost, the lawn mower manufacturer should produce 6,692 blades per production run. In addition,

$$\begin{aligned} \text{Number of production runs per year} &= \frac{D}{Q} \\ &= \frac{100,000 \text{ blades}}{6,692 \text{ blades per run}} \\ &= 14.9 \approx 15 \text{ runs} \end{aligned}$$

The manufacturer will make 15 production runs during the year at a total cost of the following:

$$\begin{aligned} \text{Total cost} &= (D \times C) + \left(\left(1 - \frac{U}{P}\right) \times \frac{Q}{2} \times H \right) + \left(\frac{D}{Q} \times S \right) \\ &= (100,000 \times \$24.85) + \left(\left(1 - \frac{400}{480}\right) \times \frac{6,692}{2} \times \$8.71 \right) + \left(\frac{100,000}{6,692} \times \$325 \right) \\ &= \$2,485,000 + \$4,857 + \$4,857 \\ &= \$2,494,714 \end{aligned}$$

Business owners must remember that the EOQ analysis is based on estimations of cost and demand. The final result is only as accurate as the input used. Consequently, this analytical tool serves only as a guideline for decision making. The final answer may not be the ideal solution because of intervening factors, such as opportunity costs or seasonal fluctuations. Knowledgeable entrepreneurs use EOQ analysis as a starting point in making a decision and then use managerial judgment and experience to produce a final decision.

Price

For the typical small business owner, price is always a substantial factor when purchasing inventory and supplies. In many cases, an entrepreneur can negotiate price with potential suppliers on large orders of frequently purchased items. In other instances, perhaps when small quantities of items are purchased infrequently, the small business owner must pay list price. The typical entrepreneur shops around to find the supplier that offers the best price. However, this does not mean that a business owner should always purchase inventory and supplies at the lowest price available. The best purchase price is the lowest price at which the owner can obtain goods and services *of acceptable quality*. As quality guru W. Edwards Deming said, “Price has no meaning without a measure of the quality being purchased.” Companies that are lured by low prices on key products or components from suppliers in foreign countries sometimes discover that currency exchange rates, shipping costs, customs fees, and the additional costs and challenges of coordinating long-distance shipments more than offset the goods’ lower prices.

Recall that one of Deming’s 14 points is “*Don’t award business on price alone.*” Without proof of quality, an item with the lowest initial price actually may produce the *highest* total cost. Deming condemned the practice of constantly switching suppliers in search of the lowest initial price because it increases the variability of a process and lowers its quality. Instead, he recommended that businesses establish long-term relationships built on mutual trust and cooperation with a single supplier. Some companies use long-term contracts that lock in the price of key raw materials for an extended time period to minimize the risks that inflation imposes on them. Texas Roadhouse Inc., a chain of steak restaurants that Kent Taylor started in 1993 in Clarksville, Indiana, creates annual contracts with its suppliers for 80 percent of the beef that it purchases for its nearly 400 restaurants. The company buys the remaining 20 percent of its meats, those beef products for which the company forecasts price decreases, on the open market.¹⁹

When evaluating a supplier’s price, small business owners must consider not only the actual price of goods and services but also the selling terms accompanying them. In some cases, the selling terms can be more important than the price itself. Some vendors’ selling terms include some type of purchase discount. Vendors typically offer three types of discounts: trade discounts, quantity discounts, and cash discounts.

Trade Discounts

Trade discounts are established on a graduated scale and depend on a small company’s position in the channel of distribution. In other words, trade discounts recognize the fact that manufacturers, wholesalers, and retailers perform a variety of vital functions at various stages in the channel of distribution and compensate them for providing these needed activities. Figure 19.6 illustrates a typical trade discount structure.

Quantity Discounts

Quantity discounts are designed to encourage businesses to order large quantities of merchandise and supplies. Vendors are able to offer lower prices on bulk purchases because the cost per unit is lower than for handling small orders. Quantity discounts normally exist in two forms: noncumulative and cumulative. Noncumulative quantity discounts are granted only if a business purchases a certain volume of merchandise in a single order. For example, a wholesaler may offer small retailers a 3 percent discount only if they purchase 10 gross of Halloween masks in a single order. Table 19.8 shows a typical noncumulative quantity discount structure.

Cumulative quantity discounts are offered if a company’s purchases from a particular vendor exceed a specified quantity or dollar value over a predetermined time period. The time frame varies, but a year is most common. For example, a manufacturer of appliances may offer a small business a 3 percent discount on subsequent orders if its purchases exceed \$50,000 per year.

4. Differentiate among the three types of purchase discounts that vendors offer.

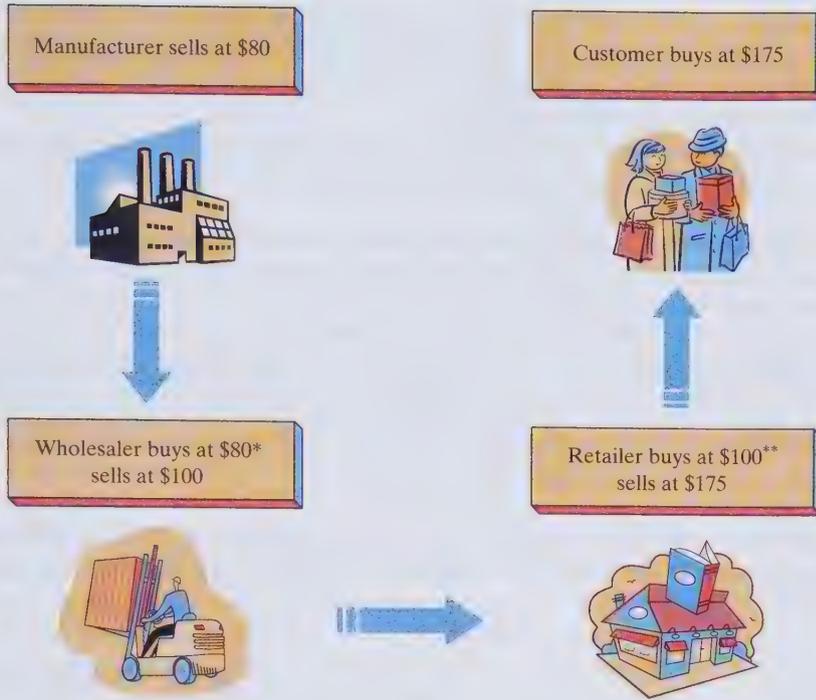


FIGURE 19.6
Trade Discount Structure

*Wholesale discount = 54% of suggested retail price.
 ** Retail discount = 43% of suggested retail price.

TABLE 19.8 Noncumulative Quantity Discount Structure

Order Size	Price
1–1,000 units	List price
1,001–5,000 units	List price—2%
5,001–10,000 units	List price—4%
10,001 units and more	List price—6%

Some small business owners who normally buy in small quantities and are unable to qualify for quantity discounts can earn quantity discounts by joining group purchasing organizations (GPOs), purchasing pools, or buying cooperatives. According to the National Cooperative Business Association, more than 29,000 cooperatives operate in the United States.²⁰ GPOs and cooperatives leverage the combined purchasing power of their members to negotiate the lowest prices and best discounts for their members.

ENTREPRENEURIAL PROFILE: EATFLEET EATFLEET is a group purchasing organization based in St. Paul, Minnesota, that bands together hundreds of independent restaurants across the United States and generates significant savings for members by negotiating quantity discounts for them. Member restaurateurs earn discounts on a variety of purchases, including food, beverages, linen services, office supplies, payroll services, secret shopper services, and others. “My food costs since joining EATFLEET have been reduced nearly \$30,000 annually,” says one satisfied restaurant owner.²¹

GPOs not only save their members money but also save them time by eliminating the need to constantly track and compare vendors’ prices to secure the best deals.

Cash Discounts

Cash discounts are offered to customers as an incentive to pay for merchandise promptly. Many vendors grant cash discounts to avoid being used as an interest-free bank by customers who purchase merchandise and then fail to pay by the invoice due date. To encourage prompt payment of invoices, many vendors allow customers to deduct a percentage of the purchase amount if they

This notation means that the total amount of the invoice is due 30 days after its date, but if the bill is paid within 10 days, the buyer may deduct 2 percent from the total. A discount offering “2/10, EOM” (EOM means “end of month”) indicates that the buyer may deduct 2 percent if the bill is paid by the tenth day of the month after purchase.

In general, it is sound business practice to take advantage of cash discounts. The money saved by paying invoices promptly is freed up for use elsewhere.

ENTREPRENEURIAL PROFILE: Jeff Schreiber: Hansen Wholesale When Jeff Schreiber, owner of Hansen Wholesale, a small distributor of home products, attended a January trade show, he purchased \$40,000 of ceiling fans from a manufacturer. The contract gave Schreiber until July to pay for the fans, but the manufacturer also included a cash discount: If Schreiber paid before May 1, he could earn a 3 percent discount on the purchase. By paying in February, Schreiber could save another 1.5 percent of the purchase price. For Schreiber, who manages his company’s cash flow meticulously, the decision was an easy one; he paid the invoice in February and saved \$1,800. “Your money works better if you take advantage of the discounts,” says Schreiber, who recently saved \$15,000 in cash discounts for his company in just one year.²²

Businesses incur an implicit (opportunity) cost of forgoing a cash discount. By failing to take advantage of a cash discount, a business owner is, in effect, paying an annual interest rate to retain the use of the discounted amount for the remainder of the credit period. For example, suppose the Print Shop receives an invoice for \$1,000 from a vendor offering a cash discount of 2/10, net 30. Figure 19.7 illustrates this situation and shows how to compute the cost of forgoing the cash discount. Actually, it costs the Print Shop \$20 to retain the use of its \$980 for an extra 20 days. Translating this into an annual interest rate gives the following result:

$$I = P \times R \times T$$

where

I = Interest (\$)

P = Principle (\$)

R = Rate of interest (%)

T = Time (number of days/360)

To compute R , the annual interest rate,

$$R = \frac{I}{P \times T}$$

In our example,

$$R = \frac{\$20}{\left(\$980 \times \frac{20}{360} \right)} = 36.7\%$$

The cost to the Print Shop of forgoing the cash discount is 36.7 percent per year! If there is \$980 available on day 10 of the trade credit period, the entrepreneur should pay the invoice unless

FIGURE 19.7
A Cash Discount

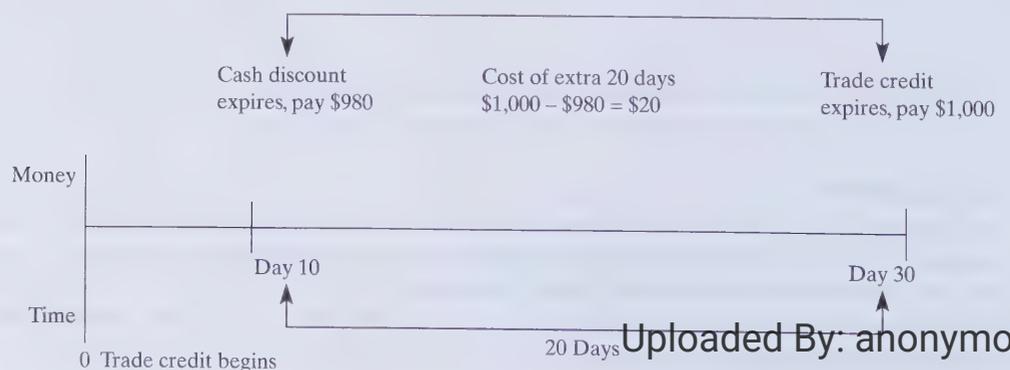


TABLE 19.9 Cost of Forgoing Cash Discounts

Cash Discount Terms	Cost of Forgoing Cash Discounts (Annually)
2/10, net 30	36.7%
2/30, net 60	34.50%
2/10, net 60	13.7%
3/10, net 30	55.7%
3/10, net 60	22.3%

he or she is able to return greater than 36.7 percent on that money. If the entrepreneur does not have \$980 on day 10 but can borrow it at less than 36.7 percent, he or she should do so to take advantage of the cash discount. Table 19.9 summarizes the cost of forgoing cash discounts offering various discount terms.

Although business owners should take advantage of cash discounts, they should not stretch their accounts payable to suppliers beyond the payment terms specified on the invoices. Letting payments become past due can destroy the trusting relationship a small company has built with its vendors.

Timing—When to Order

Timing the purchase of merchandise and supplies is also a critical element of a purchasing plan. Entrepreneurs must schedule delivery dates so that their companies do not lose customers because they run out of inventory (“stockouts”). In addition, they must concentrate on maintaining proper control over the firm’s inventory investment without tying up an excessive amount of working capital. There is a tradeoff between the cost of running out of stock and the cost of carrying additional inventory.

When planning delivery schedules for inventory and supplies, owners must consider the **lead time** for an order, the time gap between placing an order with a vendor and actually receiving the goods. In general, entrepreneurs cannot expect instantaneous delivery of merchandise. As a result, they must plan reorder points for inventory items with lead times in mind. To determine when to order merchandise for inventory, entrepreneurs must calculate the reorder point for key inventory items. Developing a reorder point model involves determining the lead time for an order, the usage rate for the item, the minimum level of stock allowable, and the EOQ. The lead time may be as little as a few hours or as long as several weeks to process purchase requisitions and orders, contact the supplier, receive the goods, and add them to the company’s inventory stock. Entrepreneurs who purchase from local vendors encounter shorter lead times than those who rely on distant suppliers. More companies are relying on third-party logistics providers (3PLs), companies that specialize in value-added supply chain services, to manage their supply chain activities,

5.

Calculate a company’s reorder point.



Entrepreneurs must coordinate both the quantity and the timing of their inventory shipments to ensure that they have enough inventory to meet customer demand but not so much that they tie up cash unnecessarily.

Source: © Jerry Bernard/Alamy.

including inventory planning, distribution, storage, and others. A recent survey by Capgemini Consulting shows that 56 percent of companies report seeing benefits from using 3PLs, including lower logistics and inventory costs and higher on-time order fill rates and order accuracy rates.²³

Business owners can determine the usage rate for a particular product from past inventory and accounting records. Business owners must estimate the speed at which the supply of merchandise will be depleted over a given time. The anticipated usage rate for a product determines how long the supply will last. For example, if an entrepreneur projects that she will use 900 units in the next six months, the usage rate is five units per day (900 units/180 days). The simplest reorder point model assumes that the firm experiences a linear usage rate; that is, depletion of the firm's stock continues at a constant rate over time.

Business owners also must determine the minimum level of stock allowable. If a firm runs out of a particular item (i.e., incurs stockouts), customers will lose faith in the business and begin to shop elsewhere. To avoid stockouts, many firms establish a minimum level of inventory greater than zero. In other words, they build a cushion, called **safety (or buffer) stock**, into their inventories in case demand runs ahead of the anticipated usage rate. If that occurs, the owners can dip into the safety stock to fill customer orders until a shipment of goods arrives. Wayne Rosenbaum, director of operations for Papaya King, a three-unit chain of stores that sell hot dogs and tropical drinks made from papayas, typically keeps a two-week supply of papaya products on hand in case problems arise in its supply chain. "When you are the 'Papaya King,' you'd better have papaya," says Rosenbaum. The company's safety stock proved to be valuable when a salmonella outbreak associated with papayas from Mexico created an interruption in its supply of fresh papayas. Papaya King turned to other suppliers, adapted its recipes, and used its safety stock to meet customer demand for its tropical drinks.²⁴

To compute the reorder point for an item, the owner must combine this inventory information with the product's EOQ. The following example illustrates the reorder point technique:

$$L = \text{Lead time for an order} = 5 \text{ days}$$

$$U = \text{Usage rate} = 18 \text{ units per day}$$

$$S = \text{Safety stock (minimum level)} = 75 \text{ units}$$

$$\text{EOQ} = 540 \text{ units}$$

The formula for computing the reorder point is:

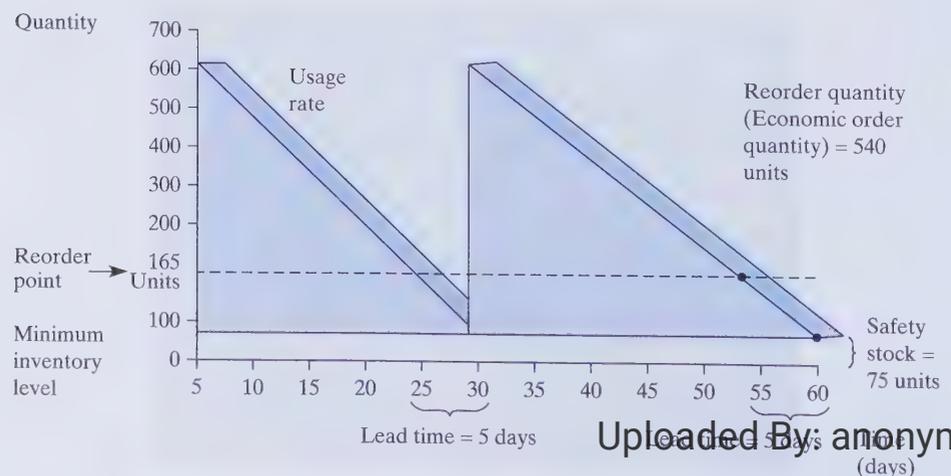
$$\text{Reorder point} = (L \times U) + S$$

In this example,

$$\begin{aligned} \text{Reorder point} &= (5 \text{ days} \times 18 \text{ units/day}) + 75 \text{ units} \\ &= 165 \text{ units} \end{aligned}$$

This business owner should order 540 more units when inventory drops to 165 units. Figure 19.8 illustrates the reorder point situation for this small business.

FIGURE 19.8
Reorder Point Model



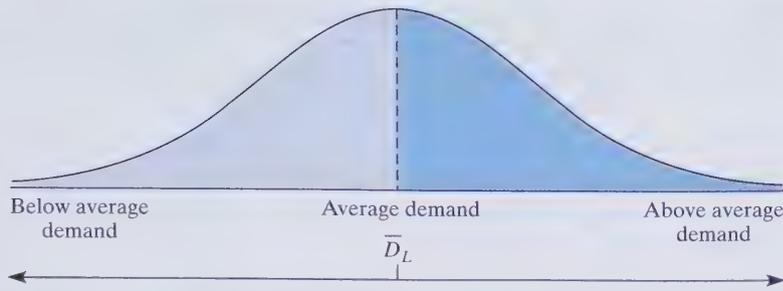


FIGURE 19.9
Demand During Leading

The simple reorder technique makes assumptions that may not be valid in particular situations. First, the model assumes that the firm’s usage rate is constant when in fact for most small businesses demand varies daily. Second, the model assumes that lead time for an order is constant when in fact few vendors deliver precisely within lead time estimates. Third, in this model, the owner never taps safety stock; however, late deliveries or accelerated demand often force owners to dip into their inventory reserves. More advanced models relax some of these assumptions, but the simple model can be a useful inventory guideline for making inventory decisions in a small company.

Another popular reorder point model assumes that the demand for a product during its lead time is normally distributed (see Figure 19.9). The area under the normal curve at any given point represents the probability that a particular demand level will occur. Figure 19.10 illustrates the application of this normal distribution to the reorder point model *without* safety stock. The model recognizes that three different demand patterns can occur during a product’s lead time. Demand pattern 1 is an example of below-average demand during lead time, demand pattern 2 is an example of average demand during lead time, and demand pattern 3 is an example of an above-average demand during lead time.

If the reorder point for this item is normal for the product during lead time, 50 percent of the time, demand will be below average (note that 50 percent of the area under the normal curve lies below average). Similarly, 50 percent of the time, demand during lead time will exceed the average, and the firm will experience stockouts (note that 50 percent of the area under the normal curve lies above average).

To reduce the probability of inventory shortage, a business owner can increase the reorder point above \bar{D}_L (average demand during the lead time). But how much should the owner increase the reorder point? Rather than attempt to define the actual costs of carrying extra inventory versus the costs of stockouts (remember the tradeoff described earlier), this model allows the small business owner to determine the appropriate reorder point by setting a desired customer service level.

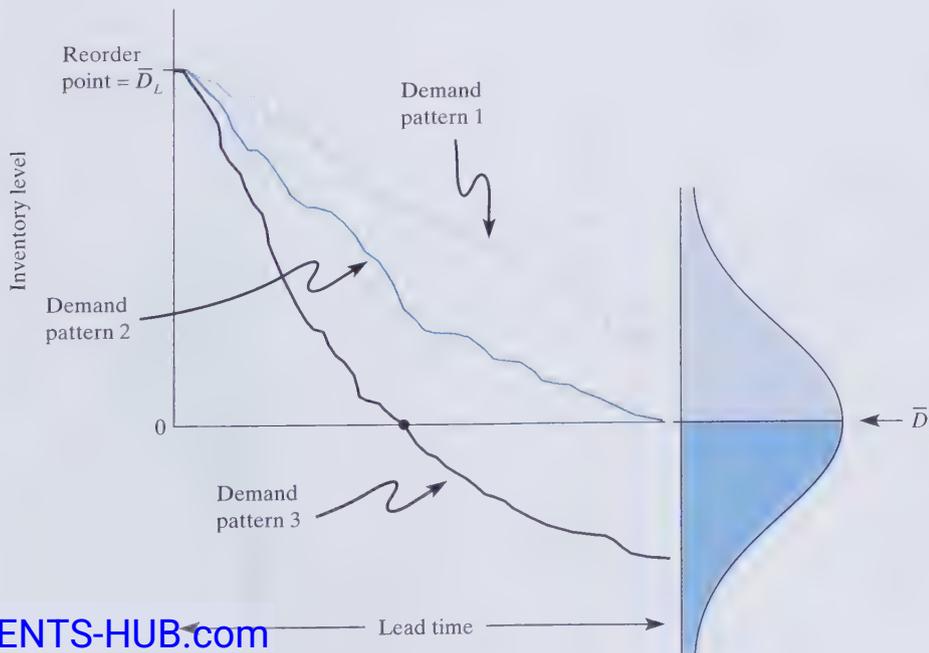


FIGURE 19.10
Reorder Point without Safety Stock

TABLE 19.10 Service Level Factors and Z Scores

Target Customer Service Level	Service Level Factor (Z Score*)
99%	2.33
97.5%	1.96
95%	1.645
90%	1.275
80%	0.845
75%	0.675

*Any basic statistics book provides a table of areas under the normal curve, which gives the appropriate Z score for any service level factor.

For example, the owner may want to satisfy 95 percent of customer demand for a product during lead time. This service level determines the amount of increase in the reorder point. In effect, these additional items serve as a safety stock:

$$\text{Safety stock} = SLF \times SD_L$$

where

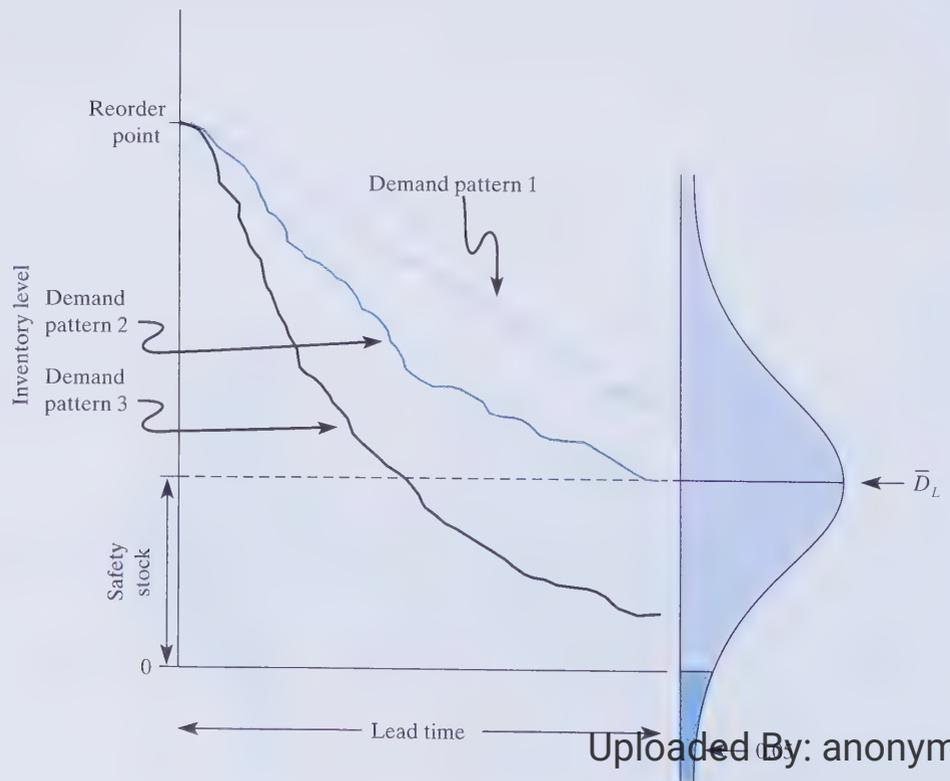
SLF = Service level factor (the appropriate Z score)

SD_L = Standard deviation of demand during lead time (a common measure of the variability in the demand during lead time)

Table 19.10 shows the appropriate service level factor (Z score) for some of the most popular target customer service levels.

Figure 19.11 shows the shift to a normally distributed reorder point model with safety stock. In this case the manager has set a 95 percent customer service level; that is, the manager wants to meet 95 percent of the demand during lead time. The normal curve in the model without safety stock (from Figure 19.10) is shifted *up* so that 95 percent of the area under the curve lies above

FIGURE 19.11
Reorder Point
with Safety Stock



the zero inventory level. The result is a reorder point that is higher than the original reorder point by the amount of the safety stock:

$$\text{Reorder point} = \bar{D}_L + (SLF \times SD_L)$$

where

\bar{D}_L = Average demand during lead time (original reorder point)

SLF = Service level factor (the appropriate Z score)

SD_L = Standard deviation of demand during lead time

To illustrate, suppose that the average demand for a product during its lead time (one week) is 325 units with a standard deviation of 110 units. If the desired service level is 95 percent, the service level factor (from Table 19.9) would be 1.645. The reorder point is as follows:

$$R = 325 + (1.645 \times 110) = 325 + 181 = 506 \text{ units}$$

Figure 19.12 illustrates the shift from a system without safety stock to one with safety stock for this example. With a reorder point of 325 units (\bar{D}_L), this small business owner will experience inventory shortages during the lead time 50 percent of the time. With a reorder point of 506 units (i.e., a safety stock of 181 units), the business owner will experience inventory stock-outs during the lead time only 5 percent of the time.

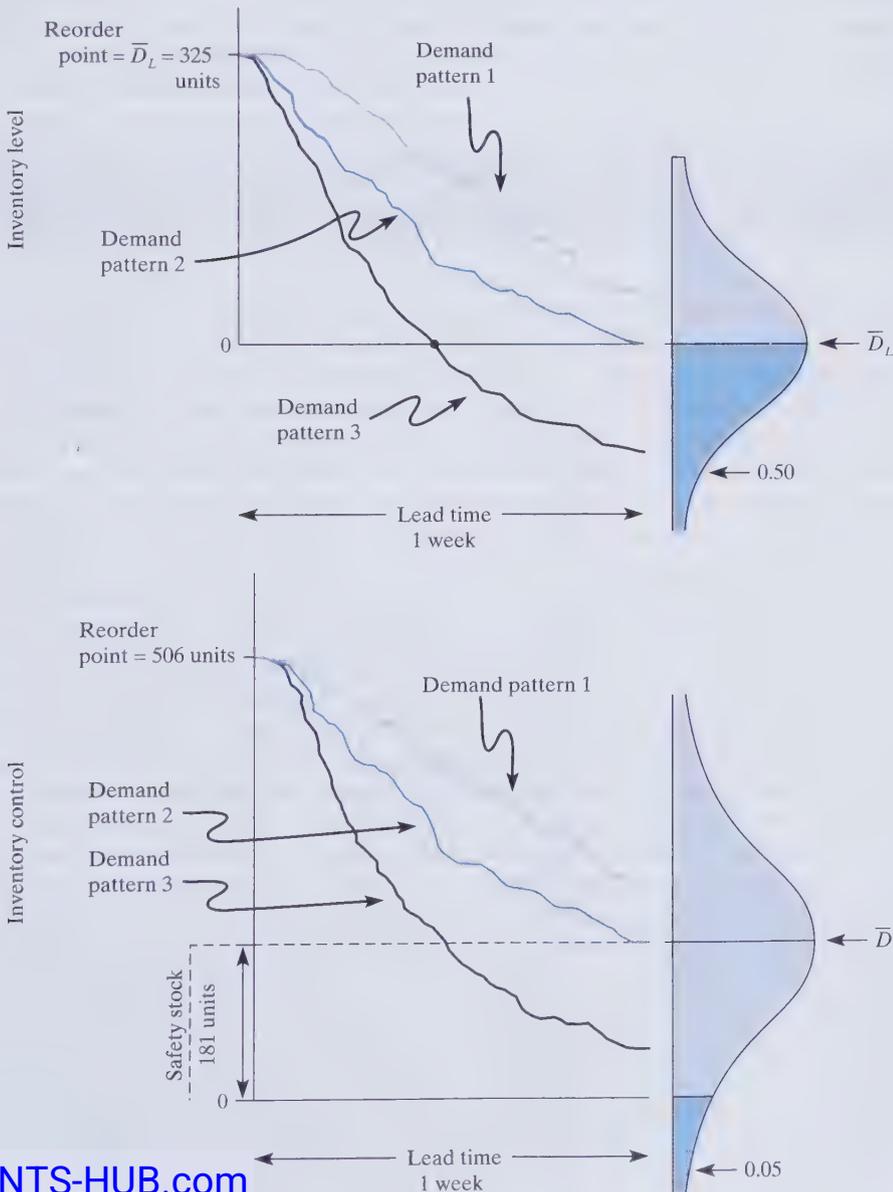


FIGURE 19.12
Shift from a No-Safety Stock System to a Safety Stock System

Managing the Supply Chain: Vendor Analysis and Selection

6.

Develop a vendor rating scale.

Businesses have discovered that managing their supply chains for maximum effectiveness and efficiency not only can increase their profitability but also can provide them with an important competitive advantage in the marketplace. Proper SCM enables companies to reduce their inventories, get products to market much faster, increase quality, and improve customer satisfaction. “We’re seeing a level of sophistication in supply chain management that didn’t exist five years ago,” says Dave Donnan, a consultant who specializes in SCM. “The separation of those [companies] that will succeed and those that will fail will be based on attention to detail.”²⁵ SCM requires businesses to forge long-term partnerships with reliable suppliers rather than to see vendors merely as “someone trying to sell me something.” Doing so can produce an impressive payoff; experts note that implementing a successful SCM system yields an average savings of 15 percent by controlling unnecessary spending, negotiating lower prices, maintaining lower inventory levels, and reducing waste and inefficiency in the purchasing process, all of which save companies vast amounts of money.²⁶

Companies are learning that, to make SCM work, they must share information with their suppliers and make their entire supply chains transparent to everyone involved in them. In the early days, that meant linking suppliers and companies as if they were parts of a single business on private data networks using electronic data interchange (EDI), which allowed companies and vendors to exchange orders and invoices electronically. The Internet takes EDI a step further. Web-based SCM, or **e-procurement**, allows companies to share information concerning production plans, shipment schedules, inventory levels, sales forecasts, and actual sales on a real-time basis with their vendors, enabling the companies to make instant adjustments to their orders and delivery schedules. Sharing sensitive information with supply chain partners requires building trusting relationships, but the potential benefits are significant. Many studies have found a correlation between the amount of information shared among supply chain members and the efficiency of the entire chain. Costs are significantly lower for retailers, wholesalers, and manufacturers when they are connected in a supply chain network with open communication and collaboration. Companies that establish efficient, collaborative supply chains gain a significant competitive advantage over their rivals by minimizing inventory investments and costs, increasing the speed of customer deliveries, and improving customer service and satisfaction levels.

With e-procurement, companies are connected via the Web to their customers and to their suppliers, which allows them to respond rapidly to changing buyer preferences by modifying in real time the inventory they purchase. In turn, suppliers can make the fast adjustments in production scheduling to produce the items that customers actually are buying. Companies “are starting to understand that the ‘supply’ side of the supply chain isn’t worth a hill of beans if the ‘demand’ side is disconnected,” says one industry expert.²⁷ A study by the consulting firm Aberdeen Group reports that companies that use e-procurement to connect seamlessly the members of their supply chains are able to reduce the prices that they pay for their purchases by 7 percent and cut the delivery time for their orders by 67 percent.²⁸ With these systems, valuable information flows from the small business selling suits to customers up the supply chain all the way to the sheep shearer harvesting wool!

A Web-based SCM process works like this: Software at a retail store captures data from sales as they happen and looks for underlying trends for use in calculating quantities of which products to purchase in the future. For instance, SCM software at a retail store may notice that sales of black low-rise jeans are selling more briskly than anticipated and forecasts the quantity of jeans the store should order. That information then goes up the supply chain to the jean maker. Taking into account delivery times and manufacturing speed, the software helps the jean maker create a detailed production plan for cutting, sewing, and shipping the garments on time. The software determines how much fabric the jean maker must have to produce the required number of black low-rise jeans and orders it from the textile producer. The software can track everything from the location of the raw materials in the production process to the quality of the finished product for everyone in the supply chain. “Supply chain analytics boost the bottom line because they produce greater efficiency, less scrap, better quality, and lower production costs and improve the top line through greater customer satisfaction,” says a top manager at IDC, a research company that has studied the impact of SCM on companies’ performance. “This is basic business made better.”²⁹ Many companies, including SAP, Netsuite, Salesforce, BizSlate, and others, offer cloud-based software applications that manage companies’ supply chains, some of the software, including

BizSlate's, is aimed specifically at small and midsize companies with annual sales between \$1 million and \$200 million.³⁰

To function smoothly, a small company's supply chain should follow the "triple As": agile, adaptable, and aligned.³¹ An *agile* supply chain is one that is fast, flexible, and responsive to changes in demand. Agile supply chains are able to deal with the inevitable disruptions and fluctuations by creating strong partnerships with suppliers, adequate but not excessive levels of safety stock, contingency plans for catastrophic events, and an information system that provides everyone in the chain with timely information. Companies that sell products such as fashion merchandise or video games that have unpredictable demand and high costs associated with stockouts and that require large end-of-season markdowns to move leftover items require an agile supply chain. Companies that sell basic products such as groceries and cosmetics that have predictable demand, carry low profit margins, and require small end-of-season markdowns require supply chains that are lean and efficient. An *adaptable* supply chain is one that changes as a company's needs change and is able to accommodate a small company's growth. Adaptable supply chains are predictive, able to anticipate changes in companies' buying and selling process and helping them to adapt to the changes in real time. A supply chain is properly *aligned* when all of companies in it work together as a team to improve the chain's performance for the benefit of the entire group. In the past, some companies were hesitant to share information with the businesses in their supply chains. Success today requires that companies not only share information seamlessly but also synchronize their efforts to maximize efficiency throughout the entire chain. Agile, adaptable, aligned supply chains reduce costs and improve performance by increasing the speed at which companies get products into customers' hands, reducing excess inventory and decreasing the use of price markdowns that erode companies' profit margins.



In the Entrepreneurial Spotlight

Integrating Local Suppliers into a Complex Supply Chain

One of the hottest trends in the restaurant industry is local sourcing, purchasing fresh ingredients from local growers and producers. A recent survey by the National Restaurant Association shows that 70 percent of people say that they are more likely to visit a restaurant that offers locally produced menu items, and more than 60 percent of people say that locally sourced menus are a key consideration when they are choosing a restaurant. Local sourcing is a "macro trend that will maintain its momentum," predicts a top official at the National Restaurant Association. A study conducted by Rabobank America, a bank that specializes in loans to farmers, ranchers, and other types of agribusiness, says that the local sourcing movement is "a permanent mainstream trend" that is generating opportunities for regional growers to take market share from larger, national suppliers. "National growers [must] adapt their business models to accommodate the desire for fresh, local produce," the study concludes.

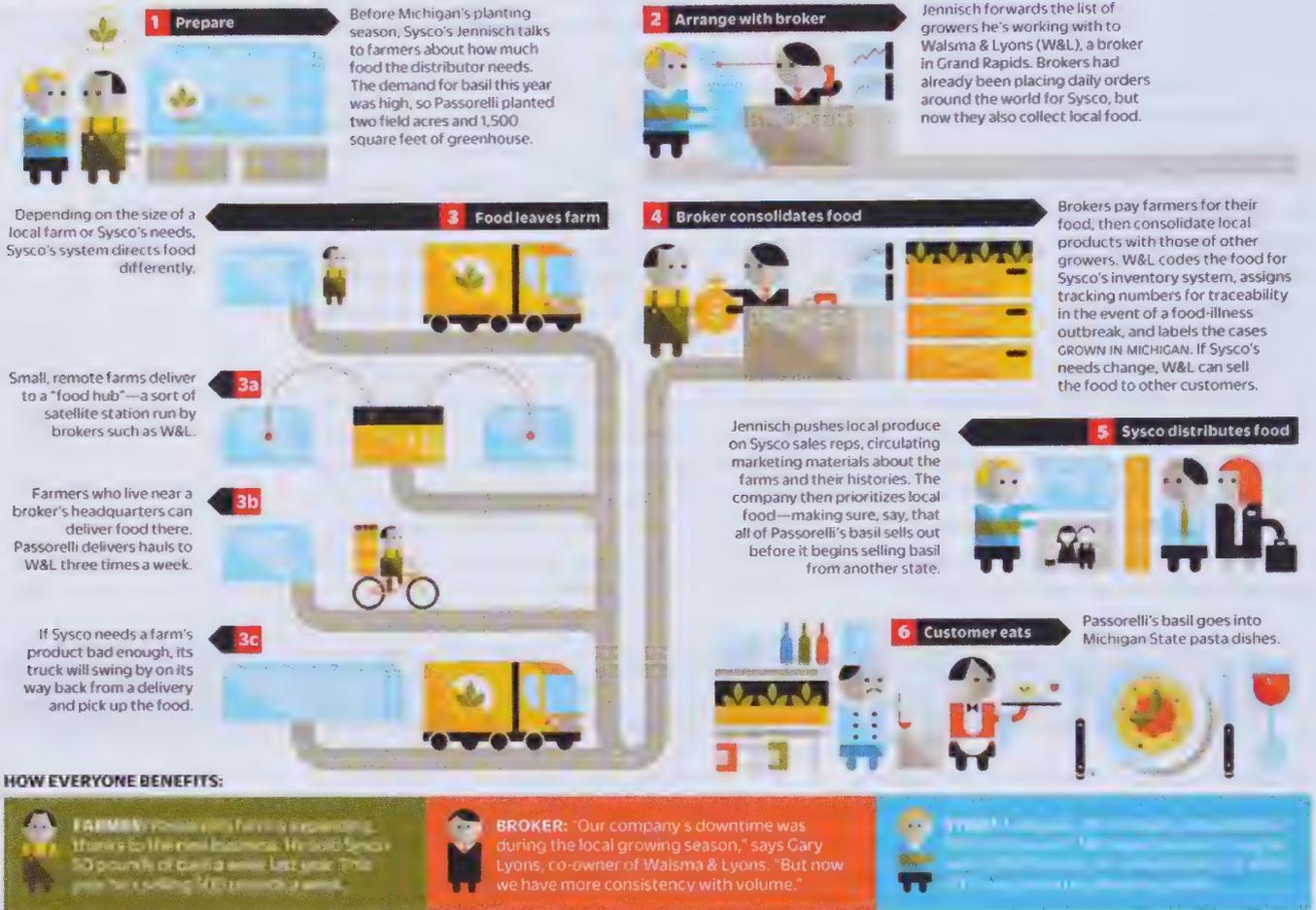
Finding reliable, consistent local suppliers poses a challenge for restaurateurs, however. Restaurants in the United States spend more than \$225 billion annually on food and beverage purchases, most of which arrive through a complex supply chain that includes value-added intermediaries at every stage. Many restaurants and restaurant chains have revamped their supply chains to accommodate customers' preferences for locally grown ingredients, but the process usually is not easy. In addition to controlling food and beverage costs, a restaurant's supply chain must meet high standards of safety and traceability. In addition, managing a complex restaurant supply chain efficiently requires an incredible amount of managing the details necessary

to ensure quality and cost control and of providing the restaurateur with a view of "the big picture." Small restaurants often get by with a piecemeal system of spreadsheets, paper invoices, and telephone orders, but as food supply chains become longer and more complex, those systems can create inefficiencies that are difficult to detect. "It's like a miles-long pipeline that's leaking from many tiny holes that can be serviced only on foot," explains one supply chain expert.

Sysco, one of the nation's largest food suppliers, recently redesigned its system to enable the company to meet restaurateurs' demand for local food. Doing so required three years; many meetings with farmers and ranchers to learn about their growing seasons, costs, and business models; and integrating their smaller-volume supplies into Sysco's distribution system, which traditionally was designed to handle large volumes of standard food items in bulk. The process began when a chef at Michigan State University asked Sysco to help him source more locally grown produce for the campus dining operation. The chef noted that Mike Passorelli grew basil in a greenhouse located just two hours west of the Michigan State campus; however, he also knew that buying from local suppliers would create a logistical nightmare that would be far too complex to organize. The chef approached Sysco about incorporating local produce, such as the basil that Passorelli grew in his greenhouse, into the company's supply chain. Two of Sysco's managers, Rich Dachman and Denis Jennisch began working on a system that would allow Sysco to incorporate locally—grown produce into their supply chain. The following diagram shows how they did it.

In the Entrepreneurial Spotlight (continued)

HOW SYSCO GETS PASSORELLI'S BASIL TO MICHIGAN STATE:



How Sysco Get Passorelli's Basil to Michigan State.

Source: Lou Lou & Tummie.

1. What advantages can a restaurant gain by offering locally sourced products on its menu?
2. What makes purchasing food and beverage supplies from local growers and suppliers so difficult for restaurateurs?
3. What steps can restaurateurs take to increase the selection of locally grown items on their menus?

Sources: Based on "Local Sourcing, Nutrition to Top 2013 Restaurant Trends," *Food Business News*, December 11, 2012, www.foodbusinessnews.net/articles/news_home/Food-Service-Retail/2012/12/Local_sourcing_nutrition_to_to.aspx?ID={6B48F136-3E21-4016-88E1-7B502BB981A1}&cck=1; Barney Wolf, "10 Trends for 2013," *QSR Magazine*, January 2013, www.qsrmagazine.com/reports/10-trends-2013; Janet Erickson, "Top 5 Supply Chain Management Issues for Restaurants," *Nation's Restaurant News*, September 17, 2012, <http://nrn.com/latest-headlines/top-5-supply-chain-management-issues-restaurants>; Kristen Hinman, "Sysco's New System," *Fast Company*, November 2011, p. 50; "Restaurant Supply Chain Management," *Nation's Restaurant News*, p. 1.

If a company's supply chain is to conform to the triple As, it must be built on the foundation of reliable vendors that can supply it with quality merchandise, equipment, supplies, and services at reasonable prices in a timely manner. Finding the right vendors sometimes can be a challenge, but the Internet is a useful tool for tracking down potential suppliers. Online supplier networks, such as Ariba Discovery (with more than 730,000 global suppliers listed) and *Thomas.net* (with more than 610,000 global suppliers listed), provide a marketplace where entrepreneurs can tap into a network of global suppliers. Supplier networks provide the businesses who use them with many benefits, including higher on-time delivery rates (77 percent for companies that use networks vs. 69 percent for those that do not), lower "cost of poor quality" expenses (10 percent for those that do not), and the ability to screen potential suppliers for financial

stability and reputation.³² Web sites such as Alibaba allow entrepreneurs to gain access to potential suppliers around the globe for almost any item—from thumb drives to thumbtacks.



ENTREPRENEURIAL PROFILE: Jonathan Shriftman and Jake Medwell: Solé Bicycles

Jonathan Shriftman and Jake Medwell cofounded Solé Bicycles, an online company that markets single-speed, fixed-gear bicycles (referred to as “fixies”), while they were students at the University of Southern California. Early on, they realized that one key to success was finding quality suppliers capable of providing the bicycles and accessories they had designed. The least expensive fixies sold for between \$800 and \$1,000, but the young entrepreneurs wanted to offer sturdy, durable bikes at a lower price point. Shriftman and Medwell turned to Alibaba, which gave “us access to countless suppliers that we would not have been able to reach on our own,” says Medwell. They began working with a reliable bicycle manufacturer in China that could provide quality bicycles at affordable prices and with which the company has forged a long-term relationship. “We’re very happy with our price point and the products we offer,” says Shriftman. The entrepreneurs recently traveled to China to visit their supplier. “It was great to meet the people who helped us launch our business,” says Medwell. “We knew that they could produce great bikes, but seeing the quality workmanship in person gave us a sense of the value they place on their product.”³³

As Shriftman’s and Medwell’s experience proves, selecting the right vendors or suppliers for a business has an impact well beyond simply obtaining goods and services at the lowest cost. Although searching for the best price always is an important factor, successful small business owners must always consider other factors in vendor selection, such as reliability, reputation, quality, support services, speed, and proximity.

Vendor Certification

To add objectivity to the vendor selection process, many firms are establishing vendor certification programs, agreements to give one supplier the majority of their business if that supplier meets rigorous quality and performance standards. Today, businesses of all sizes and types are forging long-term partnerships with vendors that meet their certification standards. When creating a vendor certification program, entrepreneurs should remember the three Cs: commitment, communication, and control. *Commitment* to consistently meeting the company’s quality standards must be paramount. No company can afford to do business with vendors that cannot meet its quality targets. Second, a company must establish two-way *communication* with vendors. Communication implies trust, and trust creates working relationships that are long term and mutually beneficial. Treating suppliers like partners can reveal ways to boost quality and lower costs for both parties. Finally, a company must make sure that its vendors and suppliers have in place the *controls* that enable them to produce quality results and to achieve continuous improvements in their processes. In today’s competitive marketplace, entrepreneurs expect all vendors to demonstrate that they operate processes built on continuous improvement.

Creating a vendor certification program requires entrepreneurs to develop a vendor rating scale that allows them to evaluate the advantages and disadvantages of each potential vendor. The scale allows entrepreneurs to score potential vendors using a measurement of the purchasing criteria that are most important to their companies’ success. The first step to developing a scale is to determine the criteria that are most important to selecting a vendor (e.g., price, quality, and prompt delivery). The next step is to assign weights to each criterion to reflect its relative importance. The third step involves developing a grading scale for comparing vendors on the criteria. Developing a usable scale requires that the owner maintain proper records of past vendor performances. Finally, the owner must compute a weighted total score for each vendor and select the vendor that scores the highest on the set of criteria. Consider the following example. Bravo Bass Boats, Inc., is faced with choosing from among several suppliers of a critical raw material. The company’s owner has decided to employ a vendor rating scale to select the best vendor using the following procedure.

Step 1. Determine important criteria. The owner of Bravo has selected the following criteria:

- Quality
- Price
- Prompt delivery

Service
Assistance

Step 2. Assign weights to each criterion to reflect its relative importance.

Criterion	Weight
Quality	35
Price	30
Prompt delivery	20
Service	10
Assistance	5
Total	100

Step 3. Develop a grading scale for each criterion.

Criterion	Grading Scale
Quality	$\frac{\text{Number of acceptable lots from Vendor X}}{\text{Total number of lots from Vendor X}}$
Price	$\frac{\text{Lowest quoted price of all vendors}}{\text{Price offered by Vendor X}}$
Prompt Delivery	$\frac{\text{Number of on-time deliveries from Vendor X}}{\text{Total number of deliveries from Vendor X}}$
Service	A subjective evaluation of the variety of service offered by each vendor
Assistance	A subjective evaluation of the advice and assistance provided by each vendor

Step 4. Compute a weighted score for each vendor.

Criterion	Weight	Grade	Weighted Score (weight \times grade)
Vendor 1			
Quality	35	9/10	31.5
Price	30	12.50/13.00	28.8
Prompt delivery	20	10/10	20.0
Service	10	8/10	8.0
Assistance	5	5/5	5.0
Total weighted score			93.3
Vendor 2			
Quality	35	8/10	28.0
Price	30	12.50/13.50	27.8
Prompt delivery	20	8/10	16.0
Service	10	8/10	8.0
Assistance	5	4/5	4.0
Total weighted score			83.8
Vendor 3			
Quality	35	7/10	24.5
Price	30	12.50/12/50	30.0
Prompt delivery	20	6/10	12.0
Service	10	7/10	7.0
Assistance	5	1/5	1.0
Total weighted score			74.5

The Final Decision

Once business owners identify potential vendors and suppliers, they must decide which one (or ones) to do business with. Entrepreneurs should consider the following factors before making the final decision about the right supplier.

NUMBER OF SUPPLIERS One important question entrepreneurs face is “Should I buy from a single supplier or from several different sources?” Concentrating purchases at a single supplier (or sole sourcing) results in special attention from the supplier, especially if orders are substantial. Second, a business may be able to negotiate quantity discounts if its orders are large enough. Finally, a small company can cultivate a closer, more cooperative relationship with the supplier. Suppliers are more willing to work with companies that prove to be loyal customers. The result of this type of partnership can be better-quality goods and services. Stratsys, a company that makes plastic prototypes for the aerospace, automotive, and medical industries, purchases some of its most important raw materials from a single source. Company managers admit that doing so involves risk, but they believe that their company produces better-quality products by eliminating the variability that multiple sources of supply would introduce into their production process.³⁴

However, using a single vendor also has disadvantages. A company can experience shortages of critical materials if its only supplier suffers a catastrophe, such as bankruptcy, a fire, a strike, or a natural disaster. To offset the risks of sole sourcing, many companies rely on the 80/20 rule. They purchase 80 percent of their supplies from their premier supplier and the remaining 20 percent from several “backup” vendors. If a catastrophe shuts down the company’s principal supplier, the business can shift its orders to its “minor” suppliers with whom it has established relationships. Although this strategy may require a compromise on getting the lowest prices, it removes the risk of sole sourcing and lets a company’s primary suppliers know that they have competition.

RELIABILITY Business owners must evaluate a potential vendor’s ability to deliver adequate quantities of quality merchandise on time. One common complaint that small businesses have against their suppliers is late delivery. Late deliveries and the resulting shortages they often cause result in lost sales and customer ill will. Large customers often take precedence over small ones when it comes to service.

PROXIMITY A supplier’s physical proximity is an important factor when choosing a vendor. The cost of transporting merchandise can increase significantly the total cost of merchandise to a buyer. Foreign manufacturers require longer delivery times, and because of the distance that shipments must travel, a hiccup anywhere in the distribution channel often results in late deliveries. In addition, entrepreneurs can solve quality problems more easily with nearby suppliers than with distant vendors. Some companies that once outsourced production of products or components to factories in foreign countries because they offered lower costs than domestic factories are bringing their orders back to companies in the United States, a trend called **reshoring**. Rapidly rising labor costs in countries such as China and India, the high cost of oil that makes shipping goods around the world more expensive, and the complexity of dealing with suppliers located 7,000 miles away have made domestic suppliers much more attractive to U.S. businesses.



ENTREPRENEURIAL PROFILE: Sonja Zozula and Jerry Anderson: LightSaver Technologies

When Sonja Zozula and Jerry Anderson started LightSaver Technologies in 2009, they outsourced production of the company’s emergency lights for home owners to a factory in China. Two years later, Zozula and Anderson decided to shift production back to a company in Carlsbad, California, located just 30 miles from their headquarters in San Clemente, California. “It’s 30 percent cheaper to manufacture in China,” says Anderson. “But [you must] factor in shipping and all the other [problems] you have to endure.” Neither Zozula nor Anderson has ever been to China, which made communicating with their suppliers there more difficult, and shipments of the company’s emergency lights often were stuck in customs for some reason, sometimes for several weeks. Sometimes, product quality was an issue, and Anderson would spend hours on the phone with managers at the Chinese factory trying to explain necessary changes to their products. “[Now] if we have an issue in manufacturing, we can walk down to the plant floor,” he says. “We can’t do that in China.” Anderson estimates that the total cost of producing LightSaver Technologies’ products in the United States is 2 to 5 percent cheaper than producing them in China.³⁵

Some companies also consider the proximity of their suppliers to one another when selecting vendors. Suppliers often locate in clusters (refer to Chapter 16), which can create operating efficiencies; however, locating near one another increases the risk of every supplier being shut down by a natural disaster, such as a flood, a hurricane, or an earthquake, or a man-made disaster, such as an explosion at a power plant.



In the Entrepreneurial Spotlight

Back in the USA

Like many manufacturers in the United States, managers at K'Nex Brands LP, a family-owned company that makes plastic building toys that children can assemble into a multitude of designs, decided a few years ago to move most of the production operation from its factory in Hatfield, Pennsylvania, to subcontractors with factories in China. Two of K'Nex Brands's rivals, Hasbro Inc. and Mattel Inc., the giants in the toy industry, had made the same move years earlier. Recently, however, Joel Glickman, K'Nex Brands's founder and chairman, began "reshoring" its manufacturing operations, returning production of the company's toys to the factory in Hatfield. "In the long term, it's much better for us to manufacture here," says Glickman, pointing out that the company can respond much faster to changes in the toy market, which tend to occur quickly, creating high demand for the latest must-have toy before dropping it in favor of the next hot toy. Not only does local production enable K'Nex Brands, which generates annual sales of \$100 million, to deliver high-demand toys to retail stores much faster, but it also gives the company greater control over the materials used in and the quality of its toys, both of which are vital to ensuring safety for the children who play with its toys. Other toy makers have suffered damaged reputations and lost sales when they recalled toys manufactured in China because they posed safety or health hazards to children. One company recalled nearly 1 million toys that it sold in the United States after its lab tests showed that a subcontractor in China had coated them in lead paint.

Like K'Nex, companies that outsourced production to "low-cost" countries have discovered many hidden costs associated with moving production to factories thousands of miles away and are reconsidering their decisions. Less control over materials and quality, longer delivery times, higher shipping costs, greater risk of supply chain interruption, and more difficulty communicating with factories thousands of miles away make the manufacturing process more difficult to coordinate. In addition, rapidly rising wages in China and higher productivity of domestic workers have made bringing manufacturing back home more attractive. "We expect net labor costs for manufacturing in China and the U.S. to converge around 2015," says the author of a report from the Boston Consulting Group. "Companies should undertake a rigorous, product-by-product analysis of their global supply networks that fully accounts for total costs rather than just factory wages. For many products sold in North America, the U.S. will become a more attractive manufacturing option."

Companies that "reshore" their manufacturing operations face challenges, however. Some companies have difficulty hiring skilled employees with manufacturing experience, and

sophisticated networks of companies linked in an efficient supply chain can be hard to find domestically. K'Nex has struggled to find domestic suppliers because toy-making skills have faded over time as more companies shifted toy production to other countries. The company still imports small battery-powered motors for its toys from suppliers in China because it has not been able to locate a domestic supplier that can provide motors at competitive prices. It also imports the head of an "Angry Birds" toy that requires a rubberized coating that would be expensive to replicate in the United States.

Although most companies will continue to make labor-intensive products in foreign factories, many of those that manufacture goods that require less manual labor and allow for more automation are returning production to factories in the United States. Because toy making involves a great deal of manual labor (which still costs more in the United States than in many other countries), K'Nex redesigned some of its toys to make them less labor intensive to produce. For instance, the company's old roller-coaster tracks were held together by metal pins that employees in China inserted by hand; its new tracks simply snap together. A roller-coaster car that once had a shiny metallic finish now comes with decals that children apply. K'Nex eliminated the metallic coating because the process used to apply it was "expensive and dirty, and we can't do it here [in the United States], so we designed it out of the product," says Joseph Smith, the company's chief development officer. Hubcaps that Chinese employees once attached to car wheels are now included as separate parts in the kit so that children can snap them into place. K'Nex also has invested in technology to make its manufacturing operation more efficient. A \$30,000 robot from Rethink Robotics Inc. currently performs simple packaging tasks, but K'Nex managers are planning to install more sophisticated robots that will enable the company to move more production and assembly tasks back to its Hatfield factory.

1. What advantages have companies gained by outsourcing their manufacturing operations to factories in foreign countries?
2. What forces are driving companies such as K'Nex to "reshore" their manufacturing operations to the United States? What benefits and challenges do they face as they pursue their reshoring strategies?

Sources: Based on James R. Hagerty, "A Toy Maker Comes Home to U.S.A.," *Wall Street Journal*, March 11, 2013, pp. B1–B2; "Coming Home," *The Economist*, January 19, 2013, www.economist.com/news/special-report/21569570-growing-number-american-companies-are-moving-their-manufacturing-back-united; *Made in America, Again: Why Manufacturing Will Return to the U.S.*, Boston Consulting Group, August 2011.

SPEED How fast can a supplier deliver products to your business? A speedy supply chain can be a competitive advantage for a company. Zara, a popular clothing chain owned by Spanish company Inditex, is known for its tightly controlled supply chain that zips the latest fashions at very affordable prices (the average item sells for \$27) to its stores in 73 countries. The company's high-tech logistics system gets the latest designer styles from the drawing board to store shelves in less than two weeks, compared to an industry average of nine months!³⁶

SERVICES Entrepreneurs must evaluate the range of services that vendors offer. Do salespeople make regular calls on the firm, and are they knowledgeable about their product line? Will the sales representatives assist in planning store layout and in creating attractive displays? Will the vendor make convenient deliveries on time? Is the supplier reasonable in making repairs on equipment after installation and in handling returned merchandise? Are sales representatives able to offer useful advice on purchasing and other managerial functions? Is the supplier willing to take the time to help you solve problems that inevitably will crop up?



ENTREPRENEURIAL PROFILE: PayCycle CPA Charles Ross uses payroll services company PayCycle to handle the payroll function for his own business and for many of his small business clients. PayCycle won Ross as a loyal customer after he discovered that he had entered a client's payroll information incorrectly, creating a problem that PayCycle remedied quickly. It was Friday afternoon, and the client's W-2 forms had to go out the following Monday, meaning that PayCycle had to recalculate an entire year's payroll. Even though it required almost a full day's work for someone at PayCycle over a weekend, the payroll service fixed the problem, and the forms went out on schedule on Monday. That level of service explains why Ross is a lifelong customer and why 90 percent of PayCycle's customers refer new customers to the company.³⁷

COLLABORATION The goal is to find a supplier that is eager to join forces with the intent of building a long-term partnership with your company. Other small companies make ideal candidates.



ENTREPRENEURIAL PROFILE: Scott Fischer and Harriet Donnelly: Center for Systems Management and Technovative Marketing When NASA approached Scott Fischer, president of the Center for Systems Management (CSM), a Vienna, Virginia, company that provides training and consulting services for corporations and government agencies, about creating a video for an internal marketing campaign, Fischer knew that the job was beyond his company's ability. Wanting the chance to expand his work with the space agency, Fischer began looking for a company with which he could partner to create the video. He had to work quickly because NASA needed the video in just 45 days. Fischer and a team of employees selected Technovative Marketing, a seven-person marketing firm headed by Harriet Donnelly. Donnelly worked on the video herself and attended every meeting that Fischer had with NASA officials. (On every project, Donnelly assigns both a staff person and a senior manager to every Technovative project to make sure that clients always have two points of contact.) Because of the partnership that CSM and Technovative Marketing forged, the project turned out to be a huge success. NASA has enlisted CSM for similar projects, and, in turn, CSM is partnering with Technovative Marketing.³⁸

ENVIRONMENTALLY FRIENDLY AND SOCIALLY RESPONSIBLE BUSINESS PRACTICES A trend that has emerged recently is customers holding companies responsible for the actions of their suppliers. Therefore, when selecting vendors, businesses must consider whether potential suppliers, especially those in foreign countries, obey child labor laws, provide workers with safe working conditions and fair wages, and comply with environmental laws. Failure to do so can tarnish a company's reputation, causing it to lose luster among customers. Apple Inc., a company whose supply chain extends throughout Asia, has struggled to ensure that its suppliers operate according to environmentally friendly and socially responsible business practices. The company conducted a thorough audit of its suppliers after combustible dust created an explosion in a Chinese factory that produced its popular iPad, killing two workers and injuring more than a dozen others. The audit revealed that 62 percent of Apple's suppliers were not complying with work-hour limits, 35 percent failed to meet the company's standards for preventing worker injuries, and 32 percent failed to comply with rules for handling hazardous substances. Other companies have faced similar problems, uncovering violations

production of palm oil, and forced labor in mining operations in the Democratic Republic of the Congo.³⁹

PRICE Small firms usually must pay list price for items that they purchase infrequently or in small quantities. However, this is not the case for goods that they purchase regularly in large quantities. Entrepreneurs should always attempt to negotiate the best prices and terms of sale with their vendors, especially on the products that they purchase in volume.

Legal Issues Affecting Purchasing

7.

Describe the legal implications of the purchasing function.

When a small business purchases goods from a supplier, ownership passes from seller to buyer, but when do title to and the risk associated with the goods pass from one party to the other? The answer is important because any number of things can happen to the merchandise after a customer orders it but before a company delivers it. When entrepreneurs order merchandise and supplies from their vendors, they should know when the ownership of the merchandise—and the risk associated with it—shifts from supplier to buyer.

Title

Before the Uniform Commercial Code (UCC) was enacted, the concept of title—the right to ownership of goods—determined where responsibility for merchandise fell. Today, however, three other concepts, identification, risk of loss, and insurable interest, play a more important role when disputes arise over lost, damaged, or destroyed shipments of goods.

IDENTIFICATION Identification is important because it gives the buyer an insurable interest in the goods. Before title can pass to the buyer, the goods must already be in existence and must be identifiable from all other similar goods. Specific goods already in existence are identified at the time the sales contract is made. For example, if Graphtech, Inc., orders a laser printer, the goods are identified at the time the contract is made. Fungible goods, those that cannot be separated from a larger mass (e.g., wheat in a silo), are identified when they are marked, shipped, or otherwise designated as the goods in the contract. For example, an order of oil may not be identified until it is loaded into a transfer truck for shipment.

Risk of Loss

Risk of loss determines which party incurs the financial risk if the goods are damaged, destroyed, or lost while in transit. Risk of loss does *not* always pass with title. Three particular rules govern the passage of title and the transfer of risk or loss:

Rule 1: Agreement. A supplier and a small business owner can agree (preferably in writing) to shift the risk of loss at any time during the transaction. In other words, any explicit agreement between buyer and seller determines when risk of loss passes to the buyer. For example, if an entrepreneur whose business is located in Freeport, Maine, orders goods from a vendor in St. Louis, Missouri, the contract may specify that risk of loss transfers from seller to buyer as soon as the truck carrying the goods crosses the Missouri border.

Rule 2: F.O.B. Seller. Under a sales contract designated F.O.B. (“free on board”) seller, title and risk of loss pass to the buyer as soon as the seller delivers the goods into the care of a carrier or shipper. In addition, an **F.O.B. seller contract** (also known as a **shipment contract**) requires that the buyer pay all shipping and transportation costs. For example, a North Carolina manufacturer sells 100,000 capacitors to a buyer in Ohio with terms “F.O.B. North Carolina.” Under this contract, the Ohio firm (buyer) pays all shipping costs, and title and risk of loss pass from the manufacturer as soon as the carrier takes possession of the shipment. If the goods are lost or damaged in transit, the *buyer* suffers the loss. Of course, the buyer can purchase insurance (see insurable interest below) and has legal recourse against the carrier if the carrier is at fault. If a contract is silent on shipping terms, the courts assume that the contract is a shipment contract (F.O.B. seller), and the buyer bears the risk of loss while the goods are in transit.

Rule 3: F.O.B. Buyer. A sales contract designated F.O.B. buyer requires that the seller deliver the goods to the buyer’s place of business (or to a place of business designated by the buyer).

such as a warehouse). Risk of loss transfers to the buyer when the carrier delivers the goods to the buyer's business or to a destination that the buyer designates. In addition, an **F.O.B. buyer contract** (also called a **destination contract**) requires the seller to pay all shipping and transportation costs. In the example above, if the contract were "F.O.B. Ohio," the North Carolina manufacturer would pay the cost of shipping the order, and title and risk of loss would pass to the Ohio company only when the shipment is delivered to its place of business. In this case, the seller would bear any losses due to goods that are lost or damaged in transit.

Breaching a contract influences when risk of loss transfers from seller to buyer. If a seller ships goods that do not comply with the terms of the contract (e.g., they are defective, the wrong color, or the incorrect size or create some other problem), risk of loss does not pass to the buyer until the seller "cures" the problem with the goods or the buyer accepts the goods despite their problems. If the buyer breaches the contract, risk of loss shifts immediately from the seller to the buyer.

Insurable Interest

Insurable interest ensures the right of either party to the sales contract to obtain insurance to protect against lost, damaged, or destroyed merchandise as long as that party has "sufficient interest" in the goods. In general, once goods are identified, the buyer has an insurable interest in them. The seller has a sufficient interest as long as the seller retains title to the goods. However, under certain circumstances, both the buyer and the seller have insurable interests even after title has passed to the buyer.



Entrepreneurship in Action

Supply Chain Innovation at Mother Dairy

Mother Dairy is a wholly owned company of the National Dairy Development Board of India. It was founded in 1974 under the Operation/Flood program. The company provides quality food and beverages to consumers at affordable prices while ensuring fair returns to the producers. Mother Dairy is committed to delivering products that meet all regulatory, industrial, consumer quality, and food safety requirements. It is focused on building a sustainable "Quality and Food Safety Program" across the food chain using state-of-the-art processes and innovative technologies.

The primary surveys conducted by Mother Dairy revealed some shortcomings in the existing fruits and vegetable supply chain both at the farmers' and the consumers' ends. At farmers' end, the main problems identified by Mother Dairy in the course of their survey were unplanned crop selection, traditional handling practices of materials, and sale of the produce in bulk to the middlemen. At the consumers' end, the main problems identified by Mother Dairy were unreliable retailer price, unavailability of all types of fruits and vegetables from a single retailer, and several kinds of discomforts during purchase.

Mother Dairy decided to address all these problems. The overall objective of the venture was to improve the returns to farmers producing vegetables and fruits in rural areas, and to provide quality products and services to the complete satisfaction of consumers in urban areas. The idea was to set up a new type of supply chain—"from field to table"—in the fruits and vegetables sector. It would involve the farmers and would aim at improving

yield and quality produce, identifying superior varieties of fruits and vegetables, adoption of better agricultural practices, expanding the market, and ensuring better market prices for the produce.

To solve the problems, an action plan was prepared, drawing valuable lessons from Mother Dairy's ongoing venture in the milk sector.

Building on its experience in the existing milk supply chain, Mother Dairy took up the challenging task of organizing a supply chain in the untried sector of fruits and vegetables. In 1984, Mother Dairy started with a pilot project in Delhi. The full-fledged activity began with a large-scale central distribution facility and cold storage complex to handle over 100,000MT vegetables annually in 1988.

A chain of Mother Dairy booths as retail outlets for consumers in Delhi was also opened in the same year.

Since then, the venture has grown and scaled new heights. Mother Dairy sells not only fresh fruits and vegetables, but also frozen, processed, and pulped produce. It justifiably received the Indian Innovation Award, 2005.

1. What were the problems faced by Mother Dairy at the time of launching its fruits and vegetables supply chain?
2. What was the overall objective of this venture?
3. How did Mother Dairy build a supply chain from "field to table"?

Source: Poornima M. Charantimath, *Entrepreneurship Development and Small Business Enterprises* (New Delhi: Pearson Education, 2007.)

Receiving Merchandise

Once the merchandise is received, the buyer must verify its identity and condition. When the goods are delivered, entrepreneurs should check the number of cartons unloaded against the carrier's delivery receipt to make sure that the shipment is complete. It is also a good idea to examine the boxes for damage; if shipping cartons are damaged, the carrier should note the damage on the delivery receipt. Entrepreneurs should open all cartons immediately after delivery, inspect the merchandise for quality and condition, and check it against the invoices for discrepancies. If merchandise is damaged or faulty, the buyer should contact the supplier immediately and follow up with a written report. Entrepreneurs should never destroy or dispose of damaged or flawed merchandise unless the supplier specifically authorizes it. Proper control techniques in receiving merchandise prevent the small business owner from paying for suppliers' and shippers' mistakes.

Selling on Consignment

Entrepreneurs who lack the necessary capital to invest or are unwilling to assume the risk of investing in inventory may be able to sell goods on consignment. Selling on **consignment** means that the entrepreneur does not actually purchase the merchandise from the supplier (called the consignor); instead, the entrepreneur pays the consignor only for the merchandise actually sold. In exchange for providing the supplier with a marketplace to sell his or her goods, the entrepreneur typically receives a percentage of the revenue on each item sold. The entrepreneur (called the **consignee**) may return any unsold merchandise to the supplier (the **consignor**) without obligation. Under a consignment agreement, title and risk of loss do not pass to the consignee unless the contract specifies these terms. In other words, the supplier bears the financial costs of lost, damaged, or stolen merchandise. Entrepreneurs who sell merchandise on consignment realize the following advantages:

- The entrepreneur does not have to invest money in these inventory items, but the merchandise is on hand and available for sale.
- The entrepreneur does not pay the consignor until the item is sold.
- Because the consignment relationship is founded on the law of agency, the consignee never takes title to the merchandise and does not bear the risk of loss for the goods.
- The supplier normally plans and sets up displays for the merchandise and is responsible for maintaining them.

Before selling items on consignment, the entrepreneur and the supplier should create a written contract that should include the following items:

- A list of items to be sold and their quantities
- Prices to be charged
- Location of the merchandise in store
- Duration of contract
- Commission charged by the consignee
- Policy on defective items and rejects
- Schedule for payments to consignor
- Delivery terms and merchandise storage requirements
- Responsibility for items lost to pilferage and shoplifting
- Provision for terminating consignment contract

If managed properly, selling goods on consignment can be beneficial to both the consignor and the consignee.

Chapter Review

1. Understand the components of a purchasing plan.
 - The purchasing function is vital to every small business's success because it influences a company's ability to sell quality goods and services at reasonable prices. Purchasing is the acquisition of needed materials, supplies, services, and equipment of the right quality, in the proper quantities, for reasonable prices, at the appropriate time, and from the right suppliers.
2. Explain the principles of total quality management, including Lean, 5S, and Six Sigma and their impact on quality.
 - Under the total quality management (TQM) philosophy, companies define a quality product as one that conforms to predetermined standards that satisfy customers' demands. The goal is to get delivery and invoicing to installation and follow-up—right the first time.
 - To implement TQM successfully, a small business owner must rely on 10 fundamental principles: shift from a management-driven culture to a participative, team-based one; modify the reward system to encourage teamwork and innovation; train workers constantly to give them the tools they need to produce quality and to upgrade the company's knowledge base; train employees to measure quality with the tools of statistical process control; use Pareto's Law to focus TQM efforts; share information with everyone in the organization; focus quality improvements on astonishing the customer; don't rely on inspection to produce quality products and services; avoid using TQM to place blame on those who make mistakes; and strive for continuous improvement in processes as well as in products and services.
 - Like TQM, Six Sigma relies on quantitative tools to improve quality. At its core is the DMAIC process: Define the quality problem, Measure current process performance to establish a baseline, Analyze the process and identify potential root causes of the problem, Improve the system by implementing solutions to remove the root causes, and Control the new process by establishing standards of measurement and procedure.
3. Conduct economic order quantity analysis to determine the proper level of inventory.
 - A major goal of the small business is to generate adequate inventory turnover by purchasing proper quantities of merchandise. A useful device for computing the proper quantity is economic order quantity (EOQ) analysis, which yields the ideal order quantity, the amount that minimizes total inventory costs. Total inventory costs consist of the cost of the units, holding (carrying) costs, and ordering (setup) costs. EOQ analysis balances the costs of ordering and of carrying merchandise to yield minimum total inventory cost.
4. Differentiate among the three types of purchase discounts vendors offer.
 - Trade discounts are established on a graduated scale and depend on a small firm's position in the channel of distribution.
 - Quantity discounts are designed to encourage businesses to order large quantities of merchandise and supplies.
 - Cash discounts are offered to customers as an incentive to pay for merchandise promptly.
5. Calculate a company's reorder point.
 - There is a time gap between the placing of an order and actual receipt of the goods. The reorder point model tells the owner when to place an order to replenish the company's inventory.
6. Develop a vendor rating scale.
 - Creating a vendor analysis model involves four steps: determine the important criteria (i.e., price, quality, prompt delivery, service, and so on), assign a weight to each criterion to reflect its relative importance, develop a grading scale for each criterion, and compute a weighted score for each vendor.
7. Describe the legal implications of the purchasing function.
 - Important legal issues involving purchasing goods involve title, or ownership of the goods; identification of the goods, risk of loss, and when it shifts from seller to buyer; and insurable interests in the goods. Both the buyer and the seller can have an insurable interest in the same goods at the same time.

Discussion Questions

- 19-1. What is SCM? Why is it important to entrepreneurs?
- 19-2. Explain the elements of a purchasing plan.
- 19-3. Explain Lean and 5S principles. What is Six Sigma? What is TQM? How can these tools help entrepreneurs achieve the quality goods and services they require?
- 19-4. What are the fundamental principles that a small business entrepreneur should consider to implement DMAIC in his or her enterprise?
- 19-5. Visit the Web site of the National Institute of Standards and Technology (www.nist.gov/baldrige/), the organization that grants the Malcolm Baldrige National Quality Award, the highest quality award in the United States. Research one of the companies that received the Baldrige Award and prepare a one-page summary of its quality initiative and the results that it produced.

- 19-6.** What are the various types of purchase discounts that vendors offer?
- 19-7.** What is the EOQ? How does it minimize total inventory costs?
- 19-8.** Explain the relevance of supply chain management to entrepreneurs in order to gain a competitive edge in the market place.
- 19-9.** Briefly outline the three types of purchase discounts. Under what circumstances is each the best choice?
- 19-10.** What is lead time? Outline the procedure for determining a product's reorder point.
- 19-11.** What is e-procurement? What are the benefits of e-procurement to a business enterprise?
- 19-12.** What factors are commonly used to evaluate suppliers?
- 19-13.** Explain the procedure for developing a vendor rating scale.
- 19-14.** Explain briefly the three concepts that have replaced the concept of title. When do title and risk of loss shift under an F.O.B. seller contract? An F.O.B. buyer contract?
- 19-15.** What are the various factors a business enterprise should consider before making the final decision about the right supplier?
- 19-16.** Explain how a small business would sell goods on consignment. What should be included in a consignment contract?

CHAPTER 20

Managing Inventory



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain the various inventory control systems and the advantages and disadvantages of each.
2. Describe how just-in-time (JIT) and JIT II inventory control techniques work.
3. Describe methods for reducing losses from slow-moving inventory.
4. Discuss employee theft and shoplifting and how to prevent them.

If a product isn't selling, I want to get it out of there because it's taking up space that can be devoted to another part of my line that moves. Besides, having a product languish on the shelves doesn't do much for our image.

—Norman Melnick, chairman
of Pentech International

Honesty pays, but it doesn't seem to pay enough to suit some people.

—F. M. Hubbard

Supply chain management and inventory control are closely linked. The previous chapter focused on managing a company's supply chain—purchasing the correct materials, of the proper quality, in the correct quantity, at the best price, from the best vendors. This chapter will continue that process by discussing various inventory control methods, how to move “slow” inventory items, and how to protect inventory from theft. An entrepreneur's goal is to maximize the value of a company's inventory while reducing both the cost and the risks of owning inventory. The issue is significant; the largest expenditure for many small businesses is in inventory (see Figure 20.1).

Although many business owners understand the dangers of carrying excess inventory, they face a constant battle to avoid the problem. A study by the Aberdeen Group reports that 70 percent of businesses rate themselves “average” or “below average” on inventory management.¹ In addition, 91 percent of them report that they are making changes to their businesses, such as improving sales forecasting, enhancing replenishment strategies, and increasing the level of cooperation with vendors to improve their ability to manage inventory more effectively.² For years, businesses maintained high levels of inventory so that their manufacturing or sales processes ran smoothly. Managers now realize that inventory simply masks other problems that a company may have, such as poor quality, sloppy supply chain management, improper pricing, inadequate marketing, inefficient layout, low productivity, and others. Reducing the amount of inventory a company carries exposes these otherwise hidden problems; only then can managers and employees solve them.

As you learned in earlier chapters, excess inventory ties up a company's cash unnecessarily, putting it at greater risk of failure. “Inventory is money sitting around in another form,” explains one business writer. “You can't use the money tied up in inventory to grow your business. You can't spend that money on marketing or hiring a new salesperson, and you can't use it to pay down your line of credit.”³ Businesses that carry excess inventory also incur high inventory carrying costs. American businesses incur \$418 billion in carrying costs each year (20.3 percent of the total value

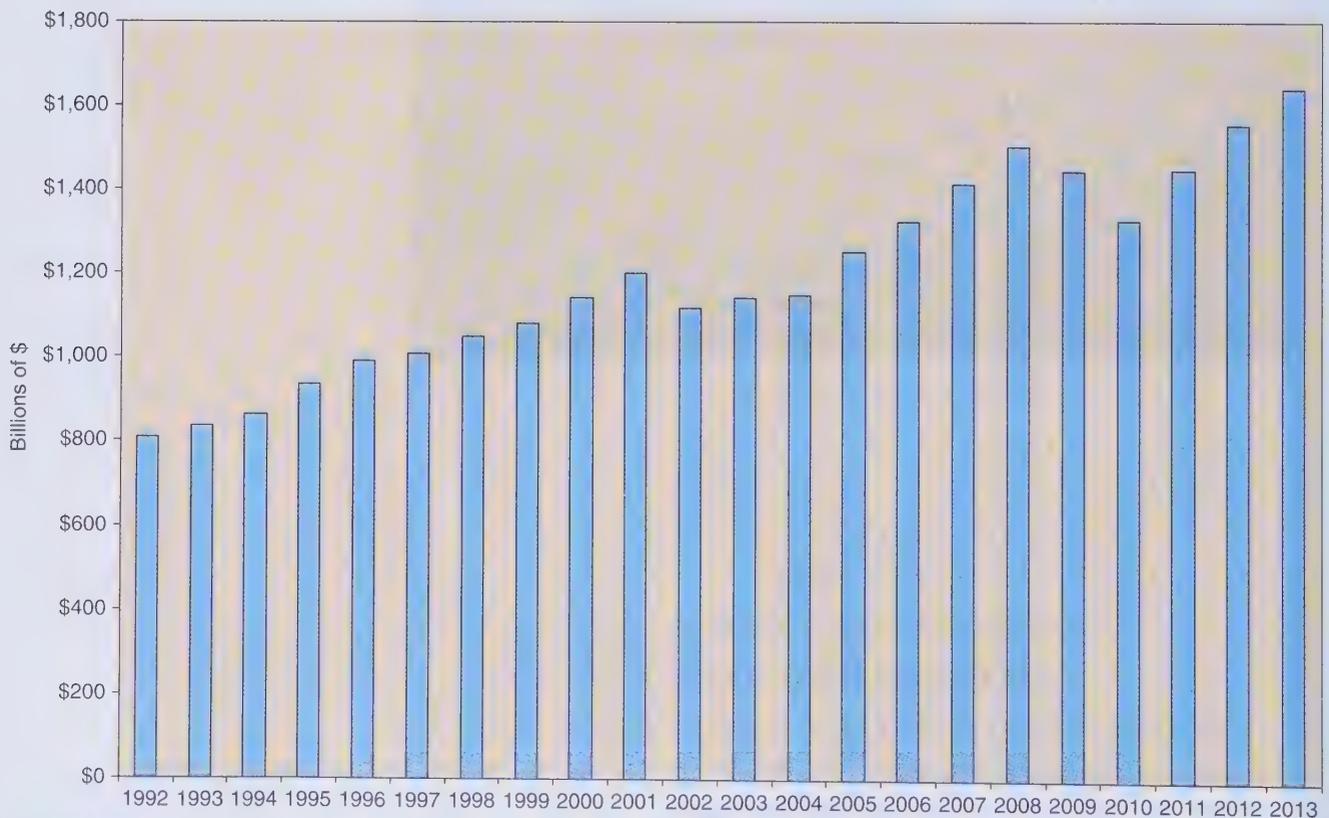


FIGURE 20.1

Total U.S. Business Inventories, 1992–2013 (in Billions of \$)

Source: Based on “Manufacturing and Trade Inventories and Sales,” U.S. Census Bureau, www.census.gov/mtis.

of the inventory they hold), the majority of it in the form of taxes, depreciation, insurance, and obsolescence.⁴ Holding excess inventory has serious consequences for a company, including renting or purchasing additional warehouse space, higher labor costs, increased borrowing, greater risk of being stuck with obsolescent merchandise, and tying up a company's valuable cash unnecessarily. Companies with lean inventory levels lower their costs of operation, and those savings go straight to the bottom line. The potential payoff for managing inventory efficiently is huge; companies that switch to lean inventory systems can increase their profitability by 20 to 50 percent.



ENTREPRENEURIAL PROFILE: Li Ning: Li Ning Company Li Ning Company, a business based in Beijing and started by its namesake, former Chinese Olympic gymnast Li Ning, incurred significant losses after the company built up significant stocks of inventory in anticipation of strong demand for the sportswear and athletic shoes it sells under several brand names after China hosted the summer Olympic Games. Unfortunately, because of intense competition from industry giants Nike and Adidas and from companies such as Gap and H&M that have entered the sportswear market, its stores were overflowing with inventory, and Li Ning was forced to offer sizable discounts to move the excess merchandise. Even at the discounted prices, the company struggled to move the inventory off the shelves of its more than 6,400 stores, which prevented it from being able to introduce new styles and products (a key to success in the sportswear industry) to customers, further harming its sales. As part of its revitalization effort, the company refocused on its core Li Ning brand and reformulated its inventory management process to increase the number of times it turns its inventory and to replenish inventory in its stores faster. Li Ning also signed marketing agreements with the Chinese Basketball Association and with National Basketball Association star Dwayne Wade to create a Wade-endorsed "Dynasty" sportswear line.⁵

The information age has made techniques such as just-in-time inventory systems available to even the smallest of businesses. Internet-based networks that connect a company seamlessly with its suppliers have dramatically reduced the time for needed parts or material to arrive and the need to hold inventory. At the other end of the pipeline, a company's customers expect to have what they need when they need it. In today's competitive market, few customers will wait beyond a reasonable time for items they want. Managing inventory properly requires business owners to master an intricate balancing act, keeping enough inventory on hand to meet customers' expectations but maintaining inventory levels low enough to avoid excessive costs.

Managing inventory effectively requires an entrepreneur to implement the following seven interrelated steps:

1. **Develop an accurate sales forecast.** The proper inventory level for each item is directly related to customers' demand for that item. A business cannot sell merchandise that it does not have, and, conversely, an entrepreneur does not want to stock inventory that customers will not buy.



ENTREPRENEURIAL PROFILE: Dan Richardson: Northway Sports Dan Richardson, owner of Northway Sports, a retailer in East Bethel, Minnesota, that sells Polaris all-terrain vehicles (ATVs), snowmobiles, and motorcycles, says that he has lost several sales of Polaris's most popular ATV because the manufacturer had not been able to deliver the units he ordered five months before. When a recession hit, Polaris, like most manufacturers, slashed production to keep its inventory lean and to avoid putting pressure on its dealers to purchase products that they could not sell. Polaris's forecasts showed sluggish sales. Several months later, however, surging demand for the company's products caught managers by surprise, and Polaris was unable to fill its dealers' orders.⁶

Economic uncertainty and volatility make forecasting sales difficult, but top-performing companies make accurate forecasting a priority. A study by the Aberdeen Group reports that 75 percent of "best-in-class" companies create accurate demand forecasts versus only 26 percent of "laggard" companies. The study shows that these top-performing companies demonstrate an average forecast accuracy level of 82.3 percent three months into the future.⁷ Best-in-class companies rely on **multiechelon inventory management**, a technique that views a company's supply chain holistically and balances its inventory levels against desired customer service levels, lead times, suppliers' production capacity, forecasted and actual customer demand, seasonality, and other factors across all product lines and at every level of the supply chain. Table 20.1 explains the differences between the traditional approach to inventory management and the multiechelon approach.

TABLE 20.1 Multiechelon Versus Traditional Inventory Policy Setting

	Traditional Approaches	Multiechelon Approaches
Target setting	Independently or sequentially set inventory target for each location or item (set target at one location or level first, then the next, and so on).	Simultaneously optimize inventory targets across all stock keeping units (SKUs), echelons, and locations to meet global service level objective (e.g., customer fill rate).
Variability	Use a normal distribution of demand to describe variability.	Allow for different measures of forecast/demand variability, such as forecast error; also takes into account supply variability and replenishment frequency impact on overall variability, often modeling actual distribution probabilities.
Inventory interdependencies	Assign inventory levels without regard to upstream or downstream inventory.	When setting inventory targets, take into account postponement opportunities and upstream/downstream inventory risk pooling.
Mix optimization	Single echelon inventory calculations assign each individual SKU location a target based on the factors in the calculation versus rules of thumb (e.g., 21 days of supply) being applied across whole production groups.	Multiechelon inventory mix optimization sets individual SKU-location targets versus broad rules of thumb, accounting for more factors in the calculation. It does this simultaneously for the different forms of inventory across time.
Goal-based optimization	Set inventory policies to meet service target defined for individual level. Typically only for finished goods and unit based.	Set inventory policies to meet global service-level objective with minimum total supply chain inventory investment.
Calculations	Calculations take into account expected demand, forecast error, and lead times for one point in the supply chain.	Optimization takes into account expected demand, forecast error, finished good service level, service times, inventory policies, cycle stock impacts, time-phased yield factors, production or distribution capacity constraints; production and handling lead times and lead time variability by location; transportation lead times and deviations by lane; handling/manufacturing/transportation cost factors; and so on.
Time sensitivity	Static inventory targets are changed when there is a shift in a product's life cycle stage.	Time-varying inventory targets account for seasonality and other time variations in demand, supply, or capacity; timing of inventory levels are coordinated across time between raw materials, and work in process through finished goods.
Demand propagation	Traditional approaches have no formal mechanism for coordinating the demand upstream for proper target setting.	Demand and demand/forecast uncertainty are propagated upstream so that inventory can be positioned properly throughout the supply chain.
Multilevel cost accumulation	Traditional approaches often do not include cost as a part of their calculation and cannot optimize based on multilevel costs.	By accounting for value added at each step along the supply chain, the multiechelon optimization can position inventory before expensive costs are added into an item while still satisfying service-level goals.
Service time coordination	No coordination of service times across the supply chain.	Coordination of service times in multi-level bills of materials and distribution routing so that excess inventory is not waiting for other long lead time components unnecessarily.

Source: Based on Aberdeen Group, December 2010, www.aberdeen.com.

2. **Develop a plan to make inventory available when and where customers want it.** Inventory will not sell if customers have a difficult time finding it. If a company is constantly running out of items customers expect to find, its customer base will dwindle over time as shoppers look elsewhere for those items. An important component of superior customer service is making sure that adequate quantities of items are available when customers want them. Two ways of measuring this aspect of customer service include calculating the percentage of customer orders that a company ships on time and the percentage of the dollar volume of orders that it ships on time. Tracking these numbers over time gives business owners sound feedback on how well they are managing their inventory levels from the customer's perspective. Polaris, the maker of all-terrain vehicles, snowmobiles, and motorcycles, once used a system that required dealers to place large orders of inventory twice a year. However, when sales slowed, the "stack 'em high, watch 'em fly" system caused problems with dealers and at Polaris. Today Polaris has switched to a system that allows

dealers to order smaller quantities of inventory more frequently, which allows them to maintain leaner inventories and match supply with customer demand more effectively.⁸

3. **Build relationships with your most critical suppliers to ensure that you can get the merchandise you need when you need it.** Business owners must keep suppliers and vendors aware of how their merchandise is selling and communicate their needs to them. Vendors and suppliers can be an entrepreneur's greatest allies in managing inventory. Increasingly, the word that describes the relationship between world-class companies and their suppliers is *partnership*.
4. **Set realistic inventory turnover objectives.** Keeping in touch with their customers' likes and dislikes and monitoring their inventory enable owners to estimate the most likely buying patterns for different types of merchandise. As you learned in Chapter 7, one of the factors having the greatest impact on a company's sales, cash flow, and ultimate success is its inventory turnover ratio.
5. **Compute the actual cost of carrying inventory.** Many business owners do not realize how expensive carrying inventory actually is. Recall that the average carrying cost for all businesses is 20.3 percent of the value of their inventory. Without an accurate cost of carrying inventory, it is impossible to determine an optimal inventory level. Carrying costs include items such as interest on borrowed money, insurance expenses associated with the inventory, inventory-related personnel expenses, obsolescence, and others. When new product introductions make existing products obsolete, companies must hold inventory to an absolute minimum. For instance, in the computer industry, the onrush of new technology causes the value of a personal computer held in inventory to decline 1 percent each week! This gives computer makers big incentives to keep their inventories as lean as possible.



ENTREPRENEURIAL PROFILE: George Falzon: G. Falzon & Company George Falzon, owner of G. Falzon & Company, a small jewelry store in Holliston, Massachusetts, watched the cost of holding inventory, particularly engagement rings and wedding bands, increase as the prices of precious metals soared. A weak economy demanded that Falzon avoid overinvesting in inventory, which is a common cause of cash crises, but potential customers expect to see a wide selection of items when shopping. Falzon developed a clever solution: He began stocking replicas of jewelry pieces made from plated silver and cubic zirconium rather than platinum, silver, gold, and diamonds. Because most engagement and wedding pieces are special orders, customers do not mind looking at the replicas. Falzon says that stocking the replicas saves him about \$75,000 in inventory, allowing him to display four times as many styles of engagement rings and wedding bands.⁹

6. **Use the most timely and accurate information system the business can afford to provide the facts and figures necessary to make critical inventory decisions.** Modern inventory control systems and point-of-sale terminals that are linked to a company's inventory records enable business owners to know exactly which items are selling and which are not. The owner of a chain of baby products stores uses a computer network to link all of his stores to the computer at central headquarters. Every night, after the stores close, the point-of-sale terminals in each store download the day's sales to the central computer, which compiles an extensive sales and inventory report. When he walks into his office every morning, the owner reviews the report and knows exactly which items are moving fast, which are moving slowly, and which are not selling at all. He credits the system with the company's above-average inventory turnover ratio and much of its success.
7. **Teach employees how inventory control systems work so that they can contribute to managing the firm's inventory on a daily basis.** All too often, the employees on the floor have no idea of how the various information systems and inventory control techniques operate or interact with one another. Consequently, the people closest to the inventory contribute little to controlling it. Well-trained employees armed with information can be one of an entrepreneur's greatest weapons in the battle to control inventory. Fast changes in product demand require inventory control systems that are capable of responding quickly, allowing entrepreneurs and their employees to make adjustments to inventory levels in real time.

The goal is to find and maintain the proper balance between the cost of holding inventory and the requirement to have merchandise on hand when customers demand it. Either extreme can be costly. If entrepreneurs focus solely on minimizing cost, they will undoubtedly incur

stockouts, lost sales, and customer ill will because they cannot satisfy their customers' needs. For instance, researchers studying inventory control systems at Bulgari, a jewelry manufacturer headquartered in Rome, Italy, discovered that stockouts of just one popular item had lowered the company's profits by 5 percent of sales.¹⁰ At the other extreme, entrepreneurs who attempt to hold enough inventory to meet every peak customer demand find that high inventory costs diminish their chances of remaining profitable. "There's a fine line between not having racks of clearance [merchandise] from leftover inventory and cutting to the bone," says one retail expert.¹¹ Walking this inventory tightrope is never easy, but the following inventory control systems can help business owners strike a reasonable balance between the two extremes.

Inventory Control Systems

1.

Explain the various inventory control systems and the advantages and disadvantages of each.

Regardless of the type of inventory control system business owners choose, they must recognize the importance of **Pareto's Law** (or the **80/20 rule**), which holds that about 80 percent of a company's sales revenue is generated by 20 percent of the items in its inventory. Sometimes a company's best-selling items are its highest-priced items, but more often they are low-priced items that sell in high volume. Because most sales are generated by a small percentage of items, entrepreneurs should focus the majority of their inventory control efforts on this 20 percent. Observing this simple principle ensures that entrepreneurs will spend time controlling only the most productive—and, therefore, most valuable—inventory items. With this technique in mind, we now examine three basic types of inventory control systems: perpetual, visual, and partial.

Perpetual Inventory Systems

Perpetual inventory systems are designed to maintain a running count of the items in inventory. Although a number of different perpetual inventory systems exist, they all have a common element: They all keep a continuous tally of each item added to or sold from the company's stock of merchandise. A manual system that uses a perpetual inventory sheet that includes fundamental product information, such as the item's name, stock number, description, economic order quantity (EOQ), and reorder point, can be time consuming to maintain and produces inaccurate results if employees add items to or take items out of stock without recording them. Fortunately, many companies offer perpetual inventory management software that connect with small companies' accounting and financial packages, such as QuickBooks and Sage 50, to create an integrated control system that is more accurate and more efficient to operate. Many of these software packages include automatic reorder point triggers that generate purchase orders for the appropriate quantities of goods to replenish the inventory.



ENTREPRENEURIAL PROFILE: Justin Bosshardt: The Mending Shed Started in 1971 in Orem, Utah, as a mom-and-pop repair shop, The Mending Shed has expanded into a repair service for almost any item and a brick-and-mortar and online wholesaler and retailer of replacement parts. "Our inventory includes parts for washers, dryers, dishwashers, hair dryers, curling irons, shavers, power wheels, power tools, lawn equipment, and the list goes on," says Justin Bosshardt, The Mending Shed's director of IT. The company uses QuickBooks, one of the most popular small business accounting software packages, but The Mending Shed had outgrown its inventory management capability. "We were constantly fighting shortages on inventory, which made customers upset when we had to put their orders on back order," says Bosshardt. "We also had inventory on the shelves that was not listed on our Web site because there was no way to keep track of it." After several months of screening, Bosshardt purchased Fishbowl Inventory, the most popular inventory management software for QuickBooks users. Fishbowl Inventory integrated seamlessly with QuickBooks, and its inventory management, order fulfillment, automatic reorder points, and automatic purchase order generation features enabled the company to reduce its average inventory level while increasing its order fulfillment and customer service levels. "Fishbowl Inventory has improved every aspect of our company in some way," says Bosshardt. The time required to prepare purchase orders decreased from six hours a day to only one hour a day. In addition, the time that workers spent picking orders from warehouse shelves decreased from two hours per 100 orders to just 15 minutes per 100 orders. "We invested a significant amount of money into Fishbowl Inventory, and it paid for itself in the first year," says Bosshardt.¹²

Many small retailers now use computerized **point-of-sale (POS)** systems that perform all of the functions of a traditional cash register and maintain and up-to-the minute inventory count. Although POS systems are not new (major retailers have been using them for more than 30 years), their affordable prices are. Not so long ago, most systems required large investments in hardware and software. Today, small business owners can set up cloud-based POS systems, such as Shopkeep, Kronos, or Revel Systems, on personal computers and tablets for as little as \$1,000. Setting up POS systems on tablets allows entrepreneurs to create mobile cash registers that are capable of taking customers' orders anywhere in the store. To prevent customers from having to wait in checkout lines (a common customer complaint), some stores dispatch employees with POS-equipped tablets to process customers' purchases and e-mail them receipts.

Combining a POS system with Universal Product Code (bar code) labels and high-speed scanners or radio frequency identification tags gives a small business a state-of-the-art checkout system that feeds vital information into its inventory control system. These systems rely on an inventory database; as items are rung up on the register, product information is recorded and inventory balances are adjusted. Using the system, business owners can tell how quickly each item is selling and how many items are in stock at any time. In addition, inventory records are accurate and are always current. Modern POS systems also allow business owners to generate an array of inventory reports instantly. Entrepreneurs can slice and dice data in a multitude of ways, allowing them to determine which items are selling the fastest and which are moving the slowest. Timely reports such as these give entrepreneurs the ability to make sound decisions about scheduling advertising, running special promotions, offering discounts, and arranging store displays. Computerized POS systems also make it possible for entrepreneurs to use perpetual inventory systems for a large number of inventory items, a task that, if performed manually, would be virtually impossible.



ENTREPRENEURIAL PROFILE: David Steingard and Hugh Jackman: Laughing Man Coffee & Tea

David Steingard, who cofounded Laughing Man Coffee & Tea with actor Hugh Jackman in 2011, was shopping for a POS system for their unique coffee and tea bar in New York City's Tribeca neighborhood but was shocked at the \$15,000 to \$30,000 price tag that traditional POS systems carried. Then Steingard discovered ShopKeep, a cloud-based POS system that runs on iPads and iPhones created by entrepreneur Jason Richelson after he could not find a suitable POS system for his small wine and food store. "We needed something that was affordable but had enough robust inventory features," says Steingard. ShopKeep provides a "back office" that allows entrepreneurs to enter inventory items, descriptions, and prices and through which they can generate customized and detailed inventory and sales reports. "It's a very easy interface," says Steingard. Because the system is cloud-based, entrepreneurs do not have to purchase servers. "You pay a monthly fee and then pay for your transactions through your merchant account," he says. At peak hours, Laughing Man employees take their iPads, greet customers, and take their orders both inside and outside the shop. "The iPad POS system helps move the line, but more important, it sends a message to our customers that we are continually working to make their coffee experience better," says Steingard.¹³



Laughing Man Marketplace.
Source: Aaron Showalter/Newscom.

VISUAL INVENTORY CONTROL SYSTEMS The most common method of controlling inventory in a small business is the **visual control system**, in which managers simply conduct periodic visual inspections to determine the quantity of various items they should order. This system suits businesses that stock a large number of low-value items with low dollar volume. Unfortunately, this method is also the least effective for ensuring accuracy and reliability. Oversights of key items often lead to stockouts and resulting lost sales. The biggest disadvantage of the visual control system is its inability to detect and to foresee shortages of inventory items.

In general, a visual inventory control system works best in firms in which daily sales are relatively consistent, the entrepreneur is closely involved with the inventory, the variety of merchandise is small, and items can be obtained quickly from vendors. For example, small firms dealing in perishable goods use visual control systems very successfully and rarely, if ever, rely on analytical inventory control tools. For these firms, shortages are less likely to occur under a visual system; when they do occur, they are not likely to create major problems. Entrepreneurs who rely on visual systems must be alert to shifts in customer buying patterns that alter required inventory levels.



In the Entrepreneurial Spotlight

An Ideal Inventory Solution

Tim Balsimo, founder of Quality Pet Products, a wholesale distributor of pet foods to veterinary clinics and retail pet stores in six states, is a 20-year veteran of the pet food industry. Before starting Quality Pet Products, Balsimo owned a successful chain of pet stores that he sold in 2001. Based in Woodbury, Minnesota, Quality Pet Products carries more than 500 different pet foods in inventory to serve more than 400 customers in Minnesota, North Dakota, South Dakota, Wisconsin, Iowa, and Nebraska. "We purchase everything from our manufacturing partners in truckloads," says Balsimo, who offers customers a 24-hour delivery guarantee on all orders placed before 10 A.M. "We have customers from Rapid City to Green Bay," he says, meaning that the company must manage its inventory carefully to be able to meet its 24-hour delivery guarantee 100 percent of the time. As a former retail pet store owner, Balsimo understands how important fast delivery is to his customers and that the guarantee is one important way of differentiating his company from the competition.

As the company's customer base grew and stretched into a broader geographic area, Balsimo began looking for ways to improve his company's efficiency, manage its inventory investment more effectively, and improve the level of customer service it provides. He began shopping for comprehensive inventory tracking software that would integrate seamlessly with QuickBooks, the popular accounting software package that Quality Pet Products uses. He also wanted to create a Web-based order-entry system for his customers that would funnel orders directly into the company's inventory control system. Finally, he wanted Quality Pet Products to earn certification from the American Institute of Baking (AIB), which requires a company to track every edible item that comes through its warehouse by lot number or bar code in case of a product recall. The software would have to keep track of every item in stock, pinpoint its location in the warehouse to maximize workers' efficiency when "picking" customers' orders, create bills of lading, track shipment weights and delivery dates, and perform other essential inventory control functions. Balsimo found software that would perform these individual functions but not as a comprehensive package. "What was missing was the ability to handle serial and lot numbers," he says, both of which were crucial to earning

AIB certification. "[AIB certification] is a safety standard," explains Balsimo. "We must have a process to track every single item that is edible in and out of the warehouse by lot number or bar code."

Balsimo found Fishbowl Inventory and conducted a test to see whether the software could meet the company's needs and measure up to his expectations. After just one month of testing, Balsimo decided to completely implement Fishbowl Inventory. "It integrated with QuickBooks so well that we were able to move our [product] information quickly to Fishbowl," he says. "It took only a week or two to fine-tune everything. We were able to write a custom ordering report that takes into account our previous sales history, quantities on hand, and 'what's on order' to develop our own ordering process based on our lead times."

According to Balsimo, Quality Pet Products's new inventory control system has produced impressive results at a very reasonable price. "We've been able to make things run as efficiently as possible from order taking right on through to our picking and shipping process," he says. "The time it saves in daily operations is the equivalent of two office people per day—16 hours per day. It saves time, allows us to do more with less staff, integrates into one piece of software, and prevents us from having to set up more workstations or servers." The system also enabled Quality Pet Products to establish a convenient, integrated, Web-based customer order-entry system and to achieve its goal of becoming AIB compliant. Balsimo also is pleased that the company now boasts a 0.001 percent inventory variance, compared to the 1 to 2 percent variance that the typical pet food distributor has. "For us, the investment certainly was worth it," he says.

1. What benefits has Quality Pet Products reaped from improving its ability to manage its inventory more accurately?
2. Go to your favorite search engine and conduct a search of the most common problems that small businesses face when managing their inventory. What steps can entrepreneurs take to avoid these problems?

Sources: Based on Christina DesMarais, "Choosing the Best Inventory Tracking Software," *Inc.*, May 24, 2011, www.inc.com/articles/201105/best-inventory-tracking-software.html; Fishbowl Case Studies: Quality Pet Products, Fishbowl, <http://marketplace.intuit.com/CaseStudyDL.asp?CaseStudyID=0x0000000000000012>.

Partial Inventory Control Systems

For small business owners with limited time and money, the most viable option for inventory management is a partial inventory control system. These systems rely on the validity of the Pareto's Law, the 80/20 rule. For example, if a small business carries 5,000 different items in stock, roughly 1,000 of them account for about 80 percent of the company's sales volume, another 1,500 items account for 15 percent of its sales, and the remaining 2,500 items account for only 5 percent of its sales. Experienced business owners focus their inventory control efforts on the 1,000 items that make up 80 percent of their companies' sales. Unfortunately, many owners seek to maintain tight control over the remaining 4,000 items, a frustrating and wasteful practice. Smart entrepreneurs design their inventory control systems with Pareto's Law in mind. One of the most popular partial inventory control systems is the ABC system.

cost of any inventory control system. The ABC method focuses control efforts on that small percentage of items that accounts for the majority of a company’s sales. The typical ABC system divides a firm’s inventory into three major categories:

- A items account for a high dollar usage volume.
- B items account for a moderate dollar usage volume.
- C items account for low dollar usage volume.

The **dollar usage volume** of an item measures the relative importance of that item in a company’s inventory. Note that value is *not* necessarily synonymous with high unit cost. In some instances, a high-cost item that generates only a small dollar volume can be classified as an A item. More frequently, however, A items are those that are low to moderate in cost and high volume by nature.

The initial step in establishing an ABC classification system is to compute the annual dollar usage volume for each product (or product category). **Annual dollar usage volume** is simply the cost per unit of an item multiplied by the annual quantity sold. For instance, the owner of a music supply house may find that she sold 190 pairs of a popular brand of speakers during the previous year. If the speakers cost \$75 per unit, their annual dollar usage volume would be as follows:

$$190 \times \$75 = \$14,250$$

The next step is to arrange the products in descending order on the basis of their computed annual dollar usage volume. Once so arranged, they can be divided into appropriate classes by applying the following rule:

- A items: roughly the top 15 percent of the items listed
- B items: roughly the next 35 percent
- C items: roughly the remaining 50 percent

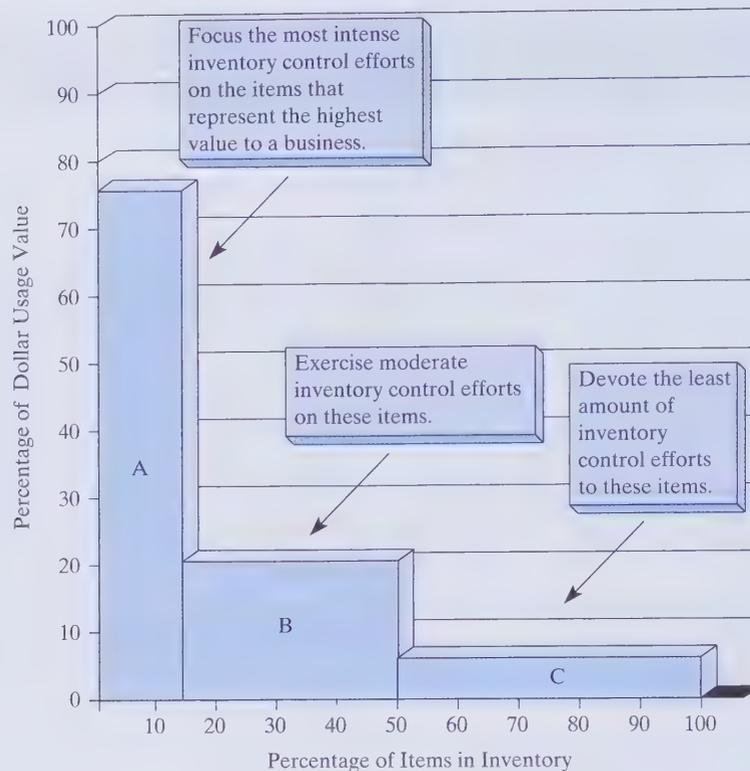
For example, Florentina’s small retail shop is interested in establishing an ABC inventory control system to lower losses from stockouts, theft, or other hazards. Florentina has computed the annual dollar usage volume for the store’s merchandise inventory, as shown in Table 20.2. (For simplicity, we show only 12 inventory items.)

TABLE 20.2 Calculating Annual Dollar Usage Volume and an ABC Inventory Analysis for Florentina’s

Item	Annual Dollar Usage Volume	% of Annual Dollar Usage	
Paragon	\$374,100	42.00	
Excelsior	294,805	33.10	
Avery	68,580	7.70	
Bardeen	54,330	6.10	
Berkeley	27,610	3.10	
Tara	24,940	2.80	
Cattell	11,578	1.30	
Faraday	9,797	1.10	
Humboldt	8,016	0.90	
Mandel	7,125	0.08	
Sabot	5,344	0.06	
Wister	4,453	0.05	
Total	\$890,678	100.00	

Classification	Items	Annual Dollar Usage	% of Total
A	Paragon, Excelsior	\$668,905	75.1
B	Avery, Bardeen, Berkeley, Tara	175,460	19.7
C	Cattell, Faraday Humboldt Mandel, Sabot, Wister	46,313	5.2
Total		\$890,678	100.00

FIGURE 20.2
ABC Inventory Control



The ABC inventory control method divides the firm's inventory items into three classes depending on the items' value. Figure 20.2 graphically portrays the segmentation of the items listed in Table 20.2.

The purpose of classifying items according to their annual dollar usage volume is to establish the proper degree of control over each item held in inventory. Clearly, exercising the same level of control over C items and A items is wasteful and inefficient.



ENTREPRENEURIAL PROFILE: Marc Isaacson: Village Green Apothecary

Marc Isaacson, CEO of Village Green Apothecary, a full-service pharmacy that Mickey Weinstein and Irv Rosenberg started in Bethesda, Maryland, in 1965, was frustrated because the business was consistently running out of its best-selling products. "We lost those particular sales, and in some cases, we lost the customers," says Isaacson. He estimates that the stockouts cost Village Green Apothecary at least 2 to 3 percent of its sales, caused employees to become frustrated because they could not fill customers' orders, and damaged the pharmacy's image as the "go-to" pharmacy among its customers. To solve the problem, Isaacson worked with his staff of 50 employees to conduct an ABC inventory analysis and identify Village Green's best-selling items, which turned out to be nearly 1,000 of the items it stocked. He drew attention to each of these "A" items by placing a stick-on blue dot on the shelf next to each one and established a safety stock for each one that is equal to three weeks of sales. Before conducting the ABC analysis, about 3 percent of Village Green's inventory was out of stock at any given time; after making the inventory control changes, that number dropped to just 0.5 percent.¹⁴

Entrepreneurs should control items in the A classification under a perpetual inventory system with as much detail as necessary. Analytical tools and frequent counts may be required to ensure accuracy, but the extra cost of tight control for these valuable items is justified. Entrepreneurs should not retain a large supply of reserve or safety stock because doing so ties up excessive amounts of money in inventory, but they must monitor the stock closely to avoid stockouts and the lost sales that result.

Control of B items should rely more on periodic control systems and basic analytical tools, such as EOQ and reorder point analysis (recall the discussion in Chapter 17). Entrepreneurs can maintain moderate levels of safety stock for these items to guard against shortages and can afford monthly or even bimonthly merchandise inspections. Because B items are not as valuable to the business as A items, they require less rigorous control systems.

C items typically constitute a minor proportion of the small firm's inventory value and, as a result, require the least effort and expense to control. These items are usually large in number and small in total value. The most practical way to control them is to use uncomplicated records and procedures. Large levels of safety stock for these items are acceptable because the cost of carrying them is usually minimal. Substantial order sizes often enable the business to take advantage of quantity discounts without having to place frequent orders. The cost involved in using detailed record keeping and inventory control procedures greatly outweighs the advantages gleaned from strict control of C items.

One practical technique for maintaining control over C items simply is the **two-bin system**, which keeps two separate bins full of material. The first bin is used to fill customer orders, and the second bin is filled with enough safety stock to meet customer demand during the lead time. When the first bin is empty, the owner places an order with the vendor large enough to refill both bins. During the lead time for the order, the manager uses the safety stock in the second bin to fill customer demand.

When storage space or the type of item makes a two-bin system impractical, an entrepreneur can use a **tag system**. Based on the same principles as the two-bin system, which is suitable for many manufacturers, the tag system applies to most retail, wholesale, and service firms. Instead of placing enough inventory to meet customer demand during lead time into a separate bin, the owner marks this inventory level with a brightly colored tag. When the supply is drawn down to the tagged level, the owner reorders the merchandise. Figure 20.3 illustrates the two-bin and tag systems of controlling C items.

In summary, business owners minimize total inventory costs when they spend time and effort controlling items that represent the greatest inventory value. Some inventory items require strict, detailed control techniques; other items simply do not justify the additional cost of tight controls. Because of its practicality, the ABC inventory system is commonly used in industry. In addition, the technique is easily computerized, speeding up the analysis and lowering its cost. Table 20.3 summarizes the use of the ABC control system.

The Two-Bin System



FIGURE 20.3

The Two-Bin and Tag Systems of Inventory Control

The Tag System

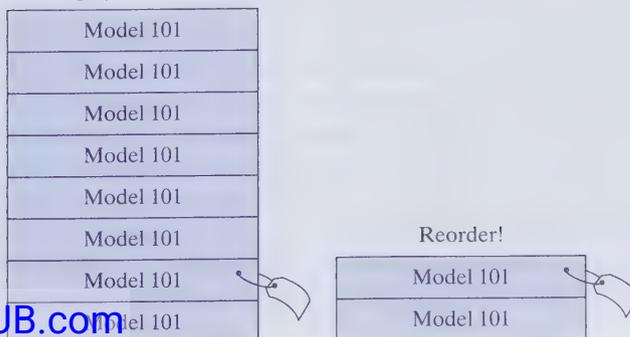


TABLE 20.3 ABC Inventory Control Features

Feature	A Items	B Items	C Items
Level of control	Monitor closely and maintain tight control.	Maintain moderate control.	Maintain loose control.
Reorder point	Based on forecasted requirements.	Based on EOQ calculations and past experience.	When level gets low, reorder.
Record keeping	Keep detailed records of receipts and disbursements.	Use periodic inspections and control procedures.	No records required.
Safety stock	Keep low levels of safety stock.	Keep moderate levels of safety stock.	Keep high levels of safety stock.
Inspection frequency	Monitor schedule changes frequently.	Check on changes in requirements periodically.	Make few checks on requirements.

Physical Inventory Count

Regardless of the type of inventory control system used, every small business owner must conduct a periodic physical inventory count. Even when a company uses a perpetual inventory system, the owner still must count the actual number of items on hand because errors will occur. A physical inventory count allows owners to reconcile the actual amount of inventory in stock with the amount reported through the inventory control system. These counts give managers a fresh start when determining the actual number of items on hand and enable them to evaluate the effectiveness and the accuracy of their inventory control systems.

The manual method of taking inventory involves two employees; one calls out the relevant information for each inventory item, and the other records the count on a tally sheet. There are two basic methods of conducting a physical inventory count. One alternative is to take inventory at regular intervals. Many businesses take inventory at the end of the year. In an attempt to minimize counting, many managers run special year-end inventory reduction sales. This **periodic count** generates the most accurate measurement of inventory. The other method of taking inventory, called **cycle counting**, involves counting a number of items on a continuous cycle. Instead of waiting until year-end to tally the entire inventory of items, an entrepreneur counts a few types of items each day or each week and checks the numbers against the inventory control system. Performing a series of “mini-counts” each day or each week allows for continuous correction of mistakes in inventory control systems and detects inventory problems faster than an annual count does.

Once again, technology can make the job of taking inventory much easier for small business owners. Cloud-based systems enable business owners to track their inventories and to place orders with vendors quickly and with few errors by linking them to their vendors electronically. These systems often rely on handheld computer terminals equipped with scanning devices. An employee runs the scanning device across a bar code label on the shelf that identifies the inventory item; then the employee counts the items on the shelf and enters that number using the number pad on the terminal. Finally, by linking the handheld terminal to a computer, the employee downloads the physical inventory count into the company’s inventory control software in seconds.

In the past, suppliers simply manufactured a product, shipped it, and then sent the customer an invoice. To place an order, employees or managers periodically estimated how many units of a particular item they needed and when they needed them. Today, however, with cloud- or Web-based supply chain management systems, a vendor is tied directly into a company’s POS system, monitoring it constantly; when the company’s supply of a particular item drops to a preset level, the vendor automatically sends a shipment to replenish its stock to an established level. Information that once traveled by mail (or was never shared at all), such as inventory balances, unit sales, purchase orders, and invoices, now travel instantly between businesses and their suppliers. The result is a much more efficient system of purchasing, distribution, and inventory control.

Radio Frequency Identification Tags

Inventory control systems that use bar codes to track the movement of inventory through the supply chain have been around for years. Increasingly, businesses are replacing their bar code

systems with more flexible systems based on **radio frequency identification (RFID)** tags that are attached to individual items or to shipments and transmit data to a company's inventory management system. Each tag, which is about the size of a grain of sand, contains a tiny microchip that stores a unique electronic product code and a tiny antenna. Because the tags use short-range radio frequencies, they can transmit information under almost any condition, avoiding the line-of-sight restrictions that bar code systems experience. Once activated, the tags perform like talking bar codes and enable business owners to identify, count, and track the inventory items to which they are attached, providing them with highly accurate, real-time information constantly. When a shipment arrives at a warehouse or retail store, the RFID tags signal an inventory system reader, an object about the size of a coin that records the identity, quantity, and characteristics of each item now in stock. The reader relays the information to a central inventory control system so that business owners can have access to all of this information online. Some stores have installed "smart" shelves equipped with readers that detect the identity and quantity of the items placed on them. When a customer makes a purchase, the smart shelf sends a message to the inventory control system, telling it to reduce the number on hand by the number of items the customer buys. In essence, RFID technology allows business owners to locate and track an item at any point in the supply chain—from the raw material stage to the store shelf.

Retailers use RFID technology to make inventory counts a breeze. Employees simply walk the aisles of the store holding a special reader that scans the RFID tags of the items on the shelves. A study conducted by the RFID Research Center at the University of Arkansas comparing the effectiveness of bar code and RFID inventory counting systems in a retail setting shows that the RFID system improved the accuracy of inventory records by 27 percent over the bar code system. Not only was the RFID system more accurate, but the time required to complete the inventory count using the RFID system was significantly less as well, counting 10,000 items in 53 hours with the bar code reader compared to just two hours with the RFID system, a 96 percent reduction.¹⁵ At some stores, fully integrated RFID systems allow cashiers to ring up customers' purchases by scanning the contents of an entire shopping cart in just seconds, minimizing the time that customers have to stand in checkout lines. The cost of RFID tags is declining and their reliability improving, meaning that more businesses will adopt the technology to improve the degree of control they have over their inventory.



ENTREPRENEURIAL PROFILE: Billabong The Billabong retail store in Iguatemi Alphaville mall in Barueri, Brazil, uses RFID technology to track inventory accurately, provide customers with detailed product information, and enhance customers' shopping experience. When a shipment of inventory arrives, employees simply wave a handheld reader near the box of products, which records the identity and the quantity of each item in the shipment and uploads the information to the store's computerized inventory system. The store's RFID system also allows customers to learn about product details by picking an item from a shelf and holding the tag near an RFID receiver that reads the information on the tag and uses a Wi-Fi connection to display more detailed information about the product. When customers take garments into the store's Smart Dressing Rooms, the system automatically reads the information on their tags and displays on a touch screen images of and information about coordinating products and their availability in various sizes and colors in the store. Customers can touch a prompt on the screen, sending a text message to a staff member's smart phone requesting any or all of the recommended items. When customers are ready to check out, an RFID receiver under the counter reads the information on each item's tag, deducts the items from the store's computerized inventory records, and totals their prices automatically. Finally, when customers leave the store, RFID readers capture the information from the tags on their purchases and check them against the store's inventory records. If someone attempts to leave the store with an item for which he or she has not paid, the system triggers an audible alarm and turns on a video camera to record the incident.¹⁶

As Billabong's experience suggests, the impact of RFID technology, which actually dates back to World War II, on inventory control is enormous. "This is an innovative technology similar to the Internet," says Mark Roberti, editor of *RFID Journal*. "You can now make any object smart."¹⁷ International consulting firm McKinsey and Company estimates that once in use, RFID technology has the ability to increase companies' revenues by as much as 6 percent by improving the availability of items that customers want to buy and reducing the time and energy that staff spend looking for merchandise.¹⁸



Lessons from the Street-Smart Entrepreneur

Best Practices in Inventory Management

Many entrepreneurs have discovered the dangers of excess inventory. Not only does it tie up a company's valuable cash unnecessarily, but it also hides a host of other operating problems that a company has and must address. When it comes to managing inventory, small business owners often face four problems:

1. They have too much of some products.
2. They have too little of other products.
3. They don't know what they have in stock.
4. They know what they have in stock but cannot find it.

Addressing these four problems requires business owners to create a system of inventory management based on best practices. "Effective inventory management allows a distributor to meet or to exceed customers' expectations of product availability by maintaining the amount of each item that will also maximize their company's net profit," says one expert. The following tips from the Street-Smart Entrepreneur about inventory management best practices help accomplish that goal:

Recognize the difference between your company's "stock" and its "stuff." "Stock" is made up of the inventory that customers want and expect a company to have available. "Stuff" is everything else that is in the warehouse or stockroom and typically includes slow-moving items. The goal is to manage the stock in such a way that the company can meet customers' demand for items and make a profit and to get rid of everything else—the "stuff."

Set up an inventory management process that recognizes the value of your company's stock. Remember that Pareto's Law, the 80/20 rule, applies to many situations, particularly inventory control. About 20 percent of the items in a typical company's inventory account for about 80 percent of its sales. The idea is to set up a system that exercises the greatest degree of control over the most valuable 20 percent of the company's items. Using the principles of ABC inventory analysis ensures that a company is applying the proper level of control to each item in its inventory.

Focus on sales forecasting accuracy. One of the most important determinants of how well a company manages its inventory is how accurate its sales forecasts are. Using sales data and past experience allows entrepreneurs to build accurate forecasting models over time. Without an accurate sales forecast, a business suffers lost sales because of too little inventory available for some items and cash shortages because of too much inventory in stock of others. Experienced entrepreneurs also know that their sales follow seasonal patterns, and so should their inventory levels. Tracking forecast error and setting goals for improving it are key ingredients in managing inventory more

Work with vendors and suppliers to keep the inventory of essential items as lean as possible. Even companies that utilize just-in-time techniques find it necessary to carry inventory; however, they keep their levels of stock to a minimum. Look for suppliers that can meet your company's quality requirements and provide rapid deliveries on short notice. Sharing information with the members of your company's supply chain and connecting with them electronically are excellent ways to shorten the lead time on the items you order.

Use computerized inventory control systems to monitor your company's stock. Computerized inventory control systems that are linked to POS terminals allow entrepreneurs to know which items they have in stock at any time. The reports that these systems generate also help them know which items are selling best and which items are not selling at all. This information leads to improved inventory decisions in the future and allows entrepreneurs to adjust their buying decisions on the fly. Antolini Luigi & Company, a producer of granite, marble, and other stone located in Verona, Italy, uses an RFID-based system to track and control its inventory of uncut stone blocks and the 900,000 finished stone slabs that it sells in a typical year. With the RFID system, an employee walks up and down each aisle of the company's large stockyard carrying a handheld reader that collects the unique identification number from each block or each slab's tag to get an accurate inventory count. Before Antolini Luigi implemented the RFID system, taking inventory required two employees who spent two days manually identifying, counting, and logging each item. The new system allows one employee to do the same job in less than three hours. When the company sells a finished slab, employees use the handheld readers to collect the information from the RFID tag on the slab, which the system uses to update inventory records automatically. The owners of the family business, started in the 1950s by its namesake, estimate that the RFID system has reduced its labor costs associated with inventory control by 40 percent, increased the accuracy of its inventory records, and reduced its average investment in inventory.

Track the inventory metrics that are most important to your company's success. A business can improve only what it measures. Common metrics for inventory control include the inventory turnover ratio (for the business as a whole and for individual products or product lines), gross profit margin, age of inventory, measures of overstock, customer order fill rate, number of back orders, and many others. Modern inventory control systems allow businesses of all sizes to track these metrics for almost every product line. Know which metrics are most important to your business, establish goals for them, and track your company's progress toward achieving them.

Organize your warehouse or stockroom to make it easy to find the items you need. Organizing a warehouse or stockroom based on the knowledge of which items are in highest demand and which ones are seldom needed allows businesses to minimize the cost of filling orders. Placing the fastest-moving items in the most accessible location, preferably nearest the packing and shipping area, minimizes the time that employees spend walking around the warehouse or stockroom. Once again, computerized inventory control systems can help by printing the warehouse “address” of the items that employees must “pick” to fill orders.

Get rid of the “stuff.” Eliminating unwanted or unnecessary inventory, especially SLOBs (slow-moving, obsolete

items), frees up valuable cash and simplifies the inventory management process. Possible ideas include the following:

- Reducing the price of the items to get rid of them.
- Offer incentives to sales people to sell slow-moving “stuff.”
- Offer the items for sale at an online auction site.

Sources: Based on Mary Catherine O’Conner, “Italian Stone Company Carves Out Savings with RFID,” *RFID Journal*, August 13, 2010, www.rfidjournal.com/articles/view?7808; Jon Schreibfeder, *The First Steps to Achieving Effective Inventory Control*, Microsoft Business Solutions, http://download.microsoft.com/download/b/f/3/bf334d7f-ad07-458e-a716-fdf46a0cf63c/eimwp1_invcontrol.pdf; “Inventory Best Practices,” *The Bottom Line*, Manufacturing Extension Partnership, June 2003, pp. 1–2; Matt Gruhn, “16 Steps to Inventory Success,” *Boating Industry White Paper*, June 2009, pp. 5–6; “Ten Common Inventory Mistakes and How to Avoid Them,” *Quality Digest*, January 10, 2012, www.qualitydigest.com/inside/quality-insider-article/ten-common-inventory-mistakes-and-how-avoid-them.html.

Just-in-Time Inventory Control Techniques

Just-in-Time Techniques

Many U.S. businesses have turned to a popular inventory control technique called **just in time (JIT)** to reduce costly inventories and turn around their financial fortunes. Until recently, these companies had accepted the following long-standing principles of manufacturing: Long production runs of standard items are ideal, machines should be up and running as much as possible, machines must produce a large number of items to justify long setup times and high costs, similar processes should be consolidated into single departments, tasks should be highly specialized and simplified, and inventories (raw materials, work in process, and finished goods) should be large enough to avoid emergencies, such as supply interruptions, strikes, and breakdowns.

The JIT philosophy, however, views excess inventory as a blanket that masks problems and as a source of unnecessary costs that inhibit a company’s competitive position. Tim Cook, CEO of Apple Inc., says that inventory is “fundamentally evil” because in the technology industry, inventory loses one to two percent of its value per week. “You want to manage [inventory] like you’re in the dairy business,” he says. “If it gets past its freshness date, you have a problem.” By managing its inventory and supply chain so closely, Apple Inc. is able to keep just 5.3 days’ worth of inventory on hand at any time, almost half that of its closest competitor, Dell, which keeps 10.2 days’ worth of inventory on hand.¹⁹ In contrast, Research in Motion, the company that makes the Blackberry smart phone and the PlayBook tablet, saw its inventory swell from \$618 million to more than \$1 billion in just one year—even after it had already written off \$485 million worth of PlayBooks from its balance sheet. In an attempt to move its stockpile of inventory, the struggling company cut the PlayBook’s price from \$299 to \$199, but its inventory levels and those of the Blackberry continued to increase.²⁰

Under a JIT system, materials and inventory arrive at the appropriate location just in time instead of becoming part of a costly inventory stockpile. JIT is a philosophy that seeks to improve a company’s efficiency. One key measure of efficiency is the level of inventory on hand; the lower the level of inventory, the more efficient is the production system. The heart of the JIT philosophy is eliminating waste in whatever form it may take—time wasted moving work in process from one part of a factory to another, money wasted when employees must scrap or rework an item because of poor quality, cash tied up unnecessarily in excess inventory because of a poorly designed process, and many others.

Companies using JIT successfully embrace a broader philosophy of continuous improvement (“kaizen”), which was discussed in the previous chapter. These companies encourage employees to find ways to improve processes by simplifying them, making them more efficient, and redesigning them to make them more flexible. A cornerstone of the JIT philosophy is making waste in a company visible. The idea is that hidden waste is easy to ignore; visible waste gives everyone an incentive to eliminate it. Managers at a small company that manufactures fabrics for

2.

Describe how just-in-time (JIT) and JIT II inventory control techniques work.

the wasted fabrics there on display. The not-so-subtle message was “help us find ways to reduce this waste.” Within a matter of months, with the help of suggestions from both individuals and teams of employees, the pile of waste shrank dramatically.

In the past, only large companies could reap the benefits of computerized JIT and inventory control software, but now a proliferation of inexpensive programs gives small companies that ability. The most effective businesses know that what is required is not simply the technology but also the critical strategic alliances with suppliers who are themselves technologically sophisticated enough to interact on a real-time basis to deliver what is needed when it is needed. The ultimate goal is to drive excess inventory to as close to zero as possible.



Motorcycle maker Harley Davidson implemented a JIT system that reduced its investment in inventory and increased the number of times it turns its inventory each year.

Source: MCT/Getty Images.



ENTREPRENEURIAL PROFILE: Harley-Davidson For years, iconic motorcycle manufacturer Harley-Davidson relied on maintaining high levels of inventory to ensure that its assembly lines never shut down for lack of parts. Not only did the company’s sizable investment in excess inventory tie up valuable cash, but it also covered up serious structural problems in the manufacturing process and in the overall business. “Parts were made in large batches for long production runs, stored until needed, then loaded onto the 3.5-mile conveyor that rattled endlessly around the plant,” says Peter Reid, author of a book on Harley-Davidson’s transformation. “Sometimes we couldn’t even find the parts we needed, or if we found them they were rusted or damaged, or there had been an engineering change since the parts were made and they didn’t even fit,” admits Tom Gelb, the company’s manager of operations. Then CEO Vaughn Beals converted Harley-Davidson’s manufacturing plant in York, Pennsylvania, to a JIT inventory system. “With JIT, as each problem is exposed, you are forced to identify its cause, fix it, and move on to the next problem that is revealed,” explains Reid. The results were impressive: Harley-Davidson’s average inventory decreased by 75 percent, the space required to store inventory declined by 25 percent, the number of inventory turns increased from 5 to 20 per year, and the percentage of completed motorcycles coming off of the production line improved from 76 to 99 percent.²¹

Just as with Harley-Davidson, when JIT is successfully implemented, companies experience six positive results:

1. Lower investment in inventory
2. Reduced inventory carrying and handling costs
3. Reduced cost from obsolescence of inventory
4. Lower investment in space for inventories and production
5. Reduced total manufacturing costs from the better coordination needed between departments to operate at lower inventory levels
6. Higher inventory turnover ratios

Despite the many benefits that JIT systems offer, they do carry risks. Because the inventory that a company has in stock is so small, any disruption in its supply chain, even for inexpensive, common items, can cause the entire operation to come to a halt. After an earthquake and resulting tsunamis devastated the infrastructure in northern Japan and many factories that produce silicon used to make silicon chips, production at companies in many industries, ranging from computers and personal electronics to autos and appliances, was paralyzed for weeks. Because of the global and interconnected nature of modern supply chains, a disruption at any link in the chain, even though it occurs thousands of miles away, is likely to have a serious impact on a company’s ability to provide its products and services.

For JIT systems to be most productive, entrepreneurs must consider the human component of the equation as well. Two elements are essential:

1. **Mutual trust and teamwork.** Managers and employees view each other as equals, have a commitment to the organization and its long-term effectiveness, and are willing to work as a team to find and solve problems.
2. **Empowerment.** Effective organizations provide their employees with the authority to take action to solve problems. The objective is to have the problems dealt with at the lowest level and as quickly as possible.

JIT is most effective in repetitive manufacturing operations where companies traditionally have relied on holding significant levels of inventory, where production requirements can be

forecast accurately, and where suppliers and customers work together as partners throughout the supply chain. Experience shows that companies with the following characteristics have the greatest success with JIT:

- Reliable deliveries of all parts and supplies
- Short distance between a company and its vendors
- Consistently high quality of vendors' products
- Stable and predictable product demand that allows for accurate production schedules

JUST-IN-TIME II TECHNIQUES In the past, some companies that adopted JIT techniques discovered an unwanted side effect: increased hostility resulting from the increased pressure they put on their suppliers to meet tight and often challenging schedules. To resolve that conflict, many businesses have turned to an extension of JIT, just-in-time II (JIT II), which focuses on creating a close, harmonious relationship with a company's suppliers so that both parties benefit from increased efficiency. Lance Dixon, who created the JIT II concept when he was a manager at Bose Corporation, a manufacturer of audio equipment, sought to create a working environment that empowered the supplier within the customer's organization. To work successfully, JIT II requires suppliers and their customers to share what was once closely guarded information in an environment of trust and cooperation. Under JIT II, customers and suppliers work hand in hand, acting more like partners than mere buyers and sellers.

In many businesses practicing JIT II, suppliers' employees work on-site at the customer's plant, factory, or warehouse almost as if they were employees of the customer. These on-site workers are responsible for monitoring, controlling, and ordering inventory from their own companies. While at Bose, Dixon decided to try JIT II because it offered the potential to reduce sharply the company's inventories of materials and components, to cut purchasing costs, and to generate cost-cutting design and production tips from suppliers who understood Bose's process. This new alliance between suppliers and their customers formed a new supply chain that lowered costs at every one of its links. To protect against leakage of confidential information, Dixon had all of the employees from Bose's suppliers who would work in its plant sign confidentiality agreements. Dixon also put a ceiling on the amount that each supplier's employee could order without previous authorization from Bose.

Manufacturers are not the only companies benefiting from JIT II. In a retail environment, the concept is more commonly known as **efficient consumer response (ECR)**, but the principles are the same. Rather than build inventories of merchandise that might sit for months before selling (or, worse, never sell at all), retailers that use efficient consumer response replenish their inventories constantly on an as-needed basis. Because vendors are linked electronically to the retailer's POS system, they can monitor the company's inventory and keep it stocked with the right merchandise mix in the right quantities. Both parties reduce the inventories they must carry and experience significant reductions in paperwork and ordering costs. JIT II works best when two companies transact a significant amount of business that involves many different parts or products. Still, maintaining trust is the biggest barrier the companies must overcome.

Turning Slow-Moving Inventory into Cash

Managing inventory effectively requires an entrepreneur to monitor the company's inventory turnover ratio and to compare it to those of other companies of similar size in the same industry. As you recall from Chapter 14, the inventory turnover ratio is calculated by dividing a company's cost of goods sold by its average inventory. This ratio expresses the number of times per year the business turns over its inventory. In most cases, the higher the inventory turnover ratio, the better a small company's financial position will be. A below-average inventory turnover ratio indicates that a company's inventory is stale and obsolete or that its inventory investment is too large.

Because of the variability in demand and the cyclical nature of the market, auto dealers often struggle to maintain adequate number of inventory turns and to keep the number of cars on their lots from ballooning, which drives up their operating costs. The longer a car sits on a dealer's lot, the greater is the cost of borrowing to pay for it (recall the discussion of floor planning in Chapter 17).

Auto companies hold 50 to 60 days' worth of cars to be an adequate inventory (54 days is the

3.

Describe methods for reducing losses from slow-moving inventory.

average). When gasoline prices increase, however, dealers see large gas-guzzling SUVs languish on their lots, with inventories increasing to more than 100 days' worth, while inventories of fuel-efficient and hybrid models fall to record lows. After one spike in gas prices, dealers held large cars in inventory for an average of 84 days, but small cars stayed on their lots for an average of only 46 days. Inventories of certain popular models, particularly fuel-efficient hybrids, such as Toyota's Highlander SUV and Ford's Fusion, stood at just five days' worth.²²

Slow-moving items carry a good chance of loss resulting from spoilage or obsolescence. Companies that sell trendy fashion merchandise or highly seasonal items often experience losses as a result of being stuck with unsold inventory for long periods of time. Some small business owners are reluctant to sell these slow-moving items by cutting prices, but it is much more profitable to dispose of this merchandise quickly at a lower profit margin than it is to hold it indefinitely in inventory.



ENTREPRENEURIAL PROFILE: Mickey Gee: Pants Store Sales during the all-important holiday season at the Pants Store, a small chain of clothing stores near Birmingham, Alabama, were slower than owner Mickey Gee expected, leaving him with 20 percent more merchandise than normal. Gee, whose father, Taylor, started the business in 1950, used markdowns, some as much as 80 percent, to turn the slow-moving merchandise into cash. He also invested in an inventory control system that helps him identify which brands and which items are selling best (and which are not) in his four locations.²³

A business owner who postpones marking down stale merchandise, fearing that it will reduce profits and hoping that the goods will sell eventually at the regular price, is making a mistake. The longer the merchandise sits, the dimmer are the prospects of ever selling it, much less selling it at a profit. Pricing these items below regular price or even below cost is difficult, but it is much better than having valuable working capital tied up in unproductive assets.

The technique that Mickey Gee used, the markdown, is the most common technique for liquidating slow-moving merchandise. Not only is the markdown effective in eliminating slow-moving goods, but it also is a successful promotional tool. Advertising special prices on such merchandise helps a small business garner a larger clientele and contributes to establishing a favorable business image. Using special sales to promote slow-moving items helps create a functional program for turning over inventory more quickly. To get rid of a large supply of out-of-style neckties, one small business offered a "one-cent sale" to customers purchasing neckwear at the regular price. One retailer of electronic and sound equipment chooses an unusual holiday—Presidents' Day—to sponsor an all-out blitz, including special sales, prices, and promotions, to reduce its inventory. Other techniques that help eliminate slow-moving merchandise include the following:

- Creating middle-of-the-aisle display islands that attract customer attention
- Offering one-day-only sales
- Giving quantity discounts for volume purchases
- Creating bargain tables with a variety merchandise for customers to explore
- Using eye-catching lights and tickets marking sale merchandise
- Setting up an online store on eBay
- Using an inventory liquidation company to get rid of excess merchandise

As inventory control techniques become increasingly sophisticated and accurate, slow-moving inventory will never be "lost" in the supply chain. Aggressive methods of selling slower-moving inventory allow business owners to convert inventory into cash and to produce an acceptable inventory turnover ratio. The inventory management tools described in this chapter also play an important role in avoiding slow-moving merchandise. They highlight those items that are slow moving, enabling business owners to avoid the mistake of ordering them again. In effect, the information on the items that *aren't* selling influences entrepreneurs' decisions about the merchandise they order in the future as much as information on those items that *are* selling well. The ability to avoid slow-moving items in the first place means that business owners can invest their working capital more effectively and produce faster inventory turnover ratios, lower costs, and higher profits.

Protecting Inventory from Theft

Small companies are a big target for crime. Businesses worldwide lose 5 percent of their total sales, nearly \$9.6 billion *per day*, to criminals, although the actual loss may be even greater because so many business crimes go unreported.²⁴ Whatever the actual loss is, its effect is staggering. If a company operates at a 5 percent net profit margin, it must generate an additional \$20 in sales to offset every \$1 lost to theft. Because small businesses often lack the sophistication to identify early on the illegal actions of employees or professional thieves and the controls to prevent theft and fraud, they are particularly vulnerable to theft and fraud. A study by the Association of Certified Fraud Examiners reports that small companies are the most frequent victims of theft and fraud and that the median loss for small companies is \$147,000.²⁵ When a company has a small asset base, a loss from theft and fraud can be a crippling blow, threatening its very existence.

Many entrepreneurs believe that the primary sources of theft originate outside the business. In reality, most firms are victimized by their own employees.

Employee Theft

Ironically, the greatest criminal threat to small businesses comes from the *inside*. Employee theft accounts for the greatest proportion of the criminal losses that businesses suffer and costs companies \$42.4 million per day.²⁶ One-third of all business bankruptcies are the result of employee theft.²⁷ Because employees have access to the inner workings of a business, they can inflict more damage than shoplifters. One study reports that dishonest employees steal on average 5.9 times more per incident than shoplifters (\$665.77 vs. \$113.30).²⁸ The types of employee theft schemes that affect small businesses are different from those that large companies encounter. Figure 20.4 shows the most common employee theft schemes in small businesses.

4. Discuss employee theft and shoplifting and how to prevent them.

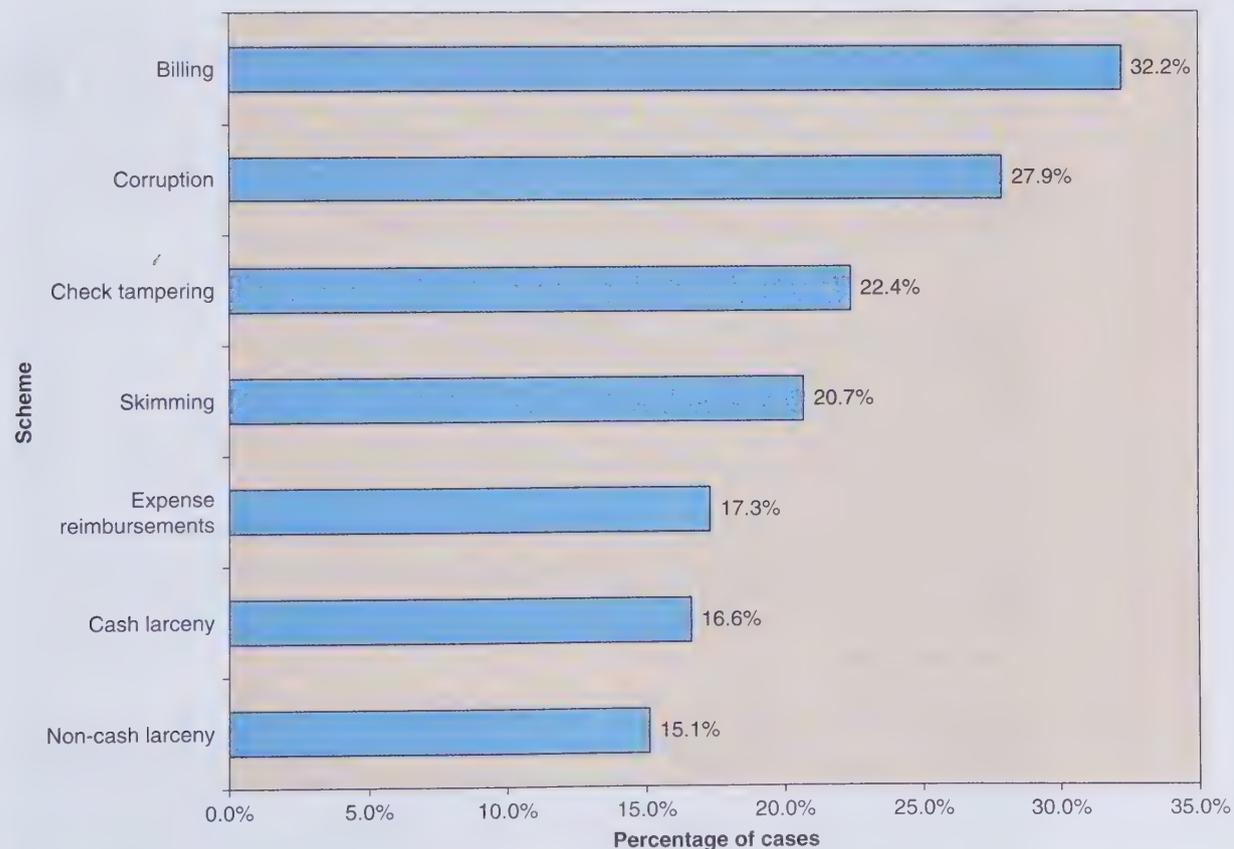


FIGURE 20.4
Employee Theft Schemes in Small Businesses

Source: Based on 2012 Report to the Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners.

Unfortunately, employee theft is more prevalent than ever. Tim Dimoff, president of Mogadore, Ohio–based SACS Consulting & Investigative Services Inc., gives one reason for the increased prevalence. “I call the attitude employees take in the workplace ‘entitlement,’” he says. “They justify in their minds that they are entitled to take things because they work so hard.” Dimoff adds that some businesses all but encourage employee theft. How? By failing to file criminal charges against employees caught stealing. Only 65 percent of businesses that have been victimized by employee theft report the incident to law enforcement officials. The main reason business owners do not report thefts: They do not want the negative publicity that results from prosecuting employee thieves.²⁹ Others worry about the cost to the company to prosecute, how the time away from management will affect the organization, and the impact that the incident will have on employee morale. Often it is easier just to ask the guilty employee to leave.³⁰

The median length of time it takes employers to catch an employee who is stealing is 18 months, and managers usually discover the theft when another employee tips them off. (Managers detect just 14 percent of employee theft schemes in small companies.³¹) How can thefts go undetected for so long? Most thefts occur when employees take advantage of the opportunities to steal that small business owners unwittingly give them. Typically, small business owners are so busy building their companies that they rarely even consider the possibility of employee theft—until disaster strikes.

In addition, many small companies do not have adequate financial, audit, and security procedures in place. Fewer than 33 percent of small companies use internal audit teams as a loss prevention tool, compared to nearly 85 percent of large companies. Even though tips from employees are the most common way of discovering employee theft and fraud, only 20 percent of small companies have installed anti-fraud hotlines for employees to report suspicious activities.³² Add to this mix of lax control procedures the high degree of trust that most small business owners place in their employees, and you have a perfect recipe for employee theft.



ENTREPRENEURIAL PROFILE: Ennis-Flint Ennis-Flint, a company based in Dallas, Texas, that makes road marking and pavement surface treatments, recently discovered that a long-time employee had embezzled more than \$700,000. For more than four years, the employee regularly submitted fictitious invoices for Outlook Environmental & Safety Solutions, a sham business that he owned, for work that Outlook Environmental had supposedly performed. In reality, Outlook Environmental had done no work for Ennis-Flint and had no employees. “This defendant took advantage of and violated his employer’s trust, using his position to embezzle money on a routine basis over a long period of time,” says U.S. Attorney Sally Quillian Bates.³³

WHAT CAUSES EMPLOYEE THEFT? Security experts estimate that 30 percent of workers pilfer small items from their employers and that 60 percent of employees will steal if given enough opportunity and motivation.³⁴ Employees steal from their companies for any number of reasons. Some may have a grudge against the company; others may have a drug, alcohol, or gambling addiction to support. Still others succumb to the temptation of an easy opportunity to steal because of a company’s lack of proper controls. The Association of Certified Fraud Examiners reports that 87 percent of employees caught stealing have never been charged or convicted of a prior theft offense.³⁵

Employees steal from the company for four reasons: need, greed, temptation, and opportunity. A business owner can control only temptation and opportunity. To minimize their losses to employee theft, business owners must understand how both the temptation and the opportunity to steal creep into their companies. The following are conditions that lead to major security gaps in small companies.

The Trusted Employee The fact is that *any* employee can be a thief, although most are not. About 48 percent of the workers who steal from their companies have been employed for less than five years, but longtime employees who steal cause more damage (a median loss of \$100,000 vs. \$229,000).³⁶ Many entrepreneurs see their longtime employees almost as partners, a view that, although not undesirable, can result in security breaches. “More times than not, it’s the most trusted person in the office who’s perpetrating the fraud,” says James Ratley, president of the Association of Certified Fraud Examiners.³⁷ Many owners refuse to believe that their most trusted employees present the greatest security threat, but these workers have the greatest accessibility to keys, cash registers, records, and even safe combinations.

Entrepreneurs must make sure that the trust they place in long-time employees, who know all of the gaps in a company's security procedures, is warranted.

Source: © SCPhotos/Alamy.



an employee's level of authority and the losses that a company incurs from his or her theft or fraud. In the United States, the median loss to an employee's theft or fraud (43 percent of cases) is \$50,000; in theft or fraud by a manager (34.3 percent of cases), the median loss is \$150,000; and in an executive's theft or fraud (18.5 percent of cases), the median loss is \$373,000.³⁸ Because of their seniority, these employees hold key positions, are familiar with a company's operations, and know where gaps in control and security procedures lie.



ENTREPRENEURIAL PROFILE: Michael and John Koss: Koss Corporation

Michael and John Koss, second-generation owners of Koss Corporation, a Milwaukee, Wisconsin-based maker of stereo headphones, discovered that the company's vice president of finance had used her position to steal more than \$31 million from the company over six years. She covered her theft for so long by inducing employees in the finance department to make fraudulent accounting entries that made her theft transactions appear to be legitimate. The employee, who had held her position at Koss for 18 years, used the money to finance purchases of cars, clothing, jewelry, home renovations, household furnishings, trips, and other personal expenditures.³⁹

Business owners also should be wary of "workaholic" employees. Is this worker really dedicated to the company, or is he or she working so hard to cover up theft? Employee thieves are unwilling to take extended breaks from their jobs for fear of being detected. As long as a dishonest employee remains on the job, he or she can cover up theft. As a security precaution, business owners should require every employee to take vacations long enough so that someone else has to take over their responsibilities (at least five consecutive business days). Most schemes are relatively simple and require day-to-day maintenance to keep them going. Business failure records are filled with stories of firms in which the "ideal" employee turned out to be a thief. "In 90 percent of the cases in which people steal from their companies, the employer would probably have described this person, right up to the time the crime was discovered as a trusted employee," says one expert.⁴⁰

Disgruntled Employees Business owners also must monitor the performance of disgruntled employees. Employees are more likely to steal if they believe that their company treats them unfairly, and the probability of their stealing goes even higher if they believe that they themselves have been treated unfairly. Employees dissatisfied with their pay or their promotions may retaliate against an employer by stealing. Dishonest employees make up the difference between what they are paid and what they believe they are worth by stealing. Many believe pilfering is a well-deserved "perk."

Organizational Atmosphere Many entrepreneurs unintentionally create an atmosphere that encourages employee dishonesty. Failing to establish formal controls and procedures invites

theft. Nothing encourages dishonest employees to steal more than knowing they are unlikely to be caught. Four factors encourage employee theft:

1. The need or desire to steal (e.g., to support a habit or to cope with a sudden financial crisis)
2. A rationalization for the act (e.g., “They owe me this.”)
3. The opportunity to steal (e.g., access to merchandise or complete control of financial functions)
4. The perception that there is a low probability of being caught (e.g., “Nobody will ever know.”)

Entrepreneurs must recognize that they set the example for security and honesty in the business. Employees place more emphasis on what owners *do* than on what they *say*. Entrepreneurs who install a complete inventory control system and then ignore it are telling employees that security is unimportant. No one should remove merchandise, materials, or supplies from inventory without recording them properly. There should be no exceptions to the rules, even for owners and their relatives. Managers should develop clear control procedures and establish penalties for violations. The single biggest deterrent (to employee theft) is a strong, top-down policy that is well communicated to all employees that theft will not be tolerated and that anyone caught stealing will be prosecuted—*no exceptions*.

Entrepreneurs must constantly emphasize the importance of security. Business owners must use every available opportunity to reduce employees’ temptation to steal. One business owner relies on payroll inserts to emphasize to employees how theft reduces the funds available for growth, expansion, and higher wages. Another useful tool is a written code of ethics that spells out penalties for violations that every worker signs. Workers must understand that security is a team effort. Security rules and procedures must be reasonable, and owners must treat workers equitably. Unreasonable rules are no more effective—and may even be more harmful—than poorly enforced procedures. A work environment that fosters honesty at every turn serves as an effective deterrent to employee theft.

Physical Breakdowns Another major factor contributing to employee theft is weak physical security. Entrepreneurs who pay little attention to the distribution of keys, safe combinations, and other entry devices are inviting theft. In addition, those who fail to lock doors and windows or to install reliable alarm systems literally are leaving their businesses open to thieves both inside and outside the organization.

Open windows and unattended doors give dishonest employees a prime opportunity to slip stolen merchandise out of the plant or store. One security expert worked with a small manufacturing operation that was experiencing high levels of employee theft during the night shift. His investigation revealed that employees could exit the building through 14 different doors with little or no supervision. The company closed most of the exits, installed security cameras at those that remained open, and assigned managers to supervise the night shift. After implementing these simple changes, employee theft plummeted to nearly zero.⁴¹

Many businesses find that their profits go out with the trash, literally. When collecting trash, a dishonest employee may stash valuable merchandise in with the refuse and dump it in the receptacle. After the store closes, the thief returns to collect the loot. One drugstore owner lost more than \$7,000 in merchandise in just six months through trash thefts.

Improper Cash Control Many small business owners encourage employee theft by failing to implement proper cash control procedures. Without a system of logical, practical audit controls on cash, a small business will likely suffer internal theft. Dishonest employees quickly discover that there is a low probability of detection and steal cash with impunity.

Cashiers clearly have the greatest accessibility to the firm’s cash and, consequently, experience the greatest temptation to steal, most often by “skimming” money from cash sales. Suppose that a customer makes a purchase with the exact amount of cash and leaves quickly. The cashier simply fails to ring up the purchase and pockets the cash without anyone’s knowledge. Some small business owners create a cash security problem by allowing too many employees to operate cash registers and handle customer payments. If a cash shortage develops, the owner is unable to trace responsibility.

A daily inspection of cash register transactions can point out potential employee theft problems. When a cashier rings up an excessive number of voided transactions or no-sale transactions, the owner should investigate. A no-sale transaction is a sale that is not recorded.

was opened to give a customer change or to steal cash. A large number of incorrect register transactions also are a sign of foul play. Employees may be camouflaging thefts by voiding transactions, underringing sales amounts, or pretending to scan items at checkout without actually ringing them up (a problem known as “sweethearting”).

PREVENTING EMPLOYEE THEFT Many incidents of employee theft go undetected, and of those employees who are caught stealing, only a small percentage is prosecuted. Because nearly half of businesses that are victims of employee theft never recover any of their losses, entrepreneurs must focus on *preventing* employee theft.⁴² Although business owners cannot eliminate the possibility of employee theft and fraud, they can reduce its likelihood by maintaining accurate inventory records and implementing basic loss prevention strategies.

Screen Employees Carefully Statistics show that, on average, one out of every 36 employees is caught committing employee theft.⁴³ Perhaps a business owner’s greatest weapon against crime is a thorough preemployment screening process. The best time to weed out prospective criminals is before hiring them! One security company conducted an analysis of more than 19,000 applicants for retail jobs and rated 19.3 percent of them as “high-risk” candidates for employee theft.⁴⁴ Although state and federal regulations prohibit employers from invading job applicants’ privacy and from using discriminatory devices in the selection process, employers have a legitimate right to determine job candidates’ integrity and qualifications. A comprehensive selection process and reliable screening devices greatly reduce the chances that an entrepreneur will hire a thief. Smart entrepreneurs verify the information applicants provide on their résumés because they know that some of them will either exaggerate or misrepresent their qualifications. A thorough background check with references and previous employers also is essential. (One question that sheds light on a former employer’s feelings toward a former employee is “Would you hire this person again?”)

Some security experts recommend the use of integrity tests, paper-and-pencil tests that offer valuable insight into job applicants’ level of honesty. Business owners can buy integrity tests for \$20 or less that are already validated (to avoid charges of discrimination) and that they can score on their own. Because drug addictions drive many employees to steal, employers also should administer drug tests consistently to all job applicants. The most reliable drug tests cost the company from \$35 to \$50 each, a small price to pay given the potential losses that can result from hiring an employee with a drug habit. In addition, business owners should conduct criminal background checks on every candidate they are considering hiring.

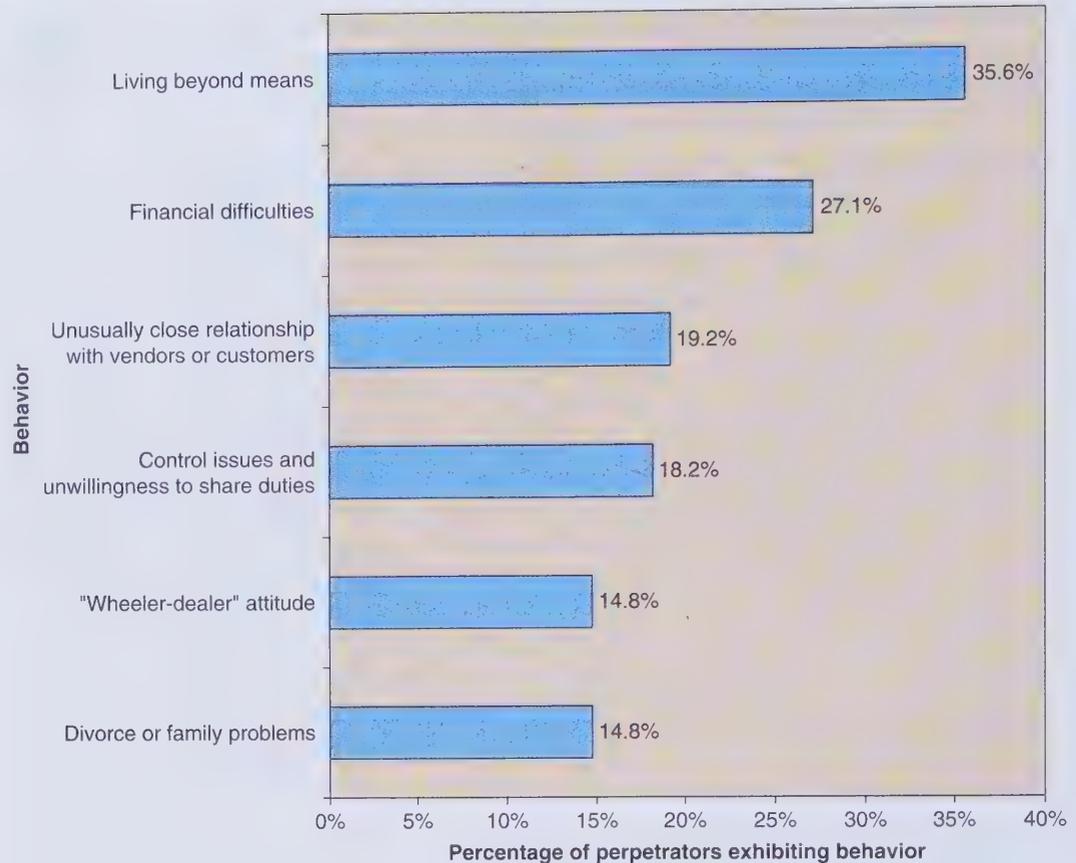
Create an Environment of Honesty Creating an environment of honesty and integrity starts at the top of an organization. This requires business owners to set an impeccable example for everyone else in the company. In addition to creating a standard of ethical behavior, business owners should strive to establish high morale among workers. A positive work environment in which employees see themselves as an important part of the team is an effective deterrent to employee theft. Establishing a written code of ethics and having employees sign “honesty clauses” offers tangible evidence of a company’s commitment to honesty and integrity.

Establish a System of Internal Controls The basis for maintaining internal security on the job is establishing a set of reasonable internal controls designed to prevent employee theft. An effective system of checks and balances goes a long way toward deterring internal crime; weak or inconsistently enforced controls are an open invitation for theft. The most basic rule is to separate among several employees related duties that might cause a security breach if assigned to a single worker. For instance, owners should avoid letting the employee who issues checks reconcile the company’s bank statement. Similarly, the person who orders merchandise and supplies should not be the one who also approves those invoices for payment. Spreading these tasks among a number of employees makes organizing a theft more difficult. The owner of a small retail art shop learned this lesson the hard way. After conducting an inventory audit, he discovered that more than \$25,000 worth of art supplies was missing. The owner finally traced the theft to the company bookkeeper, who was creating fictional invoices and then issuing checks to herself for the same amount.

Business owners should insist that all company records be kept up to date. Sloppy record keeping makes theft difficult to detect. All internal documents—shipping, ordering, invoicing, and other forms—should be numbered. Missing numbers should arouse suspicion. One subtle way

FIGURE 20.5**Behaviors Exhibited by Perpetrators of Employee Theft**

Source: Based on 2010 Report to the Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, Austin, Texas, 2010, p. 70.



to test employees' honesty is to commit deliberate errors occasionally to see whether employees detect them. If you send an extra case of merchandise to the loading dock for shipment, does the supervisor catch it, or does it disappear?

Use Technology to Control Theft A variety of technology tools help business owners minimize losses to employee theft and fraud at very reasonable prices. Simple video camera systems, such as the ones used on the Food Network's show *Restaurant Stakeout*, are responsible for nabbing many employee thieves, especially cameras that are focused on checkout stations and cash registers. Kevin Donahue, owner of a Planet Beach franchise in McLean, Virginia, uses a security system that gives him access to his store's alarm system and security cameras from almost anywhere in the world over the Internet. "It gives me the ability to travel and manage my staff remotely," says Donahue, who paid \$100 to install the system and pays a monthly fee of \$39.⁴⁵

Watch for Signs of Employee Theft Research shows that employees who are stealing tend to exhibit certain behavior patterns (see Figure 20.5). Watch for them.

Set Up a Hotline One of the most effective tools for preventing employee theft is to encourage employees to report suspicious activity. Perhaps the easiest way to encourage reporting it is to establish a hotline that allows employees provide tips anonymously.

Embrace a Zero-Tolerance Policy Business owners should demonstrate zero tolerance for theft. They must adhere strictly to company policy when dealing with employees who violate the company's trust. When business owners catch an employee thief, the best course of action is to fire the perpetrator and to prosecute. Too often, owners take the attitude "Resign, return the money, and we'll forget it." Letting thieves off, however, only encourages them to move on to other businesses where they will steal again. Prosecuting a former employee for theft is never easy, but it does send a clear signal about how the company views employee crime.

Notice in Figure 20.6 that although the primary cause of inventory shrinkage is employee theft, shoplifting also is a common problem.

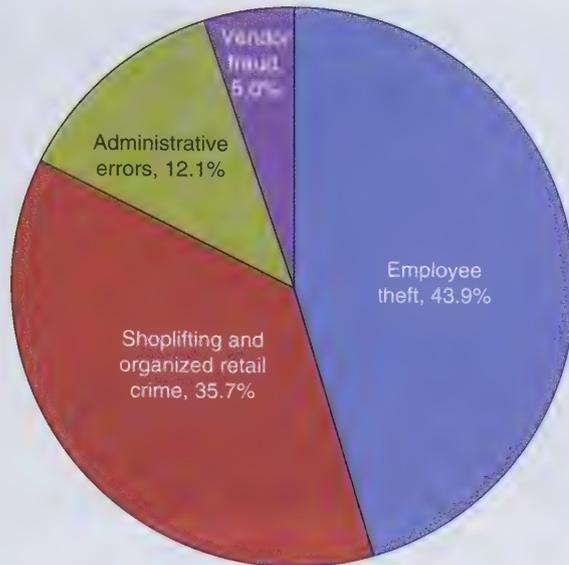


FIGURE 20.6
Causes of Inventory Shrinkage

Source: Based on 2012 National Retail Security Survey, National Retail Federation.



Entrepreneurship in Action

A Thief Within

Graff-Pinkert Inc. is a family-owned firm founded in Oak Forest, IL, in 1941. The company is owned by two brothers—Lloyd and Jim Graff. It sells machine tools to the turned parts industry, as well as deals in machines that make metal components.

Patty Preston (not the real name), a mother of three, was a book-keeper at Graff-Pinkert Inc. for 11 years. In March 2000, when she was on vacation, Jim, the vice president and treasurer of the company, discovered that something was wrong with the organization's accounts.

On investigation, Jim found some discrepancies. Preston had neglected to deposit Jim's last few salary checks in his personal bank account. When he complained, an employee voiced a more troubling allegation. She said Preston had recently charged several Rugrats videotapes to the Graff-Pinkert account at the Office Depot. Someone else claimed that Preston had bought a backyard storage shed at the Home Depot with the company's money.

Jim investigated these claims and found them to be true. The crime was clear: Preston had used company money for personal use. He reported this to his brother, Lloyd. The brothers took a decision and fired her.

But that was not end of the problem. Preston had funded her interest in riverboat gambling and an extravagant lifestyle out of the Graff-Pinkert account for at least four years. The fraud was not small: it exceeded \$200,000 which was a big hit for a company doing between \$8 million and \$10 million in sales.

As the brothers investigated more, the mechanics of Preston's fraud became evident. She would write a check, say

to Parcel Service, and get the signature of one of the Graff brothers, who were the authorized signatories. Later, she would use an erasable tape and alter the check, making it payable to her credit card company. Since Preston filed bank statements regularly, no one saw the discrepancies. Her forgery went unnoticed by the Graffs in a busy time of growing sales. Their accountants also missed the theft during annual audits.

The company took Preston's crime very hard. It was a real blow to the confidence of the Graffs. The people who worked with Preston were horrified. This was a co-worker they trusted, went out with to drink and dinner. The Graffs always trusted all their eighteen employees and did business on a handshake. The company provided employees with interest-free loans to make deposits on homes or in times of family crisis. The Graffs wanted their money back but they did not want their dirty linen to be washed in public and didn't want to look stupid for allowing someone to so easily take advantage of them.

1. Do you agree with the view that small businesses are more vulnerable to employee theft because they lack the systems to detect the signs? Explain.
2. The Graffs want their money back. How to go about it?
3. List at least five steps business owners can take to prevent employee theft.

Source: <http://www.inc.com/magazine/2003050/25414.html>; www.graffpinkert.com.

TABLE 20.4 Items That Shoplifters Steal Most Often

Shoplifters target items that are in high demand and that they can resell at prices that are close to full retail. The following products are the most commonly shoplifted items:

Grocery Items

- Cigarettes
- Energy drinks
- High-end liquor
- Infant formula

Over-the-Counter Medicine

- Allergy medicine
- Diabetic testing strips
- Pain relievers
- Weight loss pills

Health and Beauty Items

- Electric toothbrushes and replacement heads
- Lotions and creams
- Pregnancy tests

Clothing

- Jeans
- Designer clothing and denim
- Handbags

Electronics

- Cell phones
- Digital cameras
- Digital recorders
- GPS devices
- Laptop computers
- LCD televisions and monitors

Home Items

- High-end vacuum cleaners
- Kitchen Aid mixers

Source: Based on 2012 Organized Retail Crime Survey, National Retail Federation, 2012, p. 12.

Shoplifting

The most frequent business crime is shoplifting. In fact, research shows that 1 out of 10 adults in the United States has shoplifted but that only 1 in 49 is arrested for the crime.⁴⁶ Retail businesses in the United States lose an estimated \$37.1 billion annually to shoplifters each year, and the toll on small businesses is especially heavy because they usually have the weakest lines of defense against shoplifters.⁴⁷ Shoplifting exacts a price on shoppers as well. The National Retail Federation estimates that the average U.S. household pays nearly \$500 annually to cover merchants' shoplifting losses.⁴⁸ Table 20.4 shows the items that shoplifters steal most often.

TYPES OF SHOPLIFTERS Anyone who takes merchandise from a store without paying for it, no matter what the justification, is a shoplifter. Shoplifters look exactly like other customers. They can be young children in search of a new toy or elderly people who are short of money. *Anyone* can be a shoplifter, given the opportunity, the ability, and the desire to steal. Police have apprehended people from all walks of life—including wealthy socialites and famous celebrities—for shoplifting. One former senior adviser to the president of the United States who was earning \$161,000 per year was caught shoplifting several items, including a \$525 sound system, a mop that cost \$12, massage gloves priced at \$5, and two bras valued at \$10.⁴⁹

Several factors lead to increased shoplifting losses for businesses, including economic recessions, increased organized retail crime activity, stores that reduce operating costs by scheduling minimal numbers of staff and supervisors, and stores that use open display sales strategies that allow customers to interact with goods. Fortunately for small business owners, most shoplifters are amateurs who steal because the opportunity presents itself. Many steal on impulse, and the theft is the first criminal act. Many of those caught have the money to pay for their “five-finger discounts.” Observant business owners supported by trained store personnel can spot potential shoplifters and deter many shoplifting incidents; however, they must understand the shoplifter's profile. Experts identify five types of shoplifters.

Juveniles Juveniles account for approximately one-half of all shoplifters. Many juveniles steal as a result of peer pressure. Most have little fear of prosecution, assuming that they can hide behind their youth. When owners detect juvenile shoplifters, they must not let sympathy stand in the way of good judgment. Many hard-core criminals began their careers as shoplifters, and business owners who fail to prosecute the youthful offender do nothing to discourage a life of crime. Entrepreneurs should prosecute juvenile offenders through proper legal procedures just as they would any adult shoplifter.

Juveniles now use social media to coordinate their criminal activities “anonymously” on Facebook or via text messages. The National Retail Federation estimates that 10 percent of retailers



Shoplifters cost U.S. businesses \$37.1 billion annually, and small companies bear a disproportionate share of shoplifting losses.

Source: © Meritzo/Alamy.

have been victims of flash robs and that police or retail security personnel are successful in apprehending the perpetrators in only half of the incidents.⁵⁰ In Wicker Park, a suburb of Chicago, a group of about 20 teen boys descended on Mildblend Supply Company, a retail store selling designer clothing, and stole more than \$3,000 worth of jeans despite the owner's attempts to stop them.⁵¹

Impulse Shoplifters Impulse shoplifters steal on the spur of the moment when they succumb to temptation. These shoplifters do not plan their thefts, but when a prime opportunity to shoplift arises, they take advantage of it. For example, a salesperson may be showing a customer several pieces of jewelry. If the salesperson is called away, the customer might pocket an expensive ring and leave the store before the employee returns.

The most effective method of fighting impulse shoplifting is prevention. To minimize losses, the owner should remove the opportunity to steal by implementing proper security procedures and devices.

Shoplifters Supporting Other Criminal Behaviors Shoplifters motivated to steal to support a drug or alcohol habit often are easy to detect because their behavior is usually unstable and erratic. One recently apprehended shoplifter was supporting a \$100-a-day heroin habit by stealing small items from local retailers and then returning the merchandise for refunds. (The stores almost never asked for sales receipts.) Small business owners should exercise great caution in handling these shoplifters because they can easily become violent. Criminals deranged by drugs or alcohol might be armed and could endanger the lives of customers and employees if they are detained. It is best to let the police apprehend these shoplifters.

Kleptomaniacs Kleptomaniacs have a compulsive need to steal even though they have little, if any, need for the items they shoplift. In many cases, these shoplifters could afford to purchase the merchandise they steal. Kleptomaniacs account for less than 5 percent of shoplifters, but their disease costs business owners a great deal. They need professional counseling, and the owner helps them only by seeing that they are apprehended.

Professionals A study by the National Retail Federation reports that 96 percent of businesses have been victims of organized retail crime, thefts by professional shoplifters, within the last year.⁵² Professional shoplifters are individuals, groups, or gangs who steal merchandise in significant quantities as part of a criminal enterprise with the intent to resell it for financial gain rather than keep it for personal use. When it comes to shoplifting, "most people think about little Johnny stealing a pack of bubble gum," says one loss prevention expert. "This is anything but that; these are professional criminals."⁵³ Known as organized retail crime rings, these criminal operations rely on "boosters," people who are paid to steal merchandise from stores, and "fences," those who specialize in converting stolen goods into cash or drugs. "This is a completely different type of perpetrator, doing this strictly for profit, and often working in very organized groups of two, three, or more individuals," says one experienced police officer.⁵⁴ Although professional shoplifters account for 92 percent of shoplifting incidents, the dollar impact of their thefts is

disproportionately large. Police in Indiana and the head of a retail chain's organized crime division recently arrested the people behind a professional shoplifting ring that stole cosmetics, baby formula, over-the-counter drugs, medical supplies, and other items that, when resold, netted the thieves \$17 million per year.⁵⁵ In Austin, Texas, police broke up an eight-person organized retail crime ring that specialized in stealing cosmetics and household goods, including razor blades, batteries, shampoo, nail polish, lotion, hair clips, Tide detergent (known as "liquid gold" among fences), and other items. The ringleader, Maria Patricia Villegas, had seven boosters shoplifting the merchandise, which she resold at local flea markets or smuggled into Mexico. When police raided her home, they found more than \$35,000 worth of stolen goods. Another organized retail crime ring in Austin specialized in shoplifting meat from grocery stores, which the fence then resold to three local restaurants.⁵⁶ Many organized retail crime operations are so sophisticated that the thieves create schedules of the stores they have hit to avoid stealing from any one store too often and raising suspicion. Table 20.5 provides some interesting facts about shoplifting.

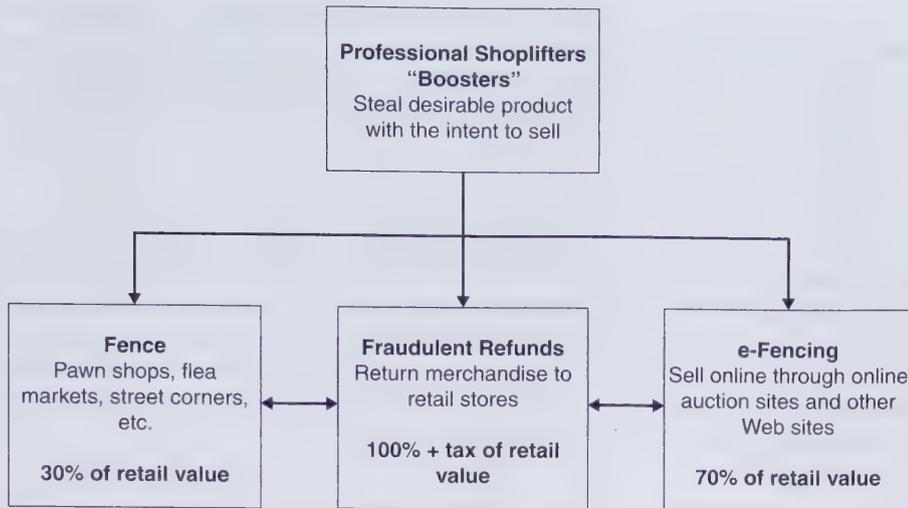
TABLE 20.5 Shoplifting Facts

- Approximately \$37 billion worth of goods are stolen from retailers each year. That's more than \$4.2 million worth of merchandise per hour.
- There are approximately 27 million shoplifters (or 1 in 11 people) in the United States. More than 10 million people have been caught shoplifting in the last five years.
- Shoplifting affects more than the offender. It overburdens the police and the courts, adds to a store's security expenses, increases the cost of goods for legitimate shoppers, reduces sales tax dollars that go to communities, and hurts children and families.
- There is no such thing as a "typical" shoplifter. *Anyone* can be a shoplifter. Men and women shoplift about equally as often.
- Approximately 25 percent of shoplifters are kids. Fifty-five percent of adult shoplifters say they started shoplifting in their teens.
- Many shoplifters buy and steal merchandise in the same visit. The average value of items that shoplifters steal per incident is \$129.
- Shoplifting is often an impulse crime: 73 percent of adult and 72 percent of juvenile shoplifters don't plan to steal in advance.
- Eighty-six percent of kids say they know other kids who shoplift, and 66 percent say they hang out with those kids.
- Shoplifters say they are caught an average of only once in every 48 times they steal. They are turned over to the police just 50 percent of the time.
- Approximately 3 percent of shoplifters are "professionals" who steal solely for resale or profit as a business. These include drug addicts who steal to feed their habit, hardened professionals who steal as a lifestyle, and international shoplifting gangs that steal for profit as a business. Eight-eight percent of retailers say that shoplifting losses from professional shoplifters has increased over the last three years.
- The majority of shoplifters are nonprofessionals who steal not out of financial need or greed but as a response to social and personal pressures in their lives.
- The excitement generated from "getting away with it" produces a chemical reaction that results in what shoplifters describe as an incredible "rush" or "high" feeling. Many shoplifters say that this high is their true reward rather than the merchandise itself.
- Drug addicts who have become addicted to shoplifting describe shoplifting as equally addicting as drugs.
- Even after getting caught, 57 percent of adults and 33 percent of juveniles say it is hard for them to stop shoplifting.
- Most nonprofessional shoplifters don't commit other types of crimes. They'll never steal an ashtray from your house and will return to you a \$20 bill that you drop. Their criminal activity is restricted to shoplifting, and therefore any rehabilitation program should be "offense specific" for this crime.
- The typical shoplifter steals an average of 1.6 times per week.

Sources: Based on National Association for Shoplifting Prevention (NASP), www.shopliftingprevention.org; 2012 Organized Retail Crime Survey, National Retail Federation, Washington, DC, 2012, p. 5; Richard C. Hollinger and Amanda Adams, 2012 National Retail Security Survey, University of Florida, pp. 9–10.

FIGURE 20.7
How Professional Shoplifters Work

Source: 2012 Organized Crime Survey, National Retail Federation, Washington, DC, p. 6.



Because professional shoplifters' business is theft, they are very difficult to detect and deter. Professional shoplifters tend to focus on expensive merchandise that they can sell quickly to their fences, such as stereo equipment, appliances, guns, or jewelry. Usually the fences don't keep the stolen goods long, often selling them on online auction sites ("e-fencing"), in pawn shops, or at flea markets at a fraction of their value. Therefore, apprehending and prosecuting professional shoplifters is quite difficult. Police have apprehended professional shoplifters with detailed maps of a city's shopping districts, showing target stores and the best times to make a "hit." Figure 20.7 shows how professional shoplifters operate.

DETECTING SHOPLIFTERS Although shoplifters can be difficult to detect, business owners who know what to look for can spot them in action. Entrepreneurs must always be on the lookout for shoplifters, but they should be especially vigilant on Saturdays and around holidays, when shoplifters can hide their thefts more easily in the frenzy of a busy shopping day.

Shoplifters can work alone or in groups. In general, impulse shoplifters prefer solitary thefts, whereas juveniles and professionals operate in groups. A common tactic for group shoplifters is for one member of the gang to create some type of distraction while other members steal the merchandise. Business owners should be wary of loud, disruptive groups that enter their stores. Professional shoplifters work in teams with each person filling a particular role, such as lookout, driver, decoy, picker, and packer. They use hand signals and smart phones to coordinate their thefts and often work from "fence lists," shopping lists of desirable merchandise provided to them by their fences.

Some shoplifters avoid working with fences and engage in receipt fraud scams. They steal merchandise from a store, create counterfeit receipts for the stolen goods, and then return them to the store for a full refund. Receipt fraud nets shoplifters the full retail price of the stolen goods rather than the 10 to 30 percent of retail price that a fence typically pays them.

Solitary shoplifters are usually quite nervous. They avoid crowds and shy away from store personnel, preferring privacy to ply their trade. To make sure they avoid detection, they constantly scan the store for customers and employees. These shoplifters spend more time nervously looking around the store than examining merchandise. In addition, they shop when the store is most likely to be understaffed, during early morning, lunch, or late evening hours. Shoplifters frequently linger in the same area for an extended time without purchasing anything. Customers who refuse the help of sales personnel or bring in large bags and packages (especially empty ones) also arouse suspicion.

Shoplifters have their own arsenal of tools to assist them in plying their trade. They often shop with booster boxes, shopping bags, umbrellas, bulky jackets, baby strollers, or containers disguised as gifts. These props often have hidden compartments that can be tripped easily, allowing the shoplifter to fill them with merchandise quickly. "Booster (or magic) bags," foil-lined bags or purses that block the signals from electronic surveillance tags attached to goods, are another commonly used shoplifting tool.

Some shoplifters use specially designed coats with hidden pockets and compartments that can hold even large items. Small business owners should be suspicious of customers wearing out-of-season clothing (e.g., heavy coats in warm weather or rain gear on clear days) that could conceal stolen goods. Hooked belts also are used to enable the shoplifter to suspend items from hangers without being detected.

Another common tactic is “ticket switching,” in which the shoplifter exchanges price tickets on items and pays a very low price for an expensive item. An inexperienced or unobservant cashier may charge \$9.95 for a \$30.00 item that the shoplifter re-marked while no one was looking. A more elaborate scheme is one in which shoplifters create counterfeit bar codes that they paste over existing bar codes on packages so that when the item is scanned, it rings up at a much lower price. After three years, police finally nabbed a shoplifter who used this technique to steal more than \$600,000 worth of toy Legos from dozens of stores in five western states. His phony bar codes caused \$100 Lego sets to ring up for just \$19 at checkout counters. He then resold the Lego sets at a markup on a Web site for toy collectors.⁵⁷



Entrepreneurship in Action

A Tale of Two Shoplifters

Anyone can be a shoplifter. The following confessions from two shoplifters offer valuable insight into what makes shoplifters tick and what merchants can do to deter them.

Lilit: Never Caught

I was a teenage shoplifter. As freshmen in high school, my best friends—we’ll call them Emma and Katie—and I spent almost every weekend at the local mall. Katie’s and Emma’s parents gave them money to go shopping, and I was jealous. They ended every Saturday with a stack of new tank tops, jeans, and dangly earrings while I was lucky to score a new T-shirt with what was left of my babysitting money. I started stealing because I wanted to balance things out. When you’re 14, every problem in life can be solved with a new sweater or a tube of lip gloss, and I fancied myself as a teenage Robin Hood, stealing from the rich (stores) to give to the poor (me).

I was good at it.

I was small and unassuming, hanging out with two friends who always bought stuff while I waited outside the dressing room. I knew which stores had cameras and which ones didn’t have security tags on their clothes. I limited myself to stealing one item per store, dancing on the invented line of morality: Either the earrings or the skirt is fine, I told myself, but not both. Shoplifting was my way of balancing it out, of making up for the perceived deficiencies in my life. At my school, rich kids were popular, and poor kids weren’t. Stealing clothes I couldn’t afford was my way of trying to make up the inequity. If I could steal clothes, I could work my way up to stealing happiness.

I never got caught. At some point, I stopped. I realized that new clothes couldn’t make a new girl. I still have one dress from my shoplifting days, a black mini-dress with spaghetti straps. I’ve worn it three times. When I stole it, I had an idea of the sort of woman I was going to grow up to be—somebody who was no longer self-conscious about money and status but somebody

Although I have enough money to pay for my clothes now, there’s still a part of me that, when I go into stores, looks around for cameras and checks to see whether the clerks are paying attention to peoples’ bags when they leave. Like any addiction, my desire to shoplift bubbles up now and again, wending through my veins and trying to make me reach for things. But I think about that black dress in my closet, and I keep walking.

Samantha: Busted!

I wish I could say that being arrested for shoplifting was a moment of madness—one of those irrational actions so far removed from my law-abiding behavior that it can be dismissed as an out-of-character blip in an otherwise upstanding, middle-class life. In reality, I had it coming to me. I’d been stealing stuff for months—for no other reason than I wanted things and didn’t have the money to pay for them. I stole audaciously, unforgivably, and because I knew I could get away with it. Nobody suspects somebody like me of being a thief, which is probably why I was able to stroll out of those shops without paying for so long. I’m a middle-class mother of three in my late thirties, living in a beautiful four-bedroom Georgian house.

My first shoplifting experience was an innocent mistake. I walked out of a shop holding a hair band for my daughter that I’d grabbed at the last minute and forgot to pay for. I should have walked back inside and admitted what had happened. But in that moment of deliberation, I felt no remorse. Far worse, it gave me a buzz—an actual high of getting something for nothing. I wasn’t a proper criminal; I was just taking a bit extra to redress the ridiculous markup of the stores. That was the beginning of my spiral into shoplifting, but when you’ve gotten away with something once, it becomes all too easy to do again. My behavior is inexcusable. It was greediness, pure and simple.

A pattern soon emerged. I never stole anything without first paying for something else. It was a case of buy one, get

one free—but not, I suspect, in the way the store campaign intended. At Christmas, I acquired all of my children's stocking stuffers without paying for them. Most people would feel tainted on Christmas morning, watching their children's eyes widen with wonder as they unwrap their gifts. I didn't. I just thought, "Thank God I got away with it."

On the day I was caught, my thirty-seventh birthday, I'd gone into town to buy something special for supper. I had time on my hands and went into a large department store. I wandered around, selecting items that caught my fancy (and had no security tags) and slinging them over my arm. The amount totaled just over £100. For the first time, I hadn't paid for anything to get my crucial "carrier bag." I walked out of the store blatantly holding clothes and not even attempting to hide what I was taking. Seconds later, a security guard and three policemen appeared out of nowhere. They had been following me and waiting for me to leave the store. In my panic, I tried to sound indignant: "I was just getting my purse from the car." But they'd heard it all before. They slapped handcuffs on my wrists and pushed me into the back of a police van and banged the doors shut. At the police station, they led me down an endless, smelly corridor to a cell. All of a sudden, I was alone behind a heavy, locked door. That's when the enormity of what I had done hit me. I thought

of my children, waiting at home with the chocolate cake they had baked for me, ready to sing "Happy Birthday," and I felt worse than a criminal. It was 10 hours before I was released. An attorney told me that the store had closed-circuit television evidence and that the chances of a jury believing I was innocent were highly unlikely. His advice was to admit guilt, apologize, and be thankful for a warning. This is what I did.

The arrest was a long-overdue slap in the face that forced me to take an uncomfortable audit of everything I could lose. I'll be forever grateful for those 10 hours in a lonely cell because they reminded me just how valuable freedom is.

1. What do the profiles of these two shoplifters say about assumptions that many business owners make about the "typical shoplifter"?
2. List and explain at least five steps businesses can take to minimize losses to shoplifting.

Sources: Adapted from Lilit Marcus, "Confessions of a Former Teenage Shoplifter," *Crushable*, June 8, 2011, www.crushable.com/2011/06/08/other-stuff/confessions-of-a-former-teenage-shoplifter; Samantha Booker, "Confessions of a Middle-Class Shoplifter: Stealing for Kicks, Even Down to Gifts for Her Children. How One Woman's Obsession Ended in a Police Cell," *Daily Mail*, March 1, 2011, www.dailymail.co.uk/femail/article-1361614/Confessions-middle-class-shoplifter-Stealing-kicks-womans-obsession-ended-police-cell.html.

One variation of traditional shoplifting techniques is the "grab-and-run," in which a shoplifter grabs an armload of merchandise located near an exit and then dashes out the door into a waiting getaway car. The element of surprise gives these thieves an advantage, and they are often gone before anyone in the store realizes what has happened. Other shoplifters are more brazen, simply walking out of the store with merchandise as if they had paid for it. One shoplifter says that he often stole kayaks from sporting goods stores by merely carrying them out in full view of store personnel, none of whom ever questioned him.⁵⁸

DETERRING SHOPLIFTERS The problem of shoplifting is worsening. Every year, business losses due to customer theft increase, and many companies are declaring war on shoplifting. Funds allocated for fighting shoplifting losses are best spent on *prevention*. By focusing on preventing shoplifting rather than on prosecuting violators after the fact, business owners take a strong stand in protecting their firms' merchandise. Of course, no prevention plan is perfect. When violations occur, owners must prosecute; otherwise, the business becomes known as an easy target. Retailers say that when a store gets a reputation for being tough on shoplifters, thefts drop off.

Knowing what to look for dramatically improves a business owner's odds in combating shoplifting:

- **Watch the eyes.** Amateurs spend excessive time looking at the merchandise they're about to steal. Their eyes, however, are usually checking to see who (if anyone) is watching them.
- **Watch the hands.** Experienced shoplifters, like good magicians, rely on sleight of hand.
- **Watch the body.** Amateurs' body movements reflect their nervousness; they appear to be unnatural.
- **Watch the clothing.** Loose, bulky clothing is the uniform of the typical shoplifter.
- **Watch for devices.** Anything a customer carries is a potential concealing device.
- **Watch for loiterers.** Many amateurs must work up the nerve to steal.
- **Watch for switches.** Working in pairs, shoplifters will split duties; one will lift the merchandise, and, after a switch, the other will take it out of the store.

Store owners can take other steps to discourage shoplifting.

Provide Good Customer Service Shoplifters need privacy to ply their trade and prefer to avoid sales personnel. Employees should walk the sales floor and interact with customers. When employees approach potential shoplifters, the shoplifters know they are being watched. Even when all salespeople are busy, an alert employee should approach the customer and say, “I’ll be with you in a moment.” Honest customers appreciate the clerk’s politeness, and shoplifters are put off by the implied surveillance.

Train Employees to Spot Shoplifters One of the best ways to prevent shoplifting is to train store personnel to be aware of shoplifters’ habits and to be alert for possible theft. In fact, most security experts agree that alert employees are the best defense against shoplifters. Employees should watch for suspicious people, especially those carrying the props of concealment. Employees in clothing stores must keep a tally of the items being taken into and out of dressing rooms. Some clothing retailers prevent unauthorized use of dressing rooms by locking them; customers who want to try on garments must check with a store employee first.

An alert cashier can be a tremendous boon to a store owner attempting to minimize shoplifting losses. A cashier who knows the store’s general pricing policy and is familiar with the prices of many specific items is the best insurance against the ticket-switching shoplifter. A good cashier also should inspect all containers being sold; tool boxes, purses, briefcases, and other items can conceal stolen merchandise.

Employees should be trained to watch for group shoplifting tactics. A group of shoppers that enters the store and then disperses in all directions may be attempting to distract employees so that some gang members can steal merchandise. Sales personnel should watch closely the customer who lingers in one area for an extended time, especially one who examines a lot of merchandise but never purchases anything.

The sales staff should watch for customers who consistently shop during the hours when most employees are on breaks. Managers can help eliminate this cause of shoplifting by ensuring that their stores are well staffed at all times. Coordinating work schedules to ensure adequate coverage is a simple but effective method of discouraging shoplifting.

The cost of training employees to be alert to shoplifting “gimmicks” can be recouped many times over by preventing losses from retail theft. The local police department or chamber of commerce may be able to conduct training seminars for small business owners and their employees, or security consulting firms might sponsor a training course on shoplifting techniques and protective methods. Refresher courses every few months can help keep employees sharp in spotting shoplifters.

Pay Attention to Store Layout A well-planned store layout also can be an effective obstacle in preventing shoplifting losses. Proper lighting throughout the store makes it easier for employees to monitor shoppers, whereas dimly lit areas give dishonest customers a prime opportunity to steal without detection. In addition, keeping displays of items low gives store personnel a clear line of sight of the entire store.

Business owners should keep small, expensive items, such as jewelry, silver, and personal electronics, inside display counters with a sales clerk nearby. Retailers should keep valuable items out of customers’ reach and should not display them near exits, where shoplifters can pick them up and quickly step outside. All merchandise displays should be neat and organized so that employees can easily notice missing items. Other protective measures include prominently posting anti-shoplifting signs describing the penalties involved and keeping unattended doors locked (within fire regulations). Exits that cannot be locked because of fire regulations should be equipped with noise alarms to detect any attempts at unauthorized exit.

Use Technology to Deter and Detect Theft Another option business owners have in the attempt to reduce shoplifting losses is to use loss prevention technology. A complete monitoring system can be expensive, but failure to implement one is usually more expensive. Closed-circuit television cameras help entrepreneurs combat both shoplifting and employee theft. Not every small business can afford to install a closed-circuit camera system, but one clever entrepreneur got the benefit of such a system without the high cost. He installed one “live” camera and several “dummy” cameras. The cameras worked because potential shoplifters thought that they were all live.



An electronic surveillance system is one of the most effective weapons in retailers' battle against shoplifting.

Source: Pavel L/Shutterstock.

An owner can deter ticket-switching shoplifters by using tamper-proof price tickets: perforated gummed labels that tear away if a customer tries to remove them or price tags attached to merchandise by hard-to-break plastic strips. Some owners use multiple price tags concealed on items to deter ticket switchers. One of the most effective weapons for combating shoplifting is the electronic article surveillance system, small tags that are equipped with electronic sensors that set off sound and light alarms if customers take them past a store exit. These tags are attached to the merchandise and can be removed only by employees with special shears. Owners using these electronic tags must make sure that all cashiers are consistent in removing them from items purchased legitimately; otherwise, they may be liable for false arrest or, at the very least, may cause customers embarrassment.

APPREHENDING SHOPLIFTERS Despite all of the weapons that business owners use to curtail shoplifting, the sad reality is that most of the time shoplifters are successful at plying their trade. Shoplifters say that they are caught an average of only once in every 48 times they steal and that they are turned over to the police just 50 percent of the time. Of those shoplifters who do get caught, less than half are prosecuted. The chance that any shoplifter will actually go before



Source: CartoonStock.

"Stopped a shoplifter yesterday.
Caught him red-handed."

a judge is about 1 in 100.⁵⁹ Building a strong case against a shoplifter is essential; therefore, small business owners must determine beforehand the procedures to follow once they detect a shoplifter. The store owner has to be certain that the shoplifter has taken or concealed the merchandise and has left the store with it. Although state laws vary, owners must do the following to make the charges stick:

1. *See* the person take or conceal the merchandise.
2. *Identify* the merchandise as the belonging to the store.
3. *Testify* that it was taken with the intent to steal.
4. *Prove* that the merchandise was not paid for.

Most security experts agree that an owner should never apprehend the shoplifter if he or she has lost sight of the suspect even for an instant. In that time, the person may have dumped the merchandise.

Another primary consideration in apprehending shoplifters is the safety of store employees. Retailers report that 15 percent of shoplifting apprehensions lead to some level of violence.⁶⁰ In general, employees should never directly accuse a customer of shoplifting and should never try to apprehend the suspect. The wisest course of action when a shoplifter is detected is to alert the police or store security personnel and let them apprehend the suspect. Apprehension *outside* the store is safest. This tactic strengthens the owner's case and eliminates unpleasant in-store scenes that upset other customers or that might be dangerous. Of course, if the stolen merchandise is very valuable or if the criminal is likely to escape once outside, the owner may have no choice but to apprehend the shoplifter in the store.

Once business owners detect and apprehend a shoplifter, they must decide whether to prosecute. Many small business owners fail to prosecute because they fear legal entanglements or negative publicity. However, failure to prosecute encourages shoplifters to try again and gives the business the image of being an easy target. Of course, each case is an individual matter. For example, the owner may choose not to prosecute elderly or senile shoplifters or those who are mentally incompetent. In most cases, however, prosecuting the shoplifter is the best option, especially for juveniles and first-time offenders. The business owner who prosecutes shoplifters consistently soon develops a reputation for toughness that most shoplifters hesitate to test.

Conclusion

Inventory control is one of those less-than-glamorous activities that business owners must perform if their businesses are to succeed. Although it doesn't offer the flash of marketing or the visibility of customer service, inventory control is no less important. In fact, business owners who invest the time and the resources to exercise the proper degree of control over their inventory soon discover that the payoff is huge!

Chapter Review

1. Explain the various inventory control systems and the advantages and disadvantages of each.
 - Inventory represents the largest investment for the typical small business. Unless properly managed, the cost of inventory will strain the firm's budget and cut into its profitability. The goal of inventory control is to balance the cost of holding and maintaining inventory with meeting customer demand.
 - Regardless of the inventory control system selected, business owners must recognize the relevance of the 80/20 rule, which states that roughly 80 percent of the value of the firm's inventory is in about 20 percent of

the items in stock. Because only a small percentage of items account for the majority of the value of the firm's inventory, managers should focus control on those items.

- Three basic types of inventory control systems are available to the small business owner: perpetual, visual, and partial. Perpetual inventory control systems are designed to maintain a running count of the items in inventory. Although they can be expensive and cumbersome to operate by hand, affordable computerized POS terminals that deduct items sold from inventory on hand make perpetual systems feasible for small

- companies. The visual inventory system is the most common method of controlling merchandise in a small business. This system works best when shortages are not likely to cause major problems. Partial inventory control systems are most effective for small businesses with limited time and money. These systems operate on the basis of the 80/20 rule.
- The ABC system is a partial system that divides a firm's inventory into three categories depending on each item's dollar usage volume (cost per unit multiplied by quantity used per time period). The purpose of classifying items according to their value is to establish the proper degree of control over them. A items are most closely controlled by perpetual inventory control systems, B items use basic analytical tools, and C items are controlled by very simple techniques, such as the two-bin system, the level control method, or the tag system.
2. Describe how JIT and JIT II inventory control techniques work.
 - The JIT system of inventory control sees excess inventory as a blanket that masks production problems and adds unnecessary costs to the production operation. Under a JIT philosophy, the level of inventory maintained is the measure of efficiency. Materials and parts should not build up as costly inventory. They should flow through the production process without stopping, arriving at the appropriate location just in time.
 - JIT II techniques focus on creating a close, harmonious relationship with a company's suppliers so that both parties benefit from increased efficiency. To work successfully, JIT II requires suppliers and their customers to share what was once closely guarded information in an environment of trust and cooperation. Under JIT II, customers and suppliers work hand in hand, acting more like partners than mere buyers and sellers.
 3. Describe methods for reducing losses from slow-moving inventory.
 - Managing inventory requires monitoring the company's inventory turnover ratio; slow-moving items result in losses from spoilage or obsolescence.
 - Slow-moving items can be liquidated by markdowns, eye-catching displays, or quantity discounts.
 4. Discuss employee theft and shoplifting and how to prevent them.
 - Employee theft accounts for the majority of business losses due to theft. Most small business owners are so busy managing their companies' daily affairs that they fail to develop reliable security systems. Thus, they provide their employees with prime opportunities to steal.
 - The organizational atmosphere may encourage employee theft. The owner sets the organizational tone for security. A complete set of security controls, procedures, and penalties should be developed and enforced. Physical breakdowns in security invite employee theft. Open doors and windows, poor key control, and improper cash controls are major contributors to the problem of employee theft. Employers can build security into their businesses by screening and selecting employees carefully. Orientation programs also help the employee to get started in the right direction. Internal controls, such as division of responsibility, spot checks, and audit procedures, are useful in preventing employee theft.
 - Shoplifting is the most common business crime. Fortunately, most shoplifters are amateurs. Juveniles often steal to impress their friends, but prosecution can halt their criminal ways early on. Impulse shoplifters steal because the opportunity suddenly arises. Simple prevention is the best defense against these shoplifters. Alcoholics, vagrants, and drug addicts steal to supply some need and are usually easiest to detect. Kleptomaniacs have a compelling need to steal. Professionals are in the business of theft and can be very difficult to detect and quite dangerous.
 - Three strategies are most useful in deterring shoplifters. First, employees should be trained to look for signs of shoplifting. Second, store layout should be designed with theft deterrence in mind. Finally, anti-theft devices should be installed in the store.

Discussion Questions

- 20-1. Describe some of the incidental costs of carrying and maintaining inventory for the small business owner.
- 20-2. What is a perpetual inventory system? How does it operate? What are the advantages and disadvantages of using such a system?
- 20-3. How are the supply chain management and the inventory control system closely linked?
- 20-4. Briefly describe the various steps an entrepreneur should follow for effective management of inventory.
- 20-5. What is the 80/20 rule, and why is it important in con-
- 20-6. Outline the ABC inventory control procedure. What is the purpose of classifying inventory items using this procedure?
- 20-7. Briefly describe the types of control techniques that should be used for A, B, and C items.
- 20-8. What is the basis for the JIT philosophy? Under what condition does a JIT system work best?
- 20-9. What is JIT II? What is its underlying philosophy? What risks does it present to businesses?
- 20-10. Outline the two methods of taking a physical inventory count. Why is it necessary for every small business manager to take inventory?

- 20-11. Why are slow-moving items dangerous to the small business? What can be done to liquidate them from inventory?
- 20-12. Briefly explain the visual inventory control system with suitable examples.
- 20-13. Why is employee theft a problem for many small businesses? Briefly describe the reasons for employee theft.
- 20-14. Construct a profile of the employee most likely to steal goods or money from an employer. What four elements must be present for employee theft to occur?
- 20-15. Briefly outline a program that could help the typical small business owner minimize losses due to employee theft.
- 20-16. List and briefly describe the major types of shoplifters.
- 20-17. Outline the characteristics of a typical shoplifter that should arouse a small business manager's suspicions. What tools and tactics is a shoplifter likely to use?
- 20-18. Briefly explain the two-bin and tag systems of inventory control.
- 20-19. Explain the relevance of the RFID in effective inventory control.
- 20-20. What must an owner do to have a good case against a shoplifter? How should a suspected shoplifter be apprehended?

CHAPTER 21

Staffing and Leading a Growing Company



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain the challenges involved in the entrepreneur's role as leader and what it takes to become a successful leader.
2. Describe the importance of hiring the right employees and how to avoid making hiring mistakes.
3. Explain how to build the kind of company culture and structure to support the entrepreneur's mission and goals and to motivate employees to achieve them.
4. Understand the potential barriers to effective communication and describe how to overcome them.
5. Discuss the ways in which entrepreneurs can motivate their employees to achieve higher levels of performance.

A leader is one who knows the way, goes the way, and shows the way.

—John C. Maxwell

The way management treats their associates is exactly how the associates will then treat the customers.

—Sam M. Walton

The Entrepreneur's Role as Leader

1.

Explain the challenges involved in the entrepreneur's role as leader and what it takes to become a successful leader.

To be successful, an entrepreneur must assume a wide range of roles, tasks, and responsibilities, but none is more important than the role of leader. Some entrepreneurs are uncomfortable assuming this role, but they must learn to be effective leaders if their companies are to grow and reach their potential. **Leadership** is the process of influencing and inspiring others to work to achieve a common goal and then giving them the power and the freedom to achieve it. Without leadership ability, entrepreneurs—and their companies—never rise above mediocrity. Entrepreneurs can learn to be effective leaders, but the task requires dedication, discipline, and hard work. In the past, business owners often relied on an autocratic management style, one built on command and control. Today's workforce is more knowledgeable, has more options, and is more skilled and, as a result, expects a different, more sophisticated style of leadership. Companies that fail to provide that leadership are at risk of losing their best employees. Leaders of small companies must gather information and make decisions with lightning-fast speed, and they must give workers the resources and the freedom to solve problems and exploit opportunities as they arise. Effective leaders empower and embolden employees to act in the best interest of the business.

Until recently, experts compared a leader's job to that of a symphony orchestra conductor. Like the symphony leader, an entrepreneur made sure that everyone in the company played from the same score, coordinated individual efforts to produce a harmonious sound, and directed the orchestra members as they played. The conductor (entrepreneur) retained virtually all of the power and made all of the decisions about how the orchestra would play the music without any input from the musicians themselves. Today's successful entrepreneur, however, is more like the leader of a jazz band, which is known for its improvisation, innovation, creativity, and freewheeling style. "The success of a small [jazz band] rests on the ability to be agile and flexible, skills that are equally central to today's business world," says Michael Gold, founder of Jazz Impact, a company that teaches management skills through jazz.¹ Business leaders, like the leaders of jazz bands, should exhibit the following characteristics:

Innovative. Entrepreneurial leaders must step out of their own comfort zones to embrace new ideas; they avoid the comfort of complacency. They understand the very changes that created the opportunity for their new venture will force them to continue to adapt and innovate.

Passionate. One of the greatest strengths of entrepreneurs is their passion for their businesses. Members of their team feed off that passion and draw inspiration from it.

Willing to take risks. "[Taking] risk is not an option in jazz or for any company that wants to be solvent ten years from now," says Gold.² Entrepreneurs understand that there is risk associated with both pursuing new things but also in not pursuing something new that actually has great promise (opportunity cost).

Adaptable. Although leaders must stand on a bedrock of resolute values, like jazz band leaders, they must adapt their leadership styles to fit the situation and the people involved.

Management and leadership are not the same, yet both are essential to a company's success. Leadership without management is unbridled; management without leadership is uninspired. Leadership gets a small business going; management keeps it going. In other words, leaders are the architects of small businesses; managers are the builders.

Some entrepreneurs are good managers yet poor leaders; others are powerful leaders but weak managers. Although both are skills that can be developed, the best bet for entrepreneurs who are strong leaders is to hire people with solid management skills to help them to execute the vision they have for their companies. Stephen Covey, author of *Principle-Centered Leadership*, explains the difference between management and leadership in this way:

Leadership deals with people; management deals with things. You manage things; you lead people. Leadership deals with vision; management deals with logistics toward that vision. Leadership deals with doing the right things; management focuses on doing things right. Leadership deals with examining the paradigms on which you are operating; management operates within those paradigms. Leadership comes first, then management, but both are necessary.³

Leadership and management are intertwined; one without the other means that a small business is going nowhere. Leadership is especially important for companies in the growth phase,

when entrepreneurs are hiring employees (often for the first time) and must keep the company and everyone in it focused on its mission as growth tests every seam in the organizational structure. At this stage, selling everyone in the company on the mission, goals, and objectives for which the leader is aiming is crucial to a business's survival and success. "People don't want to be managed," says one CEO. "They want to be led."⁴ Effective leaders exhibit certain behaviors. They do the following:

- **Create a set of values and beliefs for employees and passionately pursue them.** Employees look to their leaders for guidance in making decisions. True leaders focus attention on the principles, values, and beliefs on which they founded their companies.
- **Establish a culture of ethics.** One of the most important tasks facing leaders is to intentionally mold a highly ethical culture for their companies that reflects their values. They also must demonstrate the character and the courage necessary to stick to the ethical standards that they create—especially in the face of difficulty. Leaders' words ring hollow if they fail to "practice what they preach." Workers detect few contradictions faster than the hypocrisy of leaders who sell employees on one set of values and principles and then act according to a different set. Real leaders know that they set the ethical tone in the organization. Even small lapses in a leader's ethical standards can have a significant impact on a company's ethical climate. Workers know that they can trust leaders whose actions support their words. Similarly, they quickly learn not to trust leaders whose day-to-day dealings belie the principles they preach.
- **Define and then constantly reinforce the vision they have for the company.** Effective leaders have a clear vision of where they want their companies to go, and they concentrate on communicating that vision to those around them. Unfortunately, this is one area in which employees say their leaders could do a better job. Clarity of purpose is essential to a successful organization because people want to be a part of something that is bigger than they are; however, the purpose must be more than merely achieving continuous quarterly profits. As an entrepreneurial venture grows, communicating the vision of the business becomes the most important part of an entrepreneur's job as leader.
- **Respect and support employees.** To gain the respect of their employees, leaders must first respect those who work for them.
- **Create a climate of trust in the organization.** Leaders who demonstrate integrity soon win the trust of their employees, an essential ingredient in the success of any organization. Honest, open communication and a consistent pattern of leaders doing what they say they will do serve to build trust in a business. Research suggests that building trust among employees is another one of the most important tasks of leaders, wherever they may work. Building trust demands that leaders rely on three "Cs": competence (the leader is able to get the job done), consistency (the leader's actions are reliable, whatever the situation), and caring (the leader demonstrates compassion for those he or she leads).⁵ Employees at small businesses are more likely to trust their leaders than employees at large companies.⁶
- **Focus employees' efforts on challenging goals and keep them driving toward those goals.** Effective leaders have a clear vision of where they want their companies to go, and they are able to communicate their vision to those around them. Leaders must repeatedly reinforce the goals they set for their companies.
- **Create an environment in which people have the motivation, the training, the resources, and the freedom to achieve the goals they have set.** Leaders know that their success is determined by the success of their followers. Effective leaders know that workers cannot do their jobs well unless they have the tools they need. They provide workers with not only the physical resources they need to excel but also the necessary intangible resources, such as training, coaching, and mentoring.
- **Communicate with employees.** Leaders recognize that helping workers see the company's overarching goal is just one part of effective communication. Encouraging employee feedback and then listening is just as vital. In other words, they know that communication is a two-way street.
- **Value the diversity of workers.** Smart business leaders recognize the value of their workers' varied skills, abilities, backgrounds, and interests. When channeled in the right direction, diversity is a powerful weapon in achieving innovation and maintaining a competitive edge.

- **Celebrate workers' successes.** Effective leaders recognize that workers want to be winners and do everything they can to encourage top performance among their people. The rewards they give are not always financial; in many cases, a reward may be as simple as a handwritten congratulatory note. A true leader strives to make employees look good rather than expecting employees to make him or her look good.
- **Understand that leadership is multidimensional.** Smart leaders know that there is no single “best” style of leadership. The dimensions of leadership change depending on the people participating, the conditions and circumstances of the situation, and the desired outcome.
- **Value new ideas from employees.** Successful leaders know that because employees work every day on the front lines of the business, they see ways to improve quality, customer service, and business systems.
- **Understand that success really is a team effort.** Small companies typically depend more on their founding entrepreneurs than on anyone else. After all, someone has to take responsibility for the toughest decisions. However, effective leaders understand that their roles are only a small piece of the entire company puzzle. When they recognize this, they also build credibility with their workers. *Undercover Boss*, a television series on CBS, features CEOs of companies ranging from Waste Management and Choice Hotels to White Castle and Hooters who are disguised as new employees as they take on jobs on the front lines of their companies, where the “real work” is performed. In one episode, Larry McDonnell, CEO of Waste Management, cleans toilets and rides a garbage truck route. Along the way, he encounters hardworking people who do everything they can to help “the new guy” succeed and learns about the struggles workers face every day. In addition to seeing firsthand just how difficult many jobs can be, all of the CEOs receive a superb refresher course in how important every worker’s role is in the success of a company and how the policies that they and other senior managers create often make workers’ jobs harder.
- **Encourage creativity and risk taking throughout the organization.** Effective leaders recognize that in a rapidly changing competitive environment, everyone in the organization must make decisions with incomplete information and must be willing to take risks to succeed. Rather than punish workers who take risks and fail, effective leaders are willing to accept failure as a natural part of innovation and creativity. They know that innovative behavior is the key to future success. They do everything they can to encourage creativity among workers.
- **Become a catalyst for change.** With market and competitive conditions changing so rapidly, entrepreneurs must reinvent their companies constantly. Although leaders must cling to the values and principles that form the bedrock of their companies, they must be willing to change, sometimes radically, the policies, procedures, and processes within their businesses. If a company is headed in the wrong direction, the leader’s job is to recognize that and get the company moving in the right direction. “No leader knows enough about the future to make the optimal decision every time, but it’s better to set a clear course today and tackle problems that arise tomorrow,” says Andy Grove, former CEO of Intel, the computer chip maker.⁷
- **Develop leadership talent.** Effective leaders look beyond themselves to spot tomorrow’s leaders and take the time to help them grow into their leadership potential.
- **Maintain a sense of humor.** One of the most important tools a leader can have is a sense of humor. Without it, work can become dull and unexciting for everyone.
- **Keep an eye on the horizon.** Effective leaders are never satisfied with what they and their employees accomplished yesterday. They know that yesterday’s successes are not enough to sustain their companies indefinitely. They see the importance of building and maintaining sufficient momentum to carry their companies to the next level.

Leading an organization, whatever its size, is one of the biggest challenges any entrepreneur faces, yet for an entrepreneur, leadership success is a key determinant of a company’s success. Research suggests that there is no single “best” style of leadership; the style a leader uses depends, in part, on the situation at hand. Some situations are best suited for a participative leadership style, but in others, an authoritarian style may be best. Research by Daniel Goleman and others suggests that today’s workers tend to respond more to adaptive, humble leaders who are results oriented and

who take the time to cultivate other leaders in the organization.⁸ The practice is known as **servant leadership**, a phrase coined by Robert Greenleaf in 1970. Servant leaders are servants *first* and leaders second, putting their employees and their employees' needs ahead of their own. They are more concerned about empowering others in the organization than they are at enhancing their own power bases. "Servant leadership is about getting people to a higher level by leading people at a higher level," says author Ken Blanchard.⁹ Researchers have discovered that three dimensions of leader behavior best define effective servant leaders: service, humility, and vision.¹⁰

Entrepreneurs cannot bestow the mantle of "leader" on themselves. Managers may inherit their subordinates, but leaders have to *earn* their followers. An entrepreneur's employees determine whether he or she is worthy of leadership. *Without followers, there are no leaders.* Astute leaders know that their success depends on their employees' success. After all, the employees actually do the work, implement the strategies, and produce the results. Successful leaders establish an environment in which their followers can achieve success. Joe Tortorice Jr., founder and CEO of Jason's Deli, a privately owned company with 225 restaurants in 28 states, says, "People are looking for three things out of their leaders: direction, trust, and hope."¹¹

To be effective, entrepreneurial leaders must perform four vital tasks:

- Hire the right employees and constantly improve their skills.
- Build an organizational culture and structure that allows both workers and the company to reach their potential.
- Communicate the vision and the values of the company effectively and create an environment of trust among workers.
- Motivate workers to higher levels of performance.

Hiring the Right Employees: The Company's Future Depends on It

The decision to hire a new employee is an important one for every business but is *especially* important for small businesses because the impact of a single hire on a small company is significant. "As an entrepreneur, every single hire is critical," says Stephen Fairley, CEO of the Rainmaker Institute, a business coaching firm.¹² Every new employee a business owner hires determines the heights to which the company can climb—or the depths to which it will plunge. "Bad hires" can poison a small company's culture for years.

Hiring mistakes also are expensive. Although some employee turnover is healthy, high employee turnover rates cost companies billions of dollars annually. According to the American Management Association, the cost of employee turnover falls within a range between 25 percent of annual salary and benefits for entry-level employees up to as much as 200 percent for executive, managerial, and sales positions.¹³ Consider a small business with 20 employees that has an employee turnover rate of 21 percent, the national average. Assuming that the employees earn wages that are consistent with the national average (about \$42,980) and receive benefits that total 25 percent of their wages, the *minimum* turnover cost (above employees' salaries and benefits) to the company is \$56,411, but it could cost as much as \$451,290!

Unfortunately, hiring mistakes in business are all too common. The culprit in most cases is the company's selection and hiring process. A recent survey by SurePayroll reports that 69 percent of business owners say that they have made *at least* one bad hire in the last year.¹⁴ One study reported in the *Harvard Business Review* concludes that bad hiring decisions cause 80 percent of employee turnover.¹⁵ Some small business owners invest more time and effort into deciding which copy machine to lease than which employee to hire for a key position.

The most common causes of a company's poor hiring decisions include the following:

- Managers who rely on candidates' descriptions of themselves rather than requiring candidates to demonstrate their abilities.
- Managers who fail to follow a consistent, evidence-based selection process. Forty-seven percent of managers admit that they make hiring decisions in 30 minutes or less, and 44 percent of managers say that they rely on their intuition to make hiring decisions.
- Managers who fail to provide candidates with sufficient information about what the jobs entail.¹⁶

2.

Describe the importance of hiring the right employees and how to avoid making hiring mistakes.

Source: Scott Adams/Universal Uclick.



As crucial as finding good employees is to a small company's future, it is no easy task because entrepreneurs face a labor shortage, particularly among knowledge-based workers. The severity of this shortage will worsen as Baby Boomers retire in increasing numbers and the growth rate of the U.S. labor force slows.

The following guidelines can help small business managers avoid costly hiring mistakes.

How to Hire Winners

Even though the importance of hiring decisions is magnified in small companies, small businesses are most likely to make hiring mistakes because they lack the human resources experts and the disciplined hiring procedures that large companies have. In many small businesses, the hiring process is informal, and the results often are unpredictable. The following guidelines can help entrepreneurs to hire winners and avoid making costly hiring mistakes as they build their team of employees.

COMMIT TO HIRING THE BEST TALENT Smart entrepreneurs follow the old adage, "A players hire A players; B players hire C players." They are not threatened by hiring people who may be smarter and more talented than they are. In fact, they recognize that doing so is the best way to build a quality team.

ELEVATE RECRUITING TO A STRATEGIC POSITION IN THE COMPANY Assembling a quality workforce begins with a sound recruiting effort. By investing time and money at this crucial phase of the staffing process, entrepreneurs can generate spectacular savings down the road by hiring the best talent. The recruiting process is the starting point for building quality into a company. Recruiting is so important that many entrepreneurs choose to become actively involved in the process themselves. Visionary entrepreneurs *never* stop recruiting because top-quality talent is hard to find and is extremely valuable. Tom Bonney, founder of CMF Associates, a fast-growing financial consulting firm in Philadelphia, knows that finding superior talent is essential to the success of his service business. "I never stop recruiting," he says. "Even if I don't have a need, I am always looking."¹⁷

Attracting a pool of qualified job candidates requires not only constant attention but also creativity, especially among smaller companies that often find it difficult to match the more generous offers that large companies make. With a sound recruiting strategy and a willingness to look in new places, however, smaller companies *can* hire and retain high caliber employees. The following techniques will help.

Look Inside the Company First One of the best sources for top prospects is right inside the company itself. According to a report from the Saratoga Institute, the average cost of finding and hiring someone from outside the company is 1.7 times more than an internal hire. Additionally, research shows that between 40 and 60 percent of external hires are successful, compared to 75 percent of internal hires.¹⁸ A promotion-from-within policy serves as an incentive for existing workers to upgrade their skills and to produce results. In addition, an entrepreneur already knows the employee's work habits, and the employee already understands the company's culture. "Internal hires tend to do better than outsiders, so if you promote from within you're likely to reduce your risk," says Margaret Heffernan, successful entrepreneur and author. "You want to encourage the talent you already have, so work hard to discover what you have before you go looking for more."¹⁹

Encourage Employee Referrals To cope with the shortage of available talent, many companies offer their employees (and others) bonuses for referring candidates who come to work and prove to be valuable employees. Employees serve as reliable screens because they do not want to jeopardize their reputations with their employer. Employee referrals from social networks such as LinkedIn, Facebook, and Twitter allow employers to tap into their employees' network of contacts. A recent study by Jobvite, an online employee-recruiting platform, found that employee referrals now account for 40 percent of all hires. Employee hires have a higher conversion rate to successful hiring, get on the job more quickly, have higher job satisfaction once on the job, and are less expensive to recruit.²⁰ Sodexo, a food service and facilities management company that works with many universities across the country, reports that referred employees are 10 times more likely to be hired than other applicants. "We're focusing on what will be most efficient," says Arie Ball, vice president for talent acquisition at Sodexo. "And it's just easier to connect on social networks than it used to be."²¹

Use Multiple Channels to Recruit Talent Although newspaper ads have historically been the most common source of recruiting, employers are now using a variety of channels to recruit employees (Figure 21.1). In addition to referrals, posting positions with online job boards, utilizing job listings on career-oriented Web sites, and social media have become common source of finding employees. In fact, when it comes to recruiting, 93 percent of employers use Linked-in, 66 percent use Facebook, and 54 percent use Twitter; 70 percent of employers say that they have hired an employee whom they found through these sites.²²

Recruit on Campus For many employers, college and university campuses remain an excellent source of workers, especially for entry-level positions. After screening résumés, a recruiter can interview a dozen or more high-potential students in just one day. Companies must be sure that the recruiters they send to campuses are professional, polished, and prepared to represent the company well because 42 percent of students say that their impression of a recruiter is the primary determinant of their perception of a company.²³

Forge Relationships with Schools to Gain Access to Interns Some employers have found that forging long-term relationships with schools and other institutions can provide a valuable source of workers. As colleges and universities actively seek internship opportunities for their students, small businesses can identify potential employees by hosting one or more students for a semester or for the summer. The company has an opportunity to observe the student's work habits and, if positive, sell the student on a permanent position on his or her graduation.

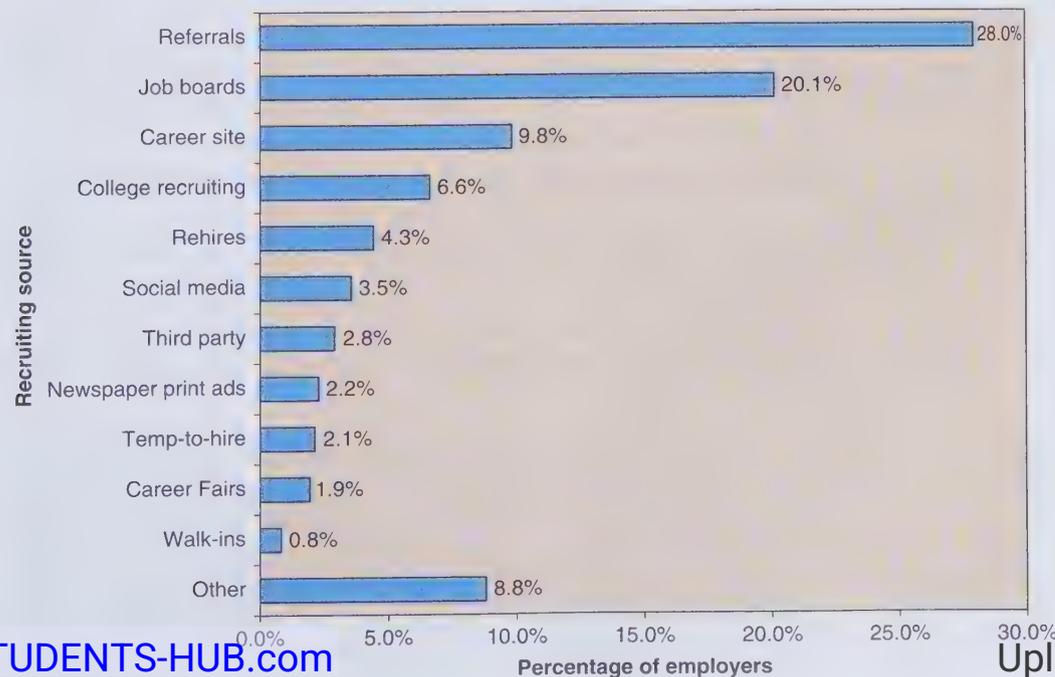


FIGURE 21.1
Sources of Recruiting Employees

Source: "2012 Sources of Hire: Channels That Influence," CareerXroads, www.careerxroads.com/news/slideshows.asp.



ENTREPRENEURIAL PROFILE: Kelsey Meyer: Digital Talent Agents Kelsey Meyer, co-founder of the public relations firm Digital Talent Agents, likes to test interns by giving them loose directions and then setting them free to complete their projects. “We want them to figure out the best way to do things on their own,” says Meyer. “It’s interesting to watch what they come up with when we aren’t breathing over their shoulders.” Meyer will occasionally ask interns for ideas for improving the business. “We make it into a contest,” she says. “If we are having a problem with a client, for example, I will task my interns with coming up with at least one solution by 2:00 P.M. The person whose idea we choose to use will receive a gift certificate for a smoothie at a nearby restaurant.” This type of exercise has proved to be a valuable way to assess interns for full-time positions. “When you are looking to hire someone full-time, you want to know how they will add value to your company,” Meyer says. “This exercise teaches them how to think strategically; the more strategically an employee thinks, the less they will think about having to leave at 5:00 P.M. They will instead be thinking about how they can contribute to making your company better.”²⁴

Recruit “Retired” Workers By 2016, nearly 35 percent of workers in the United States will 55 or older, and in 2019, the youngest members of the Baby Boom generation will turn 55.²⁵ According to the American Association of Retired Persons, three-fourths of these Baby Boomers plan to continue working after reaching retirement age. Some do this to maintain their lifestyles, but many are choosing to do this because they want to continue working.²⁶ To avoid labor shortages, small businesses must be ready to hire them, perhaps as part-time employees. With a lifetime of work experience, time on their hands, and a strong work ethic, retired workers can be the ideal solution to many entrepreneurs’ labor problems. One survey by WorldatWork, an international association of human resource professionals, reports that just 49.4 percent of employers proactively pursue older workers in their recruiting efforts.²⁷ Older employees can be a valuable asset to small firms.



ENTREPRENEURIAL PROFILE: Kevin Dent: Dentco Kevin Dent, CEO of Dentco, has turned to older workers when hiring new employees for his exterior services management firm. A growing part of Dentco’s workforce is the part-time quality service inspectors whose ages range from the mid-fifties to the mid-eighties. These inspectors work three to 10 days a month traveling from one job site to another, walking the grounds, taking photos, filing computer reports, and meeting clients. “It’s worked miraculously well,” says Dent. “There’s a whole different work ethic with senior citizens. They know how to handle people at the sites, make great ambassadors, and have empathy and discipline. They meet their commitments.”²⁸

Consider Using Offbeat Recruiting Techniques To attract the workers they need to support their growing businesses, some entrepreneurs have resorted to creative recruiting techniques such as the following:

- Sending young recruiters to mingle with college students on spring break.
- Sponsoring a “job shadowing” program that gives students and other prospects the opportunity to observe firsthand the nature of the work and the work environment.
- Inviting college seniors to a company tailgating party at a sports event.
- Posting “what it’s like to work here” videos created by current employees on YouTube and other video sites.
- Launching a monthly industry networking meeting for local workers at Internet companies.
- Hosting or joining a local job fair.
- Keeping a file of all of the workers mentioned in the “People on the Move” column in the business section of the local newspaper and then contacting them a year later to see whether they are happy in their jobs.²⁹

Offer What Workers Want Adequate compensation and benefits are important considerations for job candidates, but other, less tangible factors also weigh heavily in a prospect’s decision to accept a job. To recruit effectively, entrepreneurs must consider what a McKinsey and Company study calls the “employee value proposition,” the factors that would make the ideal employee want to work for their businesses. Flexible work schedules and telecommuting that allow employees to balance the demands of work and life can attract quality workers to small companies. In fact, a study by staffing firm Robert Half International reported that quality

and benefits, flexible work schedules and telecommuting are the most important incentives in attracting employees.³⁰

CREATE PRACTICAL JOB DESCRIPTIONS AND JOB SPECIFICATIONS Business owners must recognize that what they do *before* they ever start interviewing candidates for a position determines to a great extent how successful they will be at hiring winners. The first step is to perform a **job analysis**, the process by which a firm determines the duties and nature of the jobs to be filled and the skills and experience required of the people who are to fill them. Without a proper job analysis, a hiring decision is, at best, a coin toss. The first step in conducting a job analysis is to develop a **job description**, a written statement of the duties, responsibilities, reporting relationships, working conditions, and methods and techniques as well as materials and equipment used in a job. A results-oriented job description explains what a job entails and the duties the person filling it is expected to perform. A detailed job description includes a job title, job summary, duties to be performed, nature of supervision, job's relationship to others in the company, working conditions, and definitions of job-specific terms.

Preparing job descriptions may be one of the most important parts of the hiring process because it creates a blueprint for the job. Without this blueprint, managers tend to hire the person with experience whom they like the best. Useful sources of information for writing job descriptions include the manager's knowledge of the job, the workers currently holding the job, and the *Dictionary of Occupational Titles*, available at most libraries and online. The *Dictionary of Occupational Titles*, published by the Department of Labor, lists more than 20,000 job titles and descriptions and serves as a useful tool for getting an entrepreneur started when writing job descriptions.

The second objective of a job analysis is to create a **job specification**, a written statement of the qualifications and characteristics needed for a job stated in terms such as education, skills, and experience. A job specification shows a small business manager what kind of person to recruit and establishes the standards that an applicant must meet to do the job well. In essence, it is a written "success profile" of the ideal employee. Does the person have to be a good listener, empathetic, well organized, decisive, or a "self-starter"? Should he or she have experience in Java programming? For example, an entrepreneur about to hire a new employee who will be telecommuting from home would look for someone with excellent communication skills, problem-solving ability, a strong work ethic, and the ability to use technology comfortably. One of the best ways to develop this success profile is to study the top performers currently working for the company and to identify the characteristics that make them successful. Table 21.1 provides an example that links the tasks for a sales representative's job (drawn from the job description) to the traits or characteristics that an entrepreneur identified as necessary to succeed in that job. These traits become the foundation for writing the job specification.

SCREEN RÉSUMÉS Reviewing candidates' résumés is the starting point for screening prospective employees. A survey from the Corporate Executive Board reports that the average number of

TABLE 21.1 Linking Tasks from the Job Description to the Traits Needed to Perform a Sales Representative's Job

Job Task	Trait or Characteristic
Generate new leads and close new sales.	Outgoing, strong communication skills, persuasive, friendly
Make 15 "cold calls" per week.	A self-starter, determined, optimistic, independent, confident
Analyze customer needs and recommend proper equipment.	Good listener, intuitive, patient, empathetic
Counsel customers about options and features required.	Organized, polished speaker, "other" oriented
Prepare and explain financing methods; negotiate finance contracts.	Honest, mathematically oriented, comfortable with numbers, understands basics of finance, computer literate
Retain existing customers.	Relationship builder, customer focused

TABLE 21.2 Résumé Bloopers

All of the following résumé bloopers are real. Would you hire someone who committed these blunders?

- A job candidate listed God as one of her references (but, strangely enough, did not list a telephone number).
- A woman listed “alligator watching” as one of her hobbies.
- A man included “Master of Time and the Universe” as part of his work experience.
- One candidate’s résumé was 24 pages long, and she had been in the workforce only five years.
- A candidate wrote that he was “looking for a full-time position with minimal time commitment.”
- Under “Accomplishments,” one man listed that he “finished eighth in his class of 10.”
- An applicant claimed, “You will want me to be Head Honcho in no time.”
- A job seeker claimed that he spoke “English and Spinach.”
- One résumé listed the applicant’s skills as follows: “Strong Work Ethic, Attention to Detail, Team Player, Self Motivated, Attention to Detail.”
- A woman who sent her résumé and cover letter failed to delete comments from someone who proofed the materials, which included such comments as “I don’t think you want to say this about yourself here.”
- Under “Qualifications,” one woman explained that her “twin sister has an accounting degree.”
- A candidate listed as skills, “written communication = 3 years; verbal communication = 5 years.”
- Under education, one young applicant said, “I have a bachelorette degree in computers.”
- One job applicant claimed that he had 28 dog years of experience in sales (four human years, we assume).
- A candidate included a video with his résumé. The purpose of the video: to hypnotize the manager and persuade him to hire the man.
- One applicant used colored paper and glued glitter around the edges.
- One job candidate claimed that he possessed “demonstrated ability at multi-tasting.”
- Under “Education,” one applicant claimed to have “repeated courses repeatedly.”

Sources: Based on “Hiring Managers Share Most Memorable Resume Mistakes in New CareerBuilder Survey,” *CareerBuilder*, September 15, 2010, www.careerbuilder.com/share/aboutus/pressreleasesdetail.aspx?id=pr586&sd=9/15/2010&ed=9/15/2010; “150 Funniest Resume Mistakes, Bloopers, and Blunders Ever,” *Job Mob*, jobmob.co.il/blog/funniest-resume-mistakes.

applicants for each job opening is 118.³¹ In addition, 38 percent of managers say that they spend less than one minute reviewing a résumé, and 18 percent spend less than 30 seconds!³² Table 21.2 describes some unusual items lifted from actual résumés.

CHECK REFERENCES Entrepreneurs should take the time to check *every* applicant’s references. Although many entrepreneurs see checking references as a formality and pay little attention to it, others realize the need to protect themselves (and their customers) from hiring unscrupulous workers. A reference check is necessary because more than half of job seekers lie in their résumés, often by inflating their job titles.³³ A recent study by OfficeTeam reports that employers eliminate 21 percent of job applicants after they conduct reference checks.³⁴ Rather than rely only on the references that candidates list on their résumés, wise employers call an applicant’s previous employers and talk to their immediate supervisors to get a clear picture of the applicant’s job performance, character, and work habits.



ENTREPRENEURIAL PROFILE: Andy Levine: Development Counselors International

Andy Levine, president of Development Counselors International, now requires 12 references for the final stage of the interview process. “It can be pretty amusing when you ask for 12 references. Some candidates have an email to us within an hour; some we never hear from again” says Levine. “When I call references, I start by trying to get them comfortable. I make it clear that what they say will not travel back to the person. Then I often ask, ‘If you had to pick three words to describe this person, what are the first that come to mind?’ It’s very interesting, the picture that emerges after you’ve done eight or nine of these interviews.”³⁵

PLAN AN EFFECTIVE INTERVIEW Once an entrepreneur knows what to look for in a job candidate, he or she can develop a plan for conducting an informative job interview. Too often, business owners go into an interview unprepared, and as a result, they fail to get the information they need to judge the candidate's qualifications, qualities, and suitability for the job. A common symptom of failing to prepare for an interview is that the interviewer rather than the candidate does most of the talking. Effective interviewers spend about 25 percent of the interview talking and about 75 percent listening. This can be hard for entrepreneurs who are excited about their businesses and who are used to giving a "pitch" to everyone who will listen! Despite their popularity, interviews are less reliable in predicting job performance than samples of a candidate's work, job-knowledge tests, and peer ratings of past job performance.³⁶ The following tips improve the quality of the interview process.

Involve Others in the Interview Process Solo interviews are prone to errors. A better process is to involve other employees, particularly employees with whom the prospect would be working, in the interview process either individually or as part of a panel.

Develop a Series of Core Questions and Ask Them of Every Candidate Entrepreneurs benefit by relying on a set of relevant questions they ask in every interview. Doing so gives the screening process consistency, but entrepreneurs should customize each interview using impromptu questions based on an individual's responses. These questions should relate to the most important job requirements (tasks, demands, and organizational cultural) and employee requirements (knowledge, skills, and personality/values).

Ask Open-Ended Questions Open-ended questions demanding more than a yes-or-no response are most effective because they encourage candidates to talk about their work experience in a way that will disclose the presence or the absence of the traits and characteristics entrepreneurs are seeking. Questions that begin with phrases such as "Tell me about a time . . ." encourage candidates to tell stories that allow the interviewer to assess their fit with the organization's culture. Peter Bregman, CEO of Bregman Partners, a company that helps businesses implement change, says that one of the most revealing questions that an interviewer can ask candidates is "What do you do in your spare time?" To emphasize the importance of a candidate's hobbies, Bregman points to Captain C. B. "Sully" Sullenberger, the airline pilot who safely landed a disabled jet with 155 passengers on the Hudson River using skills that he learned from his hobby: flying gliders.³⁷

Present Hypothetical Situations Building the interview around job-specific hypothetical situations gives the owner a preview of the candidate's actual work habits and attitudes. Rather than telling interviewers about what candidates might do, these scenarios give them insight into what candidates actually do (or have done) in job-related situations.

Probe for Specific Examples in the Candidate's Past Work Experience That Demonstrate the Necessary Traits and Characteristics A common mistake interviewers make is failing to get candidates to provide the detail they need to make an informed decision.

Inquire About Recent Successes and Failures Smart interviewers look for candidates who describe them both with equal enthusiasm because they know that peak performers put as much into their failures as they do their successes and usually learn something valuable from their failures. Ask the candidates to provide examples of their successes and failures.

Create an Informal Setting Select a "noninterview" location that allows several employees to observe the candidate in an informal setting. Taking candidates on a plant tour or setting up a coffee break gives everyone a chance to judge a candidate's interpersonal skills and personality outside the formal interview process. These informal settings can be revealing. At Zappos, the online shoe store, recruiters often interview shuttle service drivers and administrative assistants to discover how job candidates treated them. "I want to know about that interaction," says recruiter Andrew Kovacs.³⁸

Table 21.3 shows an example of some interview questions the manager might use to uncover the traits and characteristics he or she seeks in a top-performing sales representative (refer to

TABLE 21.3 Interview Questions for Candidates for a Sales Representative Position

Trait or Characteristic	Question
Outgoing, persuasive, friendly, a self-starter, determined, optimistic, independent, confident	How do you persuade reluctant prospects to buy? Can you give an example?
Good listener, patient, empathetic, organized, polished speaker, other oriented	What would you say to a fellow salesperson that was getting more than her share of rejections and was having difficulty getting appointments?
Honest, customer oriented, relationship builder	How do you feel when someone questions the truth of what you say? Can you give an example of how you handled this situation?
Other questions:	
<ul style="list-style-type: none"> • If you owned a company, why would you hire yourself? • If you were head of your department, what would you do differently? Why? • How do you acknowledge the contributions of others in your department? 	



Entrepreneurship in Action

Facebook Interview Process

Facebook has developed a rigorous application process for prospective employees that ensures that the company gets top talent and finds people who fit the Facebook culture. For those interested in technical jobs, Facebook offers an online timed coding challenge, open to all, where the best performers automatically win a phone interview.

The phone interview is the first major step in the hiring process. It covers the candidate's résumé and questions about previous work experiences, especially about the leadership roles they have held in the past. Facebook recruiters pay close attention to candidates who have been successful in previous positions and show a passion for the work they did on that job. The length of the résumé is not important at Facebook. What recruiters look for is demonstrated excellence and accomplishments. For some positions, applicants may go through second, third, and even fourth telephone interviews. Some of these telephone screenings can be quite lengthy and may involve collaborative online problem-solving exercises with the person conducting the interview.

Those who pass the telephone screening are flown to the company's Silicon Valley headquarters for a series of on-site interviews with the hiring manager and several team members who are part of the work group. These interviews are designed to determine candidates' skills and their fit with the Facebook's unique culture. Team members ask many questions about the candidate's experience working in teams and make note of how they interact with the team members doing the interview. If a candidate is applying for a technical position, he or she faces more skill-based challenges and a take-home test. The team assesses not only the candidate's skills and abilities but also the approach they take to problem solving. Creative solutions are particularly important.

Facebook provides the opportunity to offer suggestions on how they might make the Facebook product or user experience

better. Interviewers want to see specific solutions and metrics to assess how the improvements are working.

Some of the typical questions asked in Facebook interviews are not that typical. Questions such as, "If you were an animal what kind would you be and why?," "What is the difference between Facebook ads and Google Ads?," "Should Facebook be available in China?," and "What do you see as Facebook's biggest challenge in the next five years?" are common. The goal of these questions is to see how each candidate responds when faced with questions that they could not prepare for in advance.

Facebook employees who are involved in the interview process then make a collective decision on the candidate's fit for the position.

Interview teams expect applicants for nontechnical positions, such as business operations, sales, marketing, or analytics, to have done a great deal of research into Facebook before they arrive for the interview. "If you are going to work for Facebook tomorrow, what project do you want to work on?" was one question posed to a recent applicant for a market research position.

Facebook managers recognize that once they have made the decision to hire, the candidate also must make a decision about his or her fit with the company's culture. "After the interview, I wasn't sure if I would be happy working at Facebook," says one software engineer candidate, "so they let me come back and speak with my would-be manager and director, as well as some coworkers, so I could make a good decision."

"We're primarily looking for builders," says Thomas Arnold, head of recruitment at Facebook, which prides itself on its entrepreneurial spirit. The company has maintained a flat organizational structure that is best for those who seek to be empowered in their jobs and are highly self-motivated.

Strong applicants also confirm this by making sure that the

candidate is an active Facebook user. If an applicant has not used his or her Facebook account for several weeks, recruiters take this as a sign that he or she will not be a good fit.

1. What are the principles behind Facebook's interview process? Do you think it is too complex? Explain.
2. What does the interview process tell you about Facebook's culture? Explain.
3. Can Facebook's interview process be applied in companies that are not technology based? How might it be applied to a company that makes golf clubs?

4. Why is hiring new employees so important for a small business? Why is it so difficult? How does the process at Facebook address some of the challenges that companies face when hiring?

Sources: Based on Claire Gordon, "Getting a Job at Facebook: Inside the 'Meritocratic' Hiring Process," *AOL Jobs*, October 5, 2012, <http://jobs.aol.com/articles/2012/10/05/want-to-get-a-job-at-facebook-weve-demystified-the-hiring-proc>; Jacquelyn Smith, "Ten Things to Know Before Interviewing at Facebook," *Forbes*, February 2, 2012, www.forbes.com/sites/jacquelynsmith/2012/02/02/ten-things-to-know-before-interviewing-at-facebook; Ben Parr, "How to: Land a Job at Facebook," *Mashable*, April 3, 2011, mashable.com/2011/04/03/facebook-jobs-2.

Conducting the Interview

An effective interview contains three phases: breaking the ice, asking questions, and selling the candidate on the company.

BREAKING THE ICE In the opening phase of the interview, the entrepreneur's primary goal is to create a relaxed environment. Icebreakers—questions about a hobby or special interest—get the candidate to relax. These icebreaker questions also allow the interviewer an opportunity to gain valuable insight into the person. These questions generate little or no pressure, allowing the interviewee to feel free to expound on something he or she knows a great deal about.

ASKING QUESTIONS During the second phase of the interview, employers ask the questions from their question bank to determine the applicant's suitability for the job. Employers' primary job at this point is to *listen*. They also take notes during the interview to help them ask follow-up questions based on a candidate's comments and to evaluate a candidate after the interview is over. Experienced interviewers also pay close attention to a candidate's nonverbal clues, or body language, during the interview. They know that candidates may be able to say exactly what they want with their words but that the candidate's body language does not lie!

Some of the most valuable interview questions attempt to gain insight into the candidate's ability to reason, be logical, and be creative. In a **puzzle interview**, the goal is to determine how job candidates think by asking them offbeat, unexpected questions, such as "How would you weigh an airplane without scales?" "Why are man-hole covers round?" or "How would you determine the height of a building using only a barometer?" At Zappos, interviewers ask candidates which superhero they would like to be and why.³⁹ Usually, the logic and creativity that a candidate uses to derive an answer is much more important than the answer itself.



ENTREPRENEURIAL PROFILE: Bob Bernstein: Bongo Java Coffee When Bob Bernstein founded Bongo Java Coffee, he had a clear vision for the kind of culture he wanted to create in his coffee shops, one that reflects his strongly held political convictions and his rather offbeat sense of humor. Bernstein decided that to achieve a common culture across his stores, he should implement a selection process that would ensure that he hired employees who would embrace and sustain the culture. The employee application became one of the vehicles to help identify people who would fit into Bongo Java's culture. Although the application begins like most others, gathering basic information about the person's experience, it soon moves into some rather nontraditional questions. Because community engagement and activism are important to Bernstein, he asks, "What volunteer activities are you currently or have you recently been involved in?" Other questions include "If you could have a one hour conversation with anybody living or dead, who would it be and what would you talk about?" and "If you were to write your autobiography what would the title be? Explain." Although these are not typical questions one might ask a potential employee, Bernstein believes that they have helped him find people who fit in his company's culture. As a result, Bongo Java's employee turnover is well below that of a typical coffee shop.⁴⁰

Another interview format is the **situational interview**, in which the interviewer gives candidates a typical job-related situation (sometimes in the form of a role-playing exercise) and presents a series of open-ended questions to assess how the candidates might respond. One entrepreneur had a candidate deal with an "angry customer" who was played by a fellow interviewer.

Studies show that situational interviews have a 54 percent accuracy rate in predicting future job performance, much higher than the 7 percent accuracy rate of the traditional interview.⁴¹

The **peer-to-peer interview** may provide a closer look at how prospective employees will get along with other staff. Applicants meet one-on-one with potential peers to ask questions about the job and the company. The employees then share their assessments with the manager. This interviewing technique is becoming more common in companies, especially those in which work is team based. “In a small organization, you’re going to spend a lot of time together,” says Michael Harris, an expert in peer-to-peer interviews. “It becomes even more important for the entrepreneur to share some of the [hiring] responsibility with the other employees.”⁴² Because employees are involved in the hiring process, they feel empowered and “buy into” the hiring process, which can be good for morale and productivity. Peer interviews also allow applicants to gain insight into an organization’s culture.



ENTREPRENEURIAL PROFILE: Clint Smith and Sara McManigal: Emma When applying to Emma, an e-mail marketing business in Nashville, Tennessee, prospective employees go through an intense screening process, and peer-to-peer interviews are a critical aspect of it. “It gets the team invested in the new hire before they ever start,” says Sara McManigal, director of talent at Emma. “If staffers are able to participate in the interview and help make the decision as to whom we hire, they’re more committed to the success of that hire once they start. The early commitment aids in keeping staffers around longer, and it allows the staffers to build a great team culture.” During the early part of the interview process, all team members take part in interviewing prospective new members for their teams, but they expand the use of peer-to-peer interviewing as a last step in the interviewing process. “At the very end of the process,” explains Clint Smith, cofounder and CEO of Emma, “We tend to have something called ‘all hands.’ The candidate has already been vetted by the team and the team leader. Everybody’s feeling pretty good, so we get a hodgepodge of folks from around the company and look for that final cultural fit.” Peer-to-peer interviewing plays a fundamental role in screening prospective employees at Emma throughout the hiring process because these interviews carry as much weight as the actual hiring manager’s recommendation.⁴³

Managers should conduct training sessions with employees who participate in the interviews to make certain that they know which questions are illegal and keep their questions job related.⁴⁴ The Equal Employment Opportunity Commission does not outlaw specific interview questions; rather, it recognizes that some questions can result in employment discrimination. If a candidate files charges of discrimination against a company, the burden of proof shifts to the employer to prove that all preemployment questions were job related and nondiscriminatory. Table 21.4 offers a quiz to help entrepreneurs understand the types of questions are most likely to result in charges of discrimination.

The goal of the interview process is to find someone who is qualified to do the job well. By steering clear of questions about subjects that are peripheral to the job itself, employers are less likely to ask questions that will land them in court. Wise entrepreneurs ask their attorneys to review their bank of questions before using them in an interview. Table 21.5 describes a simple test for determining whether an interview question might be considered discriminatory.

SELLING THE CANDIDATE ON THE COMPANY “A” players want to play for “A” teams. In the final phase of the interview, when employers have an attractive candidate, they should sell the benefits of working for the company. This phase begins by allowing the candidate to ask questions about the company, the job, or other issues. Experienced interviewers note the nature of these questions and the insights they give into the candidate’s personality. This part of the interview offers employers a prime opportunity to explain to the candidate why the company is an attractive place to work. The best candidates will have other offers, and it is up to the entrepreneur to make sure they leave the interview wanting to work for the company. Finally, before closing the interview, employers should thank the candidates and tell them what happens next, such as “We will be contacting you about our decision within two weeks.”

BACKGROUND CHECKS Background checks are essential. In addition to turning up convictions for criminal activity, a background check can show whether a job candidate has been convicted of stealing from a previous employer. A check of a candidate’s driving records will show convictions for DUI and other traffic violations. This information can save an entrepreneur thousands of dollars by avoiding a bad hire at a cost of \$50 or less for a basic check. © 2014 Entrepreneur Media, Inc. All rights reserved.

TABLE 21.4 Is It Legal?

Legal	Illegal	Interview Question
<input type="checkbox"/>	<input type="checkbox"/>	1. Are you currently using illegal drugs?
<input type="checkbox"/>	<input type="checkbox"/>	2. Have you ever been arrested?
<input type="checkbox"/>	<input type="checkbox"/>	3. Do you have any children or do you plan to have children?
<input type="checkbox"/>	<input type="checkbox"/>	4. When and where were you born?
<input type="checkbox"/>	<input type="checkbox"/>	5. Is there any limit on your ability to work overtime or travel?
<input type="checkbox"/>	<input type="checkbox"/>	6. How tall are you? How much do you weigh?
<input type="checkbox"/>	<input type="checkbox"/>	7. Do you drink alcohol?
<input type="checkbox"/>	<input type="checkbox"/>	8. How much alcohol do you drink each week?
<input type="checkbox"/>	<input type="checkbox"/>	9. Would your religious beliefs interfere with your ability to do the job?
<input type="checkbox"/>	<input type="checkbox"/>	10. What contraceptive practices do you use?
<input type="checkbox"/>	<input type="checkbox"/>	11. Are you HIV positive?
<input type="checkbox"/>	<input type="checkbox"/>	12. Have you ever filed a lawsuit or worker’s compensation claim against a former employer?
<input type="checkbox"/>	<input type="checkbox"/>	13. Do you have physical/mental disabilities that would interfere with doing your job?
<input type="checkbox"/>	<input type="checkbox"/>	14. Are you a U.S. citizen?
<input type="checkbox"/>	<input type="checkbox"/>	15. What is your Facebook password?

Answers: 1. Legal. 2. Illegal. Employers cannot ask about an applicant’s arrest record, but they can ask whether a candidate has ever been convicted of a crime. 3. Illegal. Employers cannot ask questions that could lead to discrimination against a particular group (e.g., women, physically challenged, and so on). 4. Illegal. The Civil Rights Act of 1964 bans discrimination on the basis of race, color, sex, religion, or national origin. 5. Legal. Unless a person’s physical characteristics are necessary for job performance (e.g., lifting 100-pound sacks of mulch), employers cannot ask candidates such questions. 7. Legal. 8. Illegal. Notice the fine line between question 7 and question 8; this is what makes interviewing challenging. 9. Illegal. This question would violate the Civil Rights Act of 1964. 10. Illegal. What relevance would this have to an employee’s job performance? 11. Illegal. Under the Americans with Disabilities Act, which prohibits discrimination against people with disabilities, people who are HIV positive or who have AIDS are considered “disabled.” 12. Illegal. Workers who file suits are protected from retaliation by a variety of federal and state laws. 13. Illegal. This question also would violate the Americans with Disabilities Act. 14. Illegal. This question violates the Civil Rights Act of 1964. 15. Currently legal—but creepy—and creates the possibility that employers would have access to information about which they cannot legally ask, such as religion, marital status, and others, which creates a potential legal liability.

TABLE 21.5 A Guide for Interview Questions

Small business owners can use the “OUCH” test as a guide for determining whether an interview question might be considered discriminatory:

- Does the question *Omit* references to race, religion, color, sex, or national origin?
- Does the question *Unfairly* screen out a particular class of people?
- Can you *Consistently* apply the question to every applicant?
- Does the question *Have* job relatedness and business necessity?

offers an app for smart phones that gives one free basic background check a month, with each additional check costing \$9.95. “A lot of times, employers argue that a background check is too expensive,” says Zuni Corkerton, president of Hilliard, Ohio-based RefCheck Information Services Inc. “But the litigation that comes as a result of not having done their due diligence and having been negligent in their hiring process can be far greater.”⁴⁵ Brad Carlson, vice president of sales and marketing for Minneapolis-based Orange Tree Employment Screening says, “All it takes is one theft, and you can pay for a background screening.”⁴⁶ Some employers also conduct credit checks on potential employees if the position involves handling large amounts of cash or if

A background check is a basic step in avoiding charges of negligent hiring, the failure to investigate the background of a prospective employee who proves to be dangerous to customers or other employees. For example, a Nebraska delivery driver for a pizza chain attacked a woman after delivering a pizza to her home. The employee had a previous sexual-assault conviction that a simple background check would have detected, preventing a tragedy, damage to the company's reputation, and the resulting litigation. A court ordered the pizza chain to pay the victim \$175,000.⁴⁷

Checking potential employees' social networking pages such as Facebook and Twitter also can provide a revealing look at their character. A study by CareerBuilder reports that 37 percent of employers investigate job candidates' Facebook pages and that one-third have discovered something there that caused them to reject a candidate.⁴⁸ Figure 21.2 displays the most common reasons that employers do not hire an employee based on what they discovered when conducting background checks on applicants' social media pages.

EMPLOYMENT TESTS Although various state and federal laws have made using employment tests as screening devices more difficult in recent years, many companies find them quite useful. To avoid charges of discrimination, entrepreneurs must be able to prove that the employment tests they use are both valid and reliable. A **valid test** is one that measures what it is intended to measure, for example, aptitude for selling, creativity, or integrity. A **reliable test** is one that measures consistently over time. Employers must also be sure that the tests they use measure aptitudes and factors that are job related. Many testing organizations offer ready-made tests that have been proved to be both valid and reliable, and entrepreneurs can use these tests safely. In today's environment, if a test has not been validated and proved to be reliable or is not job related, it is best not to use it.

 **ENTREPRENEURIAL PROFILE: Richard Linder: PCA Skin Inc.** PCA Skin Inc., a company based in Scottsdale, Arizona, that develops clinical skin care products, recently began using personality-based employment tests, and managers say that the tests, which take only 10 minutes to administer, have helped the company improve its hiring process. "We have had 65 candidates take the test," says CEO Richard Linder. The company has hired 17 new employees, and "so far, every hire we have made using the test has resulted in a successful placement."⁴⁹

FIGURE 21.2
Why Employers Do Not Hire Based on Content of Candidates' Social Media Pages

Source: Based on www.careerbuilder.com/share/aboutus/pressreleasesdetail.aspx?id=pr691&sd=4%2F18%2F2012&ed=4%2F18%2F2099.



According to the U.S. Department of Health and Human Services, 65.7 percent of illegal drug users are employed, and those who are employed are most likely to work for small companies, which rely less on drug tests than large businesses.⁵⁰ In an attempt to avoid hiring illegal drug users, 84 percent of employers use preemployment drug tests, and 39 percent administer postemployment random drug tests.⁵¹ Although administering drug tests adds expense to the hiring process, the cost is far less than that of the potential problems that an employee with a drug habit causes. Employers who use drug tests should establish a policy and follow it consistently.

Experienced entrepreneurs do not rely on any one element in the employee selection process. They look at the total picture painted by each part of a candidate's portfolio. They know that the hiring process provides them with one of the most valuable raw materials their companies count on for success—capable, hardworking people. They also recognize that hiring an employee is not a single event but the beginning of a long-term relationship.



Entrepreneurship in Action

Building an Intentional Culture at Zappos

Tony Hsieh first joined Zappos, an online retailer of shoes, as an investor and adviser. He had recently sold the company he founded, LinkExchange, to Microsoft for \$265 million. The main reason he sold his company? It was no longer a fun place to work! Hsieh's involvement with Zappos grew, and he soon became its CEO. His top priority was from the start—and still is today—getting the culture of Zappos right.

The core of the Zappos culture is based on one word: happiness. Hsieh focuses on making his employees and his customers feel really good. Everything at Zappos focuses on sustaining a culture of happiness.

Building and sustaining the Zappos culture begins with the hiring process. A human resource manager conducts the initial interview, which is an assessment of the cultural fit of the candidate. If the person fails the cultural fit interview, he or she is not invited to meet with the hiring manager.

Every person who passes the cultural fit interview then goes through a process in which the prospective employee meets with the supervisor and team members several times. Interviewers use behaviorally based questions that assess a candidate's potential ability to fit within the culture and to exhibit the necessary skills. Every prospect is also invited to at least one company event, often a party of some sort, to allow those who are not part of the formal interviewing process to meet the candidate. For some positions, the hiring process can last for months.

Once an employee is hired, the training process is also structured to support and sustain the Zappos culture. Every new hire—from a call center employee to a senior executive—goes through the same four-week employee orientation and training program. A team trains each new employee on each of the core values that are at the heart of the Zappos culture:

- Deliver “wow” through service
- Embrace and drive change
- Create fun and a little weirdness
- Be adventurous, creative, and open-minded
- Pursue growth and learning

- Build a positive team and family spirit
- Do more with less
- Be passionate and determined
- Be humble

“At the end of that first week of training we make an offer to the entire class that we’ll pay you for the time you’ve already spent training plus a bonus of \$2,000 to quit and leave the company right now,” says Hsieh.

Zappos rarely ever has to write a check. The company often goes more than a year before a candidate takes the buyout offer and leaves. Zappos uses the “quitting bonus” to ensure that the employees it hires are engaged and committed to the company and are a good fit with its unique culture.

As CEO of Zappos, Hsieh focuses on seven key levers to ensure that once people are integrated into the company, they help play a role in sustaining the Zappos culture:

1. **Build a company, not a product.** “I’ve never been interested in shoes,” says Hsieh. “My passion has always been customer service, company culture, and community.”
2. **Motivate through inspiration.** Zappos uses its mission and culture to inspire performance. “If you can inspire employees through a higher purpose beyond profits, that you’re doing something that can help change the world,” says Hsieh, “you can accomplish so much more.”
3. **View your company as a greenhouse.** Hsieh says that his role is to build a greenhouse that allows his employees to flourish and grow.
4. **Encourage “collisions.”** At Zappos, offices are set up to encourage interactions. Hsieh's office is right in the middle of all of the other cubicles.
5. **Make company values flexible.** Zappos has its headquarters in Las Vegas, an office in China, and a warehouse in Kentucky. The core values have to be flexible enough to be effective regardless of an employee's job function or geography.

Entrepreneurship in Action (continued)

6. **Encourage employees to continuously learn.** Zappos offers employees classes, some taught by Hsieh himself, on inspirational business books and other topics that challenge every employee to grow.
7. **Offer a clear career path.** Help employees see that they can advance in the organization and understand what it takes to do so. “Set expectations on both sides,” Hsieh says.

Zappos has created a book on its culture and core values. Each year, all employees are encouraged to submit essays that reflect on what it means to work at Zappos. The book is now almost 500 pages long. Hsieh uses the book as a way to preserve the culture, to get employees thinking about the meaning of their work at Zappos, and as way to demonstrate to the outside world the essence of Zappo’s culture.

1. Why is it so important to be intentional about creating and sustaining a culture within a business venture? What does Zappos do to sustain its culture? What are some other

ways that entrepreneurs can instill and sustain a culture within their businesses?

2. List the core values that you would use to build a culture in your business. Why are each of these important to you? Where do these values come from? What steps would you take to sustain the culture in your business as it grows?

Sources: Based on Tony Hsieh, “How Zappos Infuses Culture Using Core Values,” *Harvard Business Review*, May 24, 2010, http://blogs.hbr.org/cs/2010/05/how_zappos_infuses_culture_using_core_values.html; Sam Narisi, “You Hired Them—Now Pay Them to Quit?,” *HR Recruiting Alert*, June 16, 2008, www.hrrecruitingalert.com/new-onboarding-twist-bribing-hires-to-quit; Gwen Moran, “Zappos’ Secrets to Building an Empowering Company Culture,” *Entrepreneur*, March 6, 2013, www.entrepreneur.com/article/226003; Allison Fass, “Grow Your Company as Big as Zappos.com: 7 Tips from Tony Hsieh,” *Inc.*, November 15, 2012, www.inc.com/allison-fass/tony-hsieh-zappos-growth-strategies.html; Max Chafkin, “The Zappos Way of Managing,” *Inc.*, May 1, 2009, www.inc.com/magazine/20090501/the-zappos-way-of-managing.html; Susan M. Heathfield, “20 Ways Zappos Reinforces Its Company Culture,” <http://humanresources.about.com/od/organizationalculture/a/how-zappos-reinforces-its-company-culture.htm>; Steven Rosenbaum, “The Happiness Culture: Zappos Isn’t a Company—It’s a Mission,” *Fast Company*, June 4, 2010, www.fastcompany.com/1657030/happiness-culture-zappos-isnt-company-its-mission.

Building the Right Culture and Organizational Structure

3.

Explain how to build the kind of company culture and structure to support the entrepreneur’s mission and goals and to motivate employees to achieve them.

Company culture is the distinctive, unwritten code of conduct that governs the behavior, attitudes, relationships, and style of an organization. It is the essence of “the way we do things around here.” In many entrepreneurial companies, culture plays an important role in gaining a competitive edge. Many surveys examining why entrepreneurs started their businesses have found that creating a particular culture is among the top reasons cited for launching their businesses. A company’s culture has a powerful impact on the way people work together in a business, how they do their jobs, and how they treat their customers. Company culture manifests itself in many ways—from how workers dress and act to the language they use. At some companies, the unspoken dress code requires workers to wear suits and ties, but at many high-technology companies, employees routinely show up in jeans, T-shirts, and flip-flops. In many companies, the culture creates its own language. At Disney theme parks, workers are not “employees”; they are “cast members.” They do not merely go to work; their jobs are “parts in a performance.” Customers are referred to as “guests.” When a cast member treats someone to lunch, it’s “on the mouse.” Anything negative—such as a cigarette butt on a walkway—is “a bad Mickey,” and anything positive is “a good Mickey.”

An important ingredient in a company’s culture is the performance objectives an entrepreneur sets and against which employees are measured. If entrepreneurs want integrity, respect, honesty, customer service, and other important values to be the foundation on which a positive culture can flourish, they must establish measures of success that reflect those core values. *Effective executives know that building a positive organizational culture has a direct, positive impact on the financial outcomes of an organization.* The intangible factors that make up an organization’s culture have an influence, either positive or negative, on the tangible outcomes of profitability, cash flow, return on equity, employee productivity, innovation, and cost control. An entrepreneur’s job is to create a culture that creates a positive influence on the company’s tangible outcomes. Companies that focus on creating a positive corporate culture have better financial performance than those that do not, according to the San Francisco–based Great Places to Work Institute.⁵²

Sustaining a company’s culture begins with the hiring process. Beyond the normal requirements of competitive pay and working conditions, the hiring process must focus on finding employees who share the values of the organization. “Companies are realizing that culture is as important as strategy and that they can’t just look at the short term anymore,” says Barbara Bilodeau, a manager at Boston-based Bain & Co.⁵³ Nurturing the right culture in a company enhances a company’s competitive position by improving its ability to attract and retain quality workers and by creating an environment in which workers can grow and develop. As a new

generation of employees enters the workforce, companies are discovering that more relaxed, open cultures have an edge in attracting the best workers. These companies embrace nontraditional, fun cultures that incorporate concepts such as casual dress, team-based assignments, telecommuting, flexible work schedules, free meals, company outings, and many other unique options. Modern organizational culture relies on the following principles to create a productive, fun workplace.

1. Respect for the quality of work and a balance between work life and home life. Modern companies must recognize that their employees have lives away from work. These businesses offer flexible work schedules, part-time work, job sharing, telecommuting, sabbaticals, and conveniences such as on-site day care or concierge services that handle employees' errands. Work-life balance issues are becoming more important to employees, and companies that address them have an edge when it comes to recruiting and retaining a quality workforce. "Employers realize that by offering work-life programs, they are getting a lot in return in terms of productivity and commitment to the organization," says one consultant.⁵⁴



ENTREPRENEURIAL PROFILE: Jim Goodnight: SAS Dr. Jim Goodnight, cofounder and CEO of SAS software company in Cary, North Carolina, believes that by treating its employees well, SAS benefits as a company. "Creativity is especially important to SAS because software is a product of the mind. As such, 95 percent of my assets drive out the gate every evening. It's my job to maintain a work environment that keeps those people coming back every morning. The creativity they bring to SAS is a competitive advantage for us." SAS offers its employees heavily subsidized Montessori child care, unlimited sick time, and a free health care center staffed by physicians, nutritionists, physical therapists, and psychologists. SAS employees and their families also have free access to a sports complex that includes tennis and basketball courts, a weight room, and a heated pool. Employees also benefit from free "work-life" counseling that helps them manage the stresses of everyday life.⁵⁵



Jim Goodnight, cofounder of SAS.

Source: SAS.

A sense of purpose. These companies rely on a strong sense of purpose to connect employees to the company's mission. At motorcycle legend Harley-Davidson, employees are so in tune with the company's mission that some of them have tattoos of the company's name.

Diversity. The U.S. workforce is becoming more diverse; by 2039, the majority of the workforce will consist of minorities. Companies with appealing cultures embrace cultural diversity in their workforces, actively seeking out workers with different backgrounds. They recognize that a workforce with a rich mix of cultural diversity gives their companies more talent, skills, and abilities from which to draw. Because the entire world is now a potential market for many small companies, having a workforce that looks, acts, and thinks like their customers, with all of their ethnic, racial, religious, and behavioral variety, is a strength.

Integrity. Employees want to work for a company that stands for honesty and integrity. They do not want to have to check their personal value systems at the door when they report to work. Indeed, many workers take pride in the fact they work for a company that is ethical and socially responsible. Chapter 2 discussed the issues of ethics, integrity, and social responsibility in detail.

Participative management. Modern managers recognize that employees expect a participative management style to be part of a company's culture. Today's workforce does not respond well to the autocratic management styles of the past. To maximize productivity and encourage commitment to accomplishing the company's mission, entrepreneurs must trust and empower employees at all levels of the organization to make decisions and to take the actions necessary for doing their jobs well.

Learning environment. Progressive companies encourage and support lifelong learning among their employees. They are willing to invest in their employees, improving their skills and helping them to reach their full potential. That attitude is a strong magnet for the best and brightest workers who know that, to stay at the top of their fields, they must always be learning.



ENTREPRENEURIAL PROFILE: Ara Krafian: Symmes Maini & McKee Associates Ara Krafian, president and CEO of Symmes Maini & McKee Associates (SMMA), believes in the importance of employee learning. "It's just the culture we have—it's a learning culture," says Krafian. SMMA, an architectural firm located in Cambridge, Massachusetts, brings in academics and other experts to lecture and train employees on the latest best practices. SMMA pays for employees to take courses at several universities such as Harvard and the Massachusetts Institute of Technology.

The company also has developed its own educational programs, covering current topics including sustainable design. In addition, SMMA supports a strong mentoring program that matches senior leaders with junior employees as part of its learning culture. Krafian believes that his commitment to employee learning is one of the key reasons his company has continued to be successful in the construction sector even during recessions.⁵⁶

A sense of fun. Children laugh an average of 400 times a day; however, by the time a person reaches age 35, he or she laughs on average just 15 times a day.⁵⁷ At many successful small companies, the lines between work and play are blurred, and laughter is common. The founders of these businesses see no reason for work and fun to be mutually exclusive. In fact, they believe that a workplace that creates a sense of fun makes it easier to recruit quality workers and encourages them to be more productive and more customer oriented. “Healthy and sustainable organizations focus on the fundamentals: quality, service, fiscal responsibility, leadership—but they didn’t forget to add fun to that formula,” says Leslie Yerkes, a consultant and author.⁵⁸ At Insomniac Games, in addition to testing out the newest video games, employees get breaks for massage therapy, a quick happy hour, and silly celebrations. The company also offers company-wide movie days when the company pays for everyone to go to the movie theater and even buys them all popcorn.⁵⁹

Engagement. Employees who are fully engaged in their work take pride in making valuable contributions to the organization’s success and derive personal satisfaction from doing so. Although engaged employees are a key ingredient in superior business performance, just 30 percent of employees in the United States are fully engaged in their work, and 18 percent of them actually are disengaged. Experts estimate that actively disengaged employees cost companies between \$450 and \$550 billion per year.⁶⁰ What can managers do to improve employee engagement?

- Constantly communicate the purpose and vision of the organization and why it matters.
- Challenge employees to learn and advance in their careers and give them the resources and the incentives to do so.
- Create a culture that encourages and rewards engagement.

Companies that build their cultures on these principles have an edge when it comes to attracting, retaining, and motivating workers. In other words, creating the right culture helps a small company compete more effectively.

No screening process is perfect, which is why small companies must make sure that every new hire is an appropriate fit with their culture. “Most [employee] turnover is from a lack of cultural match,” says Julie Godshall Brown, president of Godshall and Godshall Personnel Consultants.⁶¹ The partners of a Minneapolis-based engineering firm take every new prospect bowling once the candidate makes it through the first interview. The partners have tried to build a culture in which none of the employees takes himself or herself too seriously because they did not want a firm full of “uptight engineers.” If prospective employees can relax and have fun at a bowling alley, there is a good chance that they will fit into the company’s culture.

Managing Growth and a Changing Culture

As companies grow, they often experience dramatic changes in their cultures. Procedures become more formal, operations grow more widespread, jobs take on more structure, communication becomes more difficult, and the company’s personality often begins to change. As more workers come on board, employees find it more difficult to know everyone in the company and to understand how their jobs connect with others. This transition presents a new set of demands for the entrepreneur. Unless entrepreneurs work hard to maintain their companies’ unique culture, they may wake up one day to find that they have sacrificed that culture—and the competitive edge that went with it—in the name of growth. Entrepreneurs must be aware of the challenges rapid growth brings with it; otherwise, they may find their companies crumbling around them as they reach warp speed. An entrepreneur’s challenge is to walk a fine line between retaining the small company traits that are the seeds of the company’s success and incorporating the elements of infrastructure that are essential to supporting and sustaining the company’s growth.



What a Great Place to Work!

Ruby Receptionists

Ruby Receptionists is at its core an answering service, which is a business model that has been around for many years. What makes Ruby Receptionists noteworthy is that even though it operates as a simple business in a mature industry, it has been ranked among the best places to work in the country!

To help foster its culture, Ruby Receptionists focuses on benefits and perks that make it a fun place to work. Ruby employees receive funding for art classes, book clubs, and yoga sessions and are encouraged to be involved in activities outside of work. Several employees play in bands or act in local theater. Each month, one employee makes a presentation during an all-employee meeting on any topic of his or her choice.

"We have long been creating a remarkable and rewarding workplace culture," says Jill Nelson, founder and CEO. "We all come to work each day with a real passion and purpose for the work we do—and, more importantly, for the people we work with. In an era focused on technology, we're keeping real human connections alive and well."

Ruby Receptionists holds quarterly games and competitions to reward employees for creating meaningful connections within their company. The company sponsors several legendary employee parties each year. Employees work together on various community service activities that foster team building and camaraderie.

Ruby gives employees access to company-sponsored gift cards and a prepaid Amazon.com account so that they can spontaneously send clients small, thoughtful gifts. "Smile Files" are used to store compliments and handwritten thank-you cards from customers. Ruby's "Happiness Journal" program asked employees to write daily about their gratitude over a six-week period. Ruby recently launched its "Five at Five" sabbatical program, which provides five weeks of paid sabbatical after five years of employment at Ruby. (See the "Street-Smart Entrepreneur" feature later in this chapter on company sabbaticals.)

Ruby has three full-time positions dedicated to fostering the company culture—director of culture, office champion, and the "Rubyinator." In addition, Ruby retains the services of a psychologist to help keep staff positive, motivated, and happy.

"We live our core values with our employees the same way we ask our employees to live them with our clients," says Nelson. "This enables us to deliver superior customer service while fostering an empowering, positive, and enjoyable workplace for our employees."

InQuicker

InQuicker provides an online waiting room service for emergency rooms and urgent care centers. Its software enables patients to check in and wait at home based on projected treatment times. InQuicker also offers online appointment scheduling services for medical clinics.

Michael Brody-Waite, cofounder and CEO, wants to make InQuicker a cool, fun place to work. The first thing visitors see when they walk into the InQuicker office is a ping-pong table. The workspace is open, with no cubicles, to facilitate collaboration and teamwork.

InQuicker has a "culture club" that is responsible for leading activities that facilitate building a strong culture. Team members of the club have organized happy hour meetings at a local restaurant. Once a



Michael Brody-Waite, cofounder of InQuicker.

Source: InQuicker, LLC.

month, one of the employees hosts the rest of the staff for a cook-out at his or her home. Employees dress up and eat sweets for each person's birthday and for various holidays, and each year, the team spends a week together away from the office on a company retreat.

Brody-Waite offers employees flextime and flexspace and takes great care to ensure that employees keep family time and work time separate. When employees are with family and friends, they are expected *not* to answer e-mails and phone calls from work.

To ensure that the company retains its culture, Brody-Waite's founders have rejected the opportunity to grow their business more quickly and to take on outside investments.

"I need someone to tell me why we need venture capital money," says Brody-Waite. "When you take on an investor, the number one priority is selling the company so that they can get a return on investment. For us, it's about being ambitious and (saying) 'no' to things so that you have the time and space to say 'yes' to the right things. Our approach is to stay extremely simple."

1. Many entrepreneurs believe that corporate culture can be a strong competitive advantage. Do you agree? Explain.
2. Why do company cultures like the ones at Ruby Receptionists and InQuicker appeal to employees, particularly members of Generation X and Generation Y? Would you want to work for Ruby Receptionists or InQuicker? Explain.

Sources: Based on www.greatplacetowork.com/2012-best-workplaces/ruby-receptionists/; "The 25 Best Small Companies to Work For," *CNN Money*, October 25, 2012, <http://money.cnn.com/gallery/news/companies/2012/10/25/best-small-companies-fortune/index.html>; "Great Places to Work and Fortune Name Ruby Receptionists the #1 Best Place to Work in the U.S.," October 26, 2012, www.prweb.com/releases/2012/10/prweb10058588.htm; Monica Metz, "Ruby Receptionists Named #3 Best Company to Work for in Oregon," March 6, 2012, http://blog.oregonlive.com/business-watch/2012/03/ruby-receptionists-named-3_bes.html; "InQuicker, LLC," February 22, 2013, <http://eonashville.files.wordpress.com/2013/04/eo-first-2.jpg>; E. J. Boyer, "What I Learned About InQuicker in 10 Minutes," *Nashville Business Journal*, February 15, 2013, www.bizjournals.com/nashville/blog/2013/02/what-i-learned-about-inquicker-in-10.html; Annie Johnson, "Case Study: For InQuicker, Success Means Taking It Slow," *Nashville Business Journal*, July 13, 2012, www.bizjournals.com/nashville/print-edition/2012/07/13/for-inquicker-nashville.html?page=all; Zina Moukheiber, "Health Tech Startup InQuicker Shuns Venture Money and Hype," *Forbes*, August 20, 2012, www.forbes.com/sites/zinamoukheiber/2012/08/20/health-tech-start-up-inquicker-shuns-venture-money-and-hype/

Team-Based Management

As a company grows, its success may lie in the founder's willingness to shift from a top-down, single-leader structure to one that is team based. Unlike the early days of a company when the founder handled much of the work alone, he or she must accept that the magnitude and complexity of work requires delegating authority and empowering employees to make decisions. Leaders who build successful teams understand that each team member has a role to play and that every role plays a part in a bigger picture. Companies now rely more on team-based job designs as competition and complexity increase and business problems cross departmental and geographic boundaries. Even though converting from a traditional management style to a team approach requires a major change in management style, it is often easier to implement with a small number of workers.

A **self-directed work team** is a group of workers from different functional areas of a company who work together as a unit. The team operates largely without supervision, making decisions and performing tasks that once belonged only to managers. Some teams may be temporary, attacking and solving a specific problem, but many are permanent components of an organization's structure. As their name implies, these teams manage themselves, performing functions such as setting work schedules, ordering raw materials, evaluating and purchasing equipment, developing budgets, hiring and firing team members, and solving customers' problems. Teams function best in environments in which the work is interdependent and people must interact to accomplish their goals. The goal is to get people working together to serve customers better. Johnsonville Sausage, a privately owned company founded in 1945 and based in Sheboygan Falls, Wisconsin, uses a team-based structure rather than traditional departments. The company hires "members" rather than employees, and supervisors have the title of "coaches," a not-so-subtle reminder of the role that the company expects them to fill.⁶²

Managers in companies using teams are just as involved as before, but the nature of their work changes dramatically. Before teams, managers were bosses who made most of the decisions affecting their subordinates alone. They often hoarded information and power for themselves. In a team environment, managers take on the role of coaches. They empower those around them to make decisions affecting their work and share information with their workers. As facilitators, their job is to support and to serve the teams' functioning in the organization and to make sure that the teams produce results.

Companies have strong, competitive reasons for using team-based management. Businesses that use teams effectively report significant gains in quality, reductions in cycle time, lower costs, increased customer satisfaction, and improved employee motivation and morale. A team-based approach is not appropriate for every organization, however. Although teams have saved some companies from extinction, for others the team approach has failed. A team-based management system is *not* easy to start. Switching from a traditional organizational structure to a team-based one is filled with potential pitfalls. A common criticism of teams is groupthink, a concept identified by Yale psychology professor Irving Janis in his classic book *Victims of Groupthink*. Janis observed that **groupthink** sometimes leads groups to build a false sense of confidence that produces unsound decisions that team members would not have made individually.⁶³ Years later, Jerry Harvey described another danger of group decisions that he called the **Abilene paradox**, a situation in which a group makes a decision that is precisely the *opposite* of what its individual members want to do. What makes the difference? What causes teams to fail? The following errors are common in team-oriented environments:

- Assigning a team an inappropriate task, one in which the team members may lack the necessary skills to be successful (lack of training and support).
- Creating work teams but failing to provide the team with meaningful performance targets.
- Failing to deal with known underperformers and assuming that being part of a group will solve the problem—it doesn't.
- Failing to compensate the members of the team equitably.

To ensure the success of the teams approach, entrepreneurs must do the following:

- **Make sure that teams are appropriate for the company and the nature of the work.**

A good starting point is to create a "map" of the company's work flow that shows how workers build a product or deliver a service. Is the work interdependent, complex, and interactive? If so, teamwork is likely to improve the company's performance.

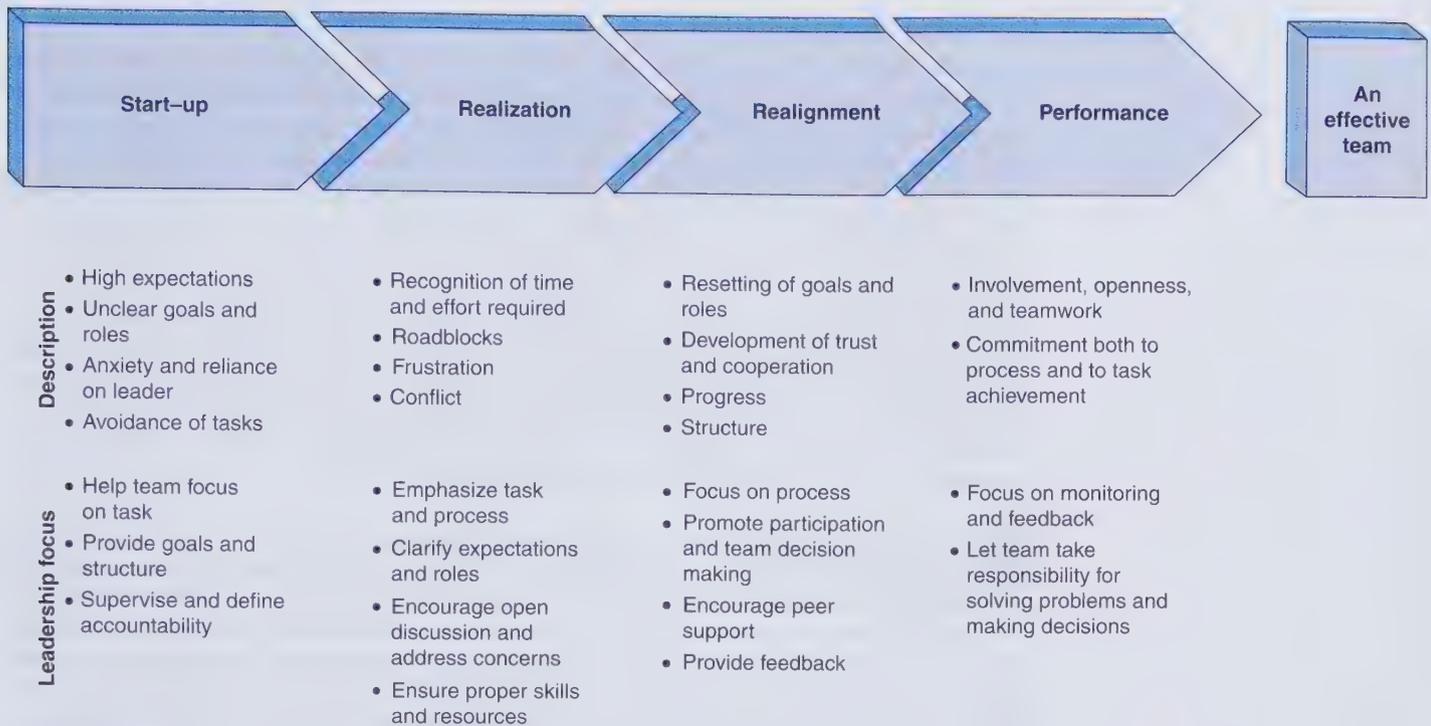


FIGURE 21.3

The Stages of Team Development

- **Form teams around the natural work flow and give them specific tasks to accomplish.** Teams can be effective only if managers challenge them to accomplish specific, measurable objectives. They need targets to shoot for.
- **Provide adequate support and training for team members and leaders.** Team success requires a new set of skills. Workers must learn how to communicate, resolve conflict, support one another, and solve problems as a team. Smart managers see that team members get the training they need.
- **Involve team members in determining how their performances will be measured, what will be measured, and when it will be measured.** Doing so gives team members a sense of ownership and pride about the tasks they are accomplishing.
- **Make at least part of team members' pay dependent on team performance.** Companies that have used teams successfully still pay members individually, but they make successful teamwork a major part of an individual's performance review.

Figure 21.3 illustrates the four stages teams go through on their way to performing effectively and reaching set goals.

Communicating Effectively

Effective communication is the lifeblood of a successful company. It reinforces the organization's vision, connects employees to the business, fosters process improvement, facilitates change, and drives business results by changing employee behavior. An important and highly visible part of entrepreneurs' role is to communicate the values, beliefs, and principles for which their businesses stand. Entrepreneurs also must help employees understand the importance of their roles and how they fit into the "big picture" of the company's success. Studies confirm that effective communication makes a difference in a company's performance. Management consulting firm Towers Watson reports that the return on investment over the last five years in companies with the most effective communications is 47 percent higher than the return for those with the least effective communications. The study also found a strong correlation between a company's communication effectiveness and its employee engagement level and retention rate.⁶⁴

4.

Understand the potential barriers to effective communication and describe how to overcome them.

Improving Communication

As a business grows, the entrepreneur's foremost job is to communicate the company's vision to everyone in the company and to empower employees to accomplish the vision within the framework of the company's culture. Much of what leaders in any organization do involves communication; indeed, leaders spend about 80 percent of their time participating in some form of communication. To some managers, communicating means only one thing: sending messages to others. Although talking to people both inside and outside the organization is an important part of an entrepreneur's job, so is encouraging communication throughout the company at all levels and across all functional areas. "Communicators are evolving from crafting the content [of the message] to facilitating the discussion," says Sharon McIntosh, director of global communications at Pepsico.⁶⁵ As more small businesses embrace the virtual office as a means of bootstrapping overhead costs, communication can become an even greater challenge. However, with the wide array of communication tools, including Skype, FaceTime, texting, e-mail, meeting software platforms, and conference calling, it is possible to build an effective system for communication even when workers do not share a common office space.



ENTREPRENEURIAL PROFILE: Andy Miller: CardStar Andy Miller, CEO of CardStar, has embraced technology as a means to keep workers in his smart phone application company connected. CardStar employees are located in three different cities, and most work from home. All of the company's employees are equipped with laptops, smart phones, and USB modems so that they can stay connected with each other anywhere and at any time. Texting and e-mail are the basic tools for quick communication, just as they can be in any organization. Video meetings using Skype substitute for face-to-face meetings. "When I was in corporate America," says Miller, "I realized that it was highly inefficient. There were so many meetings you didn't have to be at but were required anyway. You end up working harder and doing less."⁶⁶

COMMUNICATING EFFECTIVELY One of the most frustrating experiences for entrepreneurs occurs when they ask an employee to do something and nothing happens. Although entrepreneurs are quick to perceive the failure to respond as the employee's lack of motivation or weak work ethic, often the culprit is improper communication. The primary reasons employees usually don't do what they are expected to do have little to do with their motivation and desire to work. Instead, workers often fail to do what they need to do because of the following:

- They don't know what to do.
- They don't know how to do it.
- They don't have the authority to do it.
- They get no feedback on how well or how poorly they are doing it.
- They are either ignored or punished for doing it right.
- They realize that no one ever notices even if they *are* doing it right.

The common thread running through all of these causes is poor communication between the entrepreneur and employee. What barriers to effective communication must entrepreneurs overcome?

- **Managers and employees don't always feel free to say what they really mean.** CEOs and top managers in companies of any size seldom hear the truth about problems and negative results from employees. This less-than-honest feedback results from the hesitancy of subordinates to tell "the boss" bad news. Over time, this tendency paralyzes the upward communication in a company.
- **Ambiguity blocks real communication.** The same words can have different meanings to different people, especially in modern companies, where the workforce is likely to be highly diverse. For instance, an entrepreneur may tell an employee to "take care of this customer's problem as soon as you can." The owner may have meant "solve this problem by the end of the day," but the employee may think that fixing the problem by the end of the week will meet the owner's request.
- **Information overload causes the message to get lost.** With information from text messages, telephone, e-mail, Skype, social media, face-to-face conversations, and other sources, employees in modern organizations are literally bombarded with messages. With

such a large volume of information washing over workers, it is easy for some messages to get lost.

- **Selective listening interferes with the communication process.** Sometimes people hear only what they want to hear, selectively tuning in and out on a speaker's message. The result is distorted communication.
- **Defense mechanisms block a message.** When people are confronted with information that upsets them or conflicts with their perceptions, they immediately put up defenses. Defense mechanisms range from verbally attacking the source of the message to twisting perceptions of reality to maintain self-esteem.
- **Conflicting verbal and nonverbal messages confuse listeners.** Nonverbal communication includes a speaker's mannerisms, gestures, posture, facial expressions, and other forms of body language. When a speaker sends conflicting verbal and nonverbal messages, research shows that listeners will believe the nonverbal message almost every time.

How can entrepreneurs overcome these barriers to become better communicators? The following tips will help:

- **Clarify your message before you attempt to communicate it.** Identify exactly what you want the receiver to think and do as a result of the message and focus on getting that point across clearly and concisely.
- **Use face-to-face communication whenever possible.** Although not always practical, face-to-face communication reduces the likelihood of misunderstandings because it allows for immediate feedback and nonverbal clues. Even in a virtual organization, face-to-face meetings can be held using Skype, FaceTime, or Web-based conferencing platforms, such as *Gotomeeting.com*.
- **Be empathetic.** Put yourself in the place of those who will receive your message and develop it accordingly.
- **Match your message to your audience.** An entrepreneur would be very unlikely to use the same words, techniques, and style to communicate his or her company's financial position to a group of industry analysts as he or she would to a group of workers on the factory floor.
- **Be organized.** Effective communicators organize their messages so that their audiences can understand them easily.
- **Encourage feedback.** Good leaders actively seek honest feedback from as many employees as possible. At computer chip maker Intel, managers routinely hold "skip-level meetings," in which managers meet with employees who are two levels down the organization. "It's a powerful tool for getting information," says Patricia Murray, the company's director of human resources.⁶⁷
- **Get out of the office and talk to employees.** Some of the most meaningful conversations managers have take place when they leave their offices to "wander" through the workplace. Management author Tom Peters calls it "MBWA, management by wandering around."
- **Tell the truth.** The fastest way to destroy your credibility as a leader is to lie.
- **Don't be afraid to tell employees about the business, its performance, and the forces that affect it.** Too often, entrepreneurs assume that employees don't care about such details. Employees *are* interested in the business that employs them and want to understand where it is headed and how it plans to get there.

Listening

When one thinks about communication, listening typically does not come to mind, yet listening is an essential part of the communication process. Entrepreneurs must listen to what employees on the front line are learning about customers' needs and demands. "The key to success and growth is getting employees to tell you what's really going on," says Vineet Nayar, CEO of HCL Technologies and author of *Employees First, Customers Second*.⁶⁸ The employees who serve customers are the *real* experts in the company's day-to-day activities. They are in closer contact with potential problems and opportunities at the operating level than anyone else in the company, including managers. Entrepreneurs and their managers who take the time to listen to employees who are in direct contact with customers can prevent many potential problems. In addition, by

encouraging employees to develop creative solutions to problems and innovative ideas for capitalizing on opportunities and then listening to and acting on them, entrepreneurs can make their companies more successful.



ENTREPRENEURIAL PROFILE: Scott Moorehead: The Cellular Connection

Scott Moorehead, CEO of The Cellular Connection, has developed a creative way to ensure that he is able to listen to the employees who work in his more than 800 stores that sell Verizon products. “I was sitting in front of my computer, trying to come up with something I could tell all these smart people in my company that would help them do their jobs better,” says Moorehead, “and I realized that what I really should be doing is asking them what I should do.” He sent out an e-mail to all of his regional managers asking them one simple question: If today you became the CEO, what would you do to make the company better? “Overall I loved the feedback,” says Moorehead, “but, it was also depressing because a number of people said, ‘I would do whatever I could to bring back the family atmosphere we used to have in the company.’ Those responses made me feel like such a fraud. Every day I was talking about how our business is a family and about really knowing our employees . . . and that’s not how employees in the field felt.” By listening to his employees, Moorehead made the decision to stop focusing on growing his company and instead to spend more time making the business run better and ensuring that the culture is what he had intended it to be within The Cellular Connection.⁶⁹

Improvements such as these depend on entrepreneurs’ ability to listen. To improve listening skills, entrepreneurs can use the PDCH formula: identify the speaker’s *purpose*, recognize the *details* that support that purpose, see the *conclusions* they can draw from what the speaker is saying, and identify the *hidden* meanings communicated by body language and voice inflections.

The Informal Communication Network: The “Grapevine”

Despite all of the modern communication tools available, the grapevine, the informal lines of communication that exist in every company, remains an important link in a company’s communication network. The grapevine carries vital information—and sometimes rumors—through every part of the organization with incredible speed. The grapevine kicks into overdrive when the information in a company’s formal communication network is scarce. It is not unusual for employees to hear about important changes in an organization by the grapevine well before official communication channels transmit the news. Research shows that up to 70 percent of all organizational communication comes by way of the grapevine, yet many managers are not aware of the efficiency with which this informal communication channel operates.⁷⁰ Text, social media, and e-mail increase the speed at which the grapevine transmits informal communications, all under the radar of management.

Knowing that employees are connected through the grapevine allows entrepreneurs to send out ideas to obtain reactions without making a formal announcement. When management is in the loop, the grapevine can be an excellent source of informal feedback. Smart small business owners recognize the grapevine’s existence and use it as a communication tool to both send and receive meaningful information.

The Challenge of Motivating Workers

5.

Discuss the ways in which entrepreneurs can motivate their employees to achieve higher levels of performance.

Motivation is the degree of effort an employee exerts to accomplish a task; it shows up as excitement about work. Motivating workers to higher levels of performance is one of the most difficult and challenging tasks facing a small business manager. Few things are more frustrating to an entrepreneur than an employee with a tremendous amount of talent who lacks the desire to use it. This section discusses four aspects of motivation: empowerment, job design, rewards and compensation, and feedback.

Empowerment

One motivating principle is empowerment. **Empowerment** involves giving workers at every level of the organization the authority, the freedom, and the responsibility to control their own work, to make decisions, and to take action to meet the company’s objectives. Research indicates that employees experience increased initiative and motivation when they are empowered. Empowerment affects their self-confidence and the level of responsibility they will accept.

setbacks. Empowered employees take responsibility for making decisions and following them through to completion. “The credit for Virgin’s enduring and varied success is often attributed to me,” says Richard Branson, successful entrepreneur and founder of Virgin Group. “But it’s actually due to the people who piloted those businesses. My decision to give them autonomy and encourage them to take risks has allowed us to grow while keeping costs down.”⁷¹ Empowerment complements the team-based management style discussed earlier.

Empowerment builds on what real business leaders already know: that the people in their organizations bring with them to work an amazing array of talents, skills, knowledge, and abilities. Workers are willing—even anxious—to put these to use; unfortunately, in too many businesses, suffocating management styles and poorly designed jobs quash workers’ enthusiasm and motivation. Enlightened entrepreneurs recognize their workers’ abilities, develop them, and then give workers the freedom and the power to use them. Entrepreneurs who share information, responsibility, authority, and power soon discover that their success (and their companies’ success) is magnified many times over.

When implemented properly, empowerment can produce impressive results not only for the business but also for newly empowered employees. For the business, benefits typically include significant productivity gains, quality improvement, more satisfied customers, improved morale, and increased employee motivation. For workers, empowerment offers the chance to do a greater variety of work that is interesting and challenging. Empowerment challenges workers to make the most of their creativity, imagination, knowledge, and skills.

Not every worker *wants* to be empowered, however. Some will resist, wanting only to “put in their eight hours and go home.” Companies that move to an empowerment philosophy will lose about 5 percent of their workforce because they simply are unwilling or are unable to make the change. Another 75 percent of the typical workforce will accept empowerment and thrive under it, and the remaining 20 percent will pounce on it eagerly because they want to contribute their talents and their ideas.

Empowerment works best when entrepreneurs do the following:

- **Are confident enough to give workers all the authority and responsibility they can handle.** Initially, this may involve giving workers the power to tackle relatively simple assignments. As their confidence and ability grow, most workers are eager to take on additional responsibility.
- **Play the role of coach and facilitator.** Smart owners empower their workers and then get out of the way so that they can do their jobs.
- **Recognize that empowered employees will make mistakes.** The worst thing an owner can do when empowered employees make mistakes is to hunt them down and punish them. That teaches everyone in the company to avoid taking risks and to always play it safe—something that no innovative small business can afford.
- **Hire people who can blossom in an empowered environment.** Empowerment is not for everyone. Owners quickly learn that as costly as hiring mistakes are, such errors are even more costly in an empowered environment. Ideal candidates are high-energy self-starters who enjoy the opportunity to grow and enhance their skills.
- **Train workers continuously to upgrade their skills.** Empowerment demands more of workers than traditional work methods. Managers are asking workers to solve problems and make decisions they have never made before. To handle these problems well, workers need training, especially in effective problem-solving techniques, communication, teamwork, and technical skills.
- **Trust workers to do their jobs.** Once workers are trained to do their jobs, owners must learn to trust them to assume responsibility for their jobs. After all, they are the real experts; they face the problems and challenges every day.
- **Listen to workers when they have ideas, solutions, or suggestions.** Because they are the experts on the job, employees often come up with incredibly insightful, innovative ideas for improving them—if entrepreneurs give them the chance. Surveying employees, for example, can become a critical part of companies’ efforts to bolster employees’ commitment to their jobs, a concept called **employee engagement**. Engaged workers are more willing to help solve problems, take initiative, promote the company outside

of work, and offer ideas for improving the company. Failing to acknowledge or act on employees' ideas sends them a clear message: Your ideas really don't count.

- **Recognize workers' contributions.** One of the most important tasks an entrepreneur can perform is to recognize positive employee performance. In *The Carrot Principle*, authors Adrian Gostick and Chester Elton say that recognition must be frequent, specific and timely, and, of course, deserved.⁷² Some businesses reward workers with monetary awards, others rely on recognition and praise, and still others use a combination of money and praise. Whatever system an owner chooses, the key to keeping a steady flow of ideas, improvements, suggestions, and solutions is to recognize the people who supply them.



ENTREPRENEURIAL PROFILE: Don Zietlow: Kwik Trip Don Zietlow, owner and CEO of the \$2.6 billion Kwik Trip convenience store chain, is intentional about building a culture based on sharing and recognizing the results that employees produce. Zietlow returns nearly half of the company's profits to employees, gives them equity ownership in the company's real estate, and provides generous wages and health care benefits. However, a company survey revealed that employees wanted more recognition for their efforts, so Kwik Trip implemented a program that formally recognizes workers at four months, one year, three years, and five years of service. "Recognizing people fosters respect and a sense of ownership," says Zietlow. "I get a lot of thank-you notes from new employees who are surprised by recognition they've witnessed or received. It makes them want to stay." Since the inception of the employee recognition program, Kwik Trip has reduced its turnover rate by 15 percent and achieved one of the lowest turnover figures in the industry.⁷³

- **Share information with workers.** For empowerment to succeed, entrepreneurs must make sure workers get adequate information, the raw material for good decision making. Some companies have gone beyond sharing information to embrace **open-book management**, in which employees have access to *all* of a company's records, including its financial statements. The goal of open-book management is to enable employees to understand why they need to raise productivity, improve quality, cut costs, and improve customer service. Under open-book management, employees do the following:
 - Review and learn to understand the company's financial statements and other critical numbers in measuring its performance.
 - Learn that a significant part of their jobs is making sure that those critical numbers move in the right direction.
 - Have a direct stake in the company's success through profit sharing, equity-like compensation such as employee stock ownership plans, or performance-based bonuses.

Job Design

A recent survey by the Conference Board shows that only 47 percent of employees are satisfied with their jobs, a significant decrease from 61 percent in 1987. About the same percentage find their work interesting.⁷⁴ Managers have learned that the job itself and the way it is designed can make it more interesting and can be a source of satisfaction and motivation for workers. During the industrial age, work was organized on the principle of **job simplification**, which involves breaking the work down into its simplest form and standardizing each task. Assembly-line operations are based on job simplification. The scope of workers' jobs is extremely narrow, resulting in impersonal, monotonous, and boring work that creates little challenge or motivation for workers. The result is apathetic, unmotivated workers who care little about quality, customers, or costs.

To break this destructive cycle, some companies have redesigned workers' jobs. The following strategies are common: job enlargement, job rotation, job enrichment, flextime, job sharing, and flexplace.

Job enlargement (or **horizontal job loading**) adds more tasks to a job to broaden its scope. For instance, rather than an employee simply mounting four screws in computers coming down an assembly line, a worker might assemble, install, and test the entire motherboard (perhaps as part of a team). The idea is to make the job more varied and to allow employees to perform a more complete unit of work.

Job rotation involves cross training employees so that they can move from one job in the company to others, giving them a greater number and variety of tasks to perform. As employees learn other jobs within an organization, both their skills and their understanding of the company's

purpose and processes rise. Cross-trained workers are more valuable because they give a company the flexibility to shift workers from low-demand jobs to those where they are most needed. As an incentive for workers to learn to perform other jobs within an operation, some companies offer skill-based pay, a system under which the more skills workers acquire, the more they earn.

Job enrichment (or **vertical job loading**) involves building motivators into a job by increasing the planning, decision making, organizing, and controlling functions—traditionally managerial tasks—that workers perform. The idea is to make every employee a manager or at least a manager of his or her own job.

To enrich employees' jobs, a business owner must build five core characteristics into them:

- *Skill variety* is the degree to which a job requires a variety of different skills, talents, and activities from the worker. Does the job require the worker to perform a variety of tasks that demand a variety of skills and abilities, or does it force him or her to perform the same task repeatedly?
- *Task identity* is the degree to which a job allows the worker to complete a whole or identifiable piece of work. Does the employee build an entire piece of furniture (perhaps as part of a team), or does he or she merely attach four screws?
- *Task significance* is the degree to which a job substantially influences the lives or work of others—employees or final customers. Does the employee get to deal with customers, either internal or external? One effective way to establish task significance is to put employees in touch with customers so that they can see how customers use the product or service they make.
- *Autonomy* is the degree to which a job gives a worker the freedom, independence, and discretion in planning and performing tasks. Does the employee make decisions affecting his or her work, or must he or she rely on someone else (the owner, a manager, or a supervisor) to “call the shots?”
- *Feedback* is the degree to which a job gives the worker direct, timely information about the quality of his performance. Does the job give employees feedback about the quality of their work, or does the product (and all information about it) simply disappear after it leaves the worker's station?

A study conducted by researchers at the University of New Hampshire and the Bureau of Labor Statistics concludes that employees of companies that use job enrichment principles are more satisfied than those who work in jobs designed using principles of simplification.⁷⁵

Flextime is an arrangement under which employees work a normal number of hours but have flexibility about when they start and stop work. Several recent studies suggest that employees show improved mental and physical health when they work in a company that offers flextime. Most flextime arrangements require employees to build their work schedules around a set of “core hours,” such as 10 A.M. to 2 P.M., but give them the freedom to set their schedules outside of those core hours. For instance, one worker might choose to come in at 7 A.M. and leave at 3 P.M. to attend her son's soccer game, and another may work from 11 A.M. to 7 P.M. Flextime not only raises worker morale but also makes it easier for companies to attract high-quality young workers who want rewarding careers without sacrificing their lifestyles. In addition, companies using flextime schedules experience higher levels of employee engagement and lower levels of tardiness, turnover, and absenteeism.

 **ENTREPRENEURIAL PROFILE: Sara Sutton Fell: FlexJobs** Sara Sutton Fell, CEO and founder of FlexJobs, a job-listings Web site based in San Francisco, allows employees to work out of their homes from cities across the United States and Europe. FlexJobs employees work the same kind of flextime schedule as the clients they serve: FlexJobs employees set their own schedules. However, they still have an “up-front understanding of the range of hours they should be working each week,” says Fell. “They track their own hours, account for the work they do, and clock in and out as needed.”⁷⁶

Flextime is becoming an increasingly popular job design strategy. A recent survey by the Families and Work Institute reports that 77 percent of the nation's workers have flexible schedules, up from 66 percent in 2005.⁷⁷ The number of companies using flextime is likely to continue to grow. This is because recruiting capable, qualified full-time workers more difficult and less



Sara Sutton Fell, founder of FlexJobs.

technology makes working from a dedicated office space less important. Research shows that when considering job offers, candidates, particularly members of Generation Y, weigh heavily the flexibility of the work schedule that companies offer.

Job sharing is a work arrangement in which two or more people share a single full-time job. For instance, two college students might share the same 40-hour-a-week job, one working mornings and the other working afternoons. Salary and benefits are prorated between the workers sharing a job. Because job sharing is a simple solution to the growing challenge of life–work balance, it is becoming more popular. Companies already using it are finding it easier to recruit and retain qualified workers. “Employers get the combined strengths of two people, but they only have to pay for one,” says one hotel sales manager, herself a job sharer.⁷⁸

Flexplace is a work arrangement in which employees work at a place other than a traditional office, such as a satellite branch closer to their homes or, in many cases, at home. Flexplace is an easy job design strategy for companies to use because of **telecommuting**. Using modern communication technology such as iPads, smart phones, texting, e-mail, and laptop computers, employees have more flexibility in choosing where they work. Today, it is simple for workers to connect electronically to their workplaces (and to all of the people and the information there) from practically anywhere on the planet.



ENTREPRENEURIAL PROFILE: Ben Kirshner: Elite SEM Ben Kirshner, CEO of Elite SEM, a search-engine marketing firm headquartered in New York, has been allowing his staff to work remotely whenever they choose for six years. “It gives my employees the feeling of being entrepreneurs, which will make them more loyal and dedicated,” Kirshner says. Kirshner believes that small businesses are the best equipped and have the most to gain by offering flexplace work arrangements. Small businesses usually are more flexible than large companies, and small businesses are always looking for ways to bootstrap overhead costs. Flexplace work reduces the number of offices required in the company’s headquarters because not all the employees will be there at any one time. Elite SEM has been rated one of the best companies to work for, with many employees citing the flexibility given to them for work schedules and locations.⁷⁹

Before implementing telecommuting, entrepreneurs must address the following important issues:

- Does the nature of the work fit telecommuting? Obviously, some jobs are better suited for telecommuting than others.
- Have you selected the right employees for telecommuting? Telecommuting is not suitable for every job or for every worker. Experienced managers say that employees who handle it best are experienced workers who know their jobs well, are self-disciplined, and are good communicators.
- Can you monitor compliance with federal wage and hour laws for telecommuters? Generally, employers must keep the same employment records for telecommuters that they do for traditional office workers.
- Have you provided the necessary computer, communications, and ergonomically designed office equipment for employees to work offsite? Trying to “make do” with substandard equipment creates problems and frustration and undermines any telecommuting effort from the outset.
- Are you adequately insured? Employers should be sure that the telecommuting equipment that employees use in their homes is covered under their insurance policies.
- Can you keep in touch? Telecommuting works well as long as long-distance employees stay in touch with headquarters.
- Have you created an equitable telecommuting policy that defines under what conditions telecommuting is acceptable? One danger of telecommuting is that it can create resentment among employees who remain office bound.

Rewards and Compensation

The rewards an employee receives from the job itself are intrinsic, but managers use a wide variety of extrinsic rewards to motivate workers at their desks. The rewards used by managers

motivate involves tailoring the reward system to the needs and characteristics of the workers. Effective reward systems tap into the values and issues that are important to people. Smart entrepreneurs take the time to learn what makes their employees “tick” and then build their reward system around those motivational factors. For instance, a technician making \$30,000 a year may consider a chance to earn a \$5,000 bonus to be a powerful motivator; an executive earning \$200,000 a year may not.

Research by Globoforce, a Boston-based company that specializes in rewards and incentives, shows that small, frequent awards are more effective than periodic cash bonuses, which is good news for small companies that cannot always afford financial rewards. The study suggests that 80 to 90 percent of a company’s employees should get some type of reward every year and that every week a company should be giving rewards to 5 percent of its employees (a concept known as continuous reinforcement). “Small awards all the time are a way to constantly touch people,” he says. Jennifer Lepird, who works in the human resources department at software developer Intuit, recently spent several weeks and many long days integrating into Intuit’s salary structure the employees at a company that Intuit had purchased. Her manager sent her a congratulatory e-mail thanking her for her quality work and a gift certificate worth \$200. Lepird was thrilled. “The fact that somebody took the time to recognize the effort made the long hours just melt away,” she says.⁸⁰

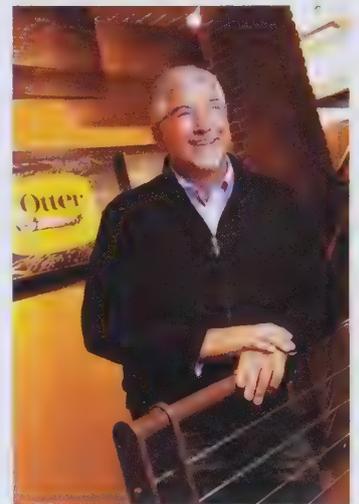
One of the most popular rewards is money. Cash is an effective motivator—up to a point; its effects tend to be short-term. Many companies have moved to **pay-for-performance compensation systems**, in which employees’ pay depends on how well they perform their jobs. In other words, extra productivity equals extra pay. By linking employees’ compensation directly to the company’s financial performance, an entrepreneur increases the likelihood that workers will achieve performance targets that are in their best interest and in the company’s best interest. A common application of the pay-for-performance concept is a **profit-sharing system** in which a company shares a portion of its profit with the employees who work to produce it.



ENTREPRENEURIAL PROFILE: Curt Richardson: OtterBox OtterBox, a Fort Collins, Colorado, company that designs and manufactures rugged cases to protect smart phones and other mobile devices, has a profit-sharing program that pays out bonuses during monthly company meetings to every employee, including part-time employees and interns. “We have a hybrid program that’s similar to profit sharing,” says Curt Richardson, company founder and CEO. “This discretionary cash bonus is available on a monthly basis and is based largely on the financial performance of the company. The elements that contribute to higher or lower bonuses are highlighted each month. This represents a better way to engage employees. They understand the business and the personal impact they have within the organization.” Employees pay attention to how their actions impact expenses and how these expenses in turn impact profitability. It has become a part of the culture at OtterBox.⁸¹

Pay-for-performance systems work only when employees see a clear correlation between their performance and their pay. This offers an advantage for small companies when the employees can see clearly the impact that their performance has on the company’s profitability and ultimate success compared to their counterparts at large corporations. To be successful, however, pay-for-performance systems should meet the following criteria:

- **Performance based.** Employees’ incentive pay must be clearly and closely linked to their performances.
- **Relevant.** Entrepreneurs must set up the system so that employees see the connection between what they do every day on the job—selling to customers, producing a product, or anything else—and the rewards they receive under the system.
- **Simple.** The system must be simple enough so that employees understand and trust it. Complex systems that employees have difficulty understanding will not produce the desired results.
- **Equitable.** Employees must consider the system fair.
- **Inclusive.** The system should be inclusive. Entrepreneurs are finding creative ways to reward all employees no matter what their jobs might be.



Curt Richardson, founder of OtterBox.

Source: Otter Products LLC.

- **Timely.** The company should make timely payouts to employees. A single annual payout is ineffective—employees have long since forgotten what they did to earn the incentive pay. The closer a reward payment is to the action that prompted it, the more effective it will be.

Money is not the only motivator entrepreneurs have at their disposal. Nonfinancial incentives can be more important sources of employee motivation. With a little creativity, small businesses can provide meaningful rewards that motivate employees without breaking the bank. Often the most meaningful motivating factors are the simplest—and least costly—ones, such as praise, recognition, respect, feedback, job security, and promotions. When an employee has done an exceptional job, an entrepreneur should be the first to recognize that accomplishment and to say “thank you.” Praise is a simple and powerful motivational tool. “Praise is the most powerful driver of performance known to mankind,” says Bob Nelson, a workplace consultant.⁸² People enjoy getting praise and recognition; it is just human nature. As Mark Twain once said, “I can live for two months on a good compliment.”



ENTREPRENEURIAL PROFILE: Jay Love: Slingshot SEO Slingshot SEO, an Indianapolis, Indiana, Web marketing consulting firm, established a program for employees to recognize the efforts of their colleagues. “Each month, I solicit open nominations for Slingshot SEO’s Outstanding Team Member of the Month,” says Jay Love, the company’s CEO. “Each employee with at least 60 seconds to spare can e-mail me with their recommendations. Although just two are publicly honored at each monthly meeting, many others are encouraged by this program: I always forward the e-mails of the remarkable kudos to all the nominees along with a few comments of my own.”⁸³

One sure way to kill high performance is failing to recognize the performance and the employees responsible for it. Failing to praise good work eventually conveys the message that the owner either doesn’t care about exceptional performance or cannot distinguish between good work and poor work. In either case, through inaction, the manager destroys employees’ motivation to excel.

Rewards do *not* have to be expensive to be effective, but they should be creative and should have a direct link to employee performance. Consider how the following rewards for exceptional performance both recognize the employee’s contribution and build a positive organizational culture:

- Frima Studio, a video game development company, recognizes creative ideas from employees with “Frima Points,” which contributors can trade in for payment for babysitters, home repair services, and other things that enhance work–family balance—a core value for Frima Studio.⁸⁴
- Beryl, a call-center company based in Texas, throws a pizza party when the company meets its monthly goals.⁸⁵
- The AAA Fair Credit Foundation in Salt Lake City, Utah, involves all of its employees in rewarding excellent performance. Employees recognize the extra efforts and special accomplishments of their coworkers by recommending them for “Dollar Days.” When an employee earns eight Dollar Days, he or she cashes them in for a day off.⁸⁶

Whatever system of rewards they use, entrepreneurs will be most successful if they match rewards to employees’ interests and tastes. For instance, the ideal reward for one employee might be tickets to a sports event; to another, it might be tickets to a theatrical performance. The better entrepreneurs know their employees’ interests and tastes, the more effective they will be at matching rewards with performance.

As Generation Y enters the workforce, entrepreneurs will rely more on nonmonetary rewards—praise, recognition, letters of commendation, and others—to create a work environment that fits what this generation values. Under this system, employees enjoy what they do and find their work challenging, exciting, and rewarding. The benefit to the company is that these employees are more likely to act like owners of the business themselves. The goal of nonmonetary rewards is to let employees know that every person is important and that the company notices, appreciates, and recognizes excellent performance.



Sabbaticals

A benefit that both large companies and small businesses have begun to offer their employees is one that used to be found only in academia—paid sabbaticals. Sabbaticals offer an extended break from work that is beyond the traditional family or sick leave. Sabbaticals are considered a time to get away to recharge, to study, or to do something different than the traditional duties of a job. One study found that 16 percent of large corporations offer paid sabbaticals to employees. The study also found that 11 percent of small companies and 19 percent of medium enterprises offer sabbaticals, although most of these businesses offer them only as unpaid leave.

Sabbaticals can help in the recruiting process. Sabbatical leave programs are a good tool to prevent employee burnout, reduce turnover, and improve health. They also lead to greater creativity and productivity when employees return and enable employees to expand their skills and knowledge and to cross train employees who fill in during the leave.

Red Frog Events, a company that offers unusual sporting and entertainment events such as obstacle courses, citywide scavenger hunts, and bar crawls, offers its 80 employees paid sabbaticals. Every five years, Red Frog employees and a guest of their choice get a fully paid one-month trip to the destination of their choice. However, the trip cannot be to a location in North America or Australia, where the company does most of its business.

"This isn't a cocktail-umbrella-on-the-beach sort of trip," says Red Frog founder and CEO Joe Reynolds. "It's a push-yourself-outside-of-your-comfort-zone, culture-drenched, that-just-changed-my-life trip. Those trips bring home game-changing ideas. Those are sabbaticals."

Reynolds believes that the benefits from sabbaticals for the company and its employees are well worth the costs. He finds that employees return recharged and ready to work, in a much more creative frame of mind, and with a stronger worldly perspective. He also thinks that because he expects high performance and long hours when they are at work, time to connect with a loved one is important. His employees show great appreciation for the opportunity to travel with a loved one to a new and exciting location.

There are several important considerations before a small business implements a sabbatical program for its employees:

- **Can we afford it?** Even an unpaid sabbatical has a cost associated with it because a company may have to hire temporary help or ask other employees to cover the slack when an employee goes on leave.
- **Should the sabbatical be paid or unpaid?** If the sabbatical is unpaid, the employee actually may be eligible for unemployment insurance in some states. In addition, will the company extend benefits to employees while they are on an unpaid sabbatical? If not, they may be eligible for COBRA health insurance.
- **Do our jobs fit with a sabbatical program?** Some companies may not have a work flow or jobs that are easily covered if employees take a sabbatical leave, especially in a smaller firm where one person may be the sole expert in a key area of responsibility. "A person on sabbatical can be hard to replace, so you'll have to find workarounds that

will prevent an employee from working too hard in the months leading up to the sabbatical and their coworkers from doing much more work to compensate for the loss," says Lance Haun, a human resource specialist and author.

- **Who will be eligible for sabbatical leaves?** At Ruby Receptionists, all employees are eligible after five years of work to apply for a five-week paid sabbatical. REI offers employees paid sabbatical leaves after 15 years of service. They get four weeks off in addition to their earned vacation time for that year. At every five-year anniversary thereafter, employees earn another sabbatical with one additional week added to the sabbatical each time.
- **What happens if the employee does not return?** Does the employee have to come back to work for a specified time? If not, what are the consequences? It can be difficult to enforce any monetary penalty on a worker who quits at the end of a sabbatical.
- **What are the expectations of the employee while on sabbatical?** Some companies view a sabbatical as purely time to rest. Others require that the employee write a white paper discussing what they did on sabbatical and how it benefited them personally and professionally.

Although a small business can offer sabbaticals on a case-by-case basis, it is advisable to implement a formal policy if sabbaticals are going to become a regular occurrence in the company. The policy should address the following questions:

- How often is an employee eligible?
 - Is there a limit as to how many sabbaticals can be granted at any given time?
 - How long will the sabbatical leave be?
 - What are the expectations while on sabbatical and when the employee returns?
 - What guarantees are there, if any, regarding position and pay on return?
 - What are the consequences for failing to return to work?
 - Will sabbatical time count toward seniority and pay increases?
 - Are employees going to be paid during the sabbatical?
 - Will standard employee benefits be extended during the sabbatical?
1. Do you think that sabbaticals are a good benefit for small businesses to offer employees? Explain.
 2. If you were to offer a sabbatical program in your company, what would you set as the rules for this program? Explain.
 3. Joe Reynolds believes that every employee deserves a sabbatical. Do you agree? Explain.

Sources: Based on www.lifemeetswork.com/knowledge-center/work-redesign/ways-to-flex/corporate-sabbatical-how-to; Alexandra Levit, "Should Companies Offer Sabbaticals?," *CNN Money*, January 3, 2011, <http://management.fortune.cnn.com/2011/01/03/should-companies-offer-sabbaticals/>; Elizabeth Wilson, "Voluntary Benefits 101," *Entrepreneur*, March 31, 2009, www.entrepreneur.com/article/201000; "Pay and Benefits," REI, www.rei.com/jobs/pay-benefits.html; Joe Reynolds, "All Employees Deserve Paid Sabbaticals," *Inc.*, February 15, 2012, www.inc.com/joe-reynolds/let-your-employees-unplug-and-take-sabbaticals.html.

Performance Feedback

Entrepreneurs not only must motivate employees to excel in their jobs but also focus employees' efforts on the right business targets. Providing feedback on progress toward those targets can be a powerful motivating force in a company. To strengthen the link between the entrepreneur's vision for the company and its operations, he or she must build a series of specific performance measures that serve as periodic monitoring points. For each critical element of the organization's performance—quality, financial performance, market position, productivity, and employee development—he or she should develop specific measures that connect daily operational responsibilities with the company's overall strategic direction. These measures establish the benchmarks for measuring employees' performance and the company's progress. The adage "what gets measured and monitored gets done" is true for most organizations. An entrepreneur defines for everyone in the company what is most important by connecting the company's long-term strategy to its daily operations and measuring performance.

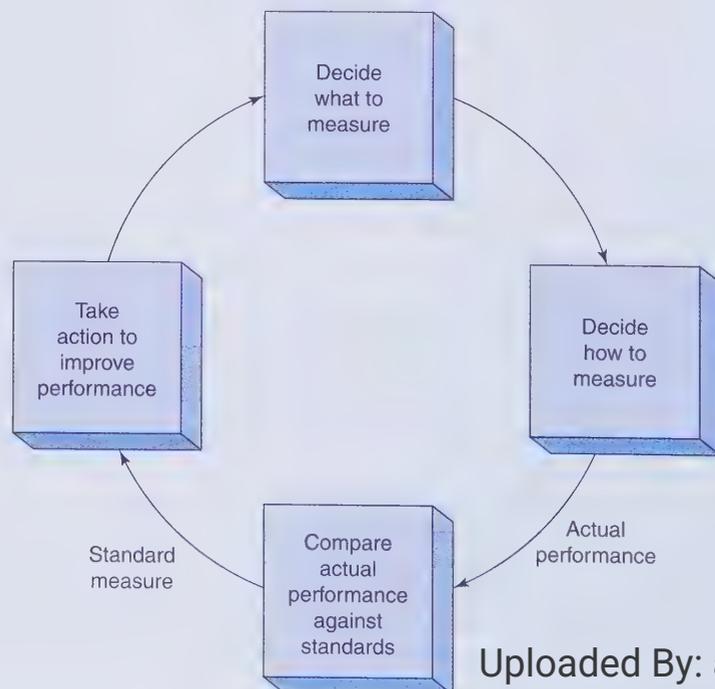
Providing feedback implies that entrepreneurs have established meaningful targets that serve as standards of performance for them, their employees, and the company as a whole. One characteristic that successful people have in common is that they set goals and objectives—usually challenging ones—for themselves. Entrepreneurs are no different. Successful entrepreneurs usually set targets for performance that make them stretch to achieve, and then they encourage their employees to do the same. The result is that they keep their companies constantly moving forward.

For feedback to serve as a motivating force in a business, entrepreneurs should follow the procedure illustrated in Figure 21.4, the feedback loop.

DECIDING WHAT TO MEASURE The first step in the feedback loop is deciding what to measure. Every business has a set of numbers that are critical to its success, and these "critical numbers" are what entrepreneurs should focus on. Obvious critical numbers include sales, profits, profit margins, cash flow, and other standard financial measures. However, supporting these measurements is an additional set of critical numbers that are unique to a company's operations. In most cases, these are the numbers that actually drive profits, cash flow, and other financial measures—they are the company's *real* critical numbers (refer to Chapter 14).

DECIDING HOW TO MEASURE Once an entrepreneur identifies his or her company's critical numbers, he or she must decide how to measure them. In some cases, identifying the critical numbers defines the measurements that owners must make, and measuring them simply becomes a matter of collecting and analyzing data. In other cases, the method of measurement is not as obvious—or as tangible. For instance, in some businesses, social responsibility is a key factor,

FIGURE 21.4
The Feedback Loop



but how should managers measure their company's performance on such an intangible concept? One of the best ways to develop methods for measuring such factors is to use brainstorming sessions involving employees, customers, and even outsiders. For example, one company used this technique to develop a "fun index," which used the results of an employee survey to measure how much fun employees are having at work. The index is an indication of how satisfied they are with their work, the company, and their managers.

COMPARING ACTUAL PERFORMANCE AGAINST STANDARDS In this stage of the feedback loop, the goal is to look for variances *in either direction* from company performance standards. In other words, opportunities to improve performance arise when there is a gap between "what should be" and "what is." The most serious deviations usually are those in which actual performance falls far below the standard. Entrepreneurs must focus their efforts on figuring out why actual performance is substandard. The goal is *not* to hunt down the guilty party (or parties) for punishment but to discover the cause of the poor performance and fix it. Managers should not ignore deviations in the other direction, however. If actual performance consistently exceeds the company's standards, it may be an indication that the standards are set too low.

TAKING ACTION TO IMPROVE PERFORMANCE When managers or employees detect a performance gap, their next challenge is to decide on a course of action that will eliminate it. Typically, several suitable alternatives to solving a performance problem exist; the key is finding an acceptable solution that solves the problem quickly, efficiently, and effectively.

Performance Appraisal

One of the most common methods of providing feedback on employee performance is through **performance appraisal**, the process of evaluating an employee's actual performance against desired performance standards. Most performance appraisal programs strive to accomplish three goals:

1. To give employees feedback about how they are performing, which can be an important source of motivation
2. To provide entrepreneurs and employees the opportunity to create a plan for developing employee skills and abilities and for improving their performance
3. To establish a basis for determining promotions and salary increases

The primary purpose of performance appraisals is to encourage and to help employees improve their performance. Unfortunately, they can turn into uncomfortable confrontations that do nothing more than upset the employees, aggravate the entrepreneur, and destroy trust and morale. This may occur because the entrepreneur does not understand how to conduct an effective performance appraisal. Although U.S. businesses have been conducting performance appraisals for at least 75 years, most companies, their managers, and their employees are dissatisfied with the process. A survey by *Salary.com* shows that 60 percent of workers say that performance appraisals do not produce any useful feedback and fail to help them set meaningful objectives.⁸⁷ Common complaints include unclear standards and objectives, managers who lack information about employees' performances, managers who are unprepared or who lack honesty and sincerity, and managers who use general, ambiguous terms to describe employees' performances.

One complaint is that the performance appraisal happens only periodically: in most cases, just once a year. Employees do not have the opportunity to receive any ongoing feedback on a regular basis. All too often, managers save up all of the negative feedback to give employees and then dump it on them in the annual performance review. Doing so destroys employees' motivation and does *nothing* to improve their performance. What good does it do to tell an employee that six months earlier, he or she botched an assignment and caused the company to lose a customer? Performance reviews that occur once or twice a year in an attempt to improve employees' performance are similar to working out once or twice a year in an attempt to get into top physical condition!

The lack of ongoing feedback is similar to asking employees to bowl in the dark. They can hear some pins falling, but they have no idea how many are down or which ones are left standing for the next frame. How motivated would you be to keep bowling? How do you know your score as you bowl? Managers should address problems when they occur rather than wait until the performance appraisal session. Continuous feedback, both positive and negative, is a much more effective way to improve employees' performance and to increase their motivation than once-a-year feedback in a performance appraisal session.

Performance appraisals require planning and preparation on the entrepreneur's part. The following guidelines can help an entrepreneur create a performance appraisal system that actually works:

- **Link the employee performance criteria to the job description discussed earlier in this chapter.** To evaluate an employee's performance effectively, a manager must fully understand of the responsibilities of the employee's position.
- **Establish meaningful, job-related, measurable, and results-oriented performance criteria.** The criteria should describe behaviors and actions, not traits and characteristics. What kind of behavior constitutes a solid performance in the job? Criteria that are quantifiable, such as customer satisfaction scores, the percentage of on-time shipments, and other specific measurements, rather than subjective criteria, such as leadership potential, initiative, and problem-solving ability, form the foundation of a meaningful performance evaluation.
- **Prepare for the appraisal session by outlining the key points you want to cover with employees.** Important points to include are employees' strengths and weaknesses and developing a plan for improving their performance.
- **Invite employees to provide an evaluation of their own job performance based on the performance criteria.** In one small company, workers rate themselves on a 1-to-5 scale in categories of job-related behavior and skills as part of the performance appraisal system. Then they meet with their supervisor to compare their evaluations with those of their supervisor and discuss them.
- **Be specific.** One of the most common complaints employees have about the appraisal process is that managers' comments are too general to be of any value. Offer the employees specific examples of their desirable or undesirable behavior.
- **Keep a record of employees' critical incidents—both positive and negative.** The most productive evaluations are those based on managers' direct observation of their employees' on-the-job performance. These records also can be vital in case legal problems arise.
- **Discuss employees' strengths and weaknesses.** An appraisal session is not the time to "unload" about everything that employees have done wrong over the past year. Use it as an opportunity to design a plan for improvement and to recognize employees' strengths, efforts, and achievements.
- **Incorporate employees' goals into the appraisal.** Ideally, the standard against which to measure employees' performance is the goal that they have played a role in setting. Workers are more likely to be motivated to achieve—and buy into—goals that they have helped establish.
- **Keep the evaluation constructive.** Avoid the tendency to belittle employees. Do not dwell on past failures. Instead, point out specific things they should do better and help them develop meaningful goals for the future and a strategy for getting there.
- **Praise good work.** Avoid focusing only on what employees do wrong. Take the time to express your appreciation for hard work and solid accomplishments.
- **Focus on behaviors, actions, and results.** Problems arise when managers move away from tangible results and actions and begin to critique employees' abilities and attitudes. Such criticism creates a negative tone for the appraisal session and undercuts its primary purpose.
- **Avoid surprises.** If entrepreneurs are doing their jobs well, performance appraisals should contain no surprises for employees or the owner. The ideal time to correct improper behavior or slumping performance is when it happens, not months later. Managers should provide employees with continuous feedback on their performance and use the appraisal session to keep employees on the right track.
- **Plan for the future.** Smart entrepreneurs use appraisal sessions as gateways to workers' future success. They spend only about 20 percent of the time discussing past performance; they use the remaining 80 percent of the time developing goals, objectives, and a plan for the future.



ENTREPRENEURIAL PROFILE: Brian Roth: Trufast Brian Roth, CEO of Trufast, a small maker of fasteners located in Bryan, Ohio, realized that his company's performance appraisal process was ineffective. "The only thing the review did was to get the employees' heads of performance," he says. "Basically, it was worthless." Roth revamped the entire process to focus on more

frequent feedback and rewards. At the end of every quarter, all 80 of the company's employees meet with their supervisors, who assign up to 25 points in each of four areas: initiative, aptitude, flexibility, and aptitude. Employees who score at least 70 points earn incentive pay—the higher their scores, the greater the bonus amount. More than 90 percent of Trufast's employees receive some bonus. Roth says that the program has reduced employee turnover and produces a return on investment of between 15 and 18 percent. "My employees keep asking me when the next review is and what they need to know to score well on it," says Roth. "That tells me all I need to know."⁸⁸

Some companies allow employees to evaluate each other's performance in **peer reviews** or evaluate their boss's performance in **upward feedback**. These are aspects of a technique called **360-degree feedback**. Peer appraisals can be especially useful because an employee's coworkers see his or her on-the-job performance every day. As a result, peer evaluations tend to be more accurate and more valid than those of some managers. In addition, they may capture behavior that managers miss. Disadvantages of peer appraisals include potential retaliation against coworkers who criticize, the possibility that appraisals will be reduced to "popularity contests," and the refusal of some workers to offer any criticism because they feel uncomfortable evaluating others. Some bosses using upward feedback report similar problems, including personal attacks and extreme evaluations by vengeful subordinates.

Regardless of the technique, employee feedback should be honest, clear, and respectful. Entrepreneurs will benefit from developing effective feedback skills as they grow the business and delegate additional responsibilities to employees.

Chapter Review

1. Explain the challenges involved in the entrepreneur's role as leader and what it takes to be a successful leader.
 - Leadership is the process of influencing and inspiring others to work to achieve a common goal and then giving them the power and the freedom to achieve it.
 - Management and leadership are not the same, yet both are essential to a small company's success. Leadership without management is unbridled; management without leadership is uninspired. Leadership gets a small business going; management keeps it going.
2. Describe the importance of hiring the right employees and how to avoid making hiring mistakes.
 - The decision to hire a new employee is an important one for every business, but its impact is magnified many times in a small company. Every "new hire" an entrepreneur makes determines the heights to which the company can climb or the depths to which it will plunge.
 - To avoid making hiring mistakes, entrepreneurs should develop meaningful job descriptions and job specifications, plan and conduct an effective interview, and check references before hiring any employee.
3. Explain how to build the kind of company culture and structure to support the entrepreneur's mission and goals and to motivate employees to achieve them.
 - Company culture is the distinctive, unwritten code of conduct that governs the behavior, attitudes, relationships, and style of an organization. Culture arises from an entrepreneur's consistent and relentless pursuit of a set of core values that everyone in the company can believe in. Small companies' flexible structures can be a major competitive weapon.
4. Understand the potential barriers to effective communication and describe how to overcome them.
 - Research shows that entrepreneurs spend about 80 percent of their time in some form of communication, yet their attempts at communicating sometimes go wrong. Barriers to effective communication include that managers and employees don't always feel free to say what they really mean, ambiguity blocks real communication, information overload causes the message to get lost, selective listening interferes with the communication process, defense mechanisms block a message, and conflicting verbal and nonverbal messages confuse listeners.
 - To become more effective communicators, entrepreneurs should clarify their messages before attempting to communicate them, use face-to-face communication whenever possible, be empathetic, match their messages to their audiences, be organized, encourage feedback, tell the truth, and not be afraid to tell employees about the business, its performance, and the forces that affect it.
5. Discuss the ways in which entrepreneurs can motivate their workers to higher levels of performance.
 - Motivation is the degree of effort an employee exerts to accomplish a task; it shows up as excitement about work. Four important tools of motivation are empowerment, job design, rewards and compensation, and feedback.
 - Empowerment involves giving workers at every level of the organization the power, the freedom, and the responsibility to control their own work, to make decisions, and to take action to meet the company's objectives.

- Job design techniques for enhancing employee motivation include job enlargement, job rotation, job enrichment, flextime, job sharing, and flexplace.
- Money is an important motivator for many workers but not the only one. The key to using rewards such as recognition and praise to motivate involves tailoring them to the needs and characteristics of the workers.
- Giving employees timely, relevant feedback about their job performance through a performance appraisal system can also be a powerful motivator.

Discussion Questions

- 21-1. What is leadership? What is the difference between leadership and management?
- 21-2. Explain the challenges involved in an entrepreneur's role as a leader.
- 21-3. Why is it so important for small companies to hire the right employees? What can entrepreneurs do to avoid making hiring mistakes?
- 21-4. Why it is important to check the background and the references of candidates in the hiring process?
- 21-5. Outline the procedure for conducting an effective interview.
- 21-6. Explain the three phases of conducting an interview.
- 21-7. What is company culture? What role does it play in a small company's success? What threats does rapid growth pose for a company's culture?
- 21-8. What mistakes do companies make when switching to team-based management? What might companies do to avoid these mistakes? Explain the four phases teams typically experience.
- 21-9. What is empowerment? What benefits does it offer workers? The company? What must a small business manager do to make empowerment work in a company?
- 21-10. Explain the differences among job simplification, job enlargement, job rotation, and job enrichment. What impact do these different job designs have on workers?
- 21-11. Is money the "best" motivator? How do pay-for-performance compensation systems work? What other rewards are available to small business managers to use as motivators? How effective are they? What motivates workers of Generation Y?
- 21-12. Suppose that a café and coffee shop that sells organic, mostly locally grown foods and fair trade coffee identifies its performance as a socially responsible company as a "critical number" in its success. Suggest some ways for the owner to measure this company's "social responsibility index."
- 21-13. What is a performance appraisal? What are the most common mistakes managers make in performance appraisals? What should small business managers do to avoid making those mistakes?

CHAPTER 22

Management Succession and Risk Management Strategies in the Family Business



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain the factors necessary for a strong family business.
2. Understand the exit strategy options available to an entrepreneur.
3. Discuss the stages of management succession.
4. Explain how to develop an effective management succession plan.
5. Understand the four risk management strategies.
6. Discuss the basics of insurance for small businesses.

When it works right, nothing succeeds like a family firm. The roots run deep, embedded in family values. The flash of the fast buck is replaced with long-term plans. Tradition counts.

—Eric Calonius

Soul is what drives all of what happens in family businesses, and it is the indefinable essence of a family's spirit and being. Soul is not something that can be measured or quantified, but it is easily recognizable by both its presence and its absence.

—Tom Hubler

Family Businesses

1.

Explain the factors necessary for a strong family business.

Nearly 90 percent of all companies in the United States, about 24.5 million businesses, are family owned. Yet family-owned businesses, those in which family members control ownership and/or decision making, are often overlooked by the media that focus most of their attention on the largest companies in our economy. In reality, family businesses generate 64 percent of the U.S. gross domestic product, account for 63 percent of all employment and 78 percent of job creation, and pay 65 percent of all wages.¹ Despite common perceptions, not all family businesses are small; 33 percent of *Fortune* 500 companies are family businesses.² Globally, family-owned businesses account for 70 to 90 percent of world gross domestic product (GDP).³ Some of the best-known companies in the world are family owned, including Ford Motor Company, Samsung, Hyundai, Sainsbury, Mars, Marriott, and Wal-Mart. In fact, Sam Walton's heirs own 49 percent of the stock in the world's largest company, Wal-Mart, and those shares are worth an estimated \$128 billion, an amount that exceeds the GDP of 124 countries in the world.⁴

When a family business works right, it is a thing of beauty. Family members share deeply rooted values that guide the company and give it a sense of harmony. Family members understand and support one another as they work together to achieve the company's mission. That harmony can produce a significant financial payoff. A study by Jim Lee of Texas A&M University–Corpus Christi shows that family-owned businesses are more profitable and experience faster employment and revenue growth over time than nonfamily businesses.⁵ Another study of companies in the Standard & Poor's 500 Index by Ronald Anderson, David Reeb, and Sattar Mansi found that family firms outperformed their nonfamily counterparts on a variety of financial measures.⁶ Other research comparing the financial performances of similar sets of family and nonfamily businesses shows that family businesses produce a return on assets that averages 6.65 percent higher than that of nonfamily firms.⁷

Benefits of Family Businesses

Family businesses have many advantages over their nonfamily rivals, including the following.

LONG-TERM FOCUS Because owners of family businesses usually see themselves as stewards of their companies for the next generation, they make decisions for the long term rather than for the next quarter. Their focus is on building an enduring legacy rather than on producing quick returns, a tendency that plagues most publicly held companies. “I would have been fired a couple of times in a publicly-traded company, where you are judged according to quarterly earnings,” says Count Anton-Wolfgang von Faber-Castell, eighth generation CEO of the family-owned Faber-Castell Company that started making pencils in Stein, Germany, in 1761.⁸



ENTREPRENEURIAL PROFILE: Chris McCormick: L.L. Bean Chris McCormick, the first non-family CEO of venerable outdoor gear and apparel retailer L.L. Bean, which Leon Leonwood Bean started in 1912, recently went to the board of the family-owned company in Freeport, Maine, and recommended that the company “have an ‘investment year’ and allow profits to fall because we needed to make a big investment in marketing and attracting younger customers.” The decision was an easy one. “They agreed,” says McCormick. “Family members understand that we want to be around another 100 years and investments in growth are critical to the long-term financial health of the business.”⁹

FASTER DECISION MAKING Family business owners say that they are more agile than their nonfamily competitors because they can make decisions faster. Their companies can identify emerging market niches and enter them quickly because decision makers share similar values and vision for the company, which streamlines the decision-making process. Anthony Halas, second-generation CEO of Seafolly, a highly successful swim- and casual-wear company based in Australia, says that “the ability to make good decisions and react quickly and not being bound by outside investors who are looking solely at the bottom line are definite advantages to operating a family firm. A family business can really invest in the future.”

AN ENTREPRENEURIAL MIND-SET Family business owners pride themselves on retaining their entrepreneurial spirit, which means that they sometimes must rework their companies over time and thrive.



ENTREPRENEURIAL PROFILE: Andrew Cornell: Cornell Iron Works Cornell Iron Works, now in its fifth generation of ownership, began in 1828 in New York City as a blacksmith shop before morphing into an ironworks company. (It created the iron base and the spiral stairs for the Statue of Liberty and ironwork for the Brooklyn Bridge.) In its more than 185-year history, the company has reinvented itself several times. During the Great Depression, the company made sidings for sanitation trucks and security doors for buildings, including the Metropolitan Museum of Art in New York City. Today, under the leadership of CEO Andrew Cornell, the company, now located in Mountaintop, Pennsylvania, focuses on a profitable niche, making specialty overhead doors for industrial, institutional, and retail customers.¹⁰

STRONG COMMITMENT TO THEIR EMPLOYEES Family businesses' long-term focus carries over to a long-term commitment to their employees. Many family-owned companies see their employees as an extension of the family and do everything they can to avoid layoffs, even in difficult economic times. The result is intense loyalty and dedication from employees. During the Great Depression, Crane and Company, a family-owned papermaking business founded in Dalton, Massachusetts, in 1770, saw demand for its paper plummet. Rather than institute layoffs, however, Crane paid workers to paint the nearly 160 houses that the company owned and rented to its workers.¹¹

LOCAL PHILANTHROPY Like most small businesses, family-owned companies give back to the communities in which they operate, particularly to causes that align with the family's shared values. A study by Family Enterprise USA reports that 94 percent of family businesses donate money to charitable organizations, 81 percent of owners volunteer in community organizations, and 53 percent encourage their employees to volunteer their time in the local community.¹² Family-owned businesses "are using philanthropy as part of their business strategies," says the head of Strategic Philanthropy. "It makes sense and can be extremely beneficial to achieving business objectives such as retaining great employees and improving the company's reputation as a good corporate citizen."



ENTREPRENEURIAL PROFILE: Eliot Orton: Vermont Country Stores Vrest and Ellen Orton, who cofounded the Vermont Country Stores in tiny Weston, Vermont, in 1945, donated time and money to local charitable causes, choosing specific projects by talking with customers while sitting around the small store's potbellied stove. Today, their grandson, Eliot Orton, is the CEO of Vermont Country Stores, which has grown into a 15,000-square-foot tourist destination and an online and catalog retail company with more \$100 million in annual sales. Eliot continues his grandparents' generosity, donating an estimated 10 percent of its annual profits and his own time as well as that of most of the company's 500 employees to charitable causes, ranging from local volunteer fire departments and food pantries to nonprofits with an international focus.¹³

The Dark Side of Family Businesses

Family businesses also have a dark side, and it stems from their lack of continuity. Sibling rivalries, quarrels about management succession, fights over control of the business, and personality conflicts often lead to nasty battles that can tear families apart and threaten or destroy once thriving businesses. Long-standing feuds can make family relationships difficult, and when mixed with business decisions and the wealth family businesses can create, the result can be explosive.



ENTREPRENEURIAL PROFILE: Luray Caverns Luray Caverns, one of the most visited show caves in the United States, is in its fourth generation of family ownership, but since 2003, the six siblings who are the current owners of the popular tourist attraction in Luray, Virginia, have been engaged in legal battles that threaten the family's ownership. In 1905, Theodore Clay Northcott, known as The Colonel, purchased Luray Caverns, and his descendants have owned the attraction, which is now worth an estimated \$20 million, since then. In the latest legal volley, the three youngest siblings, John Graves, Rod Graves, and Cornelia Graves Spain, filed a lawsuit against their older sisters, Rebecca Graves Hudson, Katherine Graves Fichtler, and Elizabeth Graves Vitu, claiming that the oldest sisters had violated provisions of the trusts that governed their inheritance and, therefore, had disqualified themselves from receiving any shares in Luray Caverns Corporation. A district court judge recently dismissed the case, stating that "this case is simply one skirmish in the complicated and contentious battle that has been waged among the descendants of Colonel Northcott over the distribution of stock and control of Luray Caverns." One observer describes the family skirmishes as "Dallas' The Daily News Channel."¹⁴

TABLE 22.1 The World's Oldest Family Businesses

William O'Hara, director of the Institute for Family Enterprise at Bryant College, and Peter Mandel have compiled a list of some of the world's oldest family businesses.

Company	Country	Nature of Business	Year Established
Hoshi Ryokan	Japan	Hotel	718
Château de Goulaine	France	Vineyard, museum, butterfly collection	1000
Fonderia Pontifica Marinelli	Italy	Bell foundry	1000
Barone Ricasoli	Italy	Wine and olive oil	1141
Barovier & Toso	Italy	Artistic glassmaking	1295
Hotel Pilgram Haus	Germany	Innkeeping	1304
Richard de Bas	France	High-quality papermaker	1326
Torrini Firenze	Italy	Goldsmiths	1369
Antinori	Italy	Wine	1385
Camuffo	Italy	Shipbuilding	1438
Baronnie de Coussergues	France	Wine	1495
Grazia Deruta	Italy	Ceramics	1500
Fabbrice D'Armi Beretta	Italy	Firearms production	1526
William Prym GmbH & Company	Germany	Copper, brass, haberdashery	1530
R.J. Balson & Son	Great Britain	Butcher	1535
Codorniu	Spain	Wine	1551
Fonjallaz	Switzerland	Wine	1552
Von Poschinger Manufaktur	Germany	Glassmaking	1568
Wachsendustrie Fulda Adam Gies	Germany	Candles and wax figures	1589
Berenberg Bank	Germany	Banking	1590

Source: Based on William T. O'Hara and Peter Mandel, "The World's Oldest Family Companies," *Family Business*, www.familybusinessmagazine.com/oldworld.html.

The stumbling block for most family businesses is management succession; 70 percent of first-generation businesses fail to survive into the second generation, and of those that do, only 13 percent make it to the third generation. Just 3 percent of family businesses survive to the fourth generation and beyond.¹⁵ The leading causes of family business failures are inadequate estate planning, failure to create a management succession plan, and lack of funds to pay estate taxes.¹⁶ Just when they are ready to make the transition from one generation of leaders to the next, family businesses are most vulnerable. As a result, the average life expectancy of a family business is 24 years, although some last *much* longer (see Table 22.1).¹⁷



ENTREPRENEURIAL PROFILE: Zenas Crane: Crane & Company Crane & Company, based in Dalton, Massachusetts, is one of the oldest family businesses in the United States. Founded in 1801 by Zenas Crane, the company generated most of its revenue from sales of high-quality stationery (including stationery that the White House uses), but as technology and social media began to dampen the demand for fine stationery, Crane & Company shifted its focus to providing paper to the U.S. government for making currency. Today, the company generates most of its revenue from sales of currency-grade paper (which it is constantly updating to thwart counterfeiters) to foreign governments. Crane & Company, which has about 100 shareholders, most of whom are sixth-, seventh-, and eighth-generation descendants of Zenas Crane, recently sold an equity stake to private equity firm Lindsay Goldberg. Only five members of the Crane family currently work for the company, and its CEO, Max Mitchell, is not a Crane family member.¹⁸

next generation, and 9 percent of the owners say that management succession is likely to cause family conflict.¹⁹ The best way to ensure the legacy of a family business and a successful transition from one generation of family owners to the next is to develop a succession plan for the company. Although business founders inevitably want their businesses to survive them and most intend to pass them on to their children, they do not always support their intentions with a plan to accomplish that goal. The study by PriceWaterhouseCoopers reports that 47 percent of family businesses have no succession plans in place.²⁰ Another survey of family business owners by MassMutual Financial Group and Arthur Andersen reports that 19 percent had not engaged in any kind of estate planning other than creating a will.²¹ For most family businesses, the greatest threat to survival comes from *within* the company rather than from outside it. Many entrepreneurs dream of their businesses continuing in the family but take no significant steps to make their dreams a reality.

Characteristics of Successful Family Businesses

Successful family businesses that have survived across multiple generations of family ownership share several important qualities: shared values, shared power, tradition, a sense of stewardship, a willingness to learn, family behavior, and strong family ties.²²

SHARED VALUES The first and probably most overlooked quality is a set of shared values. What family members value and believe about people, work, and money shapes their behavior toward the business. Families that share similar values instill those values into the family business, where they become a vital and enduring part of the company's legacy. According to the global family business survey by PriceWaterhouseCoopers, 78 percent of family business owners say that their families' shared values and culture are an important strength of their companies.²³ Without shared values, creating a sense of vision and direction for a business is difficult. "We have an edge," explains Chris McCormick, CEO of L.L. Bean. "We stick to our beliefs—customer service, quality, outdoor recreation, and our family ownership. We work as a team with shared values. These shared values have allowed the business to maintain a consistent point of view, a consistent experience, a consistent message. This is what differentiates our brand in the marketplace and keeps us relevant. If we do these basics well, profitability will follow, as it has now for more than 100 years."²⁴

To avoid the problems associated with conflicting values and goals, family business owners should consider taking the following actions:

- Make it clear to all family members that they are not required to join the business. Family members' goals, ambitions, and talents should be foremost in their career decisions. W.S. Darley and Company, a company in Itasca, Illinois, that makes firefighting equipment, including fire trucks, and is in its fourth generation of family ownership has a family participation plan that states that the business has no obligation to hire any family member, nor does any family member have an obligation to work in the family business. Andrew Cornell, fifth-generation CEO of Cornell Iron Works, has a similar philosophy. "A family business can't be a home for wayward family members," he says. "We're building a business for the good of employees and shareholders."²⁵
- Do not assume that a successor must come from within the family. Simply being born into a family does not guarantee that a person will make a good business leader. In fact, non-family executives manage between 10 and 15 percent of all family-owned businesses.²⁶ "For a family business to appoint a nonfamily chief executive is an extraordinarily big decision," says Paul Drechsler, the first nonfamily CEO to manage Wates Group, a family-owned construction firm founded in 1897 in Surrey, United Kingdom. "It's a great privilege to lead a family business, but it's also a huge responsibility."²⁷
- Give family members the opportunity to work outside the business initially to learn firsthand how others conduct business. Working for others allows family members to develop knowledge, confidence, and credibility before stepping back into the family business. Family members who work outside the family business also bring with them new ideas when they return.



ENTREPRENEURIAL PROFILE: Ed and Norma Mitchell: Mitchell's Family of Stores

Mitchell's Family of Stores, founded by Ed and Norma Mitchell in 1958 in Westport, Connecticut, is now in its third generation of family ownership and, with annual sales of more than \$100 million, has 100 stores in 15 states. It is the largest family-owned upscale clothing store in the United States. Jack and Bill Mitchell, the second generation of owners, instituted "the five-year rule," which says that family

members must work outside the family business for at least five years before joining the company. “The five-year rule not only gives the next generation work experience, but it also gives them wisdom they can bring to the family business,” explains Jack.²⁸

SHARED POWER Shared power does not necessarily mean equality of power. Rather, shared power is based on the idea that family members allow those people with the greatest expertise, ability, and knowledge in particular areas to handle decisions in those areas. Dividing responsibilities along the lines of expertise is an important way of acknowledging respect for each family member’s talents and abilities. When the third generation of family members (all sons) began working for Mitchell’s Family of Stores, each one chose a different functional area depending on his skills, talent, and ability. “One picked finance and administration, another sales and merchandising, another marketing, and several managing newly acquired stores,” says Jack Mitchell.²⁹

TRADITION Tradition is necessary for a family business because it serves to bond family members and to link one generation of business leaders to the next. However, founders must hold tradition in check when it becomes a barrier to change. The key is to select those traditions that provide a solid foundation for positive behavior while taking care not to restrict the future growth of the business. “The companies that are successful change their strategy after each generation,” says Joachim Schwass, a professor of family business at Switzerland’s IMD business school. “Bringing in the new generation and saying, ‘Son, do as I did,’ will not work.”³⁰



ENTREPRENEURIAL PROFILE: Peter and Anthony Halas: Seafolly In 1996, after a short stint as an actor, Anthony Halas began working for Seafolly, the Australian swimwear company that his father, Peter, had started with a partner in 1975. Two years later, Halas bought out his father’s partner, took on a leadership role, and began transforming from a company that once provided private-label swimwear for the discount sector into a company marketing fashionable swimwear under its own label. Within 14 years under Halas’s leadership, Seafolly became the leading swimwear company in Australia with about 40 percent market share and the operator of Sunburn, the country’s largest chain of multibrand swimwear stores. Every business decision that Halas makes is steeped in 50 years of family business history, but he continues to show that he is willing to take bold steps to innovate and keep the family business in tune with the ever-changing demands of a highly competitive industry, including expanding the product line to include casual wear and a push into international markets. Twenty-five percent of the company’s sales now come from its clothing line. Seafolly sells its products in 44 countries, but Halas is focusing on five key markets—the United States, France, Germany, Canada, and the United Kingdom.³¹

A SENSE OF STEWARDSHIP Family business owners whose businesses thrive for generations see themselves as more than just entrepreneurs; they view their roles as stewards of a family tradition, caretakers of the family business for future generations. “The core value of stewardship that family businesses embrace—leaving the company in a better place than when you took it over—drives their internal attitudes and behavior,” says the owner of one family business.³² Creating an ongoing legacy in the form of a family business requires a family to focus on five interrelated components (see Figure 22.1):

1. Heritage—maintaining the company’s and the family’s values, vision, and traditions.
2. Family and self—sustaining the family and supporting its members, enabling them to realize their goals both inside and outside the family business.
3. Business legacy—creating a sound management succession plan.
4. Community—giving back to the local community by being a good corporate citizen, volunteering, and engaging in philanthropy.
5. Wealthcare—preserving the family’s and the company’s wealth with proper estate planning strategies.³³



ENTREPRENEURIAL PROFILE: Avedis Zildjian: Zildjian Zildjian, the oldest family-owned business in the United States, traces its roots to Constantinople, Turkey, where, in 1623, Avedis Zildjian developed an alloy of copper, tin, and silver and began making cymbals with spectacular power and sound clarity. The company moved to the United States in 1929 and remains the world leader in the cymbal industry. Each generation of the Zildjian family has guided the company with a focus on future generations. Now in its fifteenth generation, the company has a rich history of



FIGURE 22.1
The Legacy Model for Sustaining a Successful Family Business

Source: "Fine Tuning Your Legacy," Hubler For Business Families, <http://www.hublerfamilybusiness.com/OwnershipPlanning/FineTuningYourLegacy.aspx>.

recently introduced a new line of electronic cymbals named "the 16th" after the next generation of Zildjians who are expected to take over the family business.³⁴

A WILLINGNESS TO LEARN AND ADAPT A willingness to learn and grow is the hallmark of any successful firm, and it is essential to a family business. A family business that actively seeks new ideas and innovative techniques reduces its risk of obsolescence.

ENTREPRENEURIAL PROFILE: Tom Flottman: Flottman Company "If you do the same thing for more than five years in a row, you're going to fall behind," says Tom Flottman, CEO of Flottman Company, a third-generation printing company founded in 1921 by Flottman's grandfather. The company, based in Crestview Hills, Kentucky, started as a commercial job shop but by the 1960s had become a full-color lithographer. In the 1970s, Flottman's entered a lucrative niche, printing drug labels and leaflets for the pharmaceutical industry. Although that business still makes up more than half of the company's \$6 million in annual sales, Tom has taken Flottman's into new markets, including multichannel communications and marketing. "To survive, we must be more than a company that puts ink on paper," he explains.³⁵

The current generation of leadership must set the stage for new ideas by involving the next generation in today's decisions. In many cases, a formal family council serves as a mechanism through which family members can propose new ideas. Perhaps more important than a family council is fostering an environment in which family members trust one another enough to express their ideas, thoughts, and suggestions. Open discussion of the merits of new ideas is a characteristic that has proved valuable for many family businesses' ability to sustain their competitive advantages.

BEHAVING LIKE FAMILIES Families that play together operate family businesses that are more likely to stay together. Time spent together outside the business creates the foundation for the relationships family members have at work. Too often, life in a family business can degenerate into nothing but day after day of work and discussions of work at home. When a family adds activities outside the scope of the business, however, new relationships develop in a different arena. A family should not force members to "play together" but instead should create an

environment that welcomes every member into fun family activities. Planned activities should be broad enough in scope to involve all family members. Over time, trust, respect, openness, and togetherness lead to behavior that communicates genuine caring and concern for the well-being of each family member, and that spills over into the working relationship as well.

A STRONG FAMILY SUPPORT NETWORK According to a global survey of family business owners, the most important advantage family businesses have is the strong support network from family members.³⁶ Strong family ties grow from one-on-one relationships. Shared time conveys the message that the family business is *more* than just a business; it is a group of people who care for one another working together for a common goal. (Think “Duck Dynasty.”) The bond that a family business creates among relatives can be strong and enduring. “There’s a love and a trust and a respect that can be very powerful when they are brought into a business environment,” says Ross Nager, director of a center for family business.³⁷

The same emotions that hold family businesses together can also rip them apart if they run counter to the company’s and the family’s best interest. Emotions run deep in family businesses, and the press is full of examples of once successful companies that have been ruined by family feuds over who controls the company and how to run it. Conflict is a natural part of any business but can be especially powerful in family businesses because family relationships magnify the passions binding family members to the company. Without a succession plan, those passions can explode into destructive behavior that can endanger the family business.

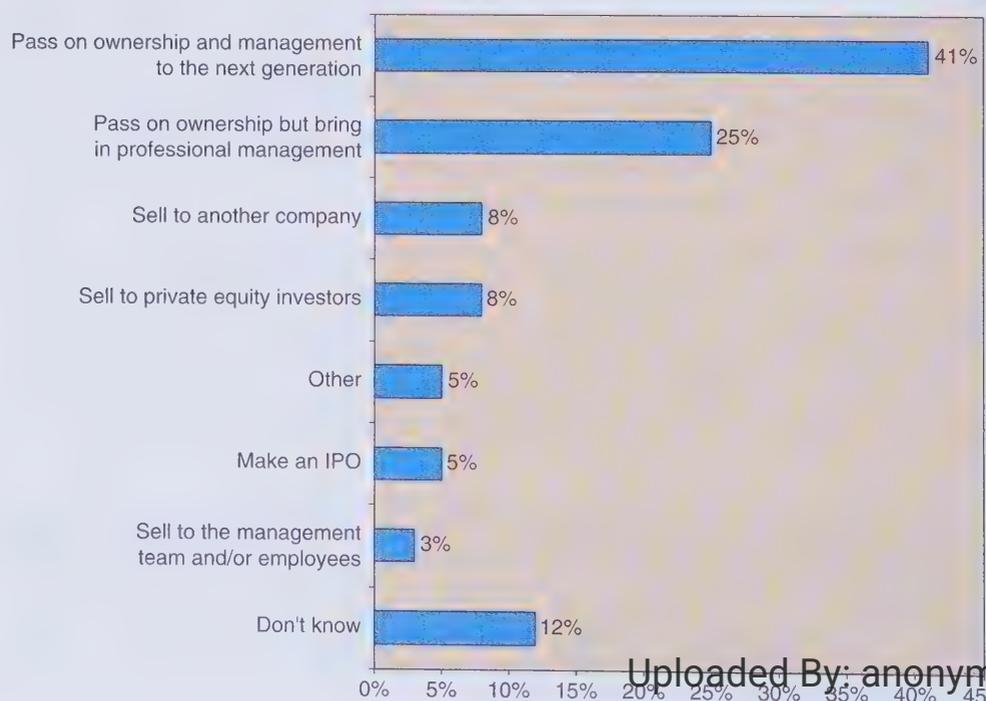
Exit Strategies

Most family business founders want their companies to stay within their families, although in some cases maintaining family control is not practical (see Figure 22.2). Sometimes no one in the next generation of family members has an interest in managing the company or has the necessary skills and experience to handle the job. Under these circumstances, the founder must look outside the family for leadership if the company is to survive. Whatever the case, entrepreneurs must confront their mortality and plan for the future of their companies. Having a solid management succession plan in place well before retirement is near is critical to success. Entrepreneurs should examine their options once they decide it is time to step down from the businesses they have founded. Three options are available to entrepreneurs planning to retire: sell to outsiders, sell to (nonfamily) insiders, or pass the business on to family members with the help of a management succession plan. We turn now to these three exit strategies.

2. Understand the exit strategy options available to an entrepreneur.

FIGURE 22.2
Plans for Passing on the Family Business

Source: Based on Family Firm: A Resilient Model for the 21st Century, PriceWaterhouseCoopers Family Business Survey, 2012, p. 14.



Selling to Outsiders

As you learned in Chapter 7, selling a business to an outsider is no simple task. Done properly, it takes time, patience, and preparation to locate a suitable buyer, strike a deal, and make the transition. Advance preparation, maintaining accurate financial records, and timing are the keys to a successful sale. Too often, however, business owners, like some famous athletes, stay with the game too long until they and their businesses are well past their prime. They postpone selling until the last minute when they reach retirement age or when they face a business crisis. Such a “fire-sale” approach rarely yields the maximum value for a business.

A straight sale may be best for entrepreneurs who want to step down immediately and turn the reins of the company over to someone else. However, selling a business outright is not an attractive exit strategy for those who want to stay with the company or for those who want to surrender control of the company gradually rather than all at once.



ENTREPRENEURIAL PROFILE: Ralph Ostrove and Paul Stuart Recently, members of the Ostrove family, descendants of Ralph Ostrove, who in 1938 founded Paul Stuart, the retailer of classic suits, shirts, ties, and shoes preferred by Wall Street executives, decided to sell the family business. Clifford Grodd, Ralph Ostrove’s son-in-law, joined the business in 1952 and served as its president until his death in 2010 at the age of 86, when Michael Ostrove took over. The family voted to sell 100 percent of Paul Stuart to Mitsui & Company, the company’s longtime distributor in Japan. Mitsui plans to broaden the product line with more casual clothing, expand the number of retail outlets in the United States and in Asia, and use the company’s “man on the fence” logo more strategically.³⁸

The financial terms of a sale also influence the selling price of the business and the number of potential bidders. Does the owner want “clean, cash only, 100 percent at closing” offers, or is he or she willing to finance a portion of the sale? A 100 percent, cash-only requirement dramatically reduces the number of potential buyers. On the other hand, the owner can exit the business “free and clear” and does not incur the risk that the buyer may fail to operate the business profitably and be unable to complete the financial transition.

Selling to Insiders

When entrepreneurs have no family members to whom they can transfer ownership or who want to assume the responsibilities of running a company, selling the business to employees is often the preferred option. In most situations, the options available to owners are (1) sale for cash plus a note, (2) a leveraged buyout, and (3) an employee stock ownership plan.

A SALE FOR CASH PLUS A NOTE Whether entrepreneurs sell their businesses to insiders, outsiders, or family members, they often finance a portion of the sales price. The buyer pays the seller a lump-sum amount of cash up front, and the seller holds a promissory note for the remaining portion of the selling price, which the buyer pays off in installments. Because of its many creative financial options, this method of selling a business is popular with buyers. They can buy promising businesses without having to come up with the total purchase price all at one time. Sellers also appreciate the security and the tax implications of accepting payment over time. They receive a portion of the sale up front and have the assurance of receiving a steady stream of income in the future. In addition, they can stretch their tax liabilities from the capital gains on the sale over time rather than having to pay them in a single year. In many cases, sellers’ risks are lower because they may even retain a seat on the board of directors to ensure that the new owners are keeping the business on track.

LEVERAGED BUYOUTS In a **leveraged buyout (LBO)**, managers and/or employees borrow money from a financial institution and pay the owner the total agreed-on price at closing; then they use the cash generated from the company’s operations to pay off the debt. The drawback of this technique is that it creates a highly leveraged business. Because of the high levels of debt they take on, the new management team has very little room for error. Too many management mistakes or a slowing economy has led many highly leveraged businesses into bankruptcy.

If properly structured, LBOs can be an attractive to both buyers and sellers. Because they get their money up front, sellers do not incur the risk of loss if the buyers cannot keep the business operating successfully. The managers and employees who buy the company have a strong incentive to make sure the business succeeds because they own a piece of the action and some of the

capital is at risk in the business. The result can be a highly motivated workforce that works hard and makes sure that the company operates efficiently.



ENTREPRENEURIAL PROFILE: Jack Stack: Springfield Remanufacturing Corporation

In one of the most successful LBOs in history, Jack Stack and a team of 12 other managers purchased an ailing subsidiary of International Harvester in an attempt to save their jobs and those of the 120 employees they managed. The new company, Springfield Remanufacturing Corporation (SRC), which specializes in engine remanufacturing for automotive, trucking, agricultural, and construction industries, began with an astronomically high debt to equity ratio of 89:1, but the team of motivated managers and employees turned the company around. Today, SRC has more than 1,200 employees and 26 divisions that range from automotive engines to home furnishings.³⁹

EMPLOYEE STOCK OWNERSHIP PLANS Unlike LBOs, **employee stock ownership plans (ESOPs)** allow employees and/or managers (i.e., the future owners) to purchase the business gradually, freeing up enough cash to finance the venture’s growth. With an ESOP, employees contribute a portion of their earnings over time toward purchasing shares of the company’s stock from the founder until they own the company outright. In a leveraged ESOP, the ESOP itself borrows the money to buy the owner’s stock up front. Then, using employees’ contributions, the ESOP repays the loan over time. One advantage of a leveraged ESOP is that the principal and the interest that the ESOP borrows to buy the business are tax deductible, and this can save thousands or even millions of dollars in taxes. Transferring ownership to employees through an ESOP is a long-term exit strategy that benefits everyone involved. The owner sells the business to the people he or she can trust the most—his or her managers and employees. The managers and employees buy a business they already know how to run successfully. In addition, because they own the company, the managers and employees have a huge incentive to see that it operates effectively and efficiently. One study of employee stock ownership plans in privately held companies found that the ESOPs increased sales, employment, and sales per employee by 2.4 percent a year.⁴⁰ Figure 22.3 shows the trend in the number of ESOPs and the number of employee owners.

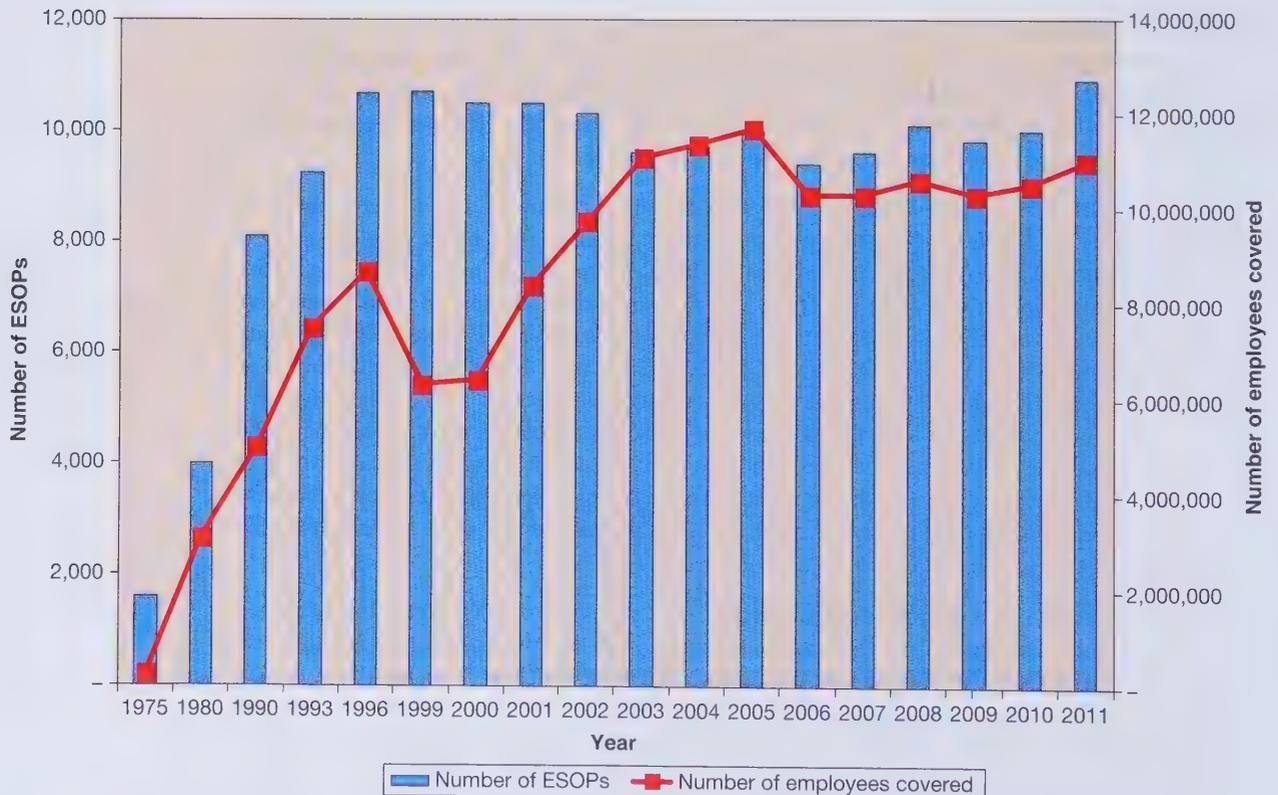


FIGURE 22.3
Employee Stock Ownership Plans

Source: Based on National Center for Employee Ownership, 2013.



ENTREPRENEURIAL PROFILE: Tom and Adele Connors: Adworkshop

Tom and Adele Connors started Adworkshop, a marketing agency located in Lake Placid, New York, in 1977. In 2009, the Connors established an ESOP and turned over 33 percent of the ownership in the business to their 30 employees with the goal of transferring 100 percent of ownership to employees through the ESOP over the next several years. Adele says that since the employees became owners in the business, they are more engaged and understand “that the harder they work, the more impact they have on the business’s success.” Kelly Frady, an account supervisor at Adworkshop says that the ESOP has fostered a stronger team spirit among the employees. “It’s a driving factor in making the company succeed in the long term,” she says.⁴¹

The third exit strategy available to company founders is transferring ownership to the next generation of family members with the help of a comprehensive management succession plan.



Lessons from the Street-Smart Entrepreneur

How to Set Up an ESOP



Dansko.

Source: Dansko.

In 1990, Mandy Cabot and her husband Peter Kjellerup discovered incredibly comfortable barn shoes while traveling in Europe and started a company, Dansko, from their farm in West Grove, Pennsylvania, to sell them in the United States. In the early days, Cabot sold Dansko shoes to individuals from the back of her Volvo station wagon before landing retail shoe stores as customers. By 1996, Dansko was growing so fast that Cabot and Kjellerup moved the company from their farm to an office and warehouse. Two years later, the company had outgrown its space once again, and the copreneurs broke ground on a larger 26,000-square-foot office and warehouse. By 2002, Dansko had sold 1 million pairs of shoes, and its sales continued to grow at an impressive 46 percent annual rate. The couple began to consider the future of their company and decided against selling to a competitor or to a private equity firm that might institute layoffs in a cost-cutting initiative. They decided that the best way to ensure Dansko’s continued success was to transfer ownership to the people who had played a vital role in building it: their employees. In 2005, they created an ESOP and began transferring ownership of the company, which is an S corporation, to

their employees, who at the time numbered more than 100. In 2012, Cabot and Kjellerup, both of whom were approaching retirement age, transferred 100 percent of the company to their 180 employees through the ESOP, giving them total control of its future. “This is our baby,” says Cabot, “but at some point we have to cease being parents and become grandparents.”

Dawn Huston started working at Dansko when she was just 20 years old, sorting shoes for delivery. Today, she is a warehouse processor and likes the idea of owning the business for which she works, although she admits that she was nervous about it at first. Huston, who now refers to Dansko as “our company,” says, “They [Cabot and Kjellerup] consider us family, and it feels like a family.”

Like Cabot and Kjellerup, many Baby Boomer entrepreneurs are transferring ownership of their businesses to their employees through ESOPs. “A company’s success isn’t driven [solely] by the brilliance of the CEO,” says Michael Keeling, president of the ESOP Association, “but also by its employees, and more owners feel that their employees deserve something more for that.” What steps should an entrepreneur who is interested in setting up an ESOP take?

Step 1. Conduct a feasibility analysis to determine whether an ESOP is right for you and your company

A company should be profitable and should have at least 20 to 30 employees to make an ESOP work and have a minimum valuation of between \$5 million and \$10 million. Only companies organized as C corporations or S corporations can create ESOPs. Creating the necessary plan documents and filing them with the proper government agencies costs about \$10,000. A business valuation, which can range from \$5,000 to \$10,000 for a small company, is a necessity. Fixed costs of administering the ESOP and complying with the Employee Retirement Income Security Act run about \$2,000 plus \$20 to \$30 per employee participant per year. A final consideration is whether the company is able to generate sufficient revenue consistently over time to be able to repay the loan in a leveraged ESOP.

Lessons from the Street-Smart Entrepreneur *(continued)*

Step 2. Hire an attorney who specializes in ESOPs to help you develop a plan for creating and implementing an ESOP

ESOPs can take many different forms, and an expert can help you determine the advantages and disadvantages of each one so that you can determine the one that is best for you and your company.

Step 3. Find the money to fund the ESOP

About 75 percent of ESOPs are leveraged, which means that they borrow the money to purchase the owner's stock from the ESOP trust. Banks and other financial institutions usually find loans to ESOPs quite attractive.

Step 4. Establish a process to operate the ESOP

Companies most often create an ESOP committee of managers and employees to provide guidance to the ESOP trust for managing the ESOP. The team also is responsible for communicating the details of the ESOP and the benefits of investing in it to company employees.

In 1991, Kim Jordan cofounded New Belgium Brewing Company in Fort Collins, Colorado, with her husband, Jeff Lebesch, who was inspired by the full-bodied local beers he encountered while bicycling through Europe. Early on, Jordan and Lebesch created an ESOP that allows employees to begin purchasing

shares of ownership in the company on the first anniversary of their employment date. (They also receive a cruiser bicycle as a gift.) Over the years, the employees purchased 41 percent of the company through the ESOP, but on December 29, 2012, Jordan and her family sold the remaining shares to the employees. New Belgium Brewing is now 100 percent employee owned. Jordan says that the goal is not only to reward employees but also to foster creativity by enhancing a culture in which employees think and act like entrepreneurs. "There are few times in life where you get to make choices that will have multigenerational impact, and this is one of those times," says Jordan. "We have an opportunity to write the next chapter of this incredible story and we're really excited about that. We have always had a high-involvement ownership culture, and this allows us to take that to the next logical level. It will provide an elegant succession framework that keeps the executive team intact ensuring our vision stays true going forward."

Sources: Based on Toddi Gutner, "What You Need to Know About ESOPs," *Fox Business Small Business Center*, December 12, 2012, <http://smallbusiness.foxbusiness.com/biz-on-main/2012/12/12/what-need-to-know-about-esops>; Angus Loten, "Founders Cash Out, but Do Workers Gain?," *Wall Street Journal*, April 18, 2013, p. B4; Karen E. Klein, "ESOPs on the Rise Among Small Businesses," *Bloomberg Business Week*, March 26, 2010, www.businessweek.com/smallbiz/content/mar2010/sb20100325_591132.htm; "ESOP Statistics," ESOP Association, www.esopassociation.org/media/media_statistics.asp; "How Small Is Too Small for an ESOP?," National Center for Employee Ownership, www.nceo.org/library/howsmall.html; "Steps to Setting Up an ESOP," National Center for Employee Ownership, www.nceo.org/library/steps.html.

Management Succession

3.

Discuss the stages of management succession.

By 2050, practically every family-owned business in the United States will lose its primary owner(s) to retirement or death. Experts estimate that by 2040, \$10.4 trillion in wealth will be transferred from one generation to the next, much of it funneled through family businesses.⁴² Sixty percent of small business owners are members of the Baby Boomer generation, born before 1964, and many of the entrepreneurs who have not yet transferred ownership to the next generation now are at or past retirement age and are ready to pass the torch of leadership. A Baby Boomer business owner retires, on average, every 57 seconds, a trend that will continue for the next 17 years.⁴³

For a smooth transition from one generation to the next, family businesses need a succession plan. Although 95 percent of small business owners acknowledge the need for a succession plan, only one in eight actually has a written plan in place for leadership continuity.⁴⁴ Without a succession plan, family businesses face an increased risk of faltering or failing in the next generation. Those businesses with the greatest probability of surviving are the ones whose owners prepare a succession plan well before it is time to transfer control to the next generation. Succession planning also allows business owners to minimize the impact of taxes on their businesses, their estates, and their successors' wealth as well and to avoid saddling the next generation of ownership with burdensome debt.

Why, then, do so many entrepreneurs postpone succession planning until it is too late? One expert explains,

Many business owners simply refuse to quit. Some would like to quit but don't trust anyone to do the job well after them. Some are tangled up by unrealistic expectations from family and business partners. Others wonder how they'll be treated once they retire and what they will do with themselves. Many simply don't see how they can attract a buyer, arrange a buyout, or realize other acceptable transactions.⁴⁵

"My business is my passion," says Dave Hale, who cofounded ScaleTronix, a designer and manufacturer of medical scales, in 1975. "The idea of ending what I do is just a terrible thought. Exiting seems like dying to me. What am I, if not my business?" Like Hale, many business

founders hesitate to let go of their businesses because their personal identities are so wrapped up in their companies. Over time, an entrepreneur's identity becomes so intertwined in the business that, in his or her mind, there is no distinction between the two. Many entrepreneurs share Hale's feelings; 52 percent of business owners say that they have no plans to retire and intend to work indefinitely.⁴⁷

Another barrier to succession planning is that, in planning the future of the business, owners must accept the painful reality of their own mortality. In addition, turning over the reins of a business they have sacrificed for, fretted over, and dedicated themselves to for so many years is extremely difficult to do—even if the successor is a son or daughter! Paul Snodgrass, son of the founder of Pella Products, a maker of apparel for work and outdoor activities who accepted leadership of the company from his father, explains, "Dad loves you and wants you to take over the business, but he also put heart and soul into that business, and he's not going to let anybody screw it up—not even you."⁴⁸ Finally, many family business founders believe that controlling the business also gives them a degree of control over family members and family behavior.

Planning for management succession protects not only the founder's, successor's, and company's financial resources, but it also preserves what matters most in a successful business: its heritage, tradition, and legacy. "Real succession planning involves developing a strategy for transferring the trust, respect, and goodwill built by one generation to the next," explains Andy Bluestone, who took over as president of the financial services company his father founded.⁴⁹ Management succession planning requires, first, an attitude of trusting others. It recognizes that other family members have a stake in the future of the business and want to participate in planning its future. Planning demonstrates an attitude that shows that decisions made with open discussion are more constructive than those without family input. Second, management succession is an evolutionary process and must reconcile an entrepreneur's inevitable anguish with the successors' desire for autonomy. Owners' emotional ties to their businesses usually are stronger than their financial ties. On the other side of the equation are the successors, who yearn to have the autonomy to run the business their way. These inherent conflicts can—and often do—result in skirmishes.

Succession planning reduces the tension and stress created by these conflicts by gradually "changing the guard." A well-developed succession plan is like the smooth, graceful exchange of a baton between runners in a relay race. The new runner still has maximum energy; the concluding runner has already spent his or her energy by running at maximum speed. The athletes never come to a stop to exchange the baton; instead, the handoff takes place on the move. The race is a skillful blend of the talents of all team members—an exchange of leadership so smooth and powerful that the business never falters but accelerates, fueled by a new source of energy at each leg of the race. At L.L. Bean, Leon Gorman, who led the company for 40 years before handing leadership over to current CEO Chris McCormick, recognized the importance of a seamless transition of leadership. He set up a three-member family governance committee made up of fourth-generation family members and encouraged family members to stay active in the business. Today, the fifth generation of family members is involved in orientation sessions in different areas of the company, and at the executive level, a structured leadership development process is in place. L.L. Bean has "moved the process down through the organization with leaders at all levels expected to contribute to succession planning," says McCormick.⁵⁰

Management succession involves a lengthy series of interconnected stages that begin very early in the life of the owner's children and extends to the point of final ownership transition (see Figure 22.4). If management succession is to be effective, it is necessary for the process to begin early in the successor's life (stage I). For instance, the owner of a catering business recalls putting his son to work in the family owned company at age seven. On weekends, the boy would arrive at dawn to baste turkeys and was paid in his favorite medium of exchange—doughnuts!⁵¹ In most cases, family business owners involve their children in their businesses while they are still in junior high or high school. "I grew up in the business," recalls Anthony Halas, now CEO of Seafolly, the swimwear company his father cofounded. "I spent my school holidays working in the warehouse, packing boxes. I always felt that [the business] was part of the family."⁵² Just as Anthony Halas experienced, the tasks in this phase may be routine, but the child is learning many important lessons, including the basics of how the business operates and an appreciation of the role the business plays in the life of the family. They learn firsthand about the values and

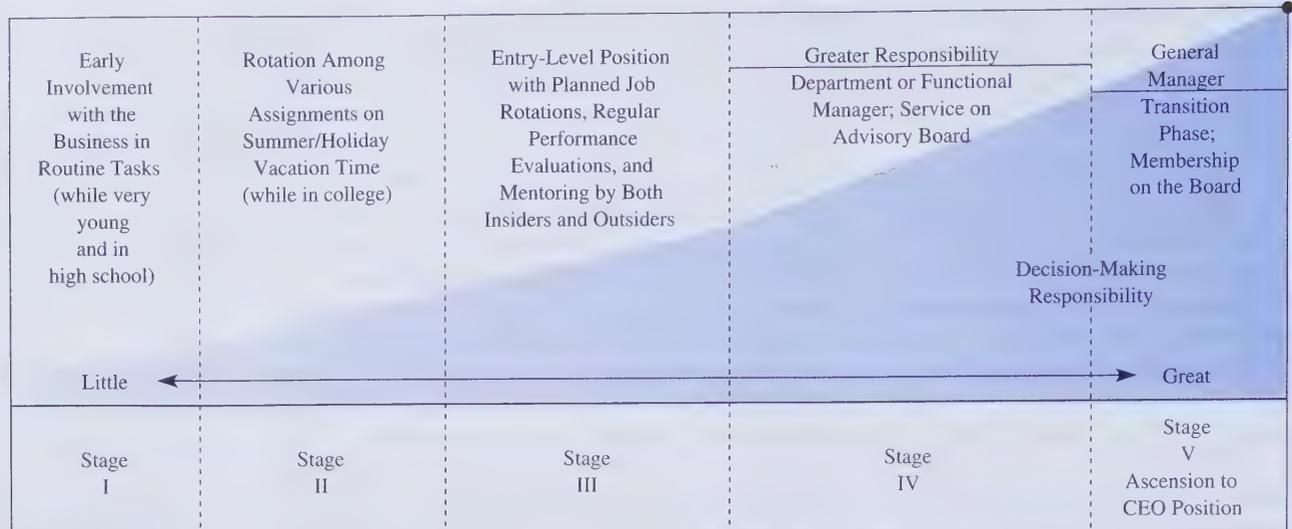


FIGURE 22.4

Stages in Management Succession

While in college, the successor moves to stage II of the continuum. During this stage, the individual rotates among a variety of job functions to both broaden his or her base of understanding of the business and permit the parents to evaluate his or her skills. On graduation from college, the successor enters stage III. At this point, the successor becomes a full-time worker and ideally has already begun to earn the respect of coworkers through his or her behavior in the first two stages of the process. In some cases, the successor may work for a time outside of the family business to gain experience and to establish a reputation for competency that goes beyond “being the boss’s kid.” Stage III focuses on the successor’s continuous development, often through a program designed to groom the successor using both family and nonfamily managers as mentors.



ENTREPRENEURIAL PROFILE: Danny Joyner: C. Dan Joyner Real Estate From the time that Danny Joyner was a young boy “helping” his father, Dan, in the real estate business that the elder Joyner had started with a \$2,000 loan, he knew that he wanted to join his father’s company. “I’ve always known that this is what I would do,” says Danny, who joined the company full-time after graduating from college. Danny managed the successful company’s commercial real estate division, and Dan’s two daughters and son-in-law, David Crigler, also worked in the family business. Because Dan had the foresight to put a succession plan in place and to help his children grow into leadership positions in the company, the company made a smooth transition into the second generation of ownership when Dan died in 2012. Danny took over as president, and Crigler assumed the role of chief operating officer. Carmen Feemster, representing the third generation of the Joyner family, recently began working for the company.⁵³

As the successor develops his or her skills and abilities, he or she moves to stage IV, in which real decision-making authority grows rapidly. Stage IV of the succession continuum is the period when the founder makes a final assessment of the successor’s competence and ability to take full and complete control over the firm. The skills the successor needs include the following:

- **Financial abilities.** Understanding the financial aspects of a business, what its financial position is, and the managerial implications of that position are crucial to success.
- **Technical knowledge.** Every business has its own body of knowledge, ranging from how the distribution system works to the trends shaping the industry, that an executive must master.
- **Negotiating ability.** Much of business, whether buying supplies and inventory or selling to customers, boils down to negotiating, and a business owner must be adept at it.
- **Leadership qualities.** Leaders must be bold enough to stake out the company’s future and then give employees the resources, the power, and the freedom to pursue it.
- **Communication skills.** Business leaders must communicate the vision they have for their businesses; good listening skills also are essential for success as a top manager.

- **Juggling skills.** Business owners must be able to handle multiple projects effectively. Like a juggler, they must maintain control over several important assignments simultaneously.
- **Integrity.** To be an effective leader of a family business, a successor must demonstrate honesty and integrity in business dealings.
- **Commitment to the business.** It helps if a successor has a genuine passion for the business. Leaders who have enthusiasm for what they do create a spark of excitement throughout the entire organization.⁵⁴

The final stage in the management succession process involves the ultimate transition of leadership. It is during this stage that the founder's role as mentor is most crucial. "One characteristic of stable family businesses is consistent leadership," says one family business expert.⁵⁵



ENTREPRENEURIAL PROFILE: Laura Michaud: Beltone Electronics Corporation

Laura Michaud, who in 1980 became the third-generation owner of Beltone Electronics Corporation, a very successful maker of hearing aids that was founded in 1940, says that the training and mentoring that her father provided was key to her success to managing the family business. Her father insisted on an extensive training program that involved Michaud in all aspects of the company, including having her actually build a hearing aid. "You need to work in all areas of operations," says Michaud, who ran the company for 17 years before selling it to a larger company.⁵⁶

In stage IV, the successor may become the organization's CEO, while the former CEO retains the title of chairman of the board. In other cases, the best solution is for the founder to step out of the business entirely and give the successor the chance to establish his or her own identity within the company. "Any leader's final legacy is building the next generation," says one business consultant.⁵⁷



In the Entrepreneurial Spotlight

Can Your Family Business Survive for Centuries?

In 1535, Henry VIII was King of England and was still married to Anne Boleyn; the first English translation of the Bible was printed in Antwerp, Belgium; and R. J. Balson began selling meat from a stall in a market on South Street in Bridport, Dorset, England. Nearly 500 years and 25 generations later, R.J. Balson and Sons is still thriving in Dorset and holds the title of the oldest family business in Great Britain. In 1880, the butcher shop moved to its current location, not far from the original South Street stall, having passed from one generation of the family to the next. Current owners Richard Balson and Rudi and Jane Boulay took over the family business after Richard and Jane's father, Donald, died in 2011 at age 88. R.J. Balson and Sons has survived for centuries by sticking to the business that the family knows best—selling a variety of meats and sausages ("bangers" in local parlance) made out of exotic meats such as elk, wild boar, duck, and ostrich, rusk (ground bread crumbs), and fresh herbs. To thrive as it has, the company also has changed over time, adapting to the dynamic environment in which it operates. Once a purely local business, R.J. Balson and Sons now sells its exotic meats to customers around the world through its Web site (www.balsonbutchers.com). "My son has come into the business to run the online side," says Richard. "He's got a son, too, so hopefully it'll keep going. The family joke is that we've just never made enough money to be able to retire."

In 2007, after a career as a professional soccer player, coach, and referee, Mike Balson, Richard's brother, returned to the family business and opened a production facility in the United States

with his son, Oliver. "They have survived many more transitions than most and have naturally had to evolve to take into account the significant economic developments that they have been part of to still be in business today," says Paul Andrews, founder of Family Business United.

What allows a family business such as R.J. Balson and Sons to succeed for 25 generations when so many fail to make the transition from the first generation to the second? The following tips increase the chances of a smooth transition from one generation to the next:

Develop a passion for passing the torch of leadership. Management succession does not happen by accident; it requires commitment from each generation of leadership. "Family business leaders feel a certain duty to act as stewards of the family business for the next generation," says Paul Andrews.

Cultivate a passion for the family business in each successive generation. Leaders of successful family businesses usually involve their children in the business early on and allow them to have fun while they work and develop an appreciation for how special a family business can be. "The love of the job, which has been passed down from generation to generation, is one of the main reasons we have been successful," says Richard Balson of R.J. Balson and Sons.

In the Entrepreneurial Spotlight *(continued)*

Develop a succession plan. As you have learned in this chapter, passing a business to the next generation requires a sound succession plan. Many family business owners work with consultants, who provide important objectivity, to create succession plans. Building and implementing a succession plan takes time, and family business leaders must resist the natural temptation to postpone this vital task until it is too late.

Select the right successor. Family business owners must look beyond seniority to determine which family member—or whether *any* family member—of the next generation is most qualified to lead the business. Leaders of some enduring family businesses, such as L.L. Bean and Zambelli Fireworks, have been bold enough to bring in managers from outside the family to run the business. One family business consultant suggests that family business owners create a list of all possible successors and rank them on a 1-to-10 scale in areas such as education, work experience, ability to learn, desire to advance, interpersonal skills, decision-making ability, knowledge of the industry and the business, character, and others.

Groom the successor over time. Once a family business leader identifies the right successor, his or her duty is to prepare the successor for the leader's job. Once again, starting early is the key because grooming a successor usually takes years. Ensuring that the successor gains experience in all of the functional areas of the business and understands the "big picture" that determines the company's ability to succeed are vital tasks.

Allow the successor to put his or her "stamp" on the business. When a successor takes the helm of the family business, the former leader must avoid undermining his or her leadership by unofficially remaining in power. Some business leaders have difficulty letting go of the reins that they have held for so long, but doing so only weakens the new leader's authority. Outgoing leaders must recognize that the new generation of leadership has its own ideas for improving the business. If the outgoing leaders have properly groomed their successors, they can be confident that the changes that the new leadership makes are consistent with the vision and mission of the company.

Establish a mechanism for dealing with conflict. Conflict is a natural part of any family and any business, but families must manage conflict if a business is to succeed. A family council that is comprised of family members from different generations and trusted business advisers from outside the family is one of the best ways to handle conflicts. Regular meetings in which everyone feels free to speak out on important issues facing the company not only help resolve conflict but also help business leaders make good decisions by hearing all sides of the issues. "The family agreed that a lack of transparent communication would be the only thing that could pull us apart," says Jack Mitchell, second-generation CEO of Mitchells Family of Stores. "We have scheduled weekly family meetings in which we discuss in a 'safe haven' any issues that are on the working family members' minds."

1. Use a search engine to learn more about family businesses that have thrived across many generations (e.g., Zambelli Fireworks, Omaha Steaks, Martin Guitars, George R. Ruhl & Son, Antoine's Restaurant, Verdin Bells and Clocks, and Hicks Nurseries). What factors have allowed these companies to be successful across many generations of owners?
2. Select one of the long-lasting family businesses that you discovered and write a one-page summary of the business, what it does, how it handles the issue of management succession, and what has enabled the business to succeed for so long.

Sources: Based on Leah Golob, "Ten Reasons Why Family Businesses Fail," *Globe and Mail*, July 20, 2012, www.theglobeandmail.com/report-on-business/small-business/sb-tools/top-tens/ten-reasons-why-family-businesses-fail/article4219703; Jack Mitchell, "Family Business: How to Pass the Baton," *CNN Money*, July 9, 2012, <http://management.fortune.cnn.com/2012/07/09/family-business-succession/>; Jean Scheid, "10 Business Success Stories: Keeping It in the Family," *Bright Hub*, October 27, 2011, www.brighthub.com/office/entrepreneurs/articles/126179.aspx; Lois Lang, "5 Tips for Family Business Succession Planning," *Landscape Management*, April 4, 2013, <http://landscapemanagement.net/2013/04/04/march-web-extra-who-gets-dads-office/>; Fraser McAlpine, "Introducing Britain's Oldest Family-Run Business," *BBC America*, November 4, 2011, www.bbcamerica.com/anglophonia/2011/11/introducing-britains-oldest-family-run-business/; Luke Salkeld, "Butcher's That's Been Around Since Henry VIII Celebrates Being Oldest Family Business in Britain," *Daily Mail*, November 3, 2011, www.dailymail.co.uk/news/article-2057236/Butchers-RJ-Balson-Sons-crowned-oldest-family-business-Britain.html; Shane Schutte, "A Glimpse Behind the History of Britain's Oldest Family Business, Dating Back to 476 Years Ago," *Real Business*, December 3, 2012, <http://realbusiness.co.uk/article/16716-the-oldest-family-businesses-in-britain/>; "History of RJ Balson and Son," RJ Balson and Son, www.balsonbutchers.com/pages/about.

Developing a Management Succession Plan

4.

Explain how to develop an effective management succession plan.

Families that are most committed to ensuring that their businesses survive from one generation to the next exhibit four characteristics: (1) They believe that owning the business helps achieve their families' missions, (2) they are proud of the values their businesses are built on and exemplify, (3) they believe that the business is contributing to society and makes it a better place to live, and (4) they rely on management succession plans to ensure the continuity of their companies.⁵⁸ Unfortunately, 55 percent of small business owners have not established a formal succession plan for their companies (including 43 percent of owners who are 67 or more years old).⁵⁹ Developing a plan takes time and dedication, yet the benefits are well worth the cost. A sound succession plan enables a company to maintain its momentum and sense of purpose and direction.

It is important to start the planning process early, well before the founder's retirement. Succession planning is not the kind of activity an entrepreneur can do in a hurry, and the sooner an entrepreneur starts, the easier it will be. Sandy and Sheeha Noce, owners of Pro 6 Cycle, a

company in Etobicoke, Canada, that provides motorbike racing experiences for cycling fans, already have begun making plans to include their daughter, Claire, who recently turned one, in the family business—if she chooses that route when she is old enough. “She has influenced all of our plans,” says Sandy.⁶⁰ Unlike the Noces, too many entrepreneurs put off succession planning until it’s too late. “Very few privately owned business make it through several generations, and one reason is the failure of the senior generation to do any planning at all until it is too late in the game,” says one expert.⁶¹ Creating a succession plan involves the following steps.

Step 1. Select the successor. Families often grow faster than a family business. A family in which each member of each generation has three children with a business that survives to the fourth generation would have 52 members (including spouses), with 27 potential successors in the fourth generation. The numbers alone dictate that a founder commits to selecting a successor long before he or she is ready to step down. The average tenure of the founder of a family business is 25 years, compared to just seven years for the CEO of a publicly held company.⁶² Yet there comes a time for even the most dedicated founder to step down and hand the reins of the company to the next generation. Entrepreneurs should never assume that their children want to take control of the business, however. Above all, they should not be afraid to ask the question “Do you really want to take over the family business?” Too often, children in this situation tell Mom and Dad what they want to hear out of loyalty, pressure, or guilt. It is critical to remember at this juncture in the life of a business that children do not necessarily inherit their parents’ entrepreneurial skills and desires. By leveling with their children about the business and their options regarding a family succession, owners can know which heirs, if any, are willing to assume leadership of the business.

One of the worst mistakes entrepreneurs can make is to postpone naming a successor until just before they are ready to step down. “I remember saying to our family business advisor, ‘If my parents do not provide me and my siblings with a clear picture of my future in the family business soon, including whether I will ever be an owner, I am out of here,’” says the daughter of a family business owner. Fortunately, her parents created a succession plan and selected her as their successor.⁶³ The problem is especially acute when more than one family member works for the company and is interested in assuming leadership of it. Sometimes founders avoid naming successors because they don’t want to hurt the family members who are not chosen to succeed them. However, both the business and the family will be better off if, after observing family members as they work in the business, the founder picks a successor based on skill and ability.



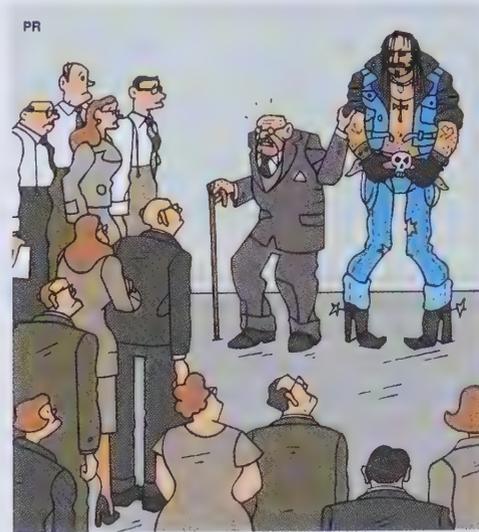
ENTREPRENEURIAL PROFILE: David de Rothschild: Rothschild Group David de Rothschild, the sixth-generation CEO of the Rothschild Group, one of the world’s largest financial advisory groups founded in the early 1800s, has been grooming his son, Alexandre, for years to become the next leader of the family business. After graduating from college, Alexandre worked in other financial services companies around the world, learning various aspects of the financial and investment industries before joining the family business. None of David’s three daughters had an interest in the family business, leaving Alexandre as the natural choice to manage the company. Alexandre remains humble about his selection. “The last thing I want to do is impose myself as leader just because I carry the [family] name.” Alexandre, who has served in a variety of roles as Rothschild Group since joining the business, will assume the leadership role within five years.⁶⁴

When naming a successor, merit is a better standard to use than gender or birth order. The key is to establish standards of performance, knowledge, education, and ability and then to identify the person who best meets those standards. As part of his company’s succession plan, Joe De La Torre selected his daughter Gina to take over Jaunita’s Foods rather than his two sons because her financial skills and her ability to solve problems were what the company needed most.⁶⁵ Gina La Torre is part of a growing trend among family businesses; 34 percent of family business founders expect the next CEO to be a woman, quite a change from just a generation ago.⁶⁶



ENTREPRENEURIAL PROFILE: Harry and Kirsten Vold: Harry Vold Rodeo Company After 60 years, Harry Vold, founder of Harry Vold Rodeo Company, a business based in Pueblo West, Colorado, that supplies rodeos with bucking broncos and bulls, turned over the reins of the

Source: CartoonStock.



"I want you to meet my son Edward.
One day, this company will belong to him
and I think it's time for all of you to get to know
each other."

family business to the youngest of his six children, Kirsten, when she was just 25 years old. Although Harry expected one of his children to take over the business, he was a bit surprised that Kirsten was the one who showed the greatest potential and stepped forward. Kirsten, too, was somewhat surprised. "I was going to be a lawyer, drive a sports car, and live in L.A.," she says with a laugh. After graduating from the University of Southern Colorado, Kirsten took a job in sports marketing but soon felt the tug of the family business and returned home to take an active role in managing it. Kirsten worked hard to prove herself in an industry that men tend to dominate. "She's earned their respect," says her mother proudly. Transferring control from one generation to the next taxed the skills, patience, and ability of both Harry and Kirsten. "It was a struggle, a power struggle, along the way, but it built character for both of us," she says. Harry is pleased with the way things worked out. "I was a bit surprised to begin with, but I'm not now," he says. "I am totally confident that she makes the right decisions. As far as I'm concerned, she's all the cowgirl I need."⁶⁷

Even in China, traditionally a male-dominated society, entrepreneurs are turning over their businesses to their daughters more frequently. Zong Qinhou, China's wealthiest person with a net worth of \$20.1 billion, recently named his daughter Kelly as his successor at Hangzhou Wahaha Group, the company that he started and built into China's largest beverage company. Kelly, a graduate of California's Pepperdine University with a degree in international business, joined her father's company in 2005 and became president in 2012.⁶⁸

Step 2. Create a survival kit for the successor. Once an entrepreneur identifies a successor, he or she should prepare a survival kit and then brief the future leader on its contents, which should include all of the company's critical documents (wills, trusts, insurance policies, financial statements, bank accounts, key contracts, corporate bylaws, and so forth). The founder should be sure that the successor reads and understands all of the relevant documents in the kit. Other important steps the owner should take to prepare the successor to take over leadership of the business include the following:

- Create a strategic analysis for the future. Working with the successor, entrepreneurs should identify the primary opportunities and the challenges facing the company and the requirements for meeting them.
- Share with the successor their vision of the business's future direction, describing key factors that have led to its success and those that will bring future success.
- Be open and listen to the successor's views and concerns.
- Teach and learn at the same time.

- Identify the industry's key success factors and link them to the company's performance and profitability.
- Explain the company's overall strategy and how it creates a competitive advantage.
- Discuss the values and philosophy of the business and how they have inspired and influenced past actions.
- Discuss the people in the business and their strengths and weaknesses.
- Describe the philosophy underlying the company's compensation policy.
- Make a list of the company's most important customers and its key suppliers or vendors and review the history of all dealings with the parties on both lists.
- Discuss how to treat the company's key stakeholders to ensure the company's continued success.
- Develop a job analysis by taking an inventory of the activities involved in leading the company. This analysis can show successors those activities on which they should be spending most of their time.
- Document as much process knowledge—"how we do things"—as possible. After many years in their jobs, business owners are not even aware of their vast reservoirs of knowledge. For them, making decisions is a natural part of their business lives. They do it effortlessly because they have so much knowledge and experience. It is easy to forget that a successor will not have the benefit of those years of experience unless the founder communicates it.
- Include an ethical will, a document that explains to the next generation of leaders the ethical principles on which the company operates. An ethical will gives company founders the chance to bequeath to their heirs not only a business but also the wisdom and ethical lessons learned over a lifetime.



ENTREPRENEURIAL PROFILE: Paul Weber: Weber's Hamburgers In 1963, Paul Weber started Weber's Hamburgers, a small restaurant that has become a landmark, in Ontario, Canada, known for its fresh, tasty burgers. Targeting vacationers and city dwellers looking for an escape, Weber selected a location near the small town of Orillia, about two hours north of Toronto. On a typical Saturday during the peak summer season, Weber's serves about 800 hamburgers per hour, a pace that tests the restaurant's systems and employees. Managing the family business is second-generation owner Paul Weber Jr., who grew up working in the restaurant and took over the family business in 1989. Paul Jr. credits much of the company's success to the systems that his father established, refined, and documented over more than a quarter of a century. In fact, the Weber family continues to document for future generations every part of their business, including the order processing procedure and the techniques they use to entertain guests when lines stretch across the parking lot.⁶⁹

Step 3. Groom the successor. The process by which business founders transfer their knowledge to the next generation is gradual and often occurs informally as they spend time with their successors. Grooming the successor is the founder's greatest teaching and development responsibility and takes time, usually 5 to 10 years. To implement the succession plan, the founder must be as follows:

- Patient, realizing that the transfer of power is gradual and evolutionary and that the successor should earn responsibility and authority one step at a time until the final transfer of power takes place
- Willing to accept that the successor will make mistakes
- Skillful at using the successor's mistakes as a teaching tool
- Able to build the successor's confidence as his or her abilities grow
- An effective communicator and an especially tolerant listener
- Capable of establishing reasonable expectations for the successor's performance
- Able to articulate the keys to the successor's performance

Teaching is in reality the art of assisting discovery and requires letting go rather than controlling. When problems arise in the business, the founder should consider delegating some of them to the successor in training. The founder also must resist the

tendency to wade in and fix the problem unless it is beyond the scope of the successor's ability. Most great teachers and leaders are remembered more for the success of their students than for their own success.

Step 4. *Promote an environment of trust and respect.* Another priceless gift a founder can leave a successor is an environment of trust and respect. Trust and respect on the part of the founder and others fuel the successor's desire to learn and excel and build the successor's confidence in making decisions. Empowering the successor by gradually delegating responsibilities creates an environment in which all parties can objectively view the growth and development of the successor. Customers, creditors, suppliers, and staff members can gradually develop confidence in the successor. The final transfer of power is not a dramatic, wrenching change but a smooth, coordinated passage.

A problem for some founders at this phase is the meddling retiree syndrome, in which they continue to show up at the office after they have officially stepped down and get involved in business issues that no longer concern them. This tendency merely undermines the authority of the successor and confuses employees as to who really is in charge. Helen Dragas, who succeeded her father at the Dragas Company, a residential construction business, praises her father for handing the reins of the company over to her and then trusting her to handle them. "He gave me the authority and then he stepped back," she says of the successful transfer of leadership.⁷⁰

Step 5. *Cope with the financial realities of estate and gift taxes.* The final step in developing a workable management succession plan structuring is the transition to minimize the impact of estate and gift taxes on family members and the business. Entrepreneurs who fail to consider the impact of these taxes (which have been as high as 55 percent) may force their heirs to sell a successful business just to pay the estate's tax (commonly known as the "death tax") bill. Despite facing potentially large tax bills, only 41 percent of business owners have created a comprehensive estate plan!⁷¹



ENTREPRENEURIAL PROFILE: Clayton Leverett: Stillwater Farm Just a few hours after Clayton Leverett's son, Whit, was born, the young father began to wonder whether Whit would be able to retain the family's 150-year-old Stillwater Ranch, a cattle ranch in Llano, Texas, now in its fifth generation of ownership. Estate taxes have cut deeply into the Leverett family's landholdings and cattle operations twice before. The family was forced to sell thousands of acres of valuable land to pay estate taxes when Clayton's grandmother died in 2006. When Clayton's father died later that same year, the family faced the estate tax a second time and once again had to sell acreage and lay off employees. Clayton also had to take on a second job to pay the estate tax. "We will only be able to sell only so much [land] before the ranch becomes unprofitable and we are forced to sell the entire operation," explains a frustrated Clayton.⁷²

Congress eliminated the estate tax in 2010 but reinstated it in 2011 (see Table 22.2). A study by Antony Davies of Duquesne University reports that for every 4.5 percent increase in the estate tax (the average increase in the tax since 1993), 6,000 small businesses are liquidated or absorbed into large companies. Conversely, Davies's research suggests that repealing the tax would create 100,000 new businesses that would employ 2 million workers with a total payroll of \$80 billion.⁷³

Entrepreneurs who fail to engage in proper estate planning subject their family members to a painful tax bite when they inherit the family business. Entrepreneurs should be actively engaged in estate planning no later than age 45; those who start businesses early in their lives or whose businesses grow rapidly may need to begin as early as age 30. A variety of options exist that may prove to be helpful in reducing the estate tax liability. Each operates in a different fashion, but their objective remains the same: to remove a portion of business owners' assets from their estates so that when they die, those assets will not be subject to estate taxes. Many of these estate planning tools need time to work their magic, so the key is to put them in place early on in the life of the business.

Buy-Sell Agreement

One of the most popular estate planning techniques is the buy-sell agreement. A **buy-sell agreement** is a contract that co-owners often rely on to ensure the continuity of a business. In a buy-sell arrangement, the co-owners create a contract stating that each agrees to buy the others out in case

TABLE 22.2 Changes in the Estate and Gift Taxes

After years of complaints from family business owners, Congress finally overhauled the often punishing structures of estate and gift taxes. The gift tax applies to gifts that a donor makes during his or her lifetime; the estate tax applies to assets that a person leaves at his or her death. The federal estate tax is actually interwoven with the gift tax but for a time, the impact of the two taxes differed. Congress repealed the estate tax in 2010, but the tax reappeared in 2011. When George Steinbrenner, owner of the New York Yankees, died in 2010, the year Congress repealed the estate tax, his heirs paid no estate taxes. Had Steinbrenner died in 2009, however, his heirs would have faced a stiff tax bill of \$500 million! The following table shows the trends in the exemptions and the maximum tax rates for the estate and gift taxes:

Year	Estate Tax Exemption	Gift Tax Exemption	Maximum Tax Rate
2001	\$675,000	\$675,000	55%
2002	\$1 million	\$1 million	50%
2003	\$1 million	\$1 million	49%
2004	\$1.5 million	\$1 million	48%
2005	\$1.5 million	\$1 million	47%
2006	\$2 million	\$1 million	46%
2007	\$2 million	\$1 million	45%
2008	\$2 million	\$1 million	45%
2009	\$3.5 million	\$1 million	45%
2010	Tax repealed	\$1 million	35% (gifts only)
2011	\$1 million	\$1 million	55%
2012	\$5.12 million	\$5.12 million	35%
2013	\$5.25 million	\$5.25 million	40%

No matter how the federal laws governing estate taxes may change over the next few years, entrepreneurs whose businesses have been successful must not neglect estate planning. Even though the federal estate tax burden has eased somewhat (at least for a while), many states have *increased* their estate tax rates.

Sources: Based on Brad Hamilton and Jeane MacIntosh, "Death's Perfect Timing," *New York Post*, July 14, 2010, www.nypost.com/p/news/local/death_perfect_timing_NusLyGIMu8cn8kyepprVJP?CMP=OTCRSS&FEEDNAME; Tom Herman, "Estate Taxes Will Turn Sharply Lower on Jan. 1," *Wall Street Journal*, November 20, 2003, p. D2; Jeanne Lee, "Death and Estate Taxes," *FSB*, April 2004, p. 96.

of the death or disability of one. That way, the heirs of the deceased or disabled owner can "cash out" of the business while leaving control of the business in the hands of the remaining owners. The buy-sell agreement specifies a formula for determining the value of the business at the time the agreement is to be executed. One problem with buy-sell agreements is that the remaining co-owners may not have the cash available to buy out the disabled or deceased owner. To resolve this issue, many businesses buy life and disability insurance for each of the owners in amounts large enough to cover the purchase price of their respective shares of the business. Without the support of adequate insurance policies, a buy-sell agreement offers virtually no protection.

Lifetime Gifting

The owners of a successful business may transfer money to their children (or other recipients) from their estate throughout the parents' lives. Current federal tax regulations allow individuals to make gifts of \$14,000 per year, per parent, per recipient, that are exempt from federal gift taxes. Another benefit: gift recipients do not have to pay taxes on the gift. For instance, husband-and-wife business owners could give \$1.68 million worth of stock to their three children and their spouses over a period of 10 years without incurring any estate or gift taxes at all.

Setting Up a Trust

A **trust** is a contract between a grantor (the founder) and a trustee (generally a bank officer or an attorney) in which the grantor gives to the trustee legal title to assets (e.g., stock in the company), which the trustee agrees to hold for the beneficiaries (the founder's children). The beneficiaries can receive income from the trust, the property in the trust, or both at some specified time. More entrepreneurs are turning to trusts to minimize the impact of estate taxes on their heirs; only 52 percent of business owners have transferred assets into a trust established for future generations.⁷⁴

Trusts can take a wide variety of forms, but two broad categories of trusts are available: revocable trusts and irrevocable trusts. A **revocable trust** is one that the grantor can change or revoke during his or her lifetime. Under present tax laws, however, the only trust that provides a tax benefit is an **irrevocable trust**, in which the grantor cannot require the trustee to return the assets held in trust. The value of the grantor's estate is lowered because the assets in an irrevocable trust are excluded from the value of that estate. However, an irrevocable trust places severe restrictions on the grantor's control of the property placed in the trust. Business owners use several types of irrevocable trusts to lower their estate tax liabilities.

BYPASS TRUST The most basic type of trust is the bypass trust (or A-B trust), which allows a business owner to put assets into a trust and name his or her spouse as the beneficiary on the owner's death. The spouse receives the income from the trust throughout his or her life, but the principal in the trust bypasses the surviving spouse's estate and goes to the couple's heirs free of estate taxes on the spouse's death. A bypass trust is particularly useful for couples who plan their estates together. By leaving assets to one another in bypass trusts, they can make sure that their assets are taxed only once between them. However, entrepreneurs should work with experienced attorneys to create bypass trusts because the IRS requires that they contain certain precise language to be valid. Because the American Taxpayer Relief Act increased the estate tax exemption to \$5.25 million (\$10.5 million per married couple), fewer entrepreneurial couples may need the tax relief that bypass trusts offer.

IRREVOCABLE LIFE INSURANCE TRUST This type of trust allows a business owner to keep the proceeds of a life insurance policy out of his or her estate and away from estate taxes, freeing up that money to pay the taxes on the remainder of the estate. To get the tax benefit, business owners must be sure that the business or the trust (rather than themselves) owns the insurance policy. The primary disadvantage of an irrevocable life insurance trust is that if the owner dies within three years of establishing it, the insurance proceeds *do* become part of the estate and *are* subject to estate taxes. Because the trust is irrevocable, it cannot be amended or rescinded once it is established. Like most trusts, irrevocable life insurance trusts must meet stringent requirements to be valid, and entrepreneurs should use experienced attorneys to create them.

IRREVOCABLE ASSET TRUST An irrevocable asset trust is similar to a life insurance trust except that it is designed to pass the assets in the parents' estate on to their children. The children do not have control of the assets while the parents are still living, but they do receive the income from those assets. On the parents' death, the assets in the trust go to the children without being subjected to the estate tax.

GRANTOR RETAINED ANNUITY TRUST A grantor retained annuity trust (GRAT) is a special type of irrevocable trust and has become a popular tool for entrepreneurs to transfer ownership of a business to their heirs while maintaining control over it and minimizing estate taxes. Under a GRAT, an owner can put property in an irrevocable trust for a maximum of ten years. While the trust is in effect, the grantor (owner) retains the voting power and receives the interest income from the property in the trust. At the end of the trust (not to exceed 10 years), the property passes to the beneficiaries (heirs). The beneficiaries are required to pay the gift tax on the value of the assets placed in the GRAT but no estate tax on them. However, the IRS taxes GRAT gifts only according to their discounted present value because the heirs did not receive use of the property while it was in trust. The primary disadvantage of using a GRAT in estate planning is that if the grantor dies during the life of the GRAT, its assets pass back into the grantor's estate. These assets then become subject to the full estate tax.

Establishing a trust requires meeting many specific legal requirements and is not something business owners should do on their own. It is much better to hire experienced attorneys, accountants, and financial advisers to assist in creating them. Although the cost of establishing a trust can be high, the tax savings they generate are well worth the expense.

ESTATE FREEZE An **estate freeze** attempts to minimize estate taxes by having family members create two classes of stock for the business: (1) preferred voting stock for the parents and (2) nonvoting common stock for the children. The value of the preferred stock is frozen, whereas the common stock reflects the anticipated increased market value of the business. Any appreciation in the value of the business after the transfer is subject to estate taxes. If the parents must pay gift tax on the value of the common stock given to the children. The value

of the common stock is the total value of the business less the value of the voting preferred stock retained by the parents. The parents also must accept taxable dividends at the market rate on the preferred stock they own.

FAMILY LIMITED PARTNERSHIP Creating a **family limited partnership (FLP)** allows business-owning parents to transfer their company to their children (thus lowering their estate taxes) while still retaining control over it for themselves. To create an FLP, the parents (or parent) set up a partnership among themselves and their children. The parents retain the general partnership interest, which can be as low as 1 percent, and the children become the limited partners. As general partners, the parents control both the limited partnership and the family business. In other words, nothing in the way the company operates has to change. Over time, the parents can transfer company stock into the limited partnership, ultimately passing ownership of the company to their children.

One of the principal tax benefits of an FLP is that it allows discounts on the value of the shares of company stock the parents transfer into the limited partnership. Because a family business is closely held, shares of ownership in it, especially minority shares, are not as marketable as those of a publicly held company. As a result, company shares transferred into the limited partnership are discounted at 20 to 50 percent of their full market value, producing a large tax savings for everyone involved. The average discount is 40 percent, but that amount varies based on the industry and the individual company involved. A business owner should consider an FLP as part of a succession plan “when there has been a buildup of substantial value in the business and the older generation has a substantial amount of liquidity,” says one expert.⁷⁵

Because of their ability to reduce estate and gift taxes, FLPs have become one of the most popular estate planning tools in recent years. However, a Tax Court ruling against a Texas entrepreneur who, two months before he died, established an FLP that contained both business and personal assets cast a pall over the use of FLPs as estate planning tools. Another case, however, calmed estate planners’ fears and reestablished the use of FLPs as legitimate estate planning tools as long as entrepreneurs create them properly. The following tips will help entrepreneurs establish an FLP that will withstand legal challenges:

- Establish a legitimate business reason other than avoiding estate taxes—such as transferring a business over time to the next generation of family members—for creating the FLP and document it on paper.
- Make sure all members of the FLP make contributions and take distributions according to a predetermined schedule. “Don’t allow partners to use partnership funds to pay for personal expenses and do not time partnership distributions with personal needs for cash,” says one attorney.⁷⁶
- Do not allow members to put their personal assets (such as a house, automobiles, or personal property) into the FLP. Commingling personal and business assets in an FLP raises a red flag to the IRS.
- Maintain proper records for establishing and operating the FLP and conduct all required meetings.
- Expect an audit of the FLP. The IRS tends to scrutinize FLPs; be prepared for a thorough audit.⁷⁷

Developing a succession plan and preparing a successor requires a wide variety of knowledge and skills, some of which the business founder will not have. That’s why it is important to bring into the process experts when necessary. Entrepreneurs often call on their attorneys, accountants, insurance agents, and financial planners to help them build a succession plan that works best for their particular situations. Because the issues involved can be highly complex and charged with emotion, bringing in trusted advisers to help improves the quality of the process and provides an objective perspective.

Risk Management Strategies

Insurance is an important part of creating a management succession plan because it can help business owners minimize the taxes on the estates they pass on to their heirs and can provide much-needed cash to pay the taxes the estate does incur. However, insurance plays an important role in many other aspects of a successful business—from covering employee injuries to protecting against

5.

Understand the four risk management strategies.

natural disasters that might shut a business down temporarily. When most small business owners think of risks such as these, they automatically think of insurance. However, insurance companies are the first to point out that insurance does not solve all risk problems. A more comprehensive strategy is risk management, which takes a proactive approach to dealing with the risks that businesses face daily. One recent survey shows that just 37 percent of small companies have an emergency preparedness plan for dealing with either a natural or man-made disaster.⁷⁸ In addition, only one-third of companies say that they are well prepared to cope with a threat or disaster.⁷⁹ “Small companies often spend more time planning the company picnic than planning for an event that could put them out of business,” says one insurance expert.⁸⁰ Dealing with risk successfully requires a combination of four risk management strategies: avoiding, reducing, anticipating, and transferring risk.

Avoiding risk requires a business to take actions to shun risky situations. For instance, conducting credit checks of customers helps decrease losses from bad debts. Wise entrepreneurs know that they can avoid some risks simply by taking proactive management actions. Workplace safety improves when business owners implement programs designed to make all employees aware of the hazards of their jobs and how to avoid being hurt. Business owners who have active risk identification and prevention programs can reduce their potential insurance costs as well as create a safer, more attractive work environment for their employees. Because avoiding risk altogether usually is not practical, however, a strategy of reducing risk becomes necessary.

A risk reducing strategy requires a company to take steps to lower the level of risk associated with a situation.



ENTREPRENEURIAL PROFILE: George Pauli: Great Embroidery LLC George Pauli, owner of Great Embroidery LLC in Mesa, Arizona, recently installed backup generators for the two machines that he uses to stitch logos on 12 garments at a time. Pauli’s business experiences power interruptions about six times a year, and before he installed the generators, each incident cost him at least \$120 in lost merchandise because the machines’ needles could not resume exactly where they had left off when the power shut off.⁸¹

Risk reduction strategies do not eliminate risk, but they lessen its impact. Even with avoidance and reduction strategies, the risk is still present; thus, losses can occur.

Risk anticipation strategies promote self-insurance. Knowing that some element of risk still exists, a business owner puts aside money each month to cover potential losses. Sometimes a self-insurance fund may not be large enough to cover the losses from a particular situation. When this happens, a business stands to lose despite the best efforts to anticipate risk, especially in the first few years before the fund is fully funded and able to cover large claims. Most businesses, therefore, include in their risk strategies some form of insurance to transfer risk. The Patient Protection and Affordable Care Act, the sweeping health care reform legislation passed in 2010, makes self-insurance a more attractive option for small businesses that provide health care to their employees. When a company is self-insured, it assumes the financial risk of paying for its employees’ medical claims. If several workers suffer catastrophic injuries or illnesses at once, a company could face a cash crisis. If employees’ claims are low in a given year, however, the company saves money over what it would have paid an insurance company in premiums. Recognizing that a self-insurance strategy alone could be risky, many self-insured businesses purchase “stop-loss” policies, which take over payment if any individual employee’s health care costs exceed a specific cap that can be as low as \$10,000. Self-insured companies usually hire a benefits administration company to handle all of the insurance paperwork; many providers now offer administration services for companies with as few as 10 employees. In addition, the Patient Protection and Affordable Care Act allows self-insured companies to switch to full insurance if several of their employees develop costly illnesses. Under the law, companies can reenter the fully insured market with no penalty because insurance companies must accept every employer or individual who applies for coverage.

Self-insurance for health care provides small companies with many benefits. They can customize their health care plans to meet the needs of their workers, maintain control over the health care reserves that they put aside, avoid prepaying insurance companies for coverage, circumvent state health insurance premium taxes, and save money.⁸²



ENTREPRENEURIAL PROFILE: NorthBay Adventure NorthBay Adventure, a company based in North East, Maryland, that provides outdoor educational experiences for children, recently switched to a self-insurance health care plan in an attempt to reduce the rapidly escalating costs of the premiums its former insurance company was charging. The company’s 60 employees,

most of whom are young and healthy, hardly noticed the change, yet executive director George Comfort says that self-insurance saves the company 45 percent per year over its former fully insured coverage.⁸³

Risk transfer strategies depend on using insurance. Purchasing insurance is a risk transfer strategy because an individual or a business shifts some of the costs of a particular risk to an insurance company that is set up to spread out the financial burdens of risk. During a specific time period, the insured business pays money (a premium) to an insurance carrier (either a private company or a government agency). In return, the carrier promises to pay the insured a certain amount of money in the event of a loss. Small companies across the United States are feeling the pinch of rapidly escalating insurance costs and are devising creative ways to control them.

Captive insurance, which is a hybrid of self-insurance and risk transfer strategies, is a technique that large businesses have used for years but is gaining popularity among small businesses. To implement a captive insurance strategy, a small company sets up its own insurance company or bands together with other small businesses to create their own insurance company and contribute enough capital to cover a defined level of risk. The group outsources the daily management of the insurance company to a business that specializes in that area and then purchases reinsurance to cover losses above the amount that they have contributed. Over time, if the group experiences no large losses, the excess capital paid into the insurance company goes back to the businesses as dividends. Experts estimate that creating a captive insurance company costs between \$30,000 and \$50,000 (including a feasibility study) and \$35,000 to \$100,000 per year to maintain. To make captive insurance viable, a company should have annual sales of at least \$15 million.⁸⁴



ENTREPRENEURIAL PROFILE: Ken Sturm: Iridium Jazz Club Ken Sturm, owner of several restaurants and clubs in New York City, including the Iridium Jazz Club, that employ about 450 people, recently established a captive insurance company after an incident in which a crane collapse forced one of his restaurants in Times Square to close for three days, costing him tens of thousands of dollars in lost sales. Sturm had business interruption insurance with a traditional insurance company, but the policy had a waiting period of 96 hours before it paid to cover any losses. Sturm spent \$25,000 to set up his captive insurance company and pays Artex Risk Solutions, a captive insurance administration company, about \$36,000 a year to maintain it.⁸⁵

The Basics of Insurance

Insurance is the transfer of risk from one entity (an individual, a group, or a business) to an insurance company. Without insurance, many of the products and services that businesses provide would be impossible because the risk of overwhelming financial loss would be too great given the litigious society in which we live, yet many small business owners fail to buy adequate insurance coverage protect their companies from the most basic risks such as property damage, fire, theft, and liability. A survey of conducted by Travelers Insurance reports that 57 percent of business owners say that they are not confident at all or are only somewhat confident that their businesses are protected against insurable risks that could result in significant financial losses or cause them to go out of business altogether.⁸⁶

To be insurable, a situation or hazard must meet the following requirements:

1. It must be possible to calculate the actual loss being insured. For example, it would probably not be possible to insure an entire city against fire because too many variables are involved. It is possible, however, to insure a specific building.
2. It must be possible to select the risk being insured. No business owner can insure against every potential hazard, but insurance companies offer a wide variety of policies. Famous insurer Lloyd's of London has sold more than 400,000 alien abduction policies (\$150 a year for \$150 million of coverage) and has actually paid one claim! Another offers werewolf insurance, but the policy pays only if the insured turns into a werewolf.⁸⁷ Lloyd's of London insured winemaker Ilja Gort's nose for \$8 million. Gort, who is prohibited under the policy from boxing, skiing, riding a motorcycle, or working as a knife thrower's assistant, owns the Chateau la Tulipe de la Garde winery in France. Gort purchased the insurance because he has "a chateau of people hanging on my nose," he says. Lloyd's also once wrote a policy to insure the hair of Troy Polamalu's hair, which plays a prominent role in a shampoo commercial for Procter and Gamble. Singer Mariah Carey's legs are insured for \$1 billion.⁸⁸

6.

Discuss the basics of insurance for small businesses.



Lloyds of London wrote an insurance policy on Troy Polamalu's hair.

Alamy.

3. There must be enough potential policyholders to assume the risk. A tightrope walker who specializes in walking between tall downtown buildings would have difficulty purchasing insurance because there are not enough people engaging in that activity to spread the risk sufficiently.

Perhaps the biggest barrier facing entrepreneurs is the difficulty of understanding the nature of the risks that they and their businesses face. The risk management pyramid (see Figure 22.5) helps entrepreneurs decide how they should allocate their risk management dollars. Begin by identifying the primary risks your company faces, such as a fire in a manufacturing plant, a lawsuit from a customer injured by your company’s product, a computer system meltdown, an earthquake, and so on. Then rate each event on three factors:

1. **Severity.** How much would the event affect your company’s ability to operate?
2. **Probability.** How likely is the event to occur?
3. **Cost.** How much would it cost your company if the event occurred?

Rate the event on each of these three factors using a simple scale: A (high) to D (low). For instance, a small technology company might rate a fire in its offices as BDA. On the other hand, that same company might rank a computer system crash as ABA. Using the risk management pyramid, a business owner sees that the event rated ABA is higher on the risk scale than the event rated BDA. Therefore, this company would focus more of its risk management dollars on preventing a computer system crash than on protecting against an office fire.

Types of Insurance

No longer is the cost of insurance an inconsequential part of doing business. Now the ability to get adequate coverage and to pay the premiums is a significant factor in starting and running a

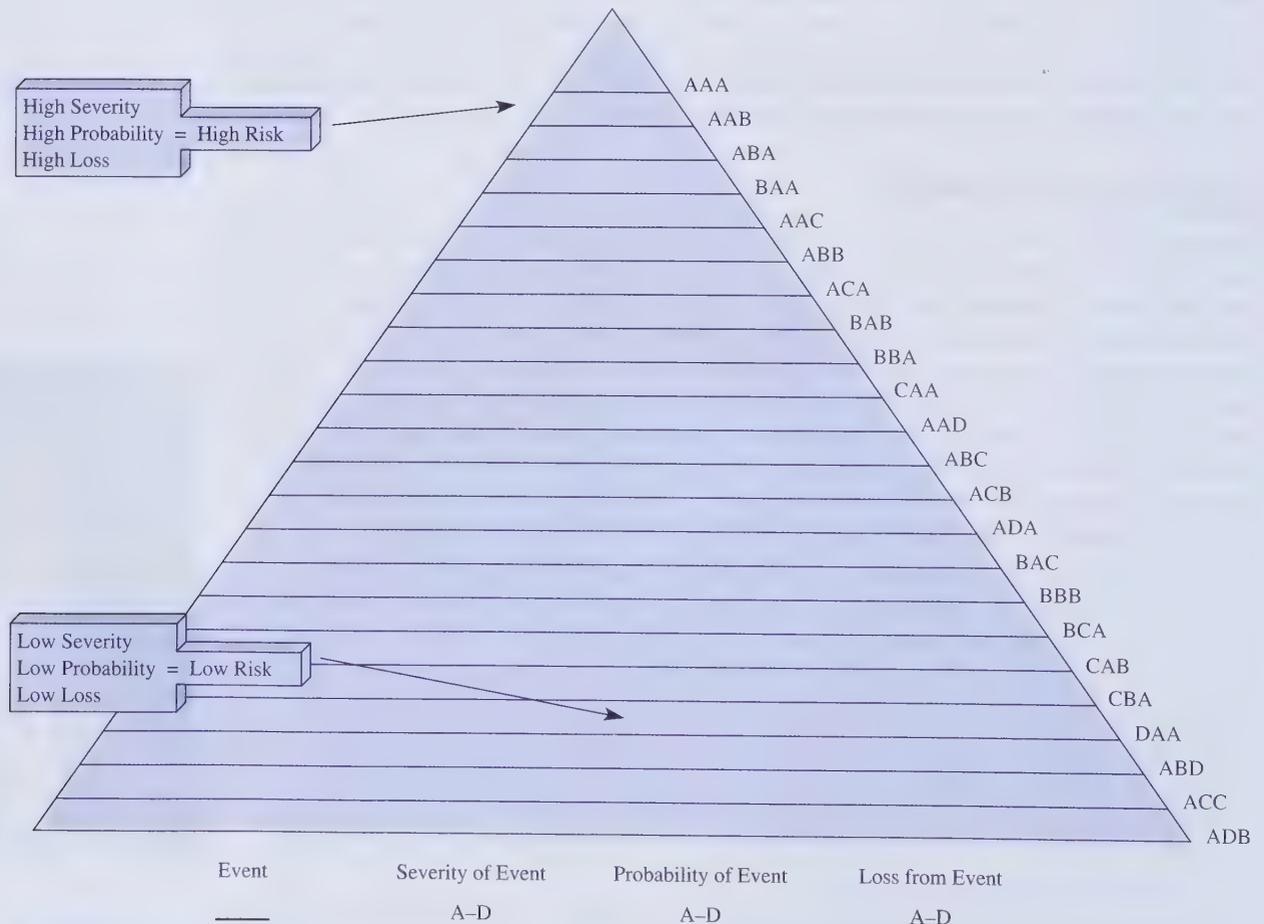


FIGURE 22.5
The Risk Management Pyramid

small business. Sometimes just *finding* coverage for their businesses is a challenge for entrepreneurs, especially those whose companies cater provide extreme entertainment.



ENTREPRENEURIAL PROFILE: Jane Reifert: Incredible Adventures For Incredible Adventures, a small Sarasota, Florida–based company founded in 1993 that offers customers the opportunity to fly in a Russian MiG jet fighter; experience weightlessness; go to the edge of space; swim with sharks; make a high-altitude, low-opening sky dive; and experience many other exciting adventures, purchasing insurance is a challenge. Prices for the company’s expeditions range from \$375 (to swim with sharks) to \$95,000 (for a suborbital flight, many of which take place outside the United States. “You can do more high adrenaline activities outside the country because of the legal climate,” says president Jane Reifert, who claims that she spends as much time with lawyers and insurance agents as she does with customers. “You can’t buy a ride in a fighter jet in the U.S. It’s illegal. You can insure people swimming in shark-infested waters, but you can’t insure people inside shark cages,” she says incredulously.⁸⁹

A wide range of business, individual, and group insurance is available to small business owners, and deciding which ones are necessary can be difficult. Some types of insurance are essential to providing a secure future for the company; others may provide additional employee benefits. The four major categories of insurance are property and casualty insurance, life and disability insurance, health insurance and workers’ compensation coverage, and liability insurance. Each category is divided into many specific types, each of which has many variations offered by insurance companies. Business owners should begin by purchasing a basic **business owner’s policy** (BOP), which typically bundles together basic property and casualty insurance, liability insurance, and perhaps basic crime, business interruption, and vehicle insurance. BOPs alone usually are not sufficient to meet most small business owners’ insurance needs, however. Entrepreneurs should start with BOPs and then customize their insurance coverage to suit their companies’ special needs by purchasing additional types of coverage.

PROPERTY AND CASUALTY INSURANCE Property and casualty insurance covers a company’s tangible assets, such as buildings, equipment, tools, inventory, machinery, signs, and others that might be damaged, destroyed, or stolen. Business owners should be sure that their policies cover the replacement cost of their property, not just its value at the time of the loss, even if this coverage costs extra.



ENTREPRENEURIAL PROFILE: John Carney: Express Oil Change and Service Center After John Carney’s Express Oil Change and Service Center was destroyed by a tornado that swept through Tuscaloosa, Alabama, his insurance policy paid to rebuild the building, but because building codes had changed, Carney had to absorb the \$300,000 in additional costs the new codes required to relocate parking lot entrances and exits, add parking spaces, and use specific building materials. “There was nothing but rubble left,” says Carney. “We had been in business 25 years, and it took a tornado 45 seconds to erase that.” Carney was able to reopen his business within four months, and two months after that, sales were back to 90 percent of pre-tornado volume.⁹⁰

Specific types of property and casualty insurance include property, surety, marine and inland marine, crime, liability, business interruption, and motor vehicle insurance.

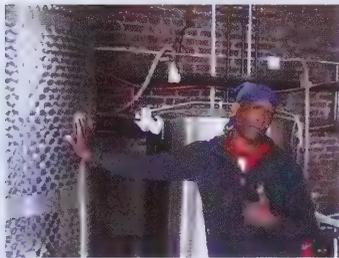
Property insurance protects a company’s assets against loss from damage, theft, or destruction. It applies to automobiles, boats, homes, office buildings, stores, factories, and other items of property. Some property insurance policies are broadly written to include all of an individual’s property up to some maximum amount of loss, whereas other policies are written to cover only one building or one specific piece of property, such as a company car. Many natural disasters, such as floods and earthquakes, are not covered under standard property insurance; business owners must buy separate insurance policies for those particular events.

Within the last decade, business owners across the United States have suffered billions of dollars in losses from natural disasters ranging from tornadoes and hurricanes to floods and ice storms. Many of the businesses that lacked proper insurance coverage were forced to close for good, and others are still struggling to recover. After a tornado ripped away the awning, blew out the windows, and destroyed a chandelier in Maria’s Pizzeria and Seafood, in Monson, Massachusetts, owner Maria Makopoulos’s insurance company paid to repair the \$15,000 in damage. Newport, Rhode Island’s Daniel O’Conner & Sons Wire Rope, a company that makes cables for ski lifts, took a direct hit from the twister and lost three buildings and many specialized tools.

Damages to the 30-year-old company totaled more than \$100,000. Rebuilding took six months, and O’Conner says that he has “gotten back about 80 percent of the value of the damage” from his insurance company and still hopes to receive the remaining 20 percent.⁹¹

Risk management experts advise entrepreneurs to create an emergency preparation plan as part of their risk reduction strategies. Unfortunately, 48 percent of small businesses have no disaster preparedness plan in place.⁹² The Federal Emergency Management Administration offers a helpful outline for preparing an emergency preparedness plan on its Web site (www.ready.gov/business). Charlie Williamson, vice president of the Ralph Brennan Restaurant Group, says that the company’s disaster preparation plan grew from two pages to a 68-page booklet that covers not only operating plans but also technology and communications plans after a hurricane devastated the historic Commander’s Palace restaurant in New Orleans, knocking it out of operation for more than a year.⁹³

BOPs do not include **flood insurance**; businesses must purchase flood insurance separately from the National Flood Insurance Program, which the federal government runs. Even relatively small amounts of water can cause significant damage; the average flood damage claim is \$85,000.⁹⁴ Some business owners learn after the fact that traditional property insurance does not cover damage caused by floods. Others say that flood insurance premiums are too expensive for them to afford.



Although Jackie Summers, founder of Jack from Brooklyn, had no flood insurance, he was able to rebuild his business after floods from Hurricane Sandy all but destroyed it.

Source: Dom Gervast.



ENTREPRENEURIAL PROFILE: Jackie Summers: Jack from Brooklyn Just five months after opening Jack from Brooklyn, a company in Brooklyn, New York, that makes a hibiscus-flavored liqueur called *sorel*, Jackie Summers saw floodwaters from a hurricane destroy his entire inventory and all of his equipment. With no flood insurance but the rugged determination of a New Yorker, Summers began rebuilding on his own with the help of local nonprofit organizations and volunteers. “No one could prepare for five feet of seawater overwhelming us,” he says. “Walking in the morning after was so wrenching. We had worked so hard to get our business running, and it was just washed away.” Thousands of dollars of loss in equipment and commodities, physical damage to the building, and the lost income from not being able to produce has been catastrophic, yet, with Jack from Brooklyn back in business, Summers is optimistic. “We’ve had so much help and the least I think we can do is to repay the people who believed in us by succeeding.”⁹⁵

A company’s BOP may insure the buildings and contents of a factory for loss from fire or natural disaster, but the owner may also buy insurance, called **extra expense coverage**, to cover expenses that occur while the destroyed factory is being rebuilt. **Extra expense coverage** pays for the costs of temporarily relocating workers and machinery so that a business can continue to operate while it rebuilds or repairs its factory. A similar type of insurance, called **business interruption insurance**, covers business owners’ lost income and ongoing expenses in case their companies cannot operate for an extended period of time. Interruptions can be devastating to a small company; about 40 percent of small businesses that are forced to close after a major disaster never reopen.⁹⁶ To collect on a business interruption policy, a small business must incur some kind of physical damage to its property that causes it to suspend or reduce its operations. After power failures caused by Hurricane Sandy shut down many businesses in New Jersey and New York, their owners were shocked to learn that their business interruption policies would not pay for the business they lost because their businesses incurred no physical damage.



ENTREPRENEURIAL PROFILE: George Forgeis: Café Noir, Bar Tabac, and Cercle Rouge George Forgeis, owner of three French bistros in New York City, lost at least \$160,000 in sales because of the power outage that lasted for several days. He filed a claim under his business interruption policy, but his insurer denied his claim because the power outage was caused by a flood at a Con Edison substation and his policy included a flood damage exclusion. “We’ll be absorbing the loss,” says Forgeis.⁹⁷

Business owners should know exactly what their business interruption policies cover—and what they do not.

After the terrorist attacks on September 11, 2001, Congress passed the Terrorism Risk Insurance Act to make **terrorism insurance** available to businesses. To be covered against losses due to a terrorist act (as defined by the federal government), businesses must purchase a special terrorism insurance rider. If they fail to purchase the terrorism insurance coverage, losses from a terrorist act are not covered under their regular business policies. A study by the Congressional

Research Service concludes that only 65 percent of businesses in the United States have purchased terrorism insurance; most of those that have not are small businesses.⁹⁸ When two brothers set off bombs near the finish line at the Boston Marathon, hundreds of businesses shut down for days as police investigated one of the largest crime scenes in the history of the United States and engaged in a five-day manhunt. Ball and Buck, a retail clothing store located two blocks away from the finish line, suffered no physical damage but was closed for several days after the bombing. Owner Mark Bollman had the foresight to purchase terrorism insurance, and his loss of business is covered. “It’s not something that you would ever want to need,” he says, “but being located downtown in a major city, we wanted to be safe rather than sorry.”⁹⁹

Machinery and equipment insurance is a common addition for many businesses and covers a wide range of problems with equipment such as production machinery; electrical systems; heating, ventilating, and air-conditioning systems; and others. For instance, a restaurant that loses thousands of dollars’ worth of food when a freezer breaks down would be covered for its loss under machinery and equipment insurance.

Auto insurance policies offer liability coverage that protects against losses resulting from injuries, damage, or theft involving the use of company vehicles. Not every BOP includes liability coverage for automobiles; business owners often must purchase a separate policy for auto insurance. The automobiles a business owns must be covered by a commercial policy, not a personal one.

A business may also purchase **surety insurance**, which protects against losses to customers that occur when a company fails to complete a contract on time or completes it incorrectly. Surety protection guarantees customers that they will get either the products or services they purchased or the money to cover losses from contractual failures.

Businesses also buy insurance to protect themselves from losses that occur when either finished goods or raw materials are lost or destroyed while being shipped. **Marine insurance** is designed to cover the risk associated with goods in transit. The name of this insurance goes back to the days when a ship’s cargo was insured against high risks associated with ocean navigation.

Crime insurance does not deter crime, but it can reimburse the small business owner for losses from the “three Ds”: dishonesty, disappearance, and destruction. Business owners should ask their insurance brokers or agents exactly what their crime insurance policies cover; after-the-fact insurance coverage surprises are seldom pleasant. Premiums for crime policies vary depending on the type of business, store location, number of employees, quality of the business’s security system, and the business’s history of losses. Coverage may include fidelity bonds, which are designed to reimburse business owners for losses from embezzlement and employee theft. Forgery bonds reimburse owners for losses sustained from the forgery of business checks.

LIFE AND DISABILITY INSURANCE Unlike most forms of insurance, life insurance does not pertain to avoiding risk because death is a certainty for everyone. Rather, **life insurance** protects families and businesses against loss of income, security, or personal services that results from an individual’s untimely death. Life insurance policies are usually issued with a face amount payable to a beneficiary on the death of the insured. Life insurance for business protection, although not as common as life insurance for family protection, is becoming more popular. As you learned in the section on management succession, life insurance policies are an important part of many estate planning tools. In addition, many businesses insure the lives of key executives to offset the costs of having to make a hurried and often unplanned replacement of important managers.

When it comes to assets that are expensive to replace, few are more costly than the key people in a business, including the owner. What would it take to replace a company’s top sales representative? Its production supervisor? Although money alone cannot solve the problem, it does allow a business to find and train key employees’ replacements and to cover the income lost because of their untimely deaths or disabilities. That is the idea behind **key-person insurance**, which provides valuable working capital to keep a business on track while it reorganizes and searches for the right person to replace the loss of someone in a key position in the company. Although 71 percent of small businesses report being “very dependent” on a few key employees, only 22 percent of them have key person insurance policies.¹⁰⁰

Pensions and annuities are special forms of life insurance policies that combine insurance with a form of saving. With an annuity or pension plan, the insured person’s premiums go partly to provide standard insurance coverage and partly to a fund that is invested by the insurance company. The income from the invested portion of the policy is then used to pay an income to the policyholder when he or she reaches a certain age. If the policyholder dies before reaching that

age, either the policy converts to income for the spouse or family of the insured or the insurance proceeds (plus interest) go to the beneficiary as they would in ordinary life insurance.

Disability insurance, like life insurance, protects an individual in the event of unexpected and often very expensive disabilities. Because a sudden disability limits a person's ability to earn a living, the insurance proceeds are designed to help make up the difference between what that person could have expected to earn if the accident had not occurred. Sometimes called income insurance, these policies usually guarantee a stated percentage of an individual's income—usually around 60 percent—while he or she is recovering and is unable to run a business. Short-term disability policies cover the 90-day gap between the time a person is injured and when workers' compensation payments begin. Long-term disability policies pay for lost income after 90 days or longer. In addition to the portion of income a policy will replace, another important factor to consider when purchasing disability insurance is the waiting period, the time gap between when the disability occurs and the disability payments begin. Although many business owners understand the importance of maintaining adequate life insurance coverage, fewer see the relevance of maintaining proper coverage for disabilities. The likelihood that a person will become disabled is 2.2 to 3.5 times greater than the risk of death, depending on age; 26 percent of today's 20-year-olds will become disabled before reaching age 67.¹⁰¹

Business owners can supplement traditional disability policies with **business overhead expense insurance**. Designed primarily for companies with fewer than 15 employees, a business overhead expense policy replaces 100 percent of a small company's monthly overhead expenses, such as rent, utilities, insurance, taxes, and others, if the owner is incapacitated. Payments typically begin 30 days after the owner is incapacitated and continue for up to two years.



In the Entrepreneurial Spotlight

The Aftermath of a Storm

Superstorm Sandy, which bashed the shores of New Jersey, New York, and Connecticut with high winds and floodwaters, was the deadliest hurricane to hit the Northeast in 40 years and with damage estimated at \$50 billion was the second costliest storm to hit the United States. A survey by Hartford Small Business Pulse reports that 74 percent of the affected businesses had to close temporarily, and the average time required to reopen was seven days. Many businesses suffered power outages, damage to their property, destruction of their inventory, disrupted supply chains, and lost sales. Most of the affected businesses were able to reopen, but some are gone forever. Many entrepreneurs who were able to reopen their businesses had to overcome significant obstacles and learned about the importance of proper insurance coverage. Unfortunately, many of the businesses affected by the storm had no flood insurance, and much of the damage they incurred was the result of flood waters driven by the intense winds. Some business owners, such as Noni Signoretti and her cousin Liz Hanna, co-owners of Brown's Hardware, a family-owned hardware store in Rockaway Park, New York, started in 1968, tried to purchase flood insurance but were denied coverage. The flooding "wiped out our whole selling floor," says Signoretti, noting that the storm destroyed the building's electrical and heating system as well. "We lost all of our merchandise." However, the determined business owners managed to restock and reopen their store within five days of the storm so that people could purchase the tools and supplies they needed to repair and rebuild their homes and businesses. To help small businesses in the area re-

In the first month after Sandy hit, Debbie Lane, owner of Testa Wines of the World, a family-owned wine importing company in Oyster Bay, New York, lost nearly \$200,000 in sales to her wholesale and retail customers located across New York City. The storm's timing—October 31—could not have been worse; more than 40 percent of Testa Wines's sales occur in November and December. One shipment of 16,000 bottles of Italian table wines that normally sell for between \$8 and \$13 was sitting in a shipping container in New York City. Floodwaters from the storm breached the container, covered the bottles, and washed off their labels. Lane's insurance company agreed to pay \$10,000 to relabel and repackage the wine; however, the wine was good only for use in cooking, meaning that Testa Wines could sell it for just \$4 per case. The result: a loss of \$92,400.

Lane's biggest concern was her six-story warehouse in South Kearney, New Jersey, where she stores the company's constantly revolving stock of 40,000 cases of wine worth about \$2 million. It was nearly three weeks after the storm before authorities allowed Lane and her son to go to the six-story warehouse that was built in the 1930s. At the height of the storm, a 10-foot surge of water from the nearby Passaic River flooded the first two floors. Fortunately, Lane had the foresight to store almost all of the wine on the warehouse's fourth floor, where it was undamaged. Only 1 percent of the wine in the warehouse—400 cases of Chiantis, Pinot Grigios, Chardonnays, and Merlots stored on the lower floors—was lost.

Once Lane and her 30 employees were able to enter the warehouse, they began to focus on filling customers' orders

to salvage what was left of the busy holiday sales season. She knew that her regular customers were counting on having the wines they had ordered in stock; otherwise, their sales would suffer. With the power out and no prospect of it coming back on for weeks, employees worked overtime to set up portable generators to power lights and lined the warehouse's stairwells with plywood so that they could slide cases of wine by hand down to ground level for shipping. Filling orders after such a devastating blow was a small miracle even though the lack of equipment slows workers' progress. Lane says that filling customers' orders took a day longer than it did under normal conditions. The trucking company that the family business had used for decades was also hit by the storm, and all but three of its trucks were ruined by floodwaters, a situation that further complicated deliveries. The company was able to lease smaller trucks to make deliveries, but space limitations necessitated more trips and more time loading and unloading.

Lane, who started working at Testa Wines at age 14, purchased the family business from her father, who started the company in 1963, when he retired in 2000 and began distributing wines produced by small family vineyards around the world. Despite the trials that Hurricane Sandy imposed on Testa Wines, Lane remains determined and optimistic about rebuilding her business.

1. What types of insurance should Testa Wines of the World have had in place? Explain.
2. Why do many small businesses lack adequate insurance coverage?
3. Work with a team of your classmates to select a local small business and interview its owner about the company's insurance coverage. Do you notice any significant gaps in the company's coverage? What recommendations can you make for filling the gaps?

Sources: Based on "Small Business Owners Hit Hard by Sandy Outages, The Hartford Finds," *The Hartford*, March 19, 2013, <http://newsroom.thehartford.com/News-Releases/Small-Business-Owners-Hit-Hard-By-Sandy-Outages-The-Hartford-Finds-5bc.aspx>; "Brian Patrick Eha, "Six Months After Hurricane Sandy, Many Businesses Are Still Struggling to Recover," *Entrepreneur*, April 29, 2013, www.entrepreneur.com/article/226520; Clare Trapasso, "Many Struggling Rockaway Merchants Miss Out on Lucrative Holiday Season," *New York Daily News*, November 28, 2012, www.nydailynews.com/new-york/queens/rockaway-merchants-holiday-shopping-article-1.1207121; Angus Loten, "Three Weeks After Sandy, Setbacks for Small Firms," *Wall Street Journal*, November 15, 2012, pp. B1, B4; Angus Loten, "Makeshift Ramps, Sympathy Orders: Small Businesses Cope After Sandy," *Wall Street Journal*, November 23, 2012, pp. B1, B7; Angus Loten, "A Month After the Floods, Owners Still Feel the Hurt," *Wall Street Journal*, November 29, 2012, pp. B1, B6; Angus Loten, "Six Months Later, They're Still Struggling," *Wall Street Journal*, May 1, 2013, <http://online.wsj.com/article/SB10001424127887324582004578457052012071148.html>; "Family Wine Business Uncovers Loss from Sandy," *Wall Street Journal*, November 22, 2012, <http://live.wsj.com/video/family-wine-business-uncovers-loss-from-sandy/17C4B747-B070-4112-BBE6-6379F3992033.html#17C4B747-B070-4112-BBE6-6379F3992033>.

HEALTH INSURANCE AND WORKERS' COMPENSATION During World War II, a shortage of workers coupled with wage and price controls that prevented companies from raising wages led businesses to offer health care insurance as a way to attract workers. Today, 56.8 percent of private sector employees get their health insurance from their employers, but the passage of the Patient Protection and Affordable Care Act is creating sweeping changes in employees' health care coverage and emphasizing consumer-driven health care options.¹⁰² Rising health care costs are a constant problem for businesses of all sizes and their employees. According to the National Federation of Independent Businesses, small business owners' greatest concern for the last 25 years has been the skyrocketing cost of health insurance.¹⁰³ Currently, health care spending in the United States accounts for 17.9 percent of GDP, an amount that will increase to 19.6 percent by 2017.¹⁰⁴ The average small company spends on average \$5,615 per year on health care insurance premiums for an employee. Because of the high cost of providing health care coverage for employees, only 61 percent of small businesses offer health insurance to their employees compared to 99 percent of large companies (see Figure 22.6).¹⁰⁵ As health care costs continue to climb and the average age of the workforce has increased, small companies are having more difficulty providing coverage for their employees (see Figure 22.7). The primary reason cited by small business owners who do not offer health care coverage is high cost.¹⁰⁶ Small businesses actually pay 18 percent more than large companies for the same health insurance because of higher broker fees and costs of administering health care plans for a smaller number of employees.¹⁰⁷

Health insurance has become an extremely important benefit to most workers (see Table 22.3). Small companies that offer thorough health care coverage often find that it gives them an edge in attracting and retaining a quality workforce. In fact, 84 percent of employees say that health care is the most important benefit that employers offer.¹⁰⁸ "Small business owners are in a Catch-22 situation," says one expert. "Even though it is increasingly difficult to offer health care benefits, a company that offers little or no health care benefits is putting up a red flag to potential talent. Businesses find it harder to attract talented individuals without offering benefits." One small business owner laments, "I can't afford it, but I can't afford *not* to have it."¹⁰⁹

ENTREPRENEURIAL PROFILE: Mark Hodesh: Downtown Home and Garden Mark

STUDENTS-HUB.com

Hodesh, owner of Downtown Home and Garden, a retail shop in Ann Arbor, Michigan, says that the premiums he pays for health benefits for his 12 employees have risen more than 300 percent

Uploaded By: anonymous

FIGURE 22.6
Percentage of Companies Offering Health Benefits by Company Size

Source: Based on Employer Health Benefits: 2012 Summary of Findings, Kaiser Family Foundation and Health Research Educational Trust, p. 5.

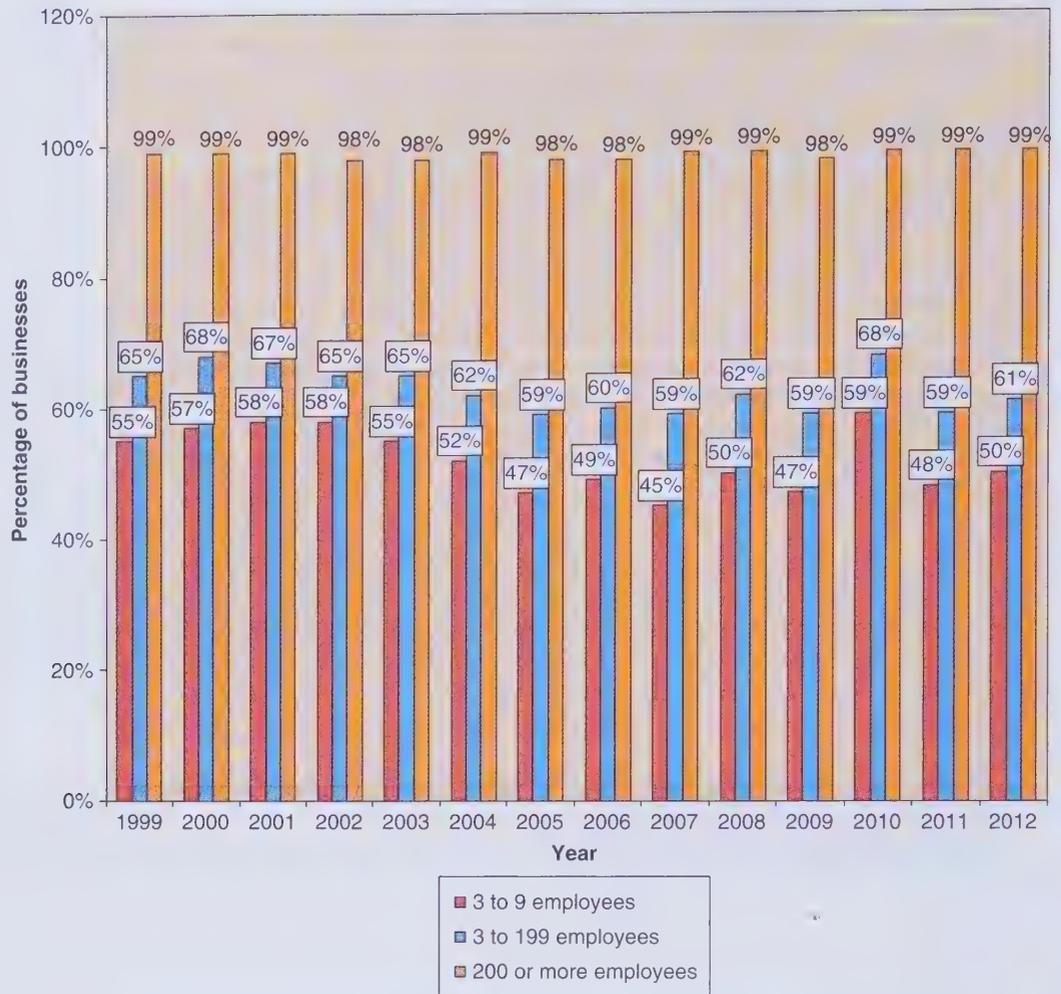


FIGURE 22.7
Average Annual Health Insurance Premiums for Family Coverage

Source: Based on Employer Health Benefits: 2012 Summary of Findings, Kaiser Family Foundation and Health Research and Education Trust, p. 1.

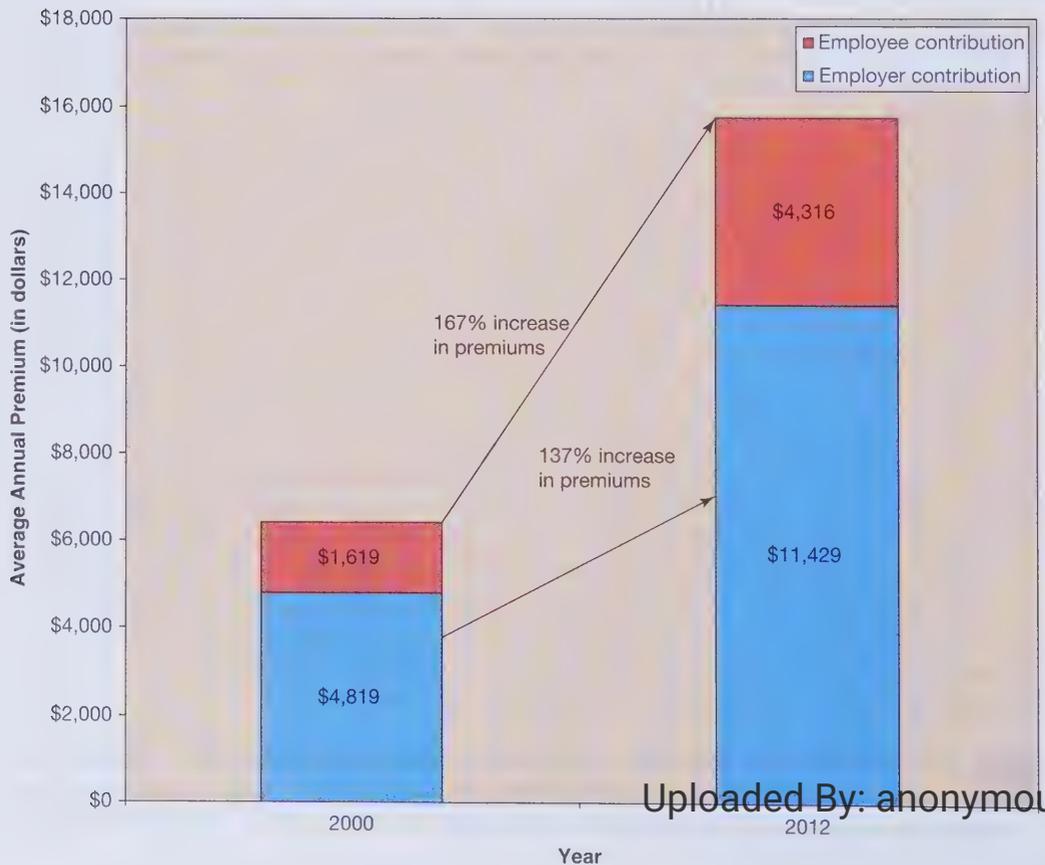


TABLE 22.3 Most Important Factors in Retaining Employees by Age-Group

Employees Less Than 40 Years Old	Employees Between 40 and 49 Years Old	Employees 50 Years Old and Older
1. Job security	1. Health care benefits	1. Job security
2. Base pay	2. Base pay	2. Health care benefits
3. Health care benefits	3. Job security	3. Base pay
4. Vacation time	4. Vacation time	4. Retirement benefits
5. Reputation of company as a great place to work	5. Challenging work	5. Length of commute

Source: Based on Joshua Bjerke, "Survey Reveals Most Important Factors in Attracting and Retaining Employees," *Recruiter*, April 27, 2012, www.recruiter.com/lifactors-in-attracting-and-retaining-employees.

since 1999. Yet he is committed to retaining the employee benefit (he pays 75 percent of the premiums for his employees) because his longtime employees are key to his company's success. "We're a 100-year-old downtown business," he says. "We're able to compete with the big box stores thanks to a knowledgeable and stable workforce. You don't keep better people if they're afraid they might lose their houses after a bad weekend at the emergency room."¹¹⁰

Although it will take business owners years to figure out how to comply with the Affordable Care Act, the law requires companies that have at least 50 full-time-equivalent workers who work at least 30 hours a week to provide "minimum essential" and "affordable" health care coverage. Employers are required to pay at least 60 percent of the total cost of a plan's benefits. Businesses that fall under the act's provisions can choose not to offer their employees insurance and pay a \$2,000 penalty for each uncovered worker beyond 30 employees. Those employees and employees of companies that have fewer than 50 full-time-equivalent workers can purchase their own coverage from health insurance companies that sell individual or small-group policies on Small Business Health Options Programs exchanges that either the states or the federal government operate. Only 14 states and the District of Columbia have created their own exchanges; the federal government operates the exchanges in the remaining 36 states. The exchanges are open only to individuals buying their own coverage (some with the help of federal subsidies) and employees of companies with 100 or fewer employees (50 or fewer in a few states with their own exchanges). The exchanges are designed to simplify health care premium payments for small businesses, which pay a lump sum to the exchange, which, in turn, distributes the money to each insurance company that covers the businesses' employees. Businesses that provide health care benefits that fail to meet the government's definition of "affordable" must pay a \$3,000 penalty for each affected worker. Abbey Duke, founder of Sugarsnap, a food retailer and caterer in Burlington, Vermont, worries about complying with the act. "What I can afford is not very good insurance," she says. "My approach is to pay them as much as I can so that they, in turn, can purchase health care coverage through the exchange."¹¹¹

Many small business owners say that cannot afford the cost that the Affordable Care Act imposes on them and are choosing to keep their workforces under the 50 full-time equivalent worker total. Many are reducing their workforces, switching full-time workers to part-time positions, and paying independent contractors to perform certain jobs rather than hiring employees.



ENTREPRENEURIAL PROFILE: Elizabeth Turley: Meesh and Mia Corporation Elizabeth

Turley, founder of Meesh and Mia Corporation, an apparel company based in Sandpoint, Idaho, that makes women's clothing with licensed college colors and logos, is on the cusp of the total of 50 full-time-equivalent workers. Turley's fast-growing company needs employees, "but we have to find another way to get there," she says, referring to the cost her company would incur under the Affordable Care Act. Her strategy is to pay independent contractors rather than hire employees to perform certain jobs even though the strategy is not ideal. Businesses do not pay taxes on wages or provide benefits to independent contractors; "you have less control over the hours they work and how much involvement they have in the business," says Turley. "Employees take more pride and ownership."¹¹²

Although the Affordable Care Act continues to change the mechanics of health care in the United States, employers face four basic health care options:

Traditional Indemnity Plans Under these plans, employees choose their own health care providers, and the insurance company either pays the provider directly or reimburses employees for the covered amounts. Only 2 percent of small companies use traditional indemnity plans.¹¹³

Managed Care Plans As part of employers' attempts to put a lid on escalating health care costs, these plans have become increasingly popular. Three variations, the health maintenance organization (HMO), the preferred provider organization (PPO), and the point of service (POS), are most common. An HMO is a prepaid health care arrangement under which employees must use health care providers who are employed by or are under contract with the HMO their company uses. Although they lower health care costs, employees have less freedom in selecting physicians under an HMO. Under a PPO, an insurance company negotiates discounts for health care with certain physicians and hospitals. If employees choose a health care provider from the approved list, they pay only a small fee for each office visit (often just \$10 to \$25). The insurance company pays the remainder. Employees may select a provider outside the PPO, but they pay more for the service. A POS is a hybrid of an HMO and a PPO that gives employees the freedom to select their health care providers (as with a PPO) and lowers costs (as with a HMO). As long as employees choose a primary care physician within the approved network, the POS will pay for that care and for care by specialists, even those outside the network, as long as the primary care physician makes the referral. PPOs are the most common managed care plans; 56 percent of covered employees are enrolled in PPOs, compared to 16 percent of covered employees in HMOs and 9 percent of covered employees in POSs.¹¹⁴ Before the Affordable Care Act, Joel Whitehurst, owner of a funeral home started by his grandfather in 1921, covered his 13 employees under an HMO. When the act went into effect, however, Whitehurst could no longer afford the higher premiums that the HMO charged and reluctantly switched everyone to a PPO, which, he says, offers coverage that is not as good as the HMO provided.¹¹⁵

Health Savings Accounts and High-Deductible Health Plan with Savings Option Created as part of a major Medicare overhaul in 2003, health savings accounts (HSAs) and high-deductible health plans with a savings option (HDHP/SOs) are similar to independent retirement accounts except employees' contributions are used for medical expenses rather than for retirement. An HSA is a special savings account coupled with a high-deductible (typically \$1,250 to \$6,250 for an individual) insurance policy that covers major medical expenses. Employees or employers contribute pretax dollars (up to a defined ceiling) from their paychecks into the fund and use them as they need to. Because an employee's deductible amount (the amount the employee actually pays out of pocket) is so high, monthly premiums for insurance coverage are lower than with other types of plans. Withdrawals from an HSA or HDHP/SO are not taxed as long as the money is used for approved medical expenses. Unused funds can accumulate indefinitely and earn tax-free interest. HSAs and HDHP/SOs offer employees incentives to contain their health care costs, but the employer must choose both an insurance carrier to provide coverage and a custodial firm to manage employees' accounts. Although critics contend that consumer-driven plans push a greater portion of health care expenses onto employees, these plans have grown in popularity among small businesses because of their potential to rein in escalating costs. The average annual premium for an HDHP/SO for a small company is \$4,928, which is 13.2 percent lower than the cost of traditional managed care plans.¹¹⁶ Although self-employed individuals find HDHP/SOs attractive, employers are adding them to their menu of health care options for employees. The percentage of employees who are covered by HDHP/SOs has increased from 8 percent in 2009 to 19 percent today.¹¹⁷

Self-Insurance As you learned earlier in this chapter, some business owners choose to insure themselves for health coverage rather than to incur the costs of fully insured plans offered by outsiders. The benefits of self-insurance include greater control over the plan's design and the coverage it offers, fewer paperwork and reporting requirements, and, in most cases, lower costs. Experts estimate that some employers can reap 30 to 40 percent cost savings by switching to self-insurance from traditional health insurance.¹¹⁸ The primary disadvantage, of course, is the possibility of having to pay large amounts to cover treatments for several employees' major illnesses at the same time, which can strain a small company's cash flow. Many self-insured businesses limit their exposure to such losses by purchasing **stop-loss insurance**, under which the business owner

pays for health care expenses up to a predetermined point; beyond that, point the stop-loss policy takes over the expenses. Although just 15 percent of covered workers in small companies are in self-insured plans, the fastest growth in self-insured plans is among small businesses.¹¹⁹

Another type of health-related coverage is **workers' compensation**, which is designed to cover employees who are injured on the job or who become sick as a result of a work environment. Worker's compensation is a mandatory insurance program; companies that fail to offer workers' compensation must pay out of pocket for workers' claims and face penalties from the state. Before passage of workers' compensation legislation in 1911, an employee who was injured on the job had to bring a lawsuit to prove the employer was liable for the worker's injury. Because of the red tape and expenses involved in these lawsuits, many employees never received compensation for job-related accidents and injuries. Although the details of coverage vary from state to state, workers' compensation laws require employers to purchase insurance that provides benefits and medical and rehabilitation costs for employees injured on the job. The amount of compensation an injured employee receives depends on a fixed schedule of payment benefits based on three factors: the wages or salary that the employee was earning at the time of the accident or injury, the seriousness of the injury, and the extent of the disability to the employee.

Only two states, New Jersey and Texas, do not require companies to purchase workers' compensation coverage once they reach a certain size (usually three or more employees). Usually, the state sets the rates businesses pay for workers' compensation coverage, and business owners purchase their coverage from private insurance companies. Rapidly escalating workers' compensation rates, driven in large part by rising medical expenses, have become a major concern for small businesses across the nation. Rates vary by industry, business size, and the number of claims a company's workers make. For instance, workers' compensation premiums are higher for a timber-cutting business than for a retail gift store. Figure 22.8 shows the 10 most dangerous occupations in the United States.

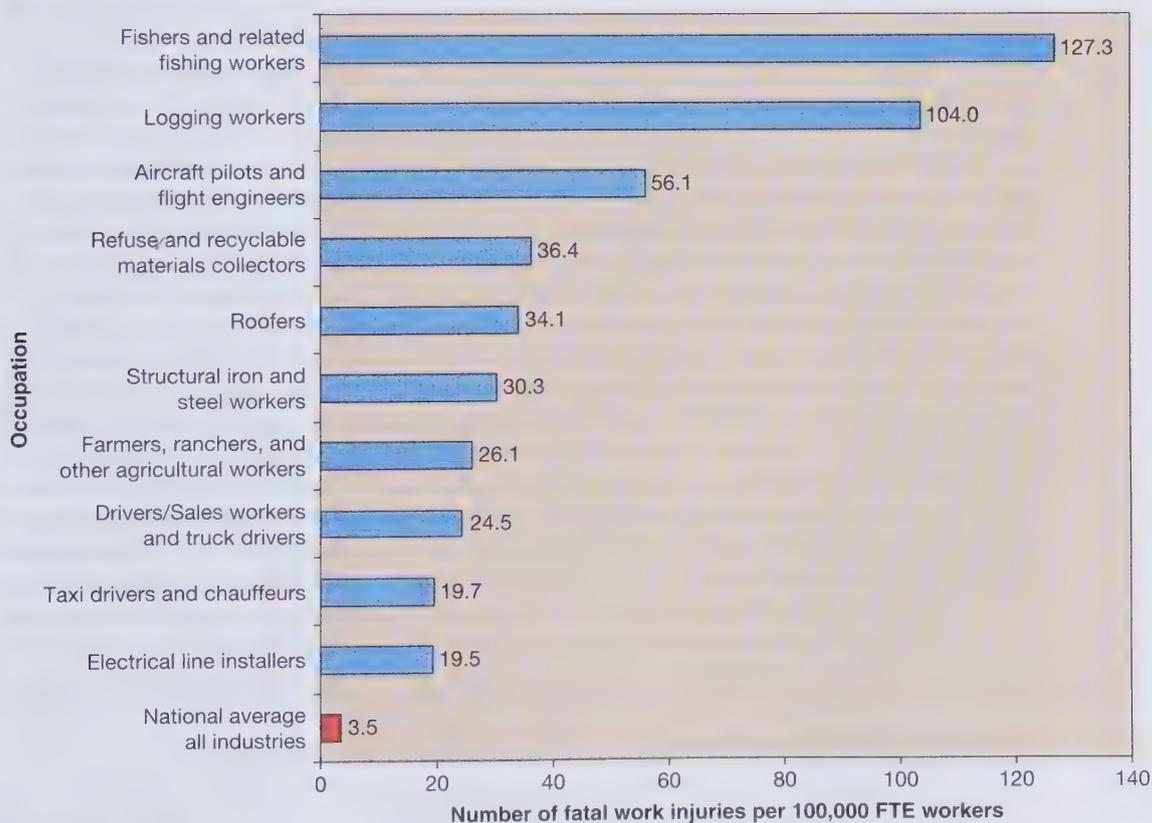


FIGURE 22.8

Most Dangerous Jobs in the US: Number of Fatal Work Injuries per 100,000 FTE Workers

LIABILITY INSURANCE One of the most common types of insurance coverage is **liability insurance**, which protects a business against losses resulting from accidents or injuries people suffer on the company's property and from its products or services and from damage the company causes to others' property. Most BOPs include basic liability coverage; however, the limits on the typical policy are not high enough to cover the potential losses many small business owners face. For example, one "slip-and-fall" case involving a customer who is injured by slipping and falling on a wet floor could easily exceed the standard limits on a basic BOP. Claims from customers injured by a company's product or service also are covered by its liability policy. Although most product liability lawsuits are settled out of court, the median award for those that go to court is more than \$2 million.¹²⁰

Even though courts often dismiss frivolous lawsuits, some small companies have been victims of frivolous lawsuits because they are seen as easy targets. Frivolous lawsuits can cost a small company thousands of dollars to defend, however. Jin and Soo Chung, owners of Custom Cleaners in Washington, D.C., were hit with a \$54 million lawsuit by a customer after the dry cleaner lost a pair of the customer's pants! The trial court ruled for Custom Cleaners, but plaintiff Roy Pearson filed an appeal, extending the legal nightmare for the small business owners, who incurred \$83,000 in legal fees to defend themselves.¹²¹ With jury awards in product liability cases often reaching into the millions of dollars, entrepreneurs who fail to purchase sufficient liability coverage may end up losing their businesses. Most insurance experts recommend purchasing an additional commercial general liability policy that provides coverage of at least \$2 million to \$3 million for the typical small business.

Another important type of liability insurance for many small businesses is **professional liability insurance** or **errors and omissions coverage**. This insurance protects against damage a business causes to customers or clients as a result of an error an employee makes or an employees' failure to take proper care and precautions. For instance, a land surveyor may miscalculate the location of a customer's property line. If the landowner relies on that property line to build a structure on what he thinks is his land and it turns out to be on his neighbor's land, the surveyor is liable for damages. Doctors, dentists, attorneys, and other professionals protect themselves through a similar kind of insurance, malpractice insurance, which protects them against the risk of lawsuits arising from errors in professional practice or judgment.

Employment practices liability (EPL) insurance provides protection against claims arising from charges of employment discrimination, improper discipline, wrongful termination, sexual harassment, and violations of the Americans with Disabilities Act, the Family and Medical Leave Act, and other employment legislation (see Figure 22.9). The most common charges are wrongful termination, discrimination, and sexual harassment.¹²² Although more than half of all EPL cases are filed against small companies, fewer than 2 percent of small businesses have EPL insurance.¹²³ Most violations of employment laws are not intentional but are the result of either carelessness or lack of knowledge; however, the company that violates them is still liable. Losing an employment practices liability case can be very expensive; the median jury award in EPL cases is \$325,000.¹²⁴ Although the plaintiff wins in just 51 percent of all EPL cases, mounting a defense can be very expensive, especially for small companies.¹²⁵ Resolving an EPL claim takes, on average, more than one year. Cases that the parties settle out of court (the average settlement is \$100,000) cost on average \$15,000 to defend, cases in which the employer wins when courts dismiss them cost \$60,000 to defend, and cases in which the employer loses cost \$125,000 to defend.¹²⁶ Because they often lack full-time human resources professionals, small companies are especially vulnerable to charges of improper employment practices, making this type of insurance coverage all the more important to them. Small businesses can take the following steps to minimize the likelihood of employment practices liability suits:

- Create and distribute an up-to-date employee handbook.
- Develop a code of ethics and review it with every employee.
- Create accurate job descriptions for every job in the business.
- Conduct training sessions for employees, particularly managers and supervisors, on how to handle employment practices complaints from workers.

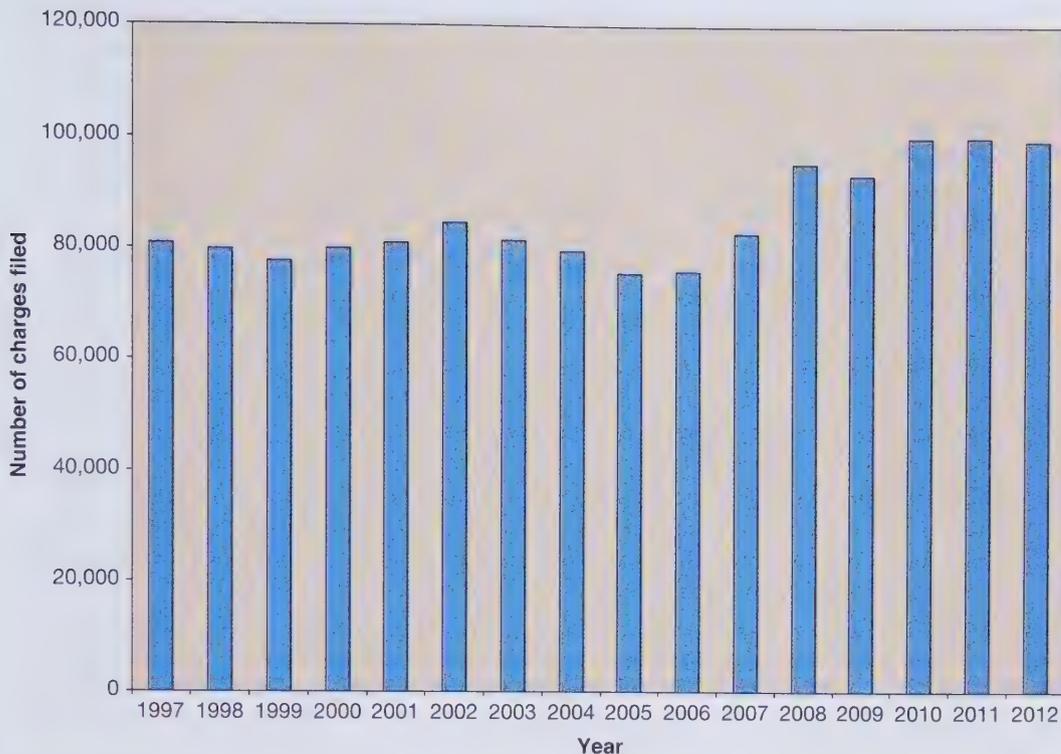


FIGURE 22.9

Number of Employment Charges Filed with EEOC

Source: Based on EEOC, <http://www.eeoc.gov/eeoc/statistics/enforcement/all.cfm>.

designed to illegally access that data and use it for illicit purposes such as identity theft and fraud, which affects 12.6 million people and cost \$20.9 billion annually.¹²⁷ Because they often lack the sophisticated data security infrastructure and tools that large businesses put in place, cyberattacks on small businesses are growing much faster; small businesses are now the victims of nearly one-third of all cyberattacks.¹²⁸ **Cyber liability insurance** is designed to protect businesses from the crippling costs that accompany data breaches and cyberattacks. Cyber insurance policies cover the costs associated with lost trade secrets and intellectual property (“first-party claims”), damages a business must pay if customers file claims over lost or compromised personal information (“third-party claims”), lost revenue a company incurs if it is shut down by a denial-of-service attack, and the cost of a forensic investigation to determine the source of the attack. Coverage for these costs “can be a life-or-death issue for smaller companies,” says Ethan Miller, an insurance attorney.¹²⁹ According to the Ponemon Institute, the cost of a data breach to a business is a whopping \$194 per lost or stolen customer record.¹³⁰

Every business’s insurance needs are somewhat unique, which means that entrepreneurs must customize the insurance coverage they need to protect their businesses. Entrepreneurs also must keep their insurance coverage updated as their companies grow; when companies expand, so do their insurance needs. The Insurance Industry Institute (www.iii.org) offers a helpful book, *Insuring Your Business: Small Business Owners’ Guide to Insurance*, for a small fee.

Controlling Insurance Costs

Small business owners face constantly rising insurance premiums. Entrepreneurs can take steps to lower insurance costs, however. To control the cost of insurance, owners should take the following steps:

1. **Pursue a loss-control program by making risk reduction a natural part of all employees’ daily routine.** As discussed earlier in this chapter, risk reduction minimizes claims and eventually lowers premiums. Establishing a loss-control program means taking steps such as installing modern fire alarms, sprinkler systems, safety programs, and sophisticated security systems.

2. ***Increase their policies' deductibles.*** If a business can afford to handle minor losses, the owner can save money by raising the deductible to a level that protects the business against catastrophic events but, in effect, self-insures against minor losses. Business owners must determine the amount of financial exposure they can reasonably accept.
3. ***Work with qualified professional insurance brokers or agents.*** Business owners should do their homework before choosing insurance brokers or agents. This includes checking their reputation, credentials, and background by asking them to supply references.
4. ***Work actively with brokers to make sure they understand business owners' particular needs.*** Brokers need to know about entrepreneurs' businesses and objectives for insurance coverage. They can help only if they know their clients' needs and the degree of risk they are willing to take.
5. ***Work with brokers to find competitive companies that want small companies' insurance business and have the resources to cover losses when they arise.*** The price of the premium should never be an entrepreneur's sole criterion for selecting insurance. The rating of the insurance company should always be a primary consideration. What good is it to have paid low premiums if, after a loss, a business owner finds that the insurance company is unable to pay? Many small business owners learned costly lessons when their insurance companies, unable to meet their obligations, filed for bankruptcy protection.
6. ***Utilize the resources of your insurance company.*** Many insurers provide risk management inspections designed to help business owners assess the level of risk in their companies either for free or for a minimal fee. Smart entrepreneurs view their insurance companies as partners in their risk management efforts.
7. ***Conduct a periodic insurance audit.*** Reviewing your company's coverage annually can ensure that insurance coverage is adequate and can lead to big cost savings as well.
8. ***Compile discrimination, harassment, hiring, and other employment policies into an employee handbook and train employees to use them.*** Companies that take an active approach to avoiding illegal employment practices have less exposure to lawsuits and therefore, may be able to negotiate lower premiums.

To control the cost of health insurance, small business owners should consider the following steps:

1. ***Increase the dollar amount of employee contributions and the amount of the employee deductibles.*** Neither option is desirable, but rising medical costs have resulted in individuals becoming more responsible for their own health insurance and self-insuring to cover high deductibles.
2. ***Switch to PPOs, POSs, or HMOs.*** Higher premium costs have encouraged some small business owners to reevaluate PPOs, POS plans, and HMOs as alternatives to traditional health insurance policies. Although some employees resent limitations on their choice of providers, PPOs, POS, and HMOs, have become the primary vehicles for companies to provide health care coverage to their employees.
3. ***Consider joining an insurance pool.*** Small businesses can lower their insurance premiums by banding together to purchase coverage. In many states, chambers of commerce, trade associations, and other groups form insurance pools that small businesses can join, spreading risk over a larger number of employees.
4. ***Keep employees informed.*** By giving employees information about the costs and the benefits of various treatment alternatives and medications, employers empower their workers to make informed decisions that can lower health care costs.
5. ***Conduct a yearly utilization review.*** A review may reveal that your employees' use of their policies is statistically lower, which may provide you leverage to negotiate lower premiums or to switch to an insurer that wants a business with your track record and offers lower premiums.
6. ***Make sure your company's health plan fits the needs of your employees.*** One of the best ways to keep health care costs in check is to offer only those benefits that employees actually need. Getting employee input is essential to the process.

7. **Create a wellness program for all employees.** We have all heard the old adage that an ounce of prevention is worth a pound of cure, but when it comes to the high cost of medical expenses, this is especially true! Companies that have created wellness programs report cost savings of up to \$3 for every \$1 they invest.¹³¹ Employees involved in wellness programs not only incur lower health care expenses but also tend to be more productive. “Companies are reforming their own health care costs by recognizing that healthy workers cost less, are more productive, and are better for the company as a whole,” says the president of a nonprofit health and productivity company.¹³² Providing a wellness program does not mean building an expensive gym, however. Instead, it may be as simple as a providing routine checkups from a nurse, incentives for quitting smoking, weight-loss counseling, or after-work athletic games that involve as many employees as possible. One recent study reports that 71 percent of companies offer their employees financial incentives to participate in wellness programs.¹³³
8. **Conduct a safety audit.** Reviewing the workplace with a safety professional to look for ways to improve its safety has the potential for saving some businesses thousands of dollars a year in medical expenses and workers’ compensation claims. The National Safety Council offers helpful information on creating a safe work environment.
9. **Create a safety manual and use it.** Incorporating the suggestions for improving safety into a policy manual and then using it reduces the number of on-the-job accidents. Training employees, even experienced ones, in proper safety procedures is also effective.
10. **Create a safety team.** Assigning the responsibility for workplace safety to workers themselves can produce amazing results. When one small manufacturer turned its safety team over to employees, the plant’s lost time due to accidents plummeted to zero for three years straight! The number of accidents is well below what it was when managers ran the safety team, and managers say that’s because employees now “own” safety in the plant.

The key to controlling insurance costs is aggressive prevention. Entrepreneurs who actively manage the risks to which their companies are exposed find that they can provide the insurance coverage their businesses need at a reasonable cost. Finding the right insurance coverage to protect their businesses is no easy matter for business owners. The key to dealing with those differences is to identify the risks that represent the greatest threat to a company and then to develop a plan for minimizing their risk of occurrence and insuring against them if they do.

Chapter Review

1. Explain the factors necessary for a strong family business.
 - More than 90 percent of all companies in the United States are family owned. Family businesses generate 64 percent of the U.S. GDP, account for 63 percent of employment, and pay 65 percent of all wages. Several factors are important to maintaining a strong family business, including shared values, shared power, tradition, a willingness to learn, behaving like families, and strong family ties.
2. Understand the exit strategy options available to an entrepreneur.
 - Family business owners wanting to step down from their companies can sell to outsiders, sell to insiders, or transfer ownership to the next generation of family members. Common tools for selling to insiders (employees or managers) include sale for cash plus a note, LBOs, and ESOPs.
 - Transferring ownership to the next generation of family members requires a business owner to develop a sound management succession plan.
3. Discuss the stages of management succession.
 - Unfortunately, 70 percent of first-generation businesses fail to survive into the second generation, and, of those that do, only 13 percent make it to the third generation. One of the primary reasons for this lack of continuity is poor succession planning. Planning for management succession not only protects the founder’s, successor’s, and company’s financial resources but also preserves what matters most in a successful business: its heritage and tradition. Management succession planning can ensure a smooth transition only if the founder begins the process early on.
4. Explain how to develop an effective management succession plan.
 - A succession plan is a crucial element in transferring a company to the next generation. Preparing a succession plan involves five steps: (1) select the successor, (2) create a survival kit for the successor, (3) groom the successor, (4) promote an environment of trust and respect, and (5) cope with the financial realities of estate taxes.

- Entrepreneurs can rely on several tools in their estate planning, including buy-sell agreements, lifetime gifting, trusts, estate freezes, and FLPs.
5. Understand the four risk management strategies.
 - Four risk strategies are available to the small business: avoiding, reducing, anticipating, and transferring risk.
 6. Discuss the basics of insurance for small businesses.
 - Insurance is a risk transfer strategy. Not every potential loss can be insured. Insurability requires that it be possible to estimate the amount of actual loss being insured against and identify the specific risk and that there be enough policyholders to spread out the risk.
 - The four major types of insurance small businesses need are property and casualty insurance, life and disability insurance, health insurance and workers' compensation coverage, and liability insurance.
 - Property and casualty insurance covers a company's tangible assets, such as buildings, equipment, inventory, machinery, signs, and others that have been damaged, destroyed, or stolen. Specific types of property and casualty insurance include extra expense coverage, business interruption insurance, surety insurance, marine insurance, crime insurance, fidelity insurance, and forgery insurance.
 - Life and disability insurance also comes in various forms. Life insurance protects a family and a business against the loss of income and security in the event of the owner's death. Disability insurance, like life insurance, protects an individual in the event of unexpected and often very expensive disabilities.
- Health insurance is designed to provide adequate health care for business owners and their employees. The Patient Protection and Affordable Care Act is creating sweeping changes in health care for small companies. Workers' compensation is designed to cover employees who are injured on the job or who become sick as a result of a work environment.
 - Liability insurance protects a business against losses resulting from accidents or injuries people suffer on the company's property and from its products or services and from damage the company causes to others' property. Typical liability coverage includes professional liability insurance or "errors and omissions" coverage, which protects against damage a business causes to customers or clients as a result of an error an employee makes or an employee's failure to take proper care and precautions. Doctors, dentists, attorneys, and other professionals protect themselves through a similar kind of insurance, malpractice insurance, which protects them against the risk of lawsuits arising from errors in professional practice or judgment. Employment practices liability insurance provides protection against claims arising from charges of employment discrimination, sexual harassment, and violations of the Americans with Disabilities Act, the Family and Medical Leave Act, and other employment legislation.

Discussion Questions

- 22-1. What factors must be present for a strong family business?
- 22-2. What are the advantages and disadvantages of a family business over a nonfamily business?
- 22-3. Explain the characteristics of a successful family business.
- 22-4. What exit strategies are available to entrepreneurs wanting to step down from their businesses?
- 22-5. Identify suitable guidelines for developing an effective management succession plan.
- 22-6. Can insurance eliminate risk? Why or why not?
- 22-7. Outline the four basic risk management strategies and give an example of each.
- 22-8. What problems occur most frequently with a risk anticipating strategy?
- 22-9. What is insurance? How can insurance companies bear such a large risk burden and still be profitable?
- 22-10. Describe the requirements for insurability.
- 22-11. Briefly describe the various types of insurance coverage available to small business owners.
- 22-12. What kinds of insurance coverage would you recommend for the following businesses?
 - A manufacturer of steel beams
 - A retail gift shop
 - A small accounting firm
 - A limited liability partnership involving three dentists
- 22-13. What can business owners do to keep their insurance costs under control?

CHAPTER 23

The Legal Environment: Business Law and Government Regulation



Learning Objectives

On completion of this chapter, you will be able to:

1. Explain the basic elements required to create a valid, enforceable contract.
2. Outline the major components of the Uniform Commercial Code governing sales contracts.
3. Discuss the protection of intellectual property rights using patents, trademarks, and copyrights.
4. Explain the basics of the law of agency.
5. Explain the basics of bankruptcy law.
6. Explain some of the government regulations affecting small businesses, including those governing trade practices, consumer protection, consumer credit, and the environment.

If you have ten thousand regulations, you destroy all respect for the law.

—Winston Churchill

Regulations grow at the same rate as weeds.

—Norman Ralph Augustine

The legal environment in which small businesses operate is becoming more complex, and entrepreneurs must understand the basics of business law if they are to avoid legal entanglements. Situations that present potential legal problems arise every day in most small businesses, although the majority of small business owners never recognize them. Routine transactions with customers, suppliers, employees, government agencies, and others have the potential to develop into costly legal problems. For example, a manufacturer of lawn mowers might face a lawsuit if a customer injures himself while using the product, or a customer who slips on a wet floor while shopping could sue the retailer for negligence. A small manufacturer who reneges on a contract for a needed raw material when he finds a better price elsewhere may be open to a breach-of-contract suit. Even when they win a lawsuit, small businesses often lose because the costs of defending themselves can run quickly into thousands of dollars, depleting their already scarce resources.



Amy Brooks, founder of Bubbles by Brooks.

Source: Bubbles By Brooks.



ENTREPRENEURIAL PROFILE: Amy Brooks: Bubbles by Brooks Amy Brooks, of Rochester, Minnesota, is a cancer survivor. Based on her experience going through treatment, she developed handcrafted soaps designed to reduce skin irritation to cancer patients and began selling her soaps under the name Bubbles by Brooks. However, Brooks Brothers, a Connecticut-based clothing company that also sells a line of fragrances and cleansing products, filed a trademark objection against Brooks. In the suit, Brooks Brothers demanded that Bubbles by Brooks withdraw its trademark application with the U.S. Patent and Trademark Office to trademark Bubbles by Brooks or face “potentially costly litigation.” In its cease and desist letter to Brooks demanding that she withdraw her trademark application, attorneys for Brooks Brothers said, “Although ‘Brooks’ may be your surname, it does not give you the right to infringe on the Brooks Brothers trademark or otherwise compete with Brooks Brothers.” Brooks’s attorneys advised her that fighting Brooks Brothers’s in court would cost \$200,000. “I’ve grown every year for the last 10 years by word of mouth,” says Brooks. “I could change my company’s name, but then there’s the domino effect. I have custom printed boxes, Web site domains. What does that affect? Absolutely everything.”¹

Even if small companies have the resources to endure a legal battle, lawsuits are bothersome distractions that prevent entrepreneurs from focusing their energy on running their businesses. In addition, one big judgment against a small company in a legal case could force it out of business. Judgments, the financial penalties that a company must pay if it loses a lawsuit, take three forms: compensatory, consequential, and punitive damages. As the name implies, **compensatory damages** are the monetary damages that are designed to place the plaintiff in the same position he or she would have been in had a contract been performed. In other words, compensatory damages require the defendant to pay the actual amount of loss the plaintiff incurred because of the defendant’s actions. Suppose that a small manufacturer creates a contract to deliver 1,000 plastic barrels for \$80 per unit by a particular date. If it fails to do so and the customer must purchase the barrels from another supplier for \$88 per unit and pay an additional \$500 for rush delivery, the customer’s compensatory damages are \$8,500 (1,000 barrels × \$8 price difference plus \$500 rush delivery charges). **Consequential damages** are awarded to offset the losses suffered by the plaintiff that go beyond simple compensatory damages because of lasting effects of the damage. If the customer in the previous example lost \$15,000 in sales because it did not receive the barrels on time, it could request consequential damages in that amount. For a party to recover consequential damages, the breaching party must have known the consequences of the breach. Courts typically award **punitive damages** in cases in which the defendant engages in intentionally wrongful behavior or behavior that is so negligent or reckless that it is considered intentional. As the name suggests, punitive damages are intended to punish the wrongdoer. The due process clause of the Fourteenth Amendment to the U.S. Constitution prohibits grossly excessive punitive awards, and many states impose limits on punitive damages in court cases.



ENTREPRENEURIAL PROFILE: Dena Lockwood: Professional Neurological Services When Professional Neurological Services (a Chicago-area company that sells medical tests to doctors) hired Dena Lockwood, she mentioned to them that she had children. The interviewer asked whether her parental responsibilities would get in the way of working 70 hours a week. Lockwood said that it would not be a problem. Professional Neurological Services hired Lockwood at a salary of \$25,000 plus 10 percent sales commission. After being hired, Lockwood learned that the company paid other female sales employees who did not have children a base of \$45,000 with the same 10 percent commission. After learning of this disparity, Lockwood renegotiated her compensation. Although she negotiated the \$45,000 base, the company cut her commission to 5 percent. Her supervisors told her

that if she could sell \$300,000, her commission would be raised to 10 percent and she would receive five vacation days a year. Lockwood reached her sales goal of \$300,000. However, her employer did not pay her a commission and told her that she would then have to reach a higher level of sales to earn any commission in the future. When Lockwood tried to take a day off to stay home with one of her children, her manager informed her that if she did not resign, she would be fired, saying that it “just wasn’t working out.” Lockwood filed a complaint with Chicago’s Human Rights Commission, which found that she was the victim of blatant discrimination against employees with children. The Commission awarded Lockwood \$213,000, which included \$100,000 in punitive damages, plus another \$87,000 for her legal fees.²

Small business owners should know the basics of the laws that govern business practices to minimize the chances that their decisions and actions lead to costly lawsuits. This chapter is designed not to make you an expert in business law or the regulations that govern businesses but to make you aware of the fundamental legal issues of which every business owner should know. Entrepreneurs should consult their attorneys for advice on legal questions involving specific situations.

The Law of Contracts

Contract law governs the rights and obligations among the parties to an agreement (contract). It is a body of laws that affects virtually every business relationship. A **contract** is simply a legally binding agreement. It is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law enforces. A contract arises from an agreement, and it creates an obligation among the parties involved. Although almost everyone has the capacity to enter into a contractual agreement (freedom of contract), not every contract is valid and enforceable. A **valid contract** has four elements:

1. **Agreement.** An agreement is composed of a valid offer from one party that is accepted by the other.
2. **Consideration.** Consideration is something of legal (not necessarily economic) value that the parties exchange as part of their bargain.
3. **Contractual capacity.** The parties must be adults capable of understanding the consequences of their agreement.
4. **Legality.** The parties’ contract must be for a legal purpose.

In addition, to be enforceable, a contract must meet two supplemental requirements: *genuineness of assent* and *form*. *Genuineness of assent* is a test to make sure that the parties’ agreement is genuine and not subject to problems such as fraud, misrepresentation, or mistakes. *Form* involves the writing requirement for certain types of contracts. Although not every contract must be in writing to be enforceable, the law does require some contracts to be evidenced by a writing.

Agreement

Agreement requires a “meeting of the minds” and is established by an offer and an acceptance. One party must make an offer to another who must accept that offer. Agreement is governed by the **objective theory of contracts**, which states that a party’s intention to create a contract is measured by outward facts—words, conduct, and circumstances—rather than by subjective, personal intentions. When settling contract disputes, courts interpret the objective facts surrounding the contract from the perspective of an imaginary reasonable person. Agreement requires that one of the parties to a contract make an offer and the other an acceptance.



ENTREPRENEURIAL PROFILE: Republic Bank v. West Penn Allegheny Health System

Republic Bank had taken ownership of a CT scanner, a CT workstation, an ultrasound machine, and an ultrasound table when the buyer defaulted on a lease. Republic hired Tetra Financial Services to find potential buyers for the equipment. Mark Loosli, a Tetra employee acting on behalf of Republic, offered in an e-mail to sell the CT scanner to West Penn Allegheny Health System for \$750,000. He also offered to sell the company the ultrasound equipment for an additional \$30,000. Michele Hutchison, West Penn’s negotiator, sent Loosli an e-mail that said, “We are interested in the 64 slice CT scanner, CT Workstation, ultrasound and ultrasound table. Our offer is as follows: Scanner—\$600,000, CT Workstation—\$50,000, Ultrasound and ultrasound table—\$26,500. If there is a good time for us to

1.

Explain the basic elements required to create a valid, enforceable contract.

talk live, let me know.” Loosli e-mailed Hutchison, stating that he had conveyed her offer to Republic’s president, Boyd Lindquist, and that he hoped to have “something concrete in the next day or so.” Loosli later e-mailed Hutchison to let her know the deal had been approved. A few weeks later, the deal for the CT scanner fell apart. West Penn claimed it was not contractually bound to purchase any of the items because West Penn had not yet signed a purchase order or sales agreement. Republic maintained that there was offer and acceptance via e-mail. Republic auctioned the equipment for \$350,303.76, which was a difference of \$299,694.24 from the agreed-on price between West Penn and Republic. Republic then sued West Penn for the difference. The Tenth Circuit Court of Appeals found that given the e-mail communications between West Penn and Tetra/Republic, Republic’s response was a valid acceptance and that West Penn understood it as such. Therefore, West Penn was liable for breach of contract.³

OFFER An **offer** is a promise or commitment to do or refrain from doing some specified thing in the future. For an offer to stand, there must be an intention to be bound by it. The terms of the offer must be defined and reasonably certain, and the offeror (the party making the offer) must communicate the offer to the offeree (the party to whom the offer is made). The offeror must genuinely intend to make an offer, and the offer’s terms must be definite, not vague. The following terms must either be expressed or be capable of being implied in an offer: the parties involved, the identity of the subject matter (which goods or services), and the quantity. Other terms of the offer should specify price, delivery terms, payment terms, timing, and shipping terms. Although these elements are not required, the more terms a party specifies, the more likely it is that an offer exists.

Courts often supply missing terms in a contract when there is a reliable basis for doing so. For instance, the court usually supplies a time term that is reasonable for the circumstances. It supplies a price term (a reasonable price at the time of delivery) if a readily ascertainable market price exists; otherwise, a missing price term defeats the contract. On rare occasions, courts supply a quantity term, but a missing quantity term usually defeats a contract. For example, a small retailer who mails an advertising circular to a large number of customers is not making an offer because one major term—quantity—is missing. Most ads are not offers but are invitations for an offer. Similarly, price lists and catalogs sent to potential customers are not offers.

In general, an offeror can revoke an offer at any time prior to acceptance, but two exceptions to this rule exist: an option contract and a merchant’s firm offer. In an **option contract**, the parties create a separate contract to keep an offer open for a particular time period. Option contracts are common in real estate transactions. For instance, the owner of a fast-food franchise created an option contract with the owner of a piece of land that the franchisee was considering purchasing. The landowner made an offer to sell the property to the franchisee, who wanted time to study the demographics, traffic count, and other data at the potential location but did not want to lose a promising piece of real estate by having the owner sell it to someone else. The franchisee and the landowner created an option contract; the franchisee paid the landowner \$5,000 for a six-month option on the land, meaning that the landowner could not revoke his offer to sell the property during the six-month option.

The other exception to the revocation-before-acceptance rule is a **merchant’s firm offer**. If a merchant seller (a merchant is defined later in this chapter in the section on the Uniform Commercial Code) makes a promise or assurance to hold an offer open in a signed writing, the offer is irrevocable for the stated time period or, if no time is stated, for a reasonable time period. Neither time period can exceed 90 days, however.

An offeror must communicate the offer to the other party because one cannot agree to a contract unless he or she knows it exists. The offeror may communicate an offer verbally, in writing, or by action.

Offers do not last forever. Several actions by either the offeror or the offeree can cause an offer to terminate. In addition, the law itself can cause an offer to cease to exist. As you have learned, an offeror can revoke an offer as long as he or she does so before the offeree accepts it. The offeree can cause an offer to terminate by rejecting the offer (e.g., saying “no” to it) or by making a counteroffer. For instance, suppose that an entrepreneur offers to purchase a piece of land for \$175,000. The landowner responds, “Your price is too low, but I’ll sell it to you for \$190,000.” When the landowner made the counteroffer, the entrepreneur’s original offer terminated. An offer terminates by operation of the law if the time specified in the offer has elapsed (“This offer is good until noon on October 7”), if the subject matter of the offer is destroyed

before the offeree accepts, or if either the offeror or the offeree dies or becomes incapacitated before the offeree accepts the offer.

ACCEPTANCE Only the person to whom the offer is made (the offeree) can accept an offer and create a contract. The offeree must accept voluntarily, agreeing to the terms exactly as the offeror presents them. When an offeree suggests alternative terms or conditions to those in the original offer, he or she is implicitly rejecting the original offer and making a counteroffer. Common law requires that the offeree's acceptance exactly match the original offer. This is called the **mirror image rule**, which says that an offeree's acceptance must be the mirror image of the offeror's offer.

Generally, silence by the offeree cannot constitute acceptance, even if the offer contains statements to the contrary. For instance, when an offeror claims, "If you do not respond to this offer by Friday at noon, I conclude your silence to be your acceptance," no acceptance exists even if the offeree does remain silent. The law requires an offeree to act affirmatively to accept an offer in most cases.

An offeree must accept an offer by the means of communication authorized by and within the time limits specified by the offeror. Generally, offers accepted by alternative media or after specified deadlines are ineffective. If the offeror specifies no means of communication, the offeree must use the same medium used to extend the offer (or a faster method). According to the **mailbox rule**, if an offeree accepts by mail, the acceptance is effective when the offeree drops the letter in the mailbox, even if it never reaches the offeror. In addition, all offers must be properly dispatched; that is, they must be properly addressed, noted, and stamped. Most courts have extended the mailbox rule to electronic communications, which means acceptance occurs instantaneously at the time the offeree accepts via e-mail or other Web-based communication.

CONSIDERATION Contracts are based on promises, and because it is often difficult to distinguish between promises that are serious and those that are not, courts require that consideration be present in virtually every contract. **Consideration** is something of *legal* value (not necessarily economic value) that the parties to a contract bargain for and exchange as the "price" for the promises given. Consideration can be money, but parties most often swap promises for promises. For example, when a buyer promises to buy an item and a seller promises to sell it, the parties have exchanged valuable consideration. The buyer's promise to buy and the seller's promise to sell constitute the consideration for their contract. To comprise valuable consideration, a promise must impose a liability or create a duty.

For a contract to be binding, the two parties involved must exchange valuable consideration. The absence of consideration makes a promise unenforceable. A promise to perform something that one is already legally obligated to do is not valuable consideration. Because consideration is something that a promisor requires in exchange for his promise, past consideration is not valid. In addition, under the common law, new promises require new consideration. For instance, if two businesspeople have an existing contract for performance of a service, any modifications to that contract must be supported by new consideration. In many states, promises made in exchange for "love and affection" are not enforceable because the contract lacks valuable consideration.

One important exception to the requirement for valuable consideration is **promissory estoppel**. Under this rule, a promise that induces another party to act can be enforceable without consideration if the promisee substantially and justifiably relies on the promise. Thus, promissory estoppel is a substitute for consideration.



ENTREPRENEURIAL PROFILE: Joseph Hoffman v. Red Owl Stores Joseph Hoffman owned a bakery in Wautoma, Wisconsin, but wanted to open a Red Owl grocery store. He approached Edward Lukowitz, a division manager for Red Owl, and told him that he had \$18,000 to invest in a Red Owl franchise. Lukowitz assured Hoffman that \$18,000 was sufficient to set him up in business as a Red Owl franchisee. Lukowitz suggested that Hoffman needed experience running a grocery store before he became a Red Owl franchisee, and Hoffman purchased a small grocery store in Wautoma. After several months, Red Owl confirmed that Hoffman was operating the store at a profit. Lukowitz then told Hoffman that he would have to sell the grocery store to purchase a Red Owl franchise, and Hoffman sold the store to one of his employees. In a meeting, Lukowitz assured Hoffman that "everything is ready to go. Get your money together and we are set." Shortly after this meeting, Lukowitz told Hoffman that he would have to sell his bakery business and building, and that this was the only "hitch" that remained. Hoffman sold the bakery and the building and moved

to Greenfield, Wisconsin, where Red Owl had found a potential site for a store. During this time, however, Red Owl Stores raised the price of the franchise from \$18,000 to \$24,100, and later to \$26,100.

Hoffman ended negotiations with Red Owl and filed a lawsuit, claiming that although Hoffman had not given any consideration, he had justifiably relied on Red Owl's promises to his detriment. The court applied the doctrine of promissory estoppel and ruled in favor of Hoffman.⁴

In most cases, courts do not evaluate the adequacy of consideration given for a promise. In other words, there is no legal requirement that the consideration the parties exchange be of approximately equal value. Even if the value of the consideration one party gives is small compared to the value of the bargain to the other party, the bargain stands. Why? The law recognizes that people have the freedom to contract and that they are just as free to enter into “bad” bargains as they are to enter into “good” ones. Only in extreme cases (e.g., cases affected by mistakes, misrepresentation, fraud, duress, and undue influence) will the court examine the value of the consideration provided in a trade.

Contractual Capacity

The third element of a valid contract requires that the parties involved in it must have contractual capacity for it to be enforceable. Not every person who attempts to enter into a contract has the capacity to do so. Under the common law, minors, intoxicated people, and insane people lack or have limited contractual capacity. As a result, contracts these people attempt to enter are *voidable*—that is, the party can annul or disaffirm the contract at his option.

MINORS Minors constitute the largest group of individuals without contractual capacity. In most states, anyone under the age 18 is a minor. With a few exceptions, any contract made by a minor is voidable at the minor's option. In addition, a minor can avoid a contract during minority and for “a reasonable time” afterward. The adult involved in the contract cannot avoid it simply because he or she is dealing with a minor.

In most states, if a minor receives the benefit of a completed contract and then disaffirms that contract, he or she must fulfill the **duty of restoration** by returning the benefit. In other words, the minor must return any consideration he or she has received under the contract to the adult and is entitled to receive any consideration he or she gave the adult under the contract. The minor must return the benefit of the contract no matter what its condition is. For instance, suppose that Brighton, a 16-year-old minor, purchases a mountain bike for \$415 from Cycle Time, a small bicycle shop. After riding the bike for a little more than a year, Brighton decides to disaffirm the contract. Under the law, all he must do is return the mountain bike to Cycle Time, whatever condition it is in (pristine, used, wrecked, or rubble), and he is entitled to get all of his money back. In most states, he does not have to pay Cycle Time for the use of the bike or the damage done to it. A few states impose an additional duty on minors. The **duty of restitution** requires that minors who disaffirm contracts return any consideration they received to the adult and must pay a “reasonable value” for the depreciation of or damage to the item (which is usually less than the actual value of the depreciation of or damage to the item). Adults enter into contracts with minors at their own risk.

Parents are usually not liable for any contracts made by their children, although a cosigner is bound equally with a minor. Entrepreneurs can protect themselves when dealing with minors by requiring an adult to cosign. If the minor disaffirms the contract, the adult cosigner remains bound by it.

INTOXICATED PEOPLE A contract entered into by an intoxicated person can be either voidable or valid, depending on the person's condition when entering into the contract. If a person's reason and judgment are impaired so that he or she does not realize that he or she is making a contract, the contract is voidable (even if the intoxication was voluntary) and the intoxicated person must return the benefit. However, if the intoxicated person understands that he is forming a contract, although it may be foolish, the contract is valid and enforceable.

PEOPLE WITH MENTAL INCAPACITIES A contract entered into by a person with a mental incapacity can be void, voidable, or valid, depending on the mental state of the person. Those people who have been judged to be so mentally incompetent that a guardian is appointed for them cannot enter into a valid contract. If such a person does make a contract, it is *void* (i.e., it does not exist). A person who has not been legally declared insane and appointed a guardian (e.g., someone suffering from Alzheimer's disease) is bound by a contract if he or she was lucid enough at the time of the contract to comprehend its consequences. On the other hand, if at the time of

entering the contract that same person was so mentally incompetent that he or she could not realize what was happening or could not understand the terms, the contract is voidable. Just as with minors, he or she must return any benefit received under the contract.

Legality

The final element required for a valid contract is legality. The purpose of the parties' contract must be legal. Because society imposes certain standards of conduct on its members, contracts that are illegal (criminal or tortious) or against public policy are void. Examples of these situations include contracts in which the stated interest rate exceeds the rate allowed by a state's usury laws, interstate gambling that is conducted in states where the type of gambling is illegal (e.g., casino games via the Internet), business transactions that violate a state's blue laws (creating certain types of contracts on Sunday), activities that require a practitioner to have a license to perform (e.g., attorneys, real estate brokers, contractors, and others), and freestanding contracts that restrain competition and trade.

If a contract contains both legal and illegal elements, courts will enforce the legal parts as long as they can separate the legal portion from the illegal portion. However, in some contracts, certain clauses are so unconscionable that the courts will not enforce them. Usually, the courts do not concern themselves with the fairness of a contract between parties because individuals are supposed to be intelligent. However, in the case of unconscionable contracts, the terms are so harsh and oppressive to one party that the courts often rule the clause to be void. These clauses, called **exculpatory clauses**, frequently attempt to free one party of all responsibility and liability for an injury or damage that might occur. For instance, suppose that Miguel Ferras signs an exculpatory clause when he leaves his new BMW with an attendant at a parking garage. The clause states that the garage is "not responsible for theft, loss, or damage to cars or articles left in cars due to fire, theft, or other causes." The attendant leaves Miguel's car unattended with the keys in the ignition, and a thief steals the car. A court would declare the exculpatory clause void because the garage owes a duty to its customers to exercise reasonable care to protect their property, a duty it breached because of gross negligence.

GENUINENESS OF ASSENT AND THE FORM OF CONTRACTS A contract that contains the four elements just discussed—agreement, consideration, capacity, and legality—is *valid*, but a valid contract may be unenforceable because of two possible defenses against it: genuineness of assent and form. **Genuineness of assent** serves as a check on the parties' agreement, verifying that it is genuine and not subject to mistakes, misrepresentation, fraud, duress, or undue influence. The existence of a contract can be affected by mistakes that one or both parties to the contract make. Different types of mistakes exist, but only mistakes of *fact* permit a party to avoid a contract. Suppose that a small contractor submits a bid on the construction of a bridge but the bidder mistakenly omits the cost of some materials. The client accepts the contractor's bid because it is \$32,000 below all others. If the client knew or should have known of the contractor's mistake, the contractor can avoid the contract; otherwise, he must build the bridge at the bid price.

Fraud also voids a contract because no genuineness of assent exists. **Fraud** is the intentional misrepresentation of a material fact, justifiably relied on, that results in injury to the innocent party. The misrepresentation with the intent to deceive can result from words, silence, or conduct. Suppose a small retailer purchases a new security system from a dealer who promises it will provide 20 years of reliable service and lower the cost of operation by 40 percent. The dealer then knowingly installs a used, unreliable system. In this case, the dealer has committed fraud, and the retailer can either rescind the contract with his original position restored or enforce it and seek damages for injuries.

Duress, forcing an individual into a contract by fear or threat, eliminates genuineness of assent. The innocent party can choose to carry out the contract or to avoid it. For example, if a supplier forces the owner of a small video arcade to enter a contract to lease his machines by threat of personal injury, the supplier is guilty of duress. Blackmail and extortion used to induce another party to enter a contract also constitute duress.

Generally, the law does not require contracts to follow a prescribed form; a contract is valid whether it is written or oral. Most contracts do *not* have to be in writing to be enforceable, but for certain types of contracts, a small business owner should insist that every contract be in writing. If a contract is oral, the party attempting to enforce it must first prove its existence and then

establish its actual terms. Although each state has its own rules, the Statute of Frauds, generally requires the following contracts to be in writing:

- Contracts for the sale of land
- Contracts involving lesser interests in land (e.g., rights-of-way or leases that last more than one year)
- Contracts that cannot by their terms be performed within one year
- Collateral contracts, such as promises to answer for the debt or duty of another
- Promises by the administrator or executor of an estate to pay a debt of the estate personally
- Contracts for the sale of goods (as opposed to services) priced above \$500

Breach of Contract

Both parties fully performing the terms of their agreement discharges the majority of contracts. Occasionally, however, one party fails to perform as agreed. This failure is called *breach of contract*, and the injured party has certain remedies available. A breach of contract can be either a minor breach in which substantial but not complete performance occurs or a material breach of contract associated with nonperformance or inferior performance. In cases where there exists a minor breach of contract, the party “in breach” may agree to complete the specific terms of the contract or compensate the other party for the unperformed component of the contract. If these two remedies are not accepted, the next step is legal action to recover the cost to repair the defect.

In contrast, a *material breach* occurs when a party renders inferior performance that impairs or destroys the essence of the contract. The nonbreaching party may either rescind the contract and recover restitution or affirm the contract and recover damages. Of course, the injured party must make a reasonable effort to minimize the damages incurred by the breach.



ENTREPRENEURIAL PROFILE: Gaia Healthcare Systems v. National Renal Alliance Gaia Healthcare Systems filed a claim against National Renal Alliance seeking more than \$178,000 in unpaid software license fees and other damages. Gaia claimed that National Renal stopped making payments on its system but continued to use its software and make “untrue and disparaging statements” about Gaia. National Renal denied Gaia’s allegations and issued a counterclaim against the vendor, alleging breach of contract, fraud, and misrepresentation. National Renal argued that Gaia’s software did not perform as promised, causing billing delays that interfered with its ability to collect payments and forced it to draw on its line of credit, pay its employees overtime, and “hire temporary employees to correct errors generated by the software.” An arbitrator with the American Arbitration Association sided with National Renal, denying Gaia’s claim in its entirety and awarding \$305,000 to National Renal.⁵

In some cases, monetary damages are inadequate to compensate an injured party for a defendant’s breach of contract. The only remedy that would compensate the nonbreaching party might be specific performance of the act promised in the contract. **Specific performance** is usually the remedy for breached contracts dealing with unique item (antiques, land, and animals). For example, if an antique auto dealer enters a contract to purchase a rare Corvette and the seller breaches the contract, the dealer may sue for specific performance. That is, she may ask the court to order the breaching party to sell the antique car. Courts rarely invoke the remedy of specific performance. Generally, contracts for performance of personal services are not subject to specific performance.

The Uniform Commercial Code

For many years, sales contracts relating to the exchange of goods were governed by a loosely defined system of rules and customs called the *Lex Mercatoria* (Merchant Law). Many of these principles were assimilated into the U.S. common law through court opinions, but they varied widely from state to state and made interstate commerce difficult and confusing for businesses. In 1952, the commission on Uniform State Laws created the **Uniform Commercial Code** (or the UCC or the Code) to replace the hodgepodge collection of confusing, often conflicting state laws that governed basic commercial transactions with a document designed to provide uniformity and consistency. The UCC replaced numerous statutes governing trade made by state legislatures of Columbia, and the Virgin Islands adopted it. (Louisiana has adopted only Articles 1, 3, 4, and 5.)

2.

Outline the major components of the Uniform Commercial Code governing sales contracts.

The Code does not alter the basic tenets of business law established by the common law; instead, it unites and modernizes them into a single body of law. In some cases, however, the Code changes some of the specific rules under the common law. The Code consists of 10 articles, but we will discuss the general principles relating to one of its most common sections, Article 2, which governs the sale of goods. The UCC creates a “caste system” of merchants and nonmerchants and requires merchants to have a higher degree of knowledge and understanding of the Code.

Sales and Sales Contracts

Every sales contract is subject to the basic principles of law that govern all contracts—agreement, consideration, capacity, and legality. However, when a contract involves the sale of goods, the UCC imposes rules that may vary slightly or substantially from basic contract law. Article 2 governs *only* contracts for the *sale of goods*, but it pertains to *every* sale of goods, whether the good involved is a 99-cent pen or a billion-dollar battleship. To be considered a good, an item must be personal property that is tangible and movable (e.g., not real estate or services), and a “sale” is “the “passing of title from the seller to the buyer for a price” (UCC Sec. 2-106[1]). The UCC does *not* cover the sale of services, although certain “mixed transactions,” such as the sale by a garage of car parts (goods) and repairs (a service), fall under the Code’s jurisdiction if the goods are the dominant element of the contract.

In addition to the rules it applies to the sale of goods in general, the Code imposes special standards of conduct in certain instances when merchants sell goods to one another. Usually, a person is considered a professional **merchant** if he “deals in goods of the kind” involved in the contract and has special knowledge of the business or of the goods, employs a merchant agent to conduct a transaction for him, or holds him- or herself out to be a merchant.

Although the UCC requires that the same elements outlined in common law be present in forming a sales contract, it relaxes many of the specific restrictions. For example, the UCC states that a contract exists even if the parties omit one or more terms (price, delivery date, place of delivery, or quantity), as long as they intended to make a contract and there is a reasonably certain method for the court to supply the missing terms. Suppose a manufacturer orders a shipment of needed raw materials from her usual supplier without asking the price. When the order arrives, the price is substantially higher than she expected, and she attempts to disaffirm the contract. The Code verifies the existence of a contract and assigns to the shipment a price that is reasonable at the time of delivery.

Common law requires that acceptance of an offer to be exactly the same as the offer; an acceptance that adds some slight modification is no acceptance at all, and no contract exists. Any modification constitutes a counteroffer. However, the UCC states that as long as an offeree’s response (words, writing, or actions) indicates a sincere willingness to accept the offer, it is a legitimate acceptance even if the offeree adds terms. This section of the UCC is known as “the battle of the forms.” In dealings between nonmerchant buyers and sellers, these added terms become “proposals for addition.” In other words, a contract is formed on the offeror’s original terms. Between merchants, however, these additional proposals *automatically* become part of the contract unless they materially alter the original contract, the offer expressly states that no terms other than those in the offer will be accepted, or the offeror objects to the particular terms. In other words, the contract is formed on the offeree’s modified terms. For example, suppose that an appliance wholesaler offers to sell a retailer a shipment of appliances for \$5,000 plus freight. The retailer responds, “I accept,” but includes an additional term by stating, “Delivery within three days.” A contract exists, and the addition will become part of the contract unless the wholesaler objects within a reasonable time.

When the offeree includes a term in the acceptance that *contradicts* a term in the offeror’s original offer, the UCC says that the two terms cancel out each other. What, then, are the terms of the resulting contract? The UCC turns to its gap-filling rules, which establish reasonable terms for prices, delivery dates, warranties, payment times, and other topics, to supply the disputed term.



ENTREPRENEURIAL PROFILE: Superior Boiler Works v. R.J. Sanders Company

The R.J. Sanders Company won a contract to install the heating system at a federal prison and negotiated a contract with Superior Boiler Works to purchase three large commercial boilers for the project. On March 27, Superior sent an offer to Sanders in which it offered to sell three boilers for \$145,827 with a delivery time of four weeks. After several discussions, Sanders sent a purchase order to Superior on July 20 for three boilers, agreeing to pay \$145,827 and stating a delivery

date of four weeks (August 20). Superior responded by sending Sanders a sales order in which it agreed to the price but stated a shipping date of October 1. Superior shipped the boilers on October 1, just as it had promised, and they arrived at Sanders on October 5. This delivery date forced Sanders to rent temporary boilers at a cost of \$45,315, and Sanders sent Superior a check for \$100,000 with a note explaining that the deduction was to offset the cost of the rented boilers. Superior sued Sanders for the \$45,000 difference, claiming that the October 1 shipping date was reasonable. The Supreme Court of Rhode Island ruled that the parties' conflicting delivery terms canceled out each other. The court then applied the UCC's gap-filling rules (boilers are goods), which state that the time for delivery of the goods must be within "a reasonable time." The court ruled in favor of Superior, stating that the October 1 shipping date was within a reasonable time.⁶

The UCC significantly changes the common law requirement that a contract modification requires new consideration. ("New promises require new consideration."). Under the Code, modifications to contract terms are binding *without* new consideration if they are made in good faith. ("New promises do *not* require new consideration.") For example, suppose that a small building contractor forms a contract to purchase a supply of lumber for \$12,000. After the agreement but before the lumber is delivered, a hurricane forces the price of the lumber to double, and the supplier notifies the contractor that it must raise the price of the lumber shipment to \$24,000. The contractor reluctantly agrees to the additional cost but later refuses to pay. According to the UCC, the contractor must pay the higher price because the contract modification requires no new consideration.

The Code also has its own Statute of Frauds provision relating to the form of contracts for the sale of goods. If the price of the goods is \$500 or more, the contract must be in writing to be enforceable. Of course, the parties can agree orally and then follow up with a written memorandum. The Code does not require both parties to sign the written agreement, but it must be signed by the party against whom enforcement is sought (which is impossible to tell before a dispute arises, so it is a good idea for *both* parties to sign the agreement at the outset).

The UCC includes a special provision involving the writing requirement in contracts between merchants. If merchants form a verbal contract for the sale of goods priced at more than \$500 and one of them sends a written confirmation of the deal to the other, the merchant receiving the confirmation must object to it *in writing* within 10 days. Otherwise, the contract is enforceable against *both* merchants even though the merchant receiving the confirmation has not actually signed anything.

Once the parties create a sales contract, they are bound to perform according to its terms. Both the buyer and the seller have certain duties and obligations under the contract. Generally, the Code assigns the obligations of "good faith" (defined as "honesty in fact in the conduct or transaction concerned") and "commercial reasonableness" (commercial standards of fair dealing) to both parties.

The seller must make delivery of the items involved in the contract, but "delivery" is not necessarily physical delivery. The seller simply must make the goods available to the buyer. The contract normally outlines the specific details of the delivery, but occasionally the parties omit this provision. In this instance, the place of delivery will be the seller's place of business if one exists; otherwise, it is the seller's residence. If both parties know the usual location of the identified goods, that location is the place of delivery (e.g., a warehouse). In addition, the seller must make the goods available to the buyer at a reasonable time and in a reasonable manner. All goods covered by the contract must be tendered in one delivery unless the parties' agreement states otherwise.

A buyer must accept the delivery of conforming goods from the seller. Of course, the buyer has the right to inspect the goods in a reasonable manner and at any reasonable time or place to ensure that they are conforming goods before making payment. However, cash-on-delivery terms prohibit the right to advance inspection unless the contract specifies otherwise. The UCC also says that if goods or tender of delivery fail, in any respect, to conform to the contract, the buyer is not required to accept them.

A buyer can indicate his acceptance of the goods in several ways. Usually the buyer indicates acceptance by an express statement that the goods are suitable. This expression can be by words or by conduct. Suppose that a small electrical contractor orders a truck to use in her business. When she receives it, she equips it to suit her trade, including a company decal on each door. Later the contractor attempts to reject the truck and return it. By customizing the truck,

the buyer has indicated her acceptance of the truck. In addition, the Code assumes acceptance if the buyer has a reasonable opportunity to inspect the goods and fails to reject them within a reasonable time.

A buyer has the duty to pay for the goods on the terms stated in the contract when they are received. A seller cannot require payment before the buyer receives the goods. Unless otherwise stated in the contract, payment must be in cash.

Breach of Sales Contracts

As we have seen, when a party to a sales contract fails to perform according to its terms, that party is said to have breached the contract. The law provides the innocent (nonbreaching) party numerous remedies, including damage awards and the right to retain possession of the goods. The object of these remedies is to place the innocent party in the same position as if the contract had been carried out. The parties to the contract may specify their own damages in case of breach. These provisions, called **liquidated damages**, must be reasonable and cannot be in the nature of a penalty. For example, suppose that Alana Mitchell contracts with a local carpenter to build a booth from which she plans to sell crafts. The parties agree that if the carpenter does not complete the booth by September 1, Mitchell will receive \$500. If the liquidated damages had been \$50,000, they would be unenforceable because such a large amount of money is clearly a penalty.

An unpaid seller has certain remedies available under the terms of the Code. Under a seller's lien, every seller has the right to maintain possession of the goods until the buyer pays for them. In addition, if the buyer uses a fraudulent payment to obtain the goods, the seller has the right to recover them. If the seller discovers that the buyer is insolvent, the seller can withhold delivery of the goods until the buyer pays in cash. If a seller ships goods to an insolvent buyer, the seller can require their return within 10 days after receipt. In some cases, the buyer breaches a contract while the goods are still unfinished in the production process. When this occurs, the seller must use "reasonable commercial judgment" to decide whether to sell them for scrap or complete them and resell them elsewhere. In either case, the buyer is liable for any loss the seller incurs. Of course, the seller has the right to withhold performance when the buyer breaches the sales contract.

When the seller breaches a contract, the buyer also has specific remedies available. For instance, if the goods do not conform to the contract's terms, the buyer has the right to reject them. If the seller fails to deliver the goods, the buyer can sue for the difference between the contract price and the market price at the time that the buyer discovers the breach. When the buyer accepts goods and then discovers that they are defective or nonconforming, he or she must notify the seller of the breach. In this instance, damages amount to the difference between the value of the goods delivered and their value if they had been delivered as promised. If a buyer pays for goods that the seller retains, the buyer can take possession of the goods if the seller becomes insolvent within 10 days after receiving the first payment. If the seller unlawfully withholds the goods from the buyer, the buyer can recover them. Under certain circumstances, a buyer can obtain specific performance of a sales contract; that is, the court orders the seller to perform according to the contract's terms. As mentioned earlier, specific performance is a remedy only when the goods involved are unique or unavailable on the market. Finally, if the seller breaches the contract, the buyer has the right to rescind the contract; if the buyer has paid any part of the purchase price, the seller must refund it.

Whenever a party breaches a sales contract, the innocent party must bring suit within a specified period of time. The Code sets the statute of limitations at four years. In other words, any action for a breach of a sales contract must begin within four years after the breach occurred.

Sales Warranties and Product Liability

The U.S. economy once emphasized the philosophy of *caveat emptor*, "let the buyer beware," but today the marketplace enforces a policy of *caveat venditor*, "let the seller beware." **Tort law** deals with cases in which one party commits a wrong against another party and causes injury or damage to the person and/or his or her property. Tort law covers a wide range of topics, including defamation of character, false imprisonment (e.g., wrongly detaining a suspected shoplifter), fraud, wrongful interference with a contractual relationship, and others. Tort liability represents a significant risk for small companies. A study by the U.S. Chamber Institute for Legal Reform reports that small companies bear 81 percent of total tort liability costs for a total of \$105 billion per year

but take in only 22 percent of total commercial revenue. Small businesses pay \$35.6 billion of their total cost of tort liability out of pocket (not paid by insurance)! Tort liability costs businesses with less than \$10 million in annual sales \$14.59 for every \$1,000 of revenue; in other words, a small company with \$5 million in revenue incurs, on average, \$72,950 in tort related costs each year.⁷ Entrepreneurs must be aware of two general categories related to torts that involve the quality and reliability of the products they sell: sales warranties and product liability.

SALES WARRANTIES Simply stated, a **sales warranty** is a promise or a statement of fact by the seller that a product will meet certain standards. Because a breach of warranty is a breach of promise, the buyer has the right to recover damages from the seller. Several different types of warranties can arise in a sale. A seller creates an **express warranty** by making statements about the condition, quality, and performance of the good that the buyer substantially relies on. Sellers create express warranties by words or actions. For example, a manufacturer selling a shipment of cloth to a customer with the promise that “it will not shrink” is creating an express warranty. Similarly, the jeweler who displays a watch in a glass of water for promotional purposes creates an express warranty that “this watch is waterproof” even though no such promise is ever spoken. Generally, an express warranty arises if the seller indicates that the goods conform to any promises of fact the seller makes, to any description of them (e.g., printed on the package or statements of fact made by salespersons), or to any display model or sample (e.g., a floor model used as a demonstrator).

Whenever someone sells goods, the UCC automatically implies certain types of warranties unless the seller specifically excludes them. These **implied warranties** take several forms. Sellers, simply by offering goods for sale, imply a **warranty of title**, which promises that their title to the goods is valid (i.e., no liens or claims exist) and that transfer of title is legitimate. A seller can disclaim a warranty of title only by using very specific language in a sales contract.

An implied **warranty of merchantability** applies to every merchant seller, and the only way to disclaim it is by mentioning the term “warranty of merchantability” in a conspicuous manner. An implied warranty of merchantability assures the buyer that the product will be of average quality—not the best and not the worst. In other words, merchantable goods are “fit for the ordinary purposes for which such goods are used.”⁸ For example, a commercial refrigeration unit that a food store purchases should keep food cold.



ENTREPRENEURIAL PROFILE: Michael Williams v. O’Charley’s Michael Williams ordered a chicken dinner at an O’Charley’s restaurant located in Concord, North Carolina. Williams had felt fine before eating the meal and ate nothing afterward. The next morning, Williams became severely ill. He went to the hospital, where he spent seven days recovering. Williams filed a lawsuit against O’Charley’s in which he described that the chicken he had eaten, which was stuck to the plate and dry, had a foul aftertaste. Although the evidence of the actual chicken was long gone, the jury relied on the expert physician witness, who testified with a reasonable degree of certainty that Williams’s illness was caused by the chicken dinner at O’Charley’s. The jury found in favor of Williams and awarded him \$140,000, finding that O’Charley’s was liable for breach of implied warranty of merchantability. Although O’Charley’s appealed the verdict, arguing that there was insufficient evidence to establish a defect in the chicken, the North Carolina Court of Appeals found numerous precedents in previous foodborne illness cases to warrant finding in favor of Williams.⁹

An implied **warranty of fitness for a particular purpose** arises when a seller knows the particular reason for which a buyer is purchasing a product and knows that the buyer is depending on the seller’s judgment to select the proper item. For example, suppose a contractor asks the owner of a paint store for a paint that adheres to metal roofs. The store owner sells the contractor paint that he says will do the job, but two months later, the paint is peeling off. The owner has violated the warranty of fitness for a particular purpose.

The Code also states that the only way a merchant can disclaim an implied warranty is to include the words “sold as is” or “with all faults,” stating that the buyer purchases the product as it is, without any guarantees. The following statement is usually sufficient to disclaim most warranties, both express and implied: “Seller hereby disclaims all warranties, express and implied, including all warranties of merchantability and all warranties of fitness for a particular purpose.” To protect a business, the statement must be printed in bold letters and placed in a conspicuous place on the product or its package.

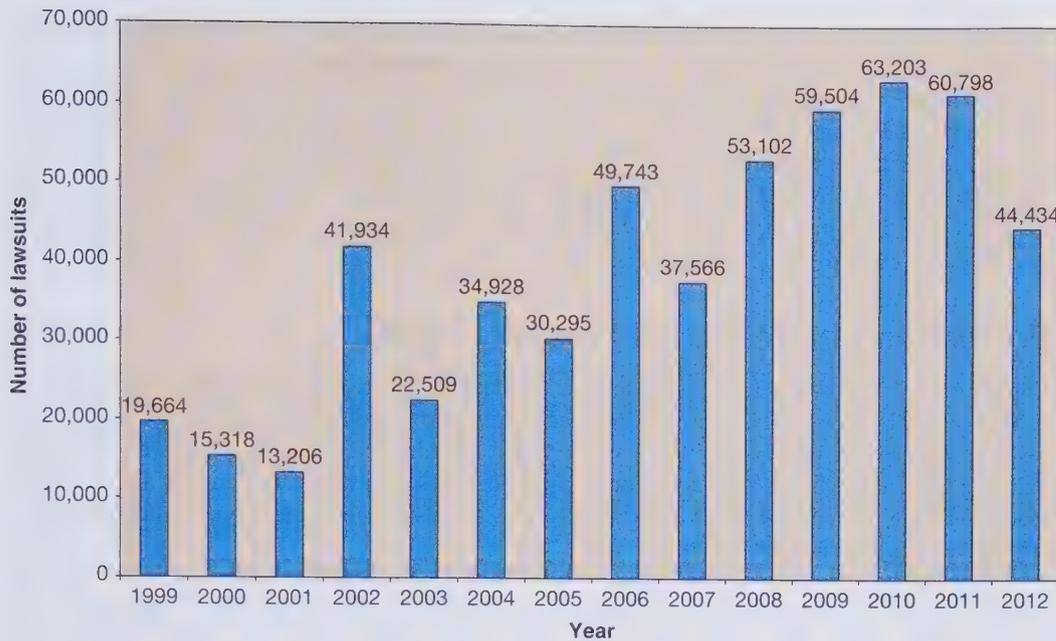


FIGURE 23.1
Number of Product Liability Lawsuits

Source: Based on Judicial Business of the United States Courts, www.uscourts.gov/Statistics/JudicialBusiness/JudicialBusiness.aspx?doc=/uscourts/Statistics/JudicialBusiness/2009/tables/S10Sep09.pdf; www.uscourts.gov/uscourts/Statistics/JudicialBusiness/2012/appendices/C02ASep12.pdf.

PRODUCT LIABILITY At one time, only the parties directly involved in the execution of a contract were bound by the law of sales warranties. Today, the UCC and the states have expanded the scope of warranties to include any person (including bystanders) incurring personal or property damages caused by a faulty product. In addition, most states allow an injured party to sue *any* seller in the chain of distribution for breach of warranty (a concept known as joint and several liability). Product liability is built on the principle that a person who introduces a product into the stream of commerce owes a duty of care not only to the person who first purchases the product but also to anyone else who might foreseeably come into contact with it. A company that may be responsible for only a small percentage of a person's injury may end up bearing the majority of the damage award in the case. If a small company is hit with a product liability lawsuit, the results can be devastating. Figure 23.1 shows the number of product liability lawsuits filed in recent years.

Many customers who ultimately file suit under product liability laws base their claims on **negligence**, when a manufacturer or distributor fails to do something that a "reasonable" person would do. Typically, negligence claims arise from one or more of the following charges:

Negligent design. In suits based on negligent design, a buyer claims that an injury occurred because the manufacturer designed the product improperly. To avoid liability charges, a company does not have to design products that are 100 percent safe, but it must design products that are free of "unreasonable" risks.

Negligent manufacturing. In cases claiming negligent manufacturing, a buyer claims that a company's failure to follow proper manufacturing, assembly, or inspection procedures allowed a defective product to get into the customer's hands and cause injury. A company must exercise "due care" (including design, assembly, and inspection) to make its products safe when they are used for their intended purpose.

Failure to warn. Although manufacturers do not have to warn customers about obvious dangers of using their products, they must warn them about the dangers of normal use and of foreseeable misuse of the product. (Have you ever read the warning label on a step-ladder?) Many businesses hire attorneys to write the warning labels they attach to their products and include in their instructions.¹⁰

Another common basis for product liability claims against businesses is **strict liability**, which states that a manufacturer is liable for its actions no matter what its intentions or the extent of its negligence. Unlike negligence, a claim of strict liability does not require the injured party to prove that the company's actions were unreasonable. The injured person must prove only that

the company manufactured or sold a product that was defective and that it caused the injury when used in a way that was foreseeable. Whereas negligence charges focus on a party's *conduct*, strict liability focuses on the *product*. For instance, the head of an axe flies off its handle, injuring the user. To sue the manufacturer under strict liability, the customer must prove that the defendant sold the axe, the axe was unreasonably dangerous to the customer because it was defective, the customer incurred physical harm to person or to property, and the defective axe was the proximate cause of the injury or damage. If these allegations are true, the axe manufacturer's liability is virtually unlimited.

Protection of Intellectual Property Rights

3.

Discuss the protection of intellectual property rights using patents, trademarks, and copyrights.

Entrepreneurs excel at coming up with innovative ideas for creative products and services. Many entrepreneurs build businesses around intellectual property, products and services that are the result of the creative process and that have commercial value. New methods that are capable of teaching foreign languages at an accelerated pace, hit songs with which we can sing along, books that bring a smile, and new drugs that fight diseases are just some of the ways intellectual property makes our lives better or more enjoyable.

Unfortunately, thieves are escalating their efforts to steal intellectual property by selling counterfeit merchandise. The U.S. Customs and Border Patrol seizes about \$1.25 billion worth of counterfeit goods each year, but sales of counterfeit goods continue to cost U.S. businesses between \$500 and \$600 billion per year.¹¹ The problem extends far beyond pirated software, fake shoes and handbags, and knockoffs of expensive watches or the latest styles of designer clothing. Authorities have discovered pirates selling counterfeit helicopter, airplane, and auto parts as well as prescription medications (including blood pressure medication and birth control pills) and many other products. A tidal wave of counterfeit products, originating mostly in China (which accounts for 72 percent of the counterfeit items that authorities confiscate), Hong Kong, India, and Taiwan, is flooding the world.¹² The International Chamber of Commerce estimates that by 2015 there will be \$1.7 trillion in counterfeit goods sold around the globe, which is more than 2 percent of the world's total economic output.¹³ Table 23.1 shows the top 10 counterfeit products that U.S. Customs agents seize based on their value.

Entrepreneurs can protect their intellectual property from unauthorized use with the help of three important tools: patents, trademarks, and copyrights.



ENTREPRENEURIAL PROFILE: Catherine Simms: Whiner and Diner Catherine Simms is the owner of Whiner and Diner, which makes pet beds and other products out of used wine crates. She has had a significant problem with copycat products and knockoffs showing up on the Web site Etsy, which allows people to buy and sell handmade and vintage products. "It's terrible,

TABLE 23.1 Top 10 Products Seized by U.S. Customs Agents

In one recent year, U.S. Customs agents conducted more than 22,000 seizures of counterfeit goods coming into the United States. Unfortunately, these seizures represent only a portion of the total traffic in pirated goods. Which items do pirates target for counterfeiting?

Rank	Item	Percentage of Seized Value
1.	Handbags and wallets	40%
2.	Watches and jewelry	15%
3.	Apparel and accessories	11%
4.	Consumer electronics and parts	8%
5.	Footwear	8%
6.	Pharmaceuticals and personal care items	8%
7.	Optical media	3%
8.	Computers and accessories	3%
9.	Labels and tags	2%
10.	Toys	1%

Source: Based on *Intellectual Property Rights: Fiscal Year 2012 Seizure Statistics*, U.S. Customs and Border Protection, Office of International Trade, 2013, p. 18.

horrible,” says Sims. “They copy the product, they re-write all of our descriptions and titles. One store just copied and pasted the whole Web site. I work on the Web site myself. It took me years to learn about [search engine] optimization. But if I optimize my text and then they use that text, they may show up [on search engine results] before we do!” Most of the violators deny that they have done anything wrong. “They send a very polite letter saying: We just happen to manufacture the same thing and we’re not using your company name, so it’s okay,” says Simms. When a cease-and-desist letter does not get the copycat to stop selling the knockoff, Simms goes to the offending Web site’s hosting company with a request to remove the questionable content, which will often comply with the Simms’s requests. “When it’s obvious, the hosting companies will just shut them down,” she says.¹⁴

Patents

A **patent** is a grant from the U.S. Patent and Trademark Office (PTO) to the inventor of a product, giving the exclusive right to make, use, or sell the invention in the United States for 20 years from the date of filing the patent application. The purpose of giving an inventor a 20-year monopoly over a product is to stimulate creativity and innovation. After 20 years, the patent expires and cannot be renewed. Most patents are granted for new product inventions, but **design patents**, issued for 3½, 7, or 14 years beyond the date the patent is issued, are given to inventors who make new, original, and ornamental changes in the design of existing products that enhance their sales. Inventors who develop a new plant can obtain a **plant patent** (issued for seven years), provided that they can reproduce the plant asexually (e.g., by grafting or crossbreeding rather than planting seeds). To be patented, a device must be new (but not necessarily better; see Figure 23.2), not obvious to a person of ordinary skill or knowledge in the related field, and useful. An inventor cannot patent a device if it has been publicized in print anywhere in the world or if it has been used or offered for sale in the United States prior to the date of the patent application. A U.S. patent is granted only to the true inventor, not to a person who discovers another’s invention. No one can copy or sell a patented invention without getting a license from its creator. A patent does not give one the right to make, use, or sell an invention but does give one the right to exclude others from making, using, or selling it unless they purchase the rights to it.

In recent years, the PTO has awarded companies, primarily Web-based businesses, patents on their business methods. Rather than giving them the exclusive rights to a product or an invention, a business method patent protects the way a company conducts business. For instance, *Amazon.com* earned a patent on its “1-Click” Web-based checkout process, precluding other e-tailers from using it. *Priceline.com* has a patent on its business model of “buyer-driven commerce,” in which customers name the prices they are willing to pay for airline tickets, hotel rooms, and other items.

Although inventors have no guarantee of getting a patent, they can enhance their chances considerably by following the basic steps suggested by the PTO. Before beginning the lengthy and involved procedure, inventors should obtain professional assistance from a patent practitioner—a patent attorney or a patent agent—who is registered with the PTO. Only attorneys and agents who are officially registered may represent an inventor seeking a patent. Approximately 98 percent of all inventors rely on these patent experts to steer them through the convoluted process.¹⁵ Experienced patent attorneys say that the cost to obtain a patent ranges from \$5,000 for a simple invention to \$25,000 or more for a highly complex invention and possibly up to \$100,000 for an international patent.

THE PATENT PROCESS Since George Washington signed the first patent law in 1790, the PTO has issued patents on everything imaginable (and some unimaginable items, too), including mousetraps, animals (genetically engineered mice), games, and various fishing devices. To date, the PTO has issued more than 8 million patents, and it receives more than 400,000 new applications each year. The first patent was issued to Samuel Hopkins on July 31, 1790, for an improved method for making potash, an ingredient in fertilizer and other products.¹⁶ Patent number 8 million went to Second Sight Medical Products, Inc. for a visual prosthesis (which provides electrical stimulation to the retina of those who have gone blind to simulate visual perceptions of patterns of light). Figure 23.3 shows the trend in the number of patent applications and number of patents actually granted in recent years.

To receive a patent, an inventor must follow these steps:

Establish the invention’s novelty. An invention is not patentable if it is known or has been used in the United States or has been described in a printed publication in the United States



(12) **United States Patent**
Daugherty

(10) **Patent No.:** **US 7,484,328 B1**
(45) **Date of Patent:** **Feb. 3, 2009**

(54) **FINGER MOUNTED INSECT DISSUASION DEVICE AND METHOD OF USE**

(76) Inventor: **John Richard Daugherty**, 1647 N. Woodhollow Way, Flagstaff, AZ (US) 86004

(*) Notice: Subject to any disclaimer, the term of this patent is extended or adjusted under 35 U.S.C. 154(b) by 122 days.

(21) Appl. No.: **11/080,023**

(22) Filed: **Mar. 15, 2005**

Related U.S. Application Data

(63) Continuation-in-part of application No. 10/839,590, filed on May 5, 2004, now abandoned.

(51) **Int. Cl.**
A01M 3/02 (2006.01)
A01M 3/00 (2006.01)

(52) **U.S. Cl.** **43/137; 43/134**

(58) **Field of Classification Search** **43/137, 43/134**

See application file for complete search history.

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Primary Examiner—Darren W Ark
(74) *Attorney, Agent, or Firm*—John R. Daugherty

(57) **ABSTRACT**

An insect dissuasion method that incorporates a miniature fly swatter adapted to be fixed onto an end of a human finger. An insect can be discouraged by simply flexing, slowly encroaching upon and then “flicking” the finger with the attached device to strike the insect. Devices of the present invention are designed to be removably attached to a finger by a ring-like structure. The ring-like structure is tailored to slip onto and engage a finger in various positions and remain attached to the finger when the finger is flicked. Joined to the ring-like structure is an extension shaft that terminates in an insect engagement head. The length and/or cross-sectional profile of the extension shaft can be altered as well as the shape of the head portion or ring-like structure.

3 Claims, 13 Drawing Sheets

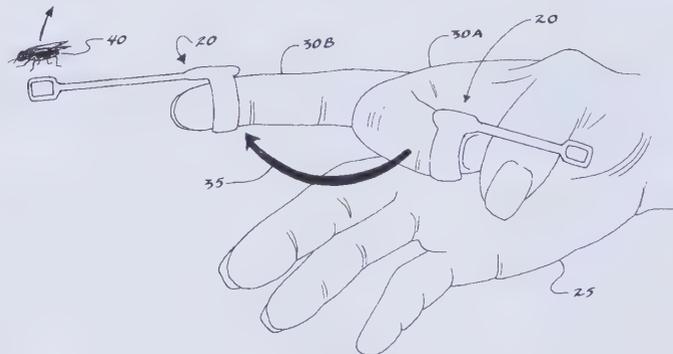


FIGURE 23.2

Design Patent # 7,484,328, Finger-Mounted Insect Dissuasion Device

Source: U.S. Patent and Trademark Office.

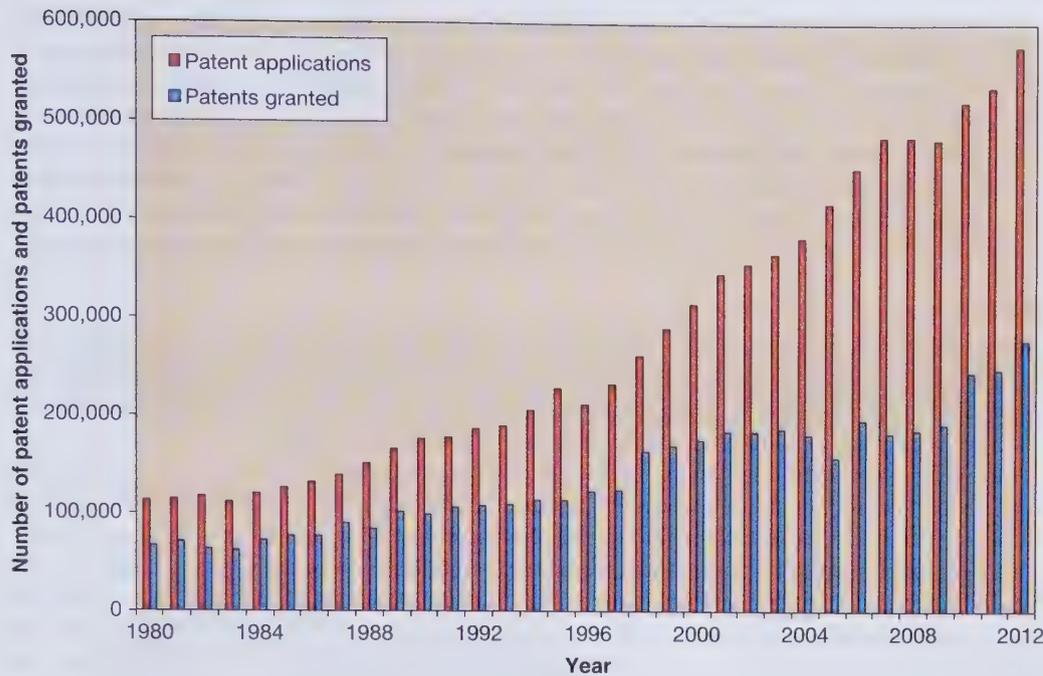


FIGURE 23.3

Patent Applications and Patents Granted, 1980–2012

Source: Based on U.S. Patent and Trademark Office, www.uspto.gov.

File a provisional patent. To protect their patent claims, inventors should be able to verify the date on which they first conceived the idea for their inventions. Inventors can document a device by keeping dated records (including drawings) of their progress on the invention and by having knowledgeable friends witness these records. Inventors also can file a provisional patent with the PTO—a process that includes submitting a written description of the invention and any supporting drawings along with the provisional patent cover sheet and filing fee to the PTO. A provisional patent gives protection for 12 months.

Search existing patents. To verify that the invention truly is new, nonobvious, and useful, inventors must conduct a search of existing patents on similar products. The purpose of the search is to determine whether the inventor has a chance of getting a patent. Most inventors hire professionals trained in conducting patent searches to perform the research. Inventors themselves can conduct an online search of all patents granted by the PTO since 1976 from the office's Web site. An online search of these patents does not include sketches; however, subscribers to Delphion's Research Intellectual Property Network can access patents, including sketches, as far back as 1971 at www.delphion.com.

Study search results. Once the patent search is finished, inventors must study the results of the search to determine their chances of getting a patent. To be patentable, a device must be sufficiently different from what has already been patented and must not be obvious to a person having ordinary skill in the area of technology related to the invention.

Submit the patent application. An inventor must file an application describing the invention with the PTO. This description, called the patent's claims, should be broad enough that others cannot easily engineer around the patent, rendering it useless. However, they cannot be so narrow as to infringe on patents that other inventors already hold. The typical patent application runs 20 to 40 pages, although some, especially those for biotech or high-tech products, are tens of thousands of pages long.

Prosecute the patent application. Before the PTO will issue a patent, one of its examiners studies the application to determine whether the invention warrants a patent. If the PTO rejects the application, the inventor can amend the application and resubmit it to the PTO. The average time for a patent to be issued is 29 months.

Defending a patent against “copycat producers” can be expensive and time consuming but often is necessary to protect an entrepreneur’s idea. Patent lawsuits are on the rise, the number filed annually more than quadrupling since the early 1990s.¹⁷ Unfortunately, the cost of defending a patent has increased as well. According to a survey by the American Intellectual Property Owners Association, the average cost to defend a patent case is about \$1 million when the amount at risk is less than \$1 million, about \$3 million when \$1 million to \$25 million is at risk, and about \$6 million when more than \$25 million is at risk.¹⁸ However, the odds of winning are in the patent holder’s favor; more than 60 percent of those holding patents win their infringement suits.¹⁹

Trademarks

A **trademark** is any distinctive word, phrase, symbol, design, name, logo, slogan, or trade dress that a company uses to identify the origin of a product or to distinguish it from other goods on the market. (A **servicemark** is the same as a trademark except that it identifies and distinguishes the source of a service rather than a product.) A trademark serves as a company’s “signature” in the marketplace. A trademark can be more than just a company’s logo, slogan, or brand name; it can also include symbols, shapes, colors, smells, or sounds. For instance, Coca-Cola holds a trademark on the shape of its bottle, and NBC owns a trademark on its three-toned chime. Components of a product’s identity such as these are part of its **trade dress**, the unique combination of elements that a company uses to create a product’s image and to promote it. For instance, a Mexican restaurant chain’s particular decor, color schemes, design, and overall “look and feel” make up its trade dress. To be eligible for trademark protection, trade dress must be inherently unique and distinctive to a company, and another company’s use of that trade dress must be likely to confuse customers.



ENTREPRENEURIAL PROFILE: Thermal-Wise Insulation v. Questar Gas Co. Rob Linden owns a small residential and commercial insulation company in Columbia Heights, Minnesota, called Thermal-Wise Insulation, that provides insulation services to commercial and residential customers. Questar Gas Co., a Utah-based natural gas utility, is suing Linden’s small business, claiming that the name “Thermal-Wise” infringes on the name of a rebate program it offers its customers called “ThermWise.” “I didn’t think what they are claiming is even possible,” says Linden. “I’m an insulation company. They sell gas.” Questar Gas Co. claims that Linden’s continued use of the Thermal-Wise name will “damage [its] reputation and impair and dilute [its] goodwill.” The financial toll on Linden’s business is mounting. He has already spent \$15,000 in legal fees fighting Questar, and his business has dropped by 70 percent, as people are hesitant to do business with a contractor in the middle of litigation. He has had to abandon his business expansion plans and has indefinitely delayed increasing his workforce. “I’ve invested a lot into this business as it is,” says Linden. “And for me to start over with a new name would be devastating. A change of name is often a sign of a failed business.” Linden offered to give up the Thermal-Wise name if Questar ever came into the Minnesota; Questar rejected that offer. “Thousands search the Internet for ThermWise to get rebates, and if they turned up something with a negative connotation that would reflect on our brand,” says Chad Jones, a spokesman for Questar. “The world is all connected on the Internet now.”²⁰

There are more than 1.8 million trademarks registered in the United States. Federal law permits a manufacturer to register a trademark, which prevents other companies from employing a similar mark to identify their goods. Businesses aggressively protect their trademarks. Each year, there are between 9,000 and 12,000 lawsuits filed regarding contested trademarks. Before 1989, a business could not reserve a trademark in advance of use. Today, the first party that either uses a trademark in commerce or files an application with the PTO has the ultimate right to register that trademark. The PTO takes an average of 10 months to process a trademark application.²¹ Unlike patents and copyrights, which are issued for limited amounts of time, trademarks last indefinitely as long as the holder continues to use it. However, a trademark cannot keep competitors from producing the same product and selling it under a different name. It merely prevents others from using the same or confusingly similar trademark for the same or similar products.

Many business owners are confused by the use of the symbols TM and ®. Anyone who claims the right to a particular trademark (or servicemark) can use the TM (or SM) symbols without having to register the mark with the PTO. The claim to that trademark or servicemark may or may not be valid, however. Only those businesses that have registered their marks with the PTO can use the ® symbol. Entrepreneurs do not have to register trademarks or servicemarks to establish their rights to those marks; however, registering a mark with the PTO does give entrepreneurs greater power to protect their marks. Filing an application to register a trademark or servicemark is

relatively easy, but it does require a search of existing names. Entrepreneurs can use the Trademark Electronic Search System (TESS) at the U.S. Patent and Trademark Office's Web site (www.uspto.gov) to determine whether a business or product name is already trademarked.

An entrepreneur may lose the exclusive right to a trademark if it loses its unique character and becomes a generic name or if the company abandons its trademark by failing to market the brand adequately. Aspirin, escalator, thermos, brassiere, super glue, yo-yo, and cellophane were once enforceable trademarks that have become common words in the English language. These generic terms can no longer be licensed as a company's trademark.



Entrepreneurship in Action

Protecting Your Brand



Wendi Levy and Kim Etheredge, cofounders of Mixed Chicks.

Source: Mixed Chicks LLC.

Wendi Levy and Kim Etheredge, both of whom are biracial, came up with the idea to develop a hair product for women of mixed race. Both women had struggled with their curly and hard-to-manage hair for most of their lives by using a combination of hair products. "We would have to use 10 different products instead of one," says Etheredge. In 2003, Levy and Etheredge decided to take their problem to a chemist in hopes that they could find out which ingredients from all of the various products were the ones that helped get their hair under control. With the chemist's help and lots of experimentation, they developed their product, which they branded as Mixed Chicks.

"The name Mixed Chicks was chosen because we both grew up in the seventies, and we were always forced to choose between our ethnicities rather than embracing both of them," says Etheredge. "We weren't allowed to check two boxes; we had to pick one on any application. We wanted our own box—one that is inclusive. Our products are meant for all curly-haired women, whether black, white, Asian, Latin, Mediterranean, or any glorious combination."

Mixed Chicks first sold its products online in 2004. Based on the success of its online sales, the company was soon able to place its products in salons and beauty-supply stores nationwide.

Mixed Chicks received a significant boost in sales when Halle Berry endorsed its product.

In 2009, Etheredge and Levy were at a trade show. A representative from Sally Beauty Supply approached Etheredge and Levy about selling Mixed Chicks in its stores. Sally Beauty Supply is a \$3.5 billion publicly traded company with more than 3,000 stores located in cities throughout North America and Europe. Although the entrepreneurs initially were excited about the prospects of selling Mixed Chicks products to a large national chain, they decided not to pursue the opportunity when they learned about Sally Beauty Supply's strict return and liberal discount policies. Neither would be good for their small company. "We wanted to make sure we had control of our merchandise and inventory," says Etheredge.

By 2011, Mixed Chicks was doing quite well, even without a contract with Sally Beauty Supply. The company's sales had grown to \$5 million, and it had introduced a variety of new products, including some for infants and toddlers. Soon, however, Levy and Etheredge began to hear from clients and customers that Sally Beauty Supply had rolled out its own product line for multiracial women called Mixed Silk. The bottles were the same shape, the packaging used the same colors and fonts, and the ads used similar language to those developed for Mixed Chicks. In fact, the Sally Beauty Supply's products looked so much like Mixed Chicks that some customers assumed that Mixed Chicks introduced a new low-cost product to segment the market. Mixed Chicks sold for \$14 to \$20 a bottle, while Mixed Silk sold for only \$8. Etheredge decided to do her own competitive research and visited a Sally Beauty store. When she asked about the Mixed Silk product being offered by Sally Beauty, a store clerk told her that Mixed Silk was a "generic" version of Mixed Chicks.

Etheredge and Levy knew that they had an uphill battle but decided to fight to protect the brand that they had worked so hard to develop. Fighting a large company like Sally Beauty Supply is the type of battle that often results in failure for many small businesses. However, Etheredge and Levy decided to forge ahead, and Mixed Chicks filed a lawsuit charging Sally Beauty Supply with trademark infringement, trade dress infringement, and unfair competition. In its lawsuit, Mixed Chicks alleged that Sally Beauty Supply marketed, sold, and advertised imitations of its products. "They messed with the wrong broads," says Etheredge.

After two years, the case finally went to trial. In 2012, after deliberating for only six hours, the jury ruled in favor of Mixed Chicks, awarding them \$839,595 in actual damages. In addition,

Entrepreneurship in Action *(continued)*

the jury awarded Mixed Chicks \$7.27 million in punitive damages in the trademark and trade dress dispute.

"Others will enter the market, but we're not afraid of competition—as long as it's fair competition," says Etheredge. "We knew we were in the right, and we're happy we can now move forward."

1. Why do you think that the jury found in favor of Mixed Chicks? Explain.
2. What are steps that a small business can take to protect its brand? Explain.

3. Even though Mixed Chicks won the lawsuit, what were the risks that they took when they went after a large company for trademark and trade dress infringements? Explain.

Sources: Based on "Wendi Levy Kaaya and Kim Etheredge Co-Owners: Mixed Chicks," *Our Ventura Blvd*, September/October 2012, www.ourventurablvd.com/September-October-2012/Wendi-Levy-Kaaya-and-Kim-Etheredge-Co-owners; Jennifer Alseaver, "Case Study: To Sue or Not to Sue," *Inc.*, January 24, 2012, www.inc.com/magazine/201202/case-study-the-rival-mixed-chicks-sally-beauty.html; Lisa Shuchman, "Mixed Chicks Gets \$8.5M Jury Award for Infringing Mixed-Race Hair Products," *Corporate Counsel*, December 5, 2012, www.law.com/corporatecounsel/PubArticleCC.jsp?id=1202580228393&Mixed_Chicks_Gets_85M_Jury_Award_for_Infringing_MixedRace_Hair_Products&streturn=20130405104009.

Copyrights

A **copyright** is an exclusive right that protects the creators of original works of authorship, such as literary, dramatic, musical, and artistic works (e.g., art, sculptures, literature, software, music, videos, video games, choreography, motion pictures, recordings, and others). The internationally recognized symbol © denotes a copyrighted work. A copyright protects only the form in which an idea is expressed, not the idea itself. A copyright on a creative work comes into existence the moment its creator puts that work into a tangible form. Just as with a trademark, obtaining basic copyright protection does not require registering the creative work with the U.S. Copyright Office; doing so, however, gives creators greater protection over their work. When author J. K. Rowling wrote the manuscripts for the immensely popular *Harry Potter* series, she automatically had a copyright on her creation. To secure her works against infringement, however, Rowling registered the copyright with the U.S. Copyright Office. Copyright applications must be filed with the Copyright Office in the Library of Congress for a fee of \$35 per application. A valid copyright on a work lasts for the life of the creator plus 70 years after his or her death. (A copyright lasts 75 to 100 years if the copyright holder is a business.) When a copyright expires, the work becomes public property and can be used by anyone free of charge.

Because they are easy to duplicate, copyright infringers most often pirate computer software, CDs, and DVDs. Copyright piracy costs tens of billions of dollars each year in lost sales. The global software industry alone loses \$63.4 billion annually to counterfeiters; experts estimate that as much as 41 percent of the software installed on PCs is pirated.²² The U.S. music industry loses \$12.5 billion annually to thieves, and the U.S. motion picture industry loses \$20.5 billion to piracy.²³

Protecting Intellectual Property

Acquiring the protection of patents, trademarks, and copyrights is useless unless an entrepreneur takes action to protect those rights in the marketplace. Unfortunately, some businesspeople do not respect others' rights of ownership to products, processes, names, and works and infringe on those rights with impunity. In other cases, the infringing behavior simply is the result of a lack of knowledge about other's rights of ownership. After acquiring the proper legal protection through patents, copyrights, or trademarks, entrepreneurs must monitor the market (and the Internet in particular) for unauthorized copycat users. If an entrepreneur has a valid patent, trademark, or copyright, stopping an infringer usually requires nothing more than a stern "cease-and-desist" letter from an attorney. Offenders usually want to avoid expensive legal battles and agree to stop their illegal behavior. If that tactic fails, the entrepreneur may have no choice but to bring an infringement lawsuit, many of which end up being settled out of court.

The primary weapon an entrepreneur has to protect patents, trademarks, and copyrights is the legal system. The major problem with relying on the legal system to enforce ownership rights is the cost of infringement lawsuits, which can quickly exceed the budget of most small business. Legal battles usually are expensive. Before bringing a lawsuit, an entrepreneur must consider the following issues:

- Can the opponent afford to pay if you win?
- Do you expect to get enough from the suit to cover the costs of hiring an attorney and preparing a case?
- Can you afford the loss of time, money, and privacy from the ensuing lawsuit?

The Law of Agency

An **agent** is one who stands in the place of and represents another in business dealings. Although an agent has the power to act for the principal, he or she remains subject to the principal's control. Many small business managers do not realize that their employees are agents while performing job-related tasks. Employers are liable only for those acts that employees perform within the scope of employment. For example, if an employee loses control of a flower shop's delivery van while making a delivery and crashes into several parked cars, the owner of the flower shop (the principal) and the employee (the agent) are liable for any damages caused by the crash. Even if the accident occurred while the employee was on a small detour of his own (e.g., to stop by his house), the owner is still liable for damages as long as the employee is working "within the scope of his employment." Normally, an employee is considered to be within the scope of his employment if he is motivated in part by the principal's action and if the place and time for performing the act is not significantly different from what is authorized.

Any person, even those lacking contractual capacity, can serve as an agent, but a principal must have the legal capacity to create contracts. Both the principal and the agent are bound by the requirements of a fiduciary relationship, one characterized by trust and good faith. In addition, each party has specific duties to the other. An agent's duties include the following:

- **Loyalty.** Every agent must be faithful to the principal in all business dealings.
- **Performance.** An agent must perform his or her duties according to the principal's instructions.
- **Notification.** The agent must notify the principal of all facts and information concerning the subject matter of the agency.
- **Duty of care.** An agent must act with reasonable care when performing duties for the principal.
- **Accounting.** An agent is responsible for accounting for all profits and property received or distributed on the principal's behalf.

A principal's duties include the following:

- **Compensation.** Unless a free agency is created, the principal must pay the agent for his or her services.
- **Reimbursement.** The principal must reimburse the agent for all payments made for the principal or any expenses incurred in the administration of the agency.
- **Cooperation.** Every principal has the duty to indemnify the agent for any authorized payments or any loss or damages incurred as a result of the agency, unless the liability is the result of the agent's mistake.
- **Safe working conditions.** The law requires a principal to provide a safe working environment for all agents. Workers' compensation laws cover an employer's liability for injuries that agents receive on the job.

As agents, employees can bind a company to agreements, even if the owner did not intend for them to do so. An employee can create a binding obligation, for instance, if the business owner presents him or her as authorized to perform such transactions. For example, the owner of a flower shop who routinely permits a clerk to place orders with supplier has given that employee *apparent authority* for purchasing. Similarly, employees have *implied authority* to create agreements when performing the normal duties of their jobs. For example, the chief financial officer of a company has the authority to create binding agreements when dealing with the company's bank.

One issue related to agency that many confronts many businesses is whether their workers are employees who are directly under their control or independent contractors who are hired temporarily by contract to perform a job. Because employers do not have to incur payroll taxes or provide health care or other benefits to independent contractors, paying an independent contractor is less expensive than hiring an employee to do the same job. In addition, an employer is liable for negligent acts by an employee but is not liable for the negligent acts of an independent contractor. However, over the past decades, the IRS has significantly narrowed the definition of

4.

Explain the basics of the law of agency.

who can actually be considered a true independent contractor. The determination is now made by three main tests:

1. **Behavioral control.** Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. **Financial control.** Are the business aspects of the worker's job controlled by the company (these include things such as how worker is paid, whether expenses are reimbursed, who provides tools/supplies, and so on)?
3. **Type of relationship between the parties.** Are there written contracts or employee type benefits (i.e., pension plan, insurance, vacation pay, and so on)? Will the relationship continue, and is the work performed a key aspect of the business?

Some businesses have experienced disputes with the IRS over the status of workers they claim are independent contractors and the IRS considers employees. In general, the more control that an employer exercises over a worker, the more likely it is that he or she is an employee. If, however, the employer controls only the final result of the work, the worker is most likely an independent contractor. Given that the cost in back taxes and penalties can be quite severe if an employer designates someone incorrectly as an independent contractor, it is always advisable to consult with a CPA or attorney who has expertise in employment law on such matters. The IRS provides guidelines for determining the difference between employees and independent contractors at its Web site at www.irs.gov.

Bankruptcy

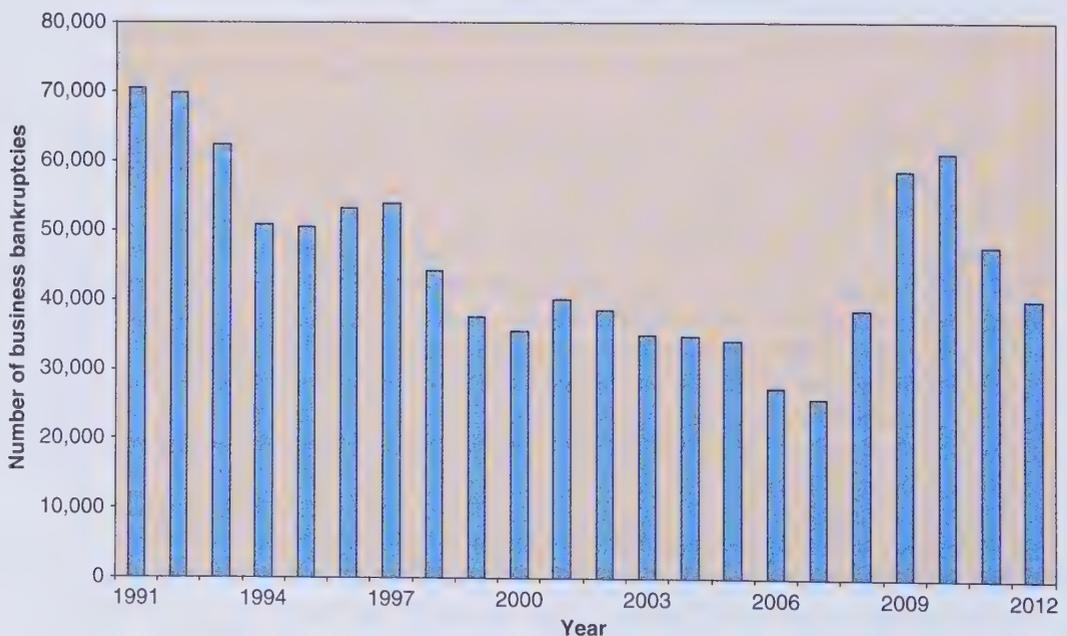
Bankruptcy occurs when a business is unable to pay its debts as they come due. Although filing for bankruptcy traditionally has had a social stigma attached to it, today it has become an accepted business strategy for troubled companies (see Figure 23.4). Companies such as American Airlines, Houghton Mifflin Harcourt (book and textbook publishing company), Reader's Digest (magazine company), Atari (video game company), Eastman Kodak (film and camera manufacturer), Hawker Beechcraft (manufacturer of business and other aircraft), Borders (book and music stores), and many others have filed for bankruptcy recently. Some of these companies have vanished, but others have emerged from bankruptcy and continue to operate. The most recent peak in the number of business bankruptcies occurred in 2009 and 2010, due to the fallout from the recession and financial crisis that began in 2008.

5.

Explain the basics of bankruptcy law.

FIGURE 23.4
Number of Business Bankruptcies

Source: Based on www.uscourts.gov/Statistics/JudicialBusiness/2012/us-bankruptcy-courts.aspx.



Forms of Bankruptcy

Many people who file for bankruptcy are small business owners seeking protection from creditors under one of the eight chapters created by the Bankruptcy Reform Act of 1978, which was amended in 2005. The Bankruptcy Reform Act of 2005 requires debtors to pay as many of their debts as possible rather than having them discharged by bankruptcy. Under the act, three chapters (7, 11, and 13) govern the majority of bankruptcies related to small businesses. Usually, small business owners in danger of failing choose from two types of bankruptcies: **liquidation** (Chapter 7, in which an owner files for bankruptcy and the business ceases to exist) and **reorganization** (Chapter 11, in which after filing for bankruptcy, the owner formulates a reorganization plan under which the business continues to operate).

CHAPTER 7: LIQUIDATIONS The most common type of bankruptcy is filed under Chapter 7 (called straight bankruptcy), which accounts for more than 70 percent of all filings. A company that completes Chapter 7 bankruptcy is liquidated and ceases to exist. The business simply declares all of its debts and turns over all of its assets to a trustee who is elected by the creditors or appointed by a court. The trustee sells the assets and distributes all proceeds first to secured creditors and then to unsecured creditors (which include stockholders). Depending on the outcome of the asset sale, creditors can receive anywhere between 0 and 100 percent of their claims against the bankrupt company. Once the bankruptcy proceeding is complete, any remaining debts are discharged, and the company disappears.



ENTREPRENEURIAL PROFILE: Maclaren USA (American Baby Products) Maclaren was long considered an elite brand of baby strollers. Parents in some of the most affluent neighborhoods could be seen walking their babies in Maclaren strollers that cost hundreds of dollars. The U.K.-based company sold its strollers in the United States through its distributor, Maclaren USA. Maclaren pioneered the lightweight, collapsible baby stroller (also called umbrella strollers). Then in 2009 Maclaren announced a recall for 1 million of its strollers. There were reports that more than 20 children had fingers amputated by the hinges on Maclaren strollers, and more than 100 more had serious injuries to their fingers. In 2011, Maclaren USA changed its name to American Baby Products and then filed for Chapter 7 bankruptcy. Parents who had filed claims against Maclaren USA were uncertain whether they would ever receive any compensation related to their children's injuries. However, in 2012, the U.K.-based Maclaren announced that it would pay all product liability claims that were filed against Maclaren USA regardless of the outcomes of its bankruptcy case.²⁴

A business begins the straight bankruptcy proceedings by filing either a voluntary or an involuntary petition. A voluntary case starts when the debtor files a petition with a bankruptcy court, stating the names and addresses of all creditors, the debtor's financial position, and all property the debtor owns. On the other hand, creditors start an involuntary petition by filing with the bankruptcy court. If there are 12 or more creditors, at least three of them whose unsecured claims total \$14,425 or more must file the involuntary petition. If a debtor has fewer than 12 creditors, only one of them having a claim of \$14,425 or more is required to file. As soon as a petition (voluntary or involuntary) is filed in a bankruptcy court, all creditors' claims against the debtor are suspended. Called an **automatic stay**, this provision prevents creditors from collecting any of the debts the debtor owed them before filing the petition. In other words, no creditor can begin or continue to pursue debt collection once the petition is filed.

Not every asset an individual bankrupt debtor owns is subject to court attachment; certain assets are exempt, although each state establishes its own exemptions. Most states make an allowance for equity in a home, interest in an automobile, interest in a large number of personal items, and other personal assets. Federal law allows a \$22,975 exemption for a home, an \$12,250 exemption for household items and clothing, a \$3,675 exemption for equity in a car, and several other exemptions.

The law does not allow a debtor to transfer the ownership of property to others to avoid its seizure in a bankruptcy. If a debtor transfers property within one year of the filing of a bankruptcy petition, the trustee can ignore the transfer and claim the assets. In addition, a court will overturn any transfer of property made for the express purpose of avoiding repayment of debts (called **fraudulent conveyance**). The new law also enables a judge to dismiss a Chapter 7 bankruptcy petition if it is a "substantial abuse" of the bankruptcy code.

CHAPTER 11: REORGANIZATION For a small business weakened by a faltering economy, excessive debt load, or management mistakes, Chapter 11 provides a second chance for success. The philosophy behind this form of bankruptcy is that ailing companies can prosper again if given a fresh start with less debt. A Chapter 11 bankruptcy filing protects a company's assets from creditors' legal actions while it formulates a plan for reorganization and repaying or settling its debts or for selling the business. In most cases, a small business and its creditors negotiate a settlement in which the company repays a percentage of its debts with the remainder of them dismissed. The business continues to operate under the court's direction, but creditors cannot foreclose on it, nor can they collect any prebankruptcy debts the company owes.

The average duration of bankruptcies is declining as companies realize the benefits of exiting bankruptcy as quickly as possible. Unlike a typical bankruptcy, which may take two or more years to complete, Section 363 bankruptcy allows a bankrupt company to emerge from bankruptcy in as little as 30 to 60 days. Because of Section 363, automaker Chrysler completed its Chapter 11 bankruptcy in just 42 days. Another exemption allows a fast-track version of Chapter 11 bankruptcy for small businesses with liabilities that do not exceed \$2 million that streamlines the process and is less expensive.

A Chapter 11 bankruptcy filing can be either voluntary or involuntary. Once the petition is filed, an automatic stay goes into effect, and the debtor has 120 days to file a reorganization plan with the court. Usually, the court does not replace management with an appointed trustee; instead, the bankrupt party, called the debtor in possession, serves as trustee. If the debtor fails to file a plan within the 120-day limit, any party involved in the bankruptcy, including creditors, may propose a plan. The plan must identify the various classes of creditors and their claims, outline how each class will be treated, and establish a method to implement the plan. It also must spell out the debts that the company cannot pay, those that it can pay, and the methods the debtor will use to pay them.

Once the plan is filed, the court must decide whether to approve it. A court will approve a plan if a majority of each of the three classes of creditors—secured, priority, and unsecured—votes in favor of it. The court will confirm a plan if it has a reasonable chance of success, is submitted in good faith, and is “in the best interest of the creditors.” If the court rejects the plan, the creditors must submit a new one for court approval.

Filing under Chapter 11 offers a weakened small business a number of advantages, the greatest of which is a chance to survive (although most of the companies that file under Chapter 11 ultimately are liquidated). In addition, employees keep their jobs, and customers get an uninterrupted supply of goods and services. However, there are costs involved in bankruptcy proceedings. Customers, suppliers, creditors, and often employees lose confidence in a company's ability to succeed. Creditors frequently incur substantial losses in Chapter 11 bankruptcies, receiving payments of just pennies for every dollar they are owed.



ENTREPRENEURIAL PROFILE: Frank McCourt: The Los Angeles Dodgers

Frank McCourt, a successful commercial real estate developer, purchased the Los Angeles Dodgers from News Corp. in 2004 for \$430 million. However, after years of financial entanglement with his personal finances, overspending on payroll that he could not support with cash flow, and finally a bitter divorce, McCourt was left with no choice but to file for Chapter 11 bankruptcy for his company that owned the Dodgers. The team had amassed more than \$500 million in debt and was no longer able to fund operations from its cash flow. In a document filed with the bankruptcy court, the team said that the Chapter 11 filing would allow it to meet payroll, sign players, pay vendors, and continue playing baseball. In 2012, McCourt agreed to sell the Dodgers to a group of investors that included former Los Angeles Laker Magic Johnson for a record price of \$2 billion, the highest ever paid for a professional sports team.²⁵

CHAPTER 13: INDIVIDUAL'S REPAYMENT PLANS Chapter 13 bankruptcy is the consumer version of Chapter 11 proceedings. Individual debtors (not businesses) with a regular income who owe unsecured debts of less than \$360,475 or secured debts of less than \$1,081,400 may file for bankruptcy under Chapter 13. Many debtors who have the choice of filing under Chapter 11 or 13 find that Chapter 13 is less complicated and less expensive. Chapter 13 proceedings must begin voluntarily. Once the debtor files a petition, creditors cannot start or continue legal action to collect payment. Under Chapter 13, only the debtor can file a repayment plan, whose terms cannot exceed five years. If the court approves the plan, the debtor may pay off the obligations—either in full or partially—on an installment basis. The plan is designed to be completed in mind, and when the debtor completes the payments under the plan, all debts are discharged.



In the Entrepreneurial Spotlight

A Second Chance at Success



Curt Jones, founder of Dippin' Dots.

Source: Dippin' Dots.

Curt Jones grew up in a small town where churning ice cream was a summer tradition. After college, Jones went to work in a lab that was developing a new kind of animal feed through a process of flash freezing using liquid nitrogen. One day while making some homemade ice cream as he had when he was young, Jones decided to try speed up the process by flash freezing it using liquid nitrogen. Not only did the process result in a unique small pellets of ice cream, but also the flash freezing process created a product with a very smooth texture.

Within six months, Jones quit his job to begin selling his "pelletized" ice cream in a small store in Lexington, Kentucky, that became the first Dippin' Dots. Because the product must be stored at -40 degrees Fahrenheit, it could not be distributed through grocery stores and other retail outlets that did not have freezers that kept product at such a low temperature, so Jones decided to grow the business through retail outlets and by selling it through kiosks in stadiums and theme parks. Dippin' Dots touted its unique frozen treat as the "ice cream of the future." Jones established the company's headquarters in Paducah, Kentucky.

Although the company experienced significant growth, the recession that began in 2008 took its toll on sales. Revenues dropped from \$33.9 million in 2009 to \$26.7 million in 2010. In 2011, Regions Bank foreclosed on the \$11.1 million in loans it had outstanding with Dippin' Dots. The company had no choice but to declare Chapter 11 bankruptcy to keep its cash available to support its operations and attempt to reorganize its debt. During the bankruptcy process, Jones stepped down as CEO of the company he founded.

Then in 2012, an investment group out of Oklahoma City bought Dippin' Dots LLC out of bankruptcy for \$12.7 million. Scott Fischer and his father Mark Fischer, who had made their fortune in the energy business, led the investment group. Fisher recalled that he enjoyed Dippin' Dots as a child visiting Six Flags and Sea World and looked forward to reviving the company with so many memories for him.

The new owners reinstated company founder Curt Jones as CEO and Scott Fischer became president of the company. The new owners also committed to keeping the company headquarters in Paducah and invested in a new 125,000-square-foot factory built in Kentucky.

After emerging from bankruptcy, Dippin' Dots began to implement several new strategies aimed at growing the brand. Dippin' Dots introduced a new line of nonfat yogurt dots called YoDots which have only 70 calories. The company plans not only to sell the product through its traditional outlets but also to begin to market it to schools. The product meets the health standards that the U.S. Department of Agriculture has established for schools, so Dippin' Dots plans to market the new product to school districts across the country.

Dippin' Dots also began to experiment with a treat for pets called Doggie Dots. The product development team is using banana and peanut butter flavors (without the sugar) as dog treats. Although they taste bland to humans, dogs seem to love them.

When the Fischers bought Dippin' Dots, they identified international growth as a key strategy for the company. The company has signed licensing agreements with sellers in Russia and Greece. They also have a new license agreement with a company from Japan that will purchase products from the existing Dippin' Dots facility in South Korea.

1. What advantages does Chapter 11 bankruptcy offer troubled companies? What disadvantages do companies that file for Chapter 11 bankruptcy incur?
2. Use the Internet to research other companies that have declared Chapter 11 bankruptcy. Select one company that is of interest to you and prepare a one-page report that describes the sequence of events that led to the bankruptcy, the company's plan for reorganizing, and the outcome for the company.

Sources: Based on Derek Thompson, "Dippin' Dots: What's the Future of the 'Ice Cream of the Future'?" *The Atlantic*, August 24, 2011, www.theatlantic.com/business/archive/2011/08/dippin-dots-whats-the-future-of-the-ice-cream-of-the-future/244040; "Dippin' Dots Maker Declares Bankruptcy: 'Ice Cream of the Future' Files for Chapter 11 Reorganization," *New York Daily News*, November 7, 2011, www.nydailynews.com/life-style/eats/dippin-dots-maker-declares-bankruptcy-ice-cream-future-files-chapter-11-reorganization-article-1.973683; Kim Peterson, "Chilly Business Pushes Dippin' Dots into Bankruptcy," *MSN Money*, November 4, 2011, <http://money.msn.com/top-stocks/post.aspx?post=357090ea-6c66-4259-945d-3c1250f68258>; Don Mecoy, "Dippin' Dots Deal Is Done," *Oklahoman*, May 18, 2012, <http://newsok.com/dippin-dots-deal-done/article/3676556#ixzz1vFQ12tWI>; G. Chambers Williams III, "Dippin' Dots Hopes for a Comeback After Bankruptcy Filing," *USA Today*, April 29, 2012, <http://usatoday30.usatoday.com/money/companies/story/2012-04-29/dippin-dots-bankruptcy-comeback/546139201>; Katy Stech, "After Bankruptcy, Dippin' Dots Aims for a Healthier Future," *Wall Street Journal*, March 26, 2013, <http://blogs.wsj.com/bankruptcy/2013/03/26/after-bankruptcy-dippin-dots-aims-for-healthier-future>.

Government Regulation

6. Explain some of the government regulations affecting small businesses, including those governing trade practices, consumer protection, consumer credit, and the environment.

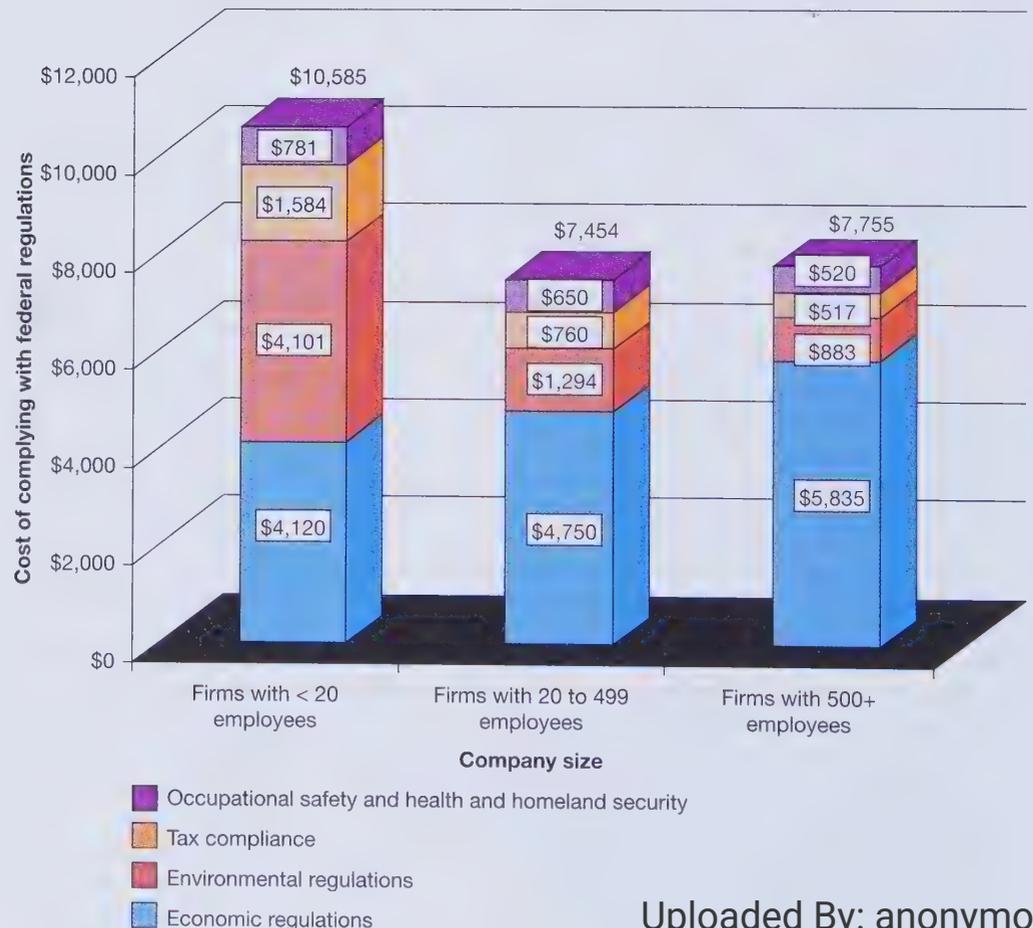
Although most entrepreneurs recognize the need for some government regulation of business, most believe that the process is overwhelming and out of control. Government regulation of business is far from new; in fact, Congress created the first regulatory agency, the Interstate Commerce Commission in 1887. The Great Depression of the 1930s triggered a great deal of regulation of business. From the 1930s on, laws regulating business practices and the creation of government agencies to enforce the regulations have expanded continuously. Not to be outdone by the federal regulators, most states have created their own regulatory agencies to create and enforce a separate set of rules and regulations. Small business owners often feel overwhelmed by the paperwork required to respond to all the governmental agencies trying to regulate and protect them. For instance, an entrepreneur who wants to start an auto repair shop must contend with 38 sets of regulations from 18 federal, state, and local agencies.²⁶

The major complaint that small business owners have concerning government regulation concerns the cost of compliance. The Small Business Administration's Office of Advocacy estimates that complying with government regulation cost businesses \$1.75 trillion per year.²⁷ Because many of the costs of complying with regulations are fixed, the impact of the regulatory burden is greater on small businesses than on big businesses. Large companies can spread the cost of compliance over a larger number of employees and consequently have a lower regulatory per employee cost. The Small Business Administration study shows that the cost of compliance per employee for small companies with 1 to 20 workers is \$10,585, which is 36 percent higher than the \$7,755 cost per employee at companies with more than 500 workers.²⁸ Figure 23.5 shows the cost of complying with federal regulations by company size.

In a competitive market, small companies cannot simply pass these additional costs forward to their customers, and consequently they experience a squeeze on their profit margins. The

FIGURE 23.5
Federal Regulatory Compliance Cost by Company Size

Source: Based on Nicole V. Crain and Mark Crain, "The Impact of Regulatory Costs on Small Firms," Small Business Administration Office of Advocacy, September 2010, p. 7.





Source: Scott Adams/Universal Uclick.

Small Business Regulatory Enforcement and Fairness Act (SBREFA) offers business owners some hope. SBREFA amended the Regulatory Flexibility Act of 1980, which Congress passed in response to small business owner's frustration at an ever-increasing burden of federal regulation. SBREFA's purpose is to require government agencies to consider the impact of their regulations on small companies and gives business owners more input into the regulatory process.

Most business owners agree that some government regulation is necessary. There must be laws governing working safety, environmental protection, package labeling, consumer credit, and other relevant issues because some dishonest, unscrupulous managers abuse the opportunity to serve the public's interest. It is not the regulations that protect workers and consumers and achieve social objectives to which business owners object but rather those that produce only marginal benefits relative to their costs. Owners of small companies, especially, seek relief from wasteful and meaningless government regulations, charging that the cost of compliance exceeds the benefits gained.



ENTREPRENEURIAL PROFILE: Richard and Eileen Bergmann v. City of Lake Elmo

Richard and Eileen Bergmann had been operating their family farm in Lake Elmo, Minnesota, for almost 40 years. The Bergmanns have a stand where they sell pumpkins to local residents during the Halloween season. To keep their stand stocked, the Bergmanns must add to their inventory with produce grown outside the city limits of Lake Elmo. One of their sources is a pumpkin farm they operate just a few miles away in Wisconsin. However, Lake Elmo had established a law that banned the Bergmanns and other farmers in the city from bringing in and selling farm goods grown outside the city limits. Under this local ordinance, violators could face 90 days in jail and a \$1,000 fine, so the Bergmanns and other local farmers filed a lawsuit in U.S. District Court for the District of Minnesota challenging Lake Elmo's trade ban as a violation of fundamental constitutional rights. In response to the lawsuit and a preliminary victory before a magistrate judge, the city changed its laws to allow sales of outside products from farms if the farm obtained a permit. The Bergmanns then obtained that permit, allowing them to freely trade across local and state lines and continue to operate their pumpkin stand on their farm.²⁹



Richard Bergmann.

Source: Institute for Justice.

Trade Practices

SHERMAN ANTITRUST ACT Contemporary society places great value on free competition in the marketplace, and antitrust laws reflect this. The notion of *laissez-faire*—that the government should not interfere with the operation of the economy—that once dominated U.S. markets no longer prevails. One of the earliest trade laws was the Sherman Antitrust Act, which was passed in 1890 to promote competition in the U.S. economy. This act is the foundation on which antitrust policy in the United States is built and was aimed at breaking up the most powerful monopolies of the late nineteenth century. The Sherman Antitrust Act contains two primary provisions affecting growth and trade among businesses.

Section I forbids “every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations.” This section outlaws any agreement among sellers that might create an unreasonable restraint on free trade in the marketplace. For example, a group of small and medium-size regional supermarkets formed a cooperative association to purchase products to resell under private labels only in restricted geographic regions. The U.S. Supreme Court ruled that their action was an attempt to restrict competition by allocating territories and had “no purpose except stifling of competition.”³⁰

Section II of the Sherman Antitrust Act makes it illegal for any person to “monopolize or attempt to monopolize any part of the trade or commerce among the several states, or with foreign nations.” The primary focus of Section II is on preventing the undesirable effects of monopoly power in the marketplace.

CLAYTON ACT Congress passed the Clayton Act in 1914 to strengthen federal antitrust laws by spelling out specific monopolistic activities. The major provisions of the Clayton Act forbid the following activities:

1. **Price discrimination.** A firm cannot charge different customers different prices for the same product, unless the price discrimination is based on an actual cost savings, is made to meet a lower price from competitors, or is justified by a difference in grade, quality, or quantity sold.
2. **Exclusive dealing and tying contracts.** A seller cannot require a buyer to purchase only her product to the exclusion of other competitive sellers’ products (an exclusive dealing agreement). In addition, the act forbids sellers to sell a product on the condition that the buyer agrees to purchase another product the seller offers (a tying agreement). For example, a computer manufacturer could not sell a computer to a business and, as a condition of the sale, require the firm to purchase software as well.
3. **Purchasing stock in competing corporations.** A business cannot purchase the stock or assets of another business when the effect may be to substantially lessen competition. This does not mean that a corporation cannot hold stock in a competing company; the rule is designed to prevent horizontal mergers that would reduce competition. The Federal Trade Commission (FTC) and the Antitrust Division of the Justice Department enforce this section, evaluating the market shares of the companies involved and the potential effects of a horizontal merger before ruling on its legality.
4. **Interlocking directorates.** The act forbids interlocking directorates—a person serving on the board of directors of two or more competing companies.

FEDERAL TRADE COMMISSION ACT To supplement the Clayton Act, Congress passed the Federal Trade Commission Act in 1914, which created its namesake agency and gave it a broad range of powers. Section 5 gives the FTC the power to prevent “unfair methods of competition in commerce and unfair or deceptive acts or practices in commerce.” To be considered deceptive, a company’s activity must involve a material misrepresentation that is likely to mislead a consumer who is acting in a reasonable manner.

Recent amendments have expanded the FTC’s powers. The FTC’s primary targets are those businesses that engage in unfair trade practices, often brought to the surface by consumer complaints. In addition, the agency has issued a number of trade regulation rules defining acceptable and unacceptable trade practices in various industries. Its major weapon is a “cease-and-desist order,” commanding the violator to stop its unfair trade practices.

The FTC Act and the Lanham Trademark Act of 1988 (plus state laws) govern the illegal practice of deceptive advertising. In general, the FTC can review any advertisement that might mislead people into buying a product or service they would not buy if they knew the truth. For instance, if a small business advertised a “huge year-end inventory reduction sale” but kept its prices the same as its regular prices, it is violating the law.

ROBINSON-PATMAN ACT Although the Clayton Act addressed price discrimination and the FTC forbade the practice, Congress found the need to strengthen the law because many businesses circumvented the original rules. In 1936, Congress passed the Robinson-Patman Act, which further restricted price discrimination in the marketplace. The act forbids any seller “to discriminate in price between different purchases of commodities of like grade and quality” unless there are differences in the cost of manufacture, sale, or delivery of the goods. Even if a price-discriminating firm escaped guilt under the Clayton Act, it violated the Robinson-Patman Act. Traditionally, the FTC has had the primary responsibility of enforcing the Robinson-Patman Act.

OTHER LEGISLATION The Celler-Kefauver Act of 1950 gave the FTC the power to review certain proposals for mergers so that it could prevent too much concentration of power in any particular industry. Congress created the Miller-Tydings Act in 1937 to introduce an exception to the Sherman Antitrust Act. This act made it legal for manufacturers to use fair trade agreements that prohibit sellers of the manufacturer's product from selling it below a predetermined fair trade price. This form of price fixing was outlawed when Congress repealed the Miller-Tydings Act in 1976. Manufacturers can no longer mandate minimum or maximum prices on their products to sellers.

Consumer Protection

Since the early 1960s, legislators have created many laws aimed at protecting consumers from unscrupulous sellers, unreasonable credit terms, and mislabeled or unsafe products. Early laws focused on ensuring that food and drugs sold in the marketplace were safe and of proper quality. The first law, the Pure Food and Drug Act, passed in 1906, regulated the labeling of various food and drug products. Later amendments empowered government agencies to establish safe levels of food additives and to outlaw carcinogenic (cancer-causing) additives. In 1938, Congress passed the Food, Drug, and Cosmetics Act, which created the Food and Drug Administration, the agency responsible for establishing standards of safe over-the-counter drugs; inspecting food and drug manufacturing operations; performing research on food, additives, and drugs; regulating drug labeling; and other, related tasks.

Congress has also created a number of laws to establish standards pertaining to product labeling for consumer protection. Since 1976, manufacturers have been required to print accurate information about the quantity and content of their products in a conspicuous place on the package. Generally, labels must identify the raw materials used in the product, the manufacturer, the distributor (and its place of business), the net quantity of the contents, and the quantity of each serving if the package states the number of servings. The law also requires labels to be truthful. For example, a candy bar labeled "new, bigger size" must actually be bigger. These requirements, created by the Fair Packaging and Labeling Act of 1976, were designed to improve customers' ability to comparison shop. A 1970 amendment to the Fair Packaging and Labeling Act, the Poison Prevention Packaging Act, required manufacturers to install childproof caps on all products that are toxic.

With the passage of the Consumer Products Safety Act in 1972, Congress created the Consumer Product Safety Commission (CPSC) to control potentially dangerous products sold to consumers, and it has broad powers over manufacturers and sellers of consumer products. For instance, the CPSC can set safety requirements for consumer products, and it has the power to ban the production of any product it considers hazardous to consumers. It can also order vendors to remove unsafe products from their shelves. In addition to enforcing the Consumer Product Safety Act, the CPSC is charged with enforcing the Refrigerator Safety Act, the Federal Hazardous Substance Act, the Child Protection and Toy Safety Act, the Poison Prevention Package Act, and the Flammable Fabrics Act.

The Magnuson-Moss Warranty Act, passed in 1975, regulates written warranties that companies offer on the consumer goods they sell. The act does not require companies to offer warranties; it regulates only the warranties that companies choose to offer. It also requires businesses to state warranties in easy-to-understand language and defines the conditions warranties must meet before they can be designated as "full warranties."

The Telemarketing and Consumer Fraud and Abuse Protection Act of 1994 put in place the following restrictions on telemarketers:

- Calling a person's residence at any time other than 8:00 A.M. to 8:00 P.M.
- Claiming an affiliation with a government agency where such an affiliation does not exist
- Claiming an ability to improve a customer's credit record or obtain a loan for a person regardless of that person's credit history
- Not telling the receiver of the call that it is a sales call
- Claiming an ability to recover goods or money lost by a consumer



Lessons from the Street-Smart Entrepreneur

Are Your Ads Setting You Up for Trouble?

Lynda and Stewart Resnick have launched several successful brands, including Fiji Water, Teleflora, and the Franklin Mint, but it was their pomegranate juice, sold as Pom Wonderful, which got them in trouble with the FTC. The company advertised Pom Wonderful as a product that could help reduce the risk of heart disease, prostate cancer, and impotence. The FTC charged Pom Wonderful and the company's owners with making false and unsubstantiated claims about the power of its product. The owners of Pom Wonderful appealed the ruling, but the commission unanimously upheld an administrative law judge's decision that the marketers of POM Wonderful deceptively advertised the products and did not have adequate clinical support for its health claims. The FTC barred the POM Wonderful marketers from making any future claims unless the claims are supported by two randomized, well-controlled, human clinical trials.

Entrepreneurs sometimes run afoul of the laws concerning advertising because they do not know how to comply with legal requirements. The FTC is the federal agency that regulates advertising and deals with problems created by deceptive ads. Under federal and state laws, an advertisement is unlawful if it misleads or deceives a reasonable customer, even if the business owner responsible for it had no intention to deceive. Any ad containing a false statement is in violation of the law although the entrepreneur may not know that the statement is false. The FTC judges an ad by the overall impression it creates and not by the technical truthfulness of its individual parts.

What can entrepreneurs do to avoid charges of deceptive advertising? The following tips from the Street-Smart Entrepreneur will help:

- **Make sure that your ads are accurate.** Avoid creating ads that promise more than a product or service can deliver. Take the time to verify the accuracy of every claim or statement in your ads. If a motor oil protects an engine from damage, don't claim that it will repair damage that already exists in an engine—unless you can prove that it actually does.
- **Understand the difference between sales 'puffery' and false advertising.** The distinction is not always clear. Sales puffery involves claims that are so general or so exaggerated that they would not confuse customers. (How many times have you seen a small restaurant advertising that it has "the best hot dog in town"?) The more specific and fact based the claims in an ad are, the more likely they are to pose problems for a company if they are false or if the company has no factual basis for making them. When Pizza Hut ("Best Pizza Under One Roof") filed a false advertising claim against Papa John's Pizza over a Papa John's ad that claimed "Better Ingredients, Better Pizza," a federal court of appeals ruled that Papa John's claim was puffery and that the company could continue to use it *if* it stopped making specific fact-based claims in the same ad that its

tomato paste and dough were superior. For instance, the ad for Papa John's claimed that its sauce, which was made from "vine-ripened tomatoes," was superior to Pizza Hut's "remanufactured tomato sauce." Because Papa John's had no facts to prove this claim, the court ruled that this was false advertising.

- **Get permission to use quotations, pictures, and endorsements.** Never use material in an ad from an outside source unless you get written permission to do so. Some business owners find themselves in trouble when they use copyrighted material (such as images, videos, photographs, and other content) in online ads or in posts that promote their companies that they find online using a search engine without first securing permission. One business owner got into trouble when he inserted a photograph of a famous athlete without his permission into an ad for his company's service.
- **Be careful when you compare competitor's products or services to your own.** False statements that harm the reputation of a competitor's business, products, or services may result not only in charges of false advertising but also in claims of trade libel. Make sure that any claims in your ads comparing your products to competitors' are fair and accurate. You can use a competitor's trademark in your advertising (e.g., for purposes of comparison) as long as it does not cause confusion among customers concerning the origin of the product or its affiliation with the competitor.
- **Stock sufficient quantities of advertised items.** Businesses that advertise items for sale must be sure to have enough units on hand to meet anticipated demand. If you suspect that demand may outstrip your supply, state in the ad that quantities are limited.
- **Avoid "bait-and-switch" advertising.** This illegal technique involves advertising an item for sale at an attractive price when a business has no real intention of selling that product at that price. Companies using this technique often claim to have sold out of the advertised special. Their goal is to lure customers in with the low price and then switch them over to a similar product at a higher price.
- **Use the word "free" carefully and accurately.** Every advertiser knows that one of the most powerful words in advertising is "free." However, anything you advertise as being free must actually be free. For instance, suppose a business advertises a free paintbrush to anyone who buys a gallon of a particular type of paint for \$19.95. If the company's regular price for the paint is less than \$19.95, the ad is deceptive because the paintbrush is not really free.
- **Be careful of what your ad does not say.** Omitting information in an ad that leaves customers with a false

impression about a product or service and its performance is also a violation of the law.

- **Describe sale prices and “savings” carefully.** Business owners sometimes get into trouble with false advertising when they advertise items at prices that offer huge “savings” over their “regular” prices. One jeweler violated the law by advertising a bracelet for \$299, a savings of \$200 from the item’s regular \$499 price. In reality, the jeweler had never sold the item at its \$499 “regular” price; the item’s normal price was the \$299 that he advertised as the “sale” price.

Sources: Adapted from *Guides Against Bait Advertising*, Federal Trade Commission (Washington, DC), www.ftc.gov/bcp/guides/baitads-gd.htm; *Advertising FAQ’s: A Guide for Small Business*, Federal Trade Commission, <http://business.ftc.gov/documents/bus35-advertising-faqs-guide-small-business>; James Astrachan, “False Advertising Primer,” Astrachan, Gunst, Thomas, PLC, 2006, www.aboutfalseadvertising.com/index1_files/FALSE%20Advertising%20Primer.pdf, p. 14; “Seven Rules for Legal Advertising,” *Inc.* (n.d.), <http://www.inc.com/articles/2000/05/20153.html>; “Consumer Protection Laws,” *Inc.*, May 12, 2000, www.inc.com/search/19691.html; Edward Wyatt, “Regulators Call Health Claims in Pom Juice Ads Deceptive,” *New York Times*, September 28, 2010, p. B1; Stuart Pfeifer, “Billionaires Behind Pom Wonderful Push Back Against FTC Ruling,” *Los Angeles Times*, June 20, 2012, <http://articles.latimes.com/2012/jun/20/business/la-fi-pom-response-20120621>; “FTC Commissioners Uphold Trial Judge Decision that POM Wonderful, LLC; Stewart and Lynda Resnick; Others Deceptively Advertised Pomegranate Products by Making Unsupported Health Claims,” Federal Trade Commission, January 16, 2013, <http://ftc.gov/opa/2013/01/pom.shtm>.

Consumer Credit

Another area subject to intense government regulation is consumer credit. This section of the law has grown in importance as credit has become a major part of many consumer purchases. The primary law regulating consumer credit is the Truth-in-Lending Act of 1969. This law requires sellers who extend credit and lenders to fully disclose the terms and conditions of credit arrangements. The FTC is responsible for enforcing the Truth-in-Lending Act. The law outlines specific requirements that any firm that offers, arranges, or extends credit to customers must meet. The two most important terms of the credit arrangement that lenders must disclose are the finance charge and the annual percentage rate. The finance charge represents the total cost—direct and indirect—of the credit, and the annual percentage rate is the relative cost of credit stated in annual percentage terms.

The Truth-in-Lending Act applies to any consumer loan for less than \$25,000 (or loans of any amount secured by mortgages on real estate) that includes more than four installments. Merchants extending credit to customers must state clearly the following information, using specific terminology:

- The price of the product
- The down payment and any trade-in allowance made
- The unpaid balance owed after the down payment
- The total dollar amount of the finance charge
- Any prepaid finance charges or required deposit balances, such as points, service charges, or lenders’ fees
- Any other charges not include in the finance charge
- The total amount to be financed
- The unpaid balance
- The deferred payment price, including the total cash price and finance and incidental charges
- The date on which the finance charge begins to accrue
- The annual percentage rate of the finance charge
- The number, amount, and due dates of payments
- The penalties imposed in case of delinquent payments
- A description of any security interest the creditor holds
- A description of any penalties imposed for early repayment of principal

Another provision of the Truth-in-Lending Act limits a credit card holder’s liability in case the holder’s card is lost or stolen. As long as the holder notifies the company of the missing card, he or she is liable for only \$50 of any amount that an unauthorized user might charge on the card (or zero if the holder notifies the company before any unauthorized use of the card).

In 1974, Congress passed the Fair Credit Billing Act, an amendment to the Truth-in-Lending Act. Under this law, a credit card holder may withhold payment on a faulty product, provided that he or she has made a good-faith effort to settle the dispute first. A credit card holder can also withhold payment to the issuing company if he or she believes that his or her bill is in error. The cardholder must notify the issuer within 60 days but is not required to pay the bill until the dispute is settled. The creditor cannot collect any finance charge during this period unless there was no error.

Another credit law designed to protect consumers is the Equal Credit Opportunity Act of 1974, which prohibits discrimination in granting credit based on race, religion, national origin, color, gender, marital status, or whether the individual receives public welfare payment.

In 1970, Congress created the Fair Credit Reporting Act to protect consumers against the circulation of inaccurate or obsolete information pertaining to credit applications. Under this act, the consumer can request the nature of any credit investigation, the type of information assembled, and the identity of those persons receiving the report. The law requires that any obsolete or misleading information contained in the file be updated, deleted, or corrected.

Congress enacted the Fair Debt Collection Practices Act in 1977 to protect consumers from abusive debt collection practices. The law does not apply to business owners collecting their own debts but only to debt collectors working for other businesses. The act prevents debt collectors from doing the following:

- Contacting the debtor at his or her workplace if the employer objects
- Using intimidation, harassment, or abusive language to pester the debtor
- Calling on the debtor at inconvenient times (before 8 A.M. or after 9 P.M.)
- Contacting third parties (except parents, spouses, and financial advisers) about the debt
- Contacting the consumer after receiving notice of refusal to pay the debt (except to inform the debtor of the involvement of a collection agency)
- Making false threats against the debtor

The Consumer Leasing Act of 1976 amended the Truth-In-Lending Act for the purpose of providing meaningful disclosure to consumers who lease goods. The Uniform Consumer Leases Act (UCLA) amended the Consumer Leasing Act. To be covered by the UCLA, a lease must run for more than four months, or the dollar value of the lease obligation must exceed \$150,000.

In 2003, Congress passed the Fair and Accurate Transactions Act (the FACT Act) to address the fastest-growing crime in the United States: identity theft. On average, someone in the United States becomes a victim of identity theft every three seconds. Experts estimate that 12.6 million people in the United States are victims of identity theft each year, most often in the form of credit card fraud. The total amount of fraud is \$21 billion per year.³¹ The FACT Act allows victims of identity theft to file theft reports with credit reporting agencies and requires those agencies to include “fraud alerts” in their credit reports.

Environmental Law

In 1970, Congress created the Environmental Protection Agency (EPA) and gave it the authority to create laws that would protect the environment from pollution and contamination. Although the EPA administers a number of federal environmental statutes, three in particular stand out: the Clean Air Act, the Clean Water Act, and the Resource Conservation and Recovery Act.

THE CLEAN AIR ACT To reduce the problems associated with global warming, acid rain, and airborne pollution, Congress passed the Clean Air Act in 1970 (and several amendments since then). The act targets everything from coal-burning power plants to automobiles. The Clean Air Act assigned the EPA the task of developing national air quality standards for carbon monoxide, hydrocarbons, sulfur oxide, ozone, lead, and other harmful substances. The agency works with state and local governments to enforce compliance with these standards.

THE CLEAN WATER ACT The Clean Water Act, passed in 1972, set out to make all navigable waters in the United States suitable for fishing and swimming by 1983 and to eliminate the discharge of pollutants into those waters by 1985. Although the EPA has made progress in cleaning up many bodies of water, it has yet to achieve these goals. The Clean Water Act requires each state to establish water quality standards and to develop plans to reach them. The act also prohibits the

draining, dredging, or filling wetlands without a permit. The Clean Water Act also addresses the issues of providing safe drinking water and cleaning up oil spills in navigable waters.

THE RESOURCE CONSERVATION AND RECOVERY ACT Congress passed the Resource Conservation and Recovery Act in 1976 to deal with solid waste disposal. The act, which was amended in 1984, sets guidelines by which solid waste landfills must operate, and it establishes rules governing the disposal of hazardous wastes. The act's goal is to prevent solid waste from contaminating the environment. What about those waste disposal sites that are already contaminating the environment? In 1980, Congress passed the Comprehensive Environmental Response, Compensation, and Liability Act to deal with those sites. The act created the Superfund, a special federal fund set up to finance and to regulate the cleanup of solid-waste disposal sites that are polluting the environment.

The Pollution Prevention Act of 1990 set forth a public policy statement that offered rewards to firms that reduced the creation of pollution. The federal government provides matching funds to states for programs that promote the use of "source reduction techniques" dealing with pollution problems. This is a milestone piece of legislation because it replaces the regulatory "stick" approach resented by business with a "carrot" approach that rewards businesses for positive actions that reduce pollution.



Entrepreneurship in Action

Small Businesses and Eminent Domain



Susette Kelo.

Source: Institute for Justice.

Susette Kelo had dreamed of owning a home that looked out over the water in her hometown of New London, Connecticut. In 1997, she purchased and restored a little house in a quiet residential neighborhood called Fort Turnbull, where the Thames River meets the Long Island Sound. She enjoyed the great view of the water from its windows. Then, the day before Thanksgiving in 2000, she received a notice of condemnation

of her property from the New London Development Corporation (NLDC), which was seizing her property under the city's eminent domain rights.

Eminent domain is the right of the government to seize property for public use and public good. Historically, the definition of "public use" had been limited by court decisions to three categories:

1. Roads, hospitals, or military bases
2. Railroads, public utilities, or stadiums
3. Blighted areas or areas that are injurious to public safety

In New London, the NLDC was using eminent domain to secure a large tract of property for the Pfizer Corporation, which had been developing plans to build a research park. The NLDC and the city wanted to help encourage Pfizer to develop the project within the city limits, because officials believed that commercial development would follow and would create economic growth in the city.

Susette Kelo and her neighbors, all of whom lived on the land being condemned for this project, decided to fight the condemnation in court. Kelo's attorneys built their case from what is known as the "taking clause" of the Fifth Amendment to the U.S. Constitution, which states that "nor shall private property be taken for public use, without just compensation." The argument was that the condemnation of the property to allow Pfizer to build a research park was not "public use."

The case (*Kelo v. New London*) eventually made its way to the U.S. Supreme Court. In a 5-to-4 decision, the Court ruled in favor of the NLDC. In effect, this decision created a fourth category of "public use" in which local or state government could use eminent domain as a tool for economic development.

In her dissenting opinion, Justice Sandra Day O'Connor stated, "Today the Court abandons this long-held, basic

Entrepreneurship in Action *(continued)*

limitation on government power. Under the banner of economic development, all private property is now vulnerable to being taken and transferred to another private owner, so long as it might be upgraded—i.e., given to an owner who will use it in a way that the legislature deems more beneficial to the public—in the process.”

What followed was a significant public and political backlash against the Court’s decision. Several states and cities passed legislation that limited the local use of eminent domain, which was permitted under the Court’s decision. However, many other local governmental entities used the expanded power of eminent domain to attempt to spur new development projects. Some examples follow:

- Local officials identified as “blighted” well-established and safe St. Louis, Missouri, residential neighborhood that was home to more than 100 families so that they could turn the property over to developers who offered the city the promise of a higher tax base.
- The city of Belmar, New Jersey labeled the Belmar Mall “blighted.” The owners of the mall had been fighting to keep their property from being condemned for a redevelopment project. The Belmar Mall contains 20 small businesses, along with three major chain tenants.
- The owners of Country International Records, a small music studio located in Nashville, Tennessee, lodged a legal and public relations battle to fight the city’s move to condemn their property after they refused to sell to a Houston developer planning to build a new hotel complex on the site.
- Central Radio is a small business that is among more than 170 residential, institutional, and business buildings condemned by the Norfolk Redevelopment and Housing Agency after its owners refused to voluntarily sell their properties. The properties are in an area near Old Dominion University that the city wanted to redevelop with a private–public development partnership.

Proponents of the use of eminent domain cite the need for cities to use economic strategies that can help spur growth that will benefit the larger community. Many proponents argue that this is particularly true during times of economic decline.

1. Develop an argument for the Supreme Court that supports the NLDC’s case.
2. Develop an argument for the Supreme Court that supports Susette Kelo’s case.
3. Which of the two arguments to you find more compelling? In other words, do you agree with the Supreme Court’s decision in this case? Explain.

Sources: Based on “Kelo et al. v. City of New London et al.,” *FindLaw*, June 23, 2005, <http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=us&vol=000&invol=04-108>; “Kelo v. New London: Lawsuit Challenging Eminent Domain Abuse in New London, Connecticut,” Institute for Justice, (n.d.), www.ij.org/kelo-v-new-london; “Eminent Domain Being Abused?,” *CBS News*, February 11, 2009, www.cbsnews.com/8301-18560_162-575343.html; “BMIA LLC v. Borough of Belmar—Eminent Domain Strikes Another Business,” National Federation of Independent Business, (n.d.), www.nfib.com/press-media/press-media-item?cmsid=31363; www.ij.org/nashville-tenn-eminent-domain-release7-21-2008; George Will, “Latest Eminent Domain Outrage,” *Newsmax.com*, January 25, 2013, www.newsmax.com/GeorgeWill/eminent-domain-Central-Radio/2013/01/24/id/472801; David M. Lewis, “Eminent Domain: Still a Useful Tool Despite Its Recent Thrashing,” *Planetizen.com*, September 5, 2006, www.planetizen.com/node/21109.

The Affordable Care Act

The Patient Protection and Affordable Care Act of 2010 (also known as “Obamacare”) requires that all Americans obtain health insurance and that all insurance companies provide coverage regardless of preexisting conditions and begins to go into effect in January 2014. Small businesses with the equivalent of 50 or more full-time employees face fines if they fail to provide full-time workers with affordable health insurance that meets certain standards. Small businesses with fewer than 50 employees, while not required to provide health insurance, will be required to fully inform employees about the law. If these small firms offer health care, their plans must comply with the mandates of the Affordable Care Act. The financial impact of this law on small businesses has created significant debate. Businesses that have not provided health insurance in the past will be mandated to do so or face penalties that can exceed \$100,000 a year. Although entrepreneurs may be tempted to create several small companies, keeping each under 50 employees, the IRS intends to evaluate privately owned companies and count employment among all companies with common ownership as part of the 50-employee threshold. For example, an entrepreneur who owns three small businesses, each with 20 employees, will be treated as if it were a single company with 60 employees and thus will be subject to the requirements of the Affordable Care Act.

Chapter Review

1. Explain the basic elements required to create a valid, enforceable contract.
 - A valid contract must contain these elements: agreement (offer and acceptance), consideration, capacity, and legality. A contract can be valid and yet unenforceable because it fails to meet two other conditions: genuineness of assent and proper form.
 - Both parties performing their promised actions fulfill most contracts; occasionally, however, one party fails to perform as agreed, thereby breaching the contract. Usually, the nonbreaching party is allowed to sue for monetary damages that would place him or her in the same position he or she would have been in had the contract been performed. In cases where money is an insufficient remedy, the injured party may sue for specific performance of the contract's terms.
2. Outline the major components of the UCC governing sales contracts.
 - The UCC was an attempt to create a unified body of law governing routine business transactions. Of the 10 articles in the UCC, Article 2 on the sale of goods affects many business transactions.
 - Contracts for the sale of goods must contain the same four elements of a valid contract, but the UCC relaxes many of the specific restrictions that the common law imposes on contracts. Under the UCC, once the parties create a contract, they must perform their duties in good faith.
 - The UCC also covers sales warranties. A seller creates an express warranty when he or she makes a statement about the performance of a product or indicates by example certain characteristics of the product. Sellers automatically create other warranties—warranties of title, implied warranties of merchantability, and, in certain cases, implied warranties of fitness for a particular purpose—when they sell a product.
3. Discuss the protection of intellectual property rights using patents, trademarks, and copyrights.
 - A patent is a grant from the federal government that gives an inventor exclusive rights to an invention for 20 years. To submit a patent, an inventor must establish novelty, document the device, search existing patents, study the search results, submit a patent application to the PTO, and prosecute the application.
 - A trademark is any distinctive word, symbol, or trade dress that a company uses to identify its product or to distinguish it from other goods. It serves as the company's "signature" in the marketplace.
4. Explain the basic workings of the law of agency.

In an agency relationship, one party (the agent) agrees to represent another (the principal). The agent has the power to act for the principal but remains subject to the principal's control. While performing job-related tasks, employees play an agent's role.

 - An agent has the following duties to a principal: loyalty, performance, notification, duty of care, and accounting. The principal has certain duties to the agent: compensation, reimbursement, cooperation, indemnification, and safe working conditions.
5. Explain the basics of bankruptcy law.
 - Entrepreneurs whose businesses fail often have no other choice but to declare bankruptcy under one of three provisions: Chapter 7 liquidations, where the business sells its assets, pays what debts it can, and disappears; Chapter 11, reorganizations, where the business asks that its debts be forgiven or restructured and then reemerges; and Chapter 13, straight bankruptcy, which is for individuals only.
6. Explain some of the government regulations affecting small businesses, including those governing trade practices, consumer protection, consumer credit, and the environment.
 - Businesses operate under a multitude of government regulations governing many areas, including trade practices, where laws forbid restraint of trade, price discrimination, exclusive dealing and tying contracts, purchasing controlling interests in competitors, and interlocking directorates.
 - Other areas subject to government regulations include consumer protection (the Food, Drug, and Cosmetics Act and the Consumer Product Safety Act) and consumer credit (the Consumer Credit Protection Act, the Fair Debt Collection Practices Act, and the Fair Credit Reporting Act), and the environment (the Clean Air Act, the Clean Water Act, the Resource Conservation and Recovery Act), and health (the Affordable Care Act).

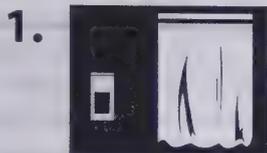
Discussion Questions

- 23-1. What is a contract? List and describe the four elements required for a valid contract. Must a contract be in writing to be valid?
- 23-2. What constitutes an agreement?
- 23-3. What is a breach of contract?
- 23-4. What is a sales warranty and product liability?
- 23-5. What is breach of contract? What remedies are available to a party injured by a breach?
- 23-6. What is the UCC? To which kinds of contracts does the UCC apply? How does it alter the requirements for a sales contract?
- 23-7. Under the UCC, what remedies does a seller have when a buyer breaches a sales contract? What remedies does a buyer have when a seller breaches a contract?
- 23-8. What is a sales warranty? Explain the different kinds of warranties that sellers offer.
- 23-9. Explain the different kinds of implied warranties the UCC imposes on sellers of goods. Can sellers disclaim these implied warranties? If so, how?
- 23-10. What is product liability? Explain the charges that most often form the basis for product liability claims. What must a customer prove under these charges?
- 23-11. Explain the salient features of the law of agency.
- 23-12. Explain the differences among patents, trademarks, and copyrights. What does each protect? How long does each last?
- 23-13. What must an inventor prove to receive a patent?
- 23-14. Briefly explain the patent application process.
- 23-15. Explain the duties of an agent mentioned in the law of agency.
- 23-16. Explain the differences among the three major forms of bankruptcy: Chapter 7, Chapter 11, and Chapter 13.
- 23-17. Explain the statement "For each benefit gained by regulation, there is a cost."
- 23-18. Explain some of the prominent government regulations affecting small businesses.

The picturebooth co.

THE
picturebooth
co.

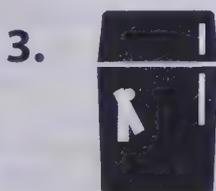
Traditional Booth



Squeeze in booth



Receive picture strips



Place on fridge

1 Our booth is open, meaning all of your guests can get in on the action. Take advantage of our amazing background choices or we can design a custom background for you showcasing your company or event logo. Just like the red carpet.

Our Booth



1

Take your picture



+ EDIT/LOGO/
WATERMARK

Pictures are edited



Facebook Twitter
Instagram

Pictures go social



Share and interact

2 Not only does our PictureBooth take the best pictures around, they are edited and watermarked with the logo of your choice to ensure that everyone who sees them knows where they came from.

2

3 The pictures from your event are uploaded to Facebook, Twitter, Instagram and any other picture sharing site you choose. This makes it easy for your guests to find them.

3

4 If you are a brand, get ready because your pictures are about to go viral! At an event with just over 200 attendees, the pictures were viewed by over 8,000 unique visitors.

4

Executive Summary

PictureBooth is a photo booth start-up based in Nashville, Tennessee. I have been in the event industry for about five years as a DJ, specializing in weddings. In September, as my standard photo booth rental numbers started to climb, I realized that it was time to start my own photo booth business. By asking some of my potential clients simple questions, I found that there is a need in the market for a more affordable photo booth rental. To provide them what they wanted, I decided to design my own.

Our Mission Is to Provide High-Quality Photo Booths at an Affordable Price

PictureBooth is not your typical photo booth business that operates in one city or a few cities within close distances of each other. PictureBooth is designed to be the most portable booth on the market and can operate anywhere. PictureBooth is designed so that an individual of any size or stature can receive the booth, read its simple assembly instructions, and have the booth set up within 5 to 10 minutes. PictureBooth rentals start at \$400, compared to the standard \$800 to \$1,400 rental within the industry. We chose the \$500 price point because the brides to whom we talked told us it was a “no-brainer” price point for almost any wedding reception.

Our company has three different streams of revenue that we can tap. The first is special event rentals, such as weddings, proms, birthday parties, office parties, and so on. Our booth will be a lower priced option in this space; however, because of the technology we use, it will produce the highest quality content. The second stream of revenue is contracted branding deals. We have a mission to create organic and interactive social media content for businesses through our booths. The third stream of revenue is permanent booth installations in businesses. There are many different types of businesses that are looking for a way to create a social media presence through organic content.

WEDDINGS The wedding industry in the United States is a \$54 billion industry, with \$23 billion being spent on event rentals and about \$6 billion spent on photography services. Although PictureBooth is not limited to the wedding industry, these numbers provide concrete evidence of PictureBooth’s target market, the special event industry. Our target market is weddings and special events that typically occur on weekends, but we also will have booths that are available throughout the week. We will reach our customers primarily through the Internet. Our initial market is in our home base of Nashville but will expand nationwide by the end of 2013.

We will market PictureBooth to the wedding industry through several online wedding vendor distribution sites, such as WeddingWire, which receives 2.8 million unique visitors per month, and Perfect Wedding guide, which receives thousands of unique local visitors per month. We will also employ a part-time SEO specialist located in Nashville to implement our strategy. We will differentiate ourselves from our competitors at the outset by creating a professional Web site and professional print materials. In addition to these online

marketing strategies, we will use other standard means of reaching bridal customers, such as bridal shows and cold calling.

BRANDING The second major market that PictureBooth will appeal to is corporations that want to promote their brands. Our booths are designed so that companies can create custom design booths inspired by their brands. Our booths take advantage of the digital space by creating interactive social media content for brands at an event. In the appendix to this business plan is an example of a proposal [not included] we send to prospective clients explaining why our booth is better for them in the short term and the long term.

We are currently building a relationship with one of the most recognized brands in the world, RedBull. We attracted RedBull as a customer because of the quality of the photos we provide as well as our booth rental rates. RedBull offered us nearly 40 events in the Nashville/Middle Tennessee area in exchange for a price concession. We set the price at \$275 per event. In return, we are now in the position to work with RedBull on a national scale and provide booths for hundreds of their events.

PERMANENT INSTALLATIONS The third market is permanent installations. PictureBooth will lease or sell custom-designed booths to clients who are looking for a way to generate content through their permanent locations. For example, for pediatric dentistry, it is difficult to continuously create relevant social media content. By installing a photo booth, it is now the patients and their parents creating interactive social media content and not the office. We are no longer in the age of information; we are in the age of recommendation. As parents tag their children in Facebook pictures, not only does it expose the dentist’s office to potential new customers, but it also gives a digital “stamp of approval” from parents, telling their friends, “My kids can have fun here, and so can yours.”

What Makes Us Stand Out?

What makes our booth unique for our customers? For weddings, our booth is unique in that it provides brides with an alternative option to the standard expensive photo booth rental and gives them exceptionally high quality pictures that they can print and/or share with friends and family digitally. For companies, it provides a way to create organic interactive social media content with their brands. When an individual takes a picture in the booth, that picture is edited and watermarked with the company’s logo. Instead of allowing individuals to post pictures directly to their Facebook pages, they must instead go to the specified page (the brand’s Facebook page) and tag themselves in the photo. When individuals tag themselves in photos, it shows up on their timelines/news feeds, allowing their friends to view the photos and thereby increase brand awareness because of the watermarked logos. Another interactive quality is that individuals must seek out the brand’s Facebook page. If companies properly maintain their pages, they have the opportunity to engage individuals as regular visitors to their pages.

Ross Hill will serve as president and CEO of PictureBooth throughout the first three years. My main purpose right now is to manage the growth of our company as well as the sales and distribution of our product.

a multifunctional, part-time role, including photo editing, transporting the booths to and from upcoming events, and other jobs.

I have invested countless hours and around \$10,000 into PictureBooth, but to continue growing the business, I need more money. I have estimated the start-up cost of this business at around \$40,000, but it could easily be more. I plan to get a loan for this start-up capital. This money will go toward building three to five booths as well as covering some of our other start-up expenses. We estimate that we will reach our break-even point in May. At that point, we plan to use internally generated cash to grow at a constant rate. It may be necessary for us to find investors if the company's internal cash engine cannot keep up with its growth and capital needs. My salary will be supplemented by income earned through other businesses during the first year, but I will give myself a \$20,000 bonus at the end of year one if we hit our benchmark goals. Our original financial estimates show that in year one, we will hit the \$150,000 mark in sales and grow to \$300,000 by year three.

MISSION STATEMENT PictureBooth is a high-quality, portable photo booth designed to create interactive social media content for events, artists, and brands.

ADDITIONAL CONCEPT DESCRIPTION PictureBooth's business model is simple; we call it "Ship, Use, Ship." PictureBooth is a portable photo booth, about the same size as a carry-on suitcase that is designed to be shipped to our clients or representatives, used at an event, and shipped back to a central warehouse.

CORE VALUES In every venture that I enter into, I strive to bring four values along with me: hard work, serving others, providing opportunity, and fairness. These four values will help in shaping the culture of my organization.

KEY OBJECTIVES My primary objectives with PictureBooth are designing a career that allows me to spend an ample amount of time with my family, making enough money to provide a great life for myself and my family, giving other people an opportunity to succeed in life and learn lessons that I learned at an early age, and creating a product that brings immense value to its clients.

Value Proposition

PictureBooth was invented out of necessity. I have been in the event industry for almost five years, and one concept that has always held true in the event production realm is product setup efficiency. The individual executing the setup and teardown of the event wants to spend the least possible amount of time doing the job. Photo booths are notorious for having long setup times because of their size and their lack of innovative design.

PictureBooth solves many problems with standard photo booths, but it solves primarily two major problems in corporate branding as well as social media marketing.

Value Proposition #1

PictureBooth was designed with the user in mind. PictureBooth is about the same size as a carry-on suitcase and is very light. Anyone, if not you, can use the booth with ease. It

takes between 5 and 10 minutes to set up the booth, and tear-down is just as easy. Users do not have to drive vans or trucks to transport the booth; they can now fit multiple PictureBooths inside their cars.

Another value that PictureBooth offers is its affordability, coupled with high-quality shareable content. Many of our clients want to use our booth to increase brand awareness. An event with just 200 attendees created more than 8,000 unique Facebook interactions, meaning that 8,000 different people interacted with the branded pictures.

Proof of Concept

Photo booths at events have been a growing trend since 2008. A simple Google search including the name of a city and photo booth will show that there is a lot of competition. This is both good and bad, but it proves that there is a market. There are millions of events each year that could benefit from the use of a photo booth. Some different types of events where photo booths could be deployed include weddings, proms, university events, fraternity and sorority socials, corporate branding initiatives, and artist tours.

Why Is This a Bad Thing?

Ideally, you would enter a market that has little competition. We will be entering a market that is proven but has a lot of competition.

Why Is This a Good Thing?

Our competition cannot compete with us easily. PictureBooth differentiates itself by offering a product that is affordable, but it is also portable and does not require an operator. For some of our high-cost competitors to compete with us, they will have to radically change their business models. For other similar business models to compete with us, they will have to enter the market and lose the first-mover advantage.

Competitive Analysis

We differentiate ourselves from our competitors by giving customers four things that most photo booth companies do not focus on. One is portability and ease of use. Most photo booths weigh a couple of hundred pounds, take an hour to set up, and require an operator throughout the event. PictureBooth can be handled by one person of any size or stature, set up in about 5 to 10 minutes at an event, and taken down in the same amount of time. Our booth weighs only 26 pounds and is about the same size as a carry-on suitcase.

Another differentiator is affordability. The average photo booth rental is between \$800 and \$1,400. Our photo booth rentals start at \$500. We set our price point at \$500 to gain customers that wouldn't normally choose to have a photo booth at their event, but because of the low price point, this makes it an easier choice to have at an event.

Furthermore, PictureBooth sets itself apart from the competition because of its high-quality shareable content creation. Many photo booths in the industry take low-quality pictures, and they lack the ability to provide the content.

The photo booth industry is very competitive, which is both positive and negative. From the negative perspective, there is a lot of competition; therefore, it may be more difficult to break into certain parts of industry because of already established relationships. On the positive side, it will be very difficult for already existing photo booth companies to compete with us. Our operating costs are substantially lower than those of our competitors, and our booths are much more technologically advanced.

Market Entry Strategy

Target Market

Our target market is the special events industry, including weddings, proms, corporate events, and artist tours. Our customer is someone who produces events or has his or her own event. We have gained the greatest traction in corporate branding and plan to continue to nurture these relationships. We have booked more than 50 dates with only one corporate brand and have the potential to book hundreds more.

Promotion

PictureBooth will be promoted through several streams, one of which will be strategic networking. Thus far, we have gained the most traction through personal contacts and meetings. We will always employ this principle throughout the growth of our business. Another form of promotion we will be using is creating extremely high quality digital content, including videos and product animations for our pitches. We will take full advantage of our first-mover strategy and plan to gain market share in the beginning before competitors have a chance to catch up. A unique aspect of our business is that the booth itself creates quality content for us to use in promotion. When other companies find out that some of the largest and most recognized brands in the world use our booths, they will be attracted to our PictureBooths.

Place

It is our goal to get PictureBooth in front of as many people as possible. We will do this by becoming a part of as many events as possible. We currently have an opportunity for our product to be utilized in more than 3,000 events this year. These events will create buzz for our company, and we believe that being a part of this many events in our first year will give us instant credibility. Another place where customers will discover us is online. Our Web site is designed for ease of use, just like our product. Our site will include e-commerce, giving customers the ability to book PictureBooths for their events instantly.

Operating Plan

Currently, we are acquiring the majority of our customers through personal connections. These connections have helped us gain immense traction, and we have hundreds of events

on the table. Strategic networking will always be part of our customer acquisition strategy. Another way we will acquire customers is through a unique distribution strategy using new and existing vendors in different cities as well as direct to consumer.

For delivery of our product, we will be partnering with J3BLLC, an online retailer based in Nashville. Because of their sales volume, they receive some of the best shipping rates possible. J3BLLC will handle all order fulfillment functions for PictureBooth. We will have a part-time employee receiving and prepping booths at their warehouse, but J3BLLC will be responsible for shipping.

Our e-commerce sales will be cash payments, collected immediately. Our account receivables orders will be under a 2/10, net 30 arrangement. This arrangement will be used strictly with our large corporate clients that book a substantial number of events. We will devote energy into creating an engaging online store experience for our customers, and we expect that by doing this, we can generate a significant cash sales that will fund other business activities.

We are currently in the product development phase of our business, but we have hard deadlines that we must meet. The cost of each booth is roughly \$2,500. The estimated lifetime of each booth is around 100 events, meaning that each booth has the potential to generate \$50,000 in revenue. Once we are manufacturing these booths on a larger scale, our cost per booth will decrease substantially.

In the beginning, we will lower our initial equipment investment costs by using a just-in-time build philosophy. We create contracts for events well in advance, giving us the time we need to build more booths if needed. We plan to employ this strategy during the growth phase of our company.

We are in the process of hiring a bookkeeper, an accountant, and a lawyer. As we begin to book more events and are spending and receiving money on a daily basis, we need to hire someone who is in charge of that aspect of the business.

During the first year, I will assume the position of CEO, CMO, and COO. We plan to hire one or two people in April to get our systems in place for our May launch. I will not be paying myself until the end of the first year, when we have hit our benchmark goals. My advisers and investors include my dad, Vaughn Hill; my girlfriend's dad, Dallen Wendt; my brother-in-law, Morgan Dillow; and an outside investment firm, Byte Ventures. I keep in constant contact with them about the majority of my business decisions to bounce ideas off of and allow them to give me their opinions on my business activities.

We will grow our company on a lean philosophy. I will not hire unnecessary employees. I want to employ as many people as we need but no more than that.

In the beginning, PictureBooth will have very humble space needs. We need a small warehouse space or storage unit to hold product until it is time to ship, and we also need an office space to call home and a place to meet with clients.

Growth

Currently, PictureBooth has an opportunity to be a part of about 1,000 events in its first year of operation. These events have come from just three different clients. The potential for PictureBooth is huge, and our goal is to have our booths utilized at 4,000 to 5,000 events in our second year. We will be using our first-mover advantage to gain maximum market share early on.

Financial Plan

Sources of Financing

PictureBooth is receiving a total investment of about \$100,000.

PictureBooth generates revenue through online sales and through large contracts. Our photo booth rental price starts at \$500 and increases to \$1,200, depending on the customization and options that customers choose.

Worst-Case Scenario

In our worst-case scenario, the RedBull and Krispy Kreme events disappear, as does the hope for more events through those connections. We built five fully functioning booths, and we know how to make more and the time we need to accomplish that. We begin launching our product distribution strategy (licensing strategy) through other vendors in other states who are looking to add a photo booth rental feature to their rental inventory or to their “additional services.” After contacting 1,000 DJs and event rental companies, we have found 50 of them willing to carry and promote our product. We will collect a licensing fee from them of \$1,000. In return for their licensing fees, they get the ability to sell our product and a custom subdomain on our Web site built for their companies. In this worst-case scenario, our per event rental cost is \$500 for the base model; for the first 10 events, we collect \$200, and for every rental beyond that, we collect only \$150 per event. In this scenario, we book 100 of our own events between the months of May and December, but we also do 220 events through our “distributors.” We stay on a constant growth pattern for the next two years with our distributors, but we start to book some big corporate contracts along the way.

Most-Likely Scenario

Once we have our product built and ready to distribute, I will begin to use my network to find opportunities. One of my strengths is connecting with people. RedBull and Krispy Kreme are *ready* to move forward; we need to meet the demand. I will also begin using my connections in the music industry to get in front of people who can use PictureBooth. At the same time, starting in June, we will begin to reach out to our potential distributors, show them how the business model works, send them product demonstration videos, and possibly even ship them booths. Our goal is to build a network of “regulars.” At the end of year one, we have successfully booked 560 events. A majority of those events are from large contracts that we have established. In year two, as our wedding distribution business begins to pick up and we continue to grow our base of large clients, we do 880 events. In year three, we have 1,180 events.

Best-Case Scenario

All cylinders are firing perfectly; we are ramping up growth immediately out of the gate because we have our product ready. Our first year is comparable to our most-likely scenario because we believe that the majority of our growth will happen in year two, when our distribution model is in full swing. We want to be in 40 cities around the United States but could potentially be in many more. We finish year one with 630 events, year two with 1,300, and year three with 1,900. This may seem like a lot, but some of the big companies do close to 3,000 events a year through their franchisees.

Investment Proposal

Based on the current market, I am placing a \$250,000 valuation on PictureBooth. This number is based on current intent and interest, which accounts for almost 1,000 events; however, because we have signed no long-term contracts, I cut the revenue generated from those potential events in half for my evaluation. PictureBooth is a start-up venture with no previous track record, meaning that there is substantial risk in investing. No one can predict the future, but I will do everything in my power to make this happen and for everyone to at the very least break even and hopefully generate an attractive return.

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12	Total
REVENUES													
Cash sales	-	-	20,000	20,000	25,000	40,000	35,000	35,000	25,000	30,000	30,000	20,000	280,000
Charge sales	-	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL SALES	-	-	20,000	20,000	25,000	40,000	35,000	35,000	25,000	30,000	30,000	20,000	280,000
DIRECT EXPENSES													
Direct Costs	-	-	-	-	-	-	-	-	-	-	-	-	-
Salaries	-	-	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	20,000	29,000
Benefits	-	-	187	187	187	187	187	187	187	187	187	3,730	5,409
Rent	-	-	-	-	-	-	-	-	-	-	-	-	-
Utilities	-	-	-	-	-	-	-	-	-	-	-	-	-
Telephone	-	-	-	-	-	-	-	-	-	-	-	-	-
Transportation	-	-	120	120	120	120	120	120	120	120	120	120	1,200
Insurance	-	-	-	-	-	-	-	-	-	-	-	-	-
Bad debt expense	100	100	100	100	100	100	100	100	100	100	100	100	1,200
	-	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL DIRECT EXPENSES	100	100	1,407	1,407	1,407	1,407	1,407	1,407	1,407	1,407	1,407	23,950	36,809
	(100)	(100)	18,594	18,594	23,594	38,594	33,594	33,594	23,594	28,594	28,594	(3,950)	243,192
OPERATING MARGIN													
General & Admin. Expenses	1,200	1,200	4,800	4,800	4,800	4,800	4,800	4,800	4,800	4,800	4,800	4,800	50,400
Salaries	224	224	895	895	895	895	895	895	895	895	895	895	9,400
Benefits	500	500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	16,000
Rent	-	-	-	-	-	-	-	-	-	-	-	-	-
Utilities	-	-	-	-	-	-	-	-	-	-	-	-	-
Telephone	-	-	60	60	60	60	60	60	60	60	60	60	600
Transportation	-	-	100	100	100	100	100	100	100	100	100	100	1,000
Insurance	1,000	-	-	-	-	-	-	-	-	-	-	-	1,000
Legal & Accounting	-	-	200	200	200	200	200	200	200	200	200	200	2,000
Software and Website	15,000	-	-	-	-	-	-	-	-	-	-	-	15,000
Marketing	1,100	750	150	1,200	1,200	1,200	2,600	1,700	1,700	1,200	1,200	1,200	14,700
Office supplies	30	30	30	30	30	30	30	30	30	30	30	30	360
Equipment leases	-	-	-	-	-	-	-	-	-	-	-	-	-
Depreciation-Building	-	-	-	-	-	-	-	-	-	-	-	-	-
Depreciation-Equipment	278	278	278	556	556	556	1,111	1,111	1,667	2,222	2,778	2,778	14,167
TOTAL G&A	19,332	2,982	8,013	9,341	9,341	9,896	11,296	10,952	11,007	11,007	11,563	11,563	124,626
EBIT	(19,432)	(3,082)	10,581	9,253	14,253	29,253	23,697	22,297	12,642	17,586	17,031	(15,513)	118,565
Interest Expense	-	-	-	-	-	-	-	-	-	-	-	-	-
EARNINGS BEFORE TAXES	(19,432)	(3,082)	10,581	9,253	14,253	29,253	23,697	22,297	12,642	17,586	17,031	(15,513)	118,565

BALANCE SHEET—Year 1	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12
Cash	15,846	13,042	23,901	23,709	38,517	68,326	73,134	96,542	90,851	90,659	90,467	77,732
Accounts Receivable	-	-	-	-	-	-	-	-	-	-	-	-
Total Current Assets	15,846	13,042	23,901	23,709	38,517	68,326	73,134	96,542	90,851	90,659	90,467	77,732
Land	-	-	-	-	-	-	-	-	-	-	-	-
Building	-	-	-	-	-	-	-	-	-	-	-	-
Equipment	10,000	10,000	10,000	20,000	20,000	20,000	40,000	40,000	60,000	80,000	100,000	100,000
-LESS Accum. Depreciation	(278)	(556)	(833)	(1,389)	(1,944)	(2,500)	(3,611)	(4,722)	(6,389)	(8,611)	(11,389)	(14,167)
Net Fixed Assets	9,722	9,444	9,167	18,611	18,056	17,500	36,389	35,278	53,611	71,389	88,611	85,833
TOTAL ASSETS	25,568	22,487	33,067	42,320	56,573	85,826	109,523	131,820	144,462	162,048	179,078	163,565
LIABILITIES	-	-	-	-	-	-	-	-	-	-	-	-
Accounts payable	-	-	-	-	-	-	-	-	-	-	-	-
Short-term loan inc. interest	-	-	-	-	-	-	-	-	-	-	-	-
Interest on long-term	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL CURRENT	-	-	-	-	-	-	-	-	-	-	-	-
Long-term loans	-	-	-	-	-	-	-	-	-	-	-	-
Total liabilities	-	-	-	-	-	-	-	-	-	-	-	-
OWNERS' EQUITY	-	-	-	-	-	-	-	-	-	-	-	-
Investment by owner	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000
Retained earnings (loss)	(19,432)	(22,513)	(11,933)	(2,680)	11,573	40,826	64,523	86,820	99,462	117,048	134,078	118,565
Net equity	25,568	22,487	33,067	42,320	56,573	85,826	109,523	131,820	144,462	162,048	179,078	163,565
TOTAL LIAB AND OWNERS	25,568	22,487	33,067	42,320	56,573	85,826	109,523	131,820	144,462	162,048	179,078	163,565

CASH FLOW—Year 1	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12	Total
Cash flow from operations													
Receipts													
Cash sales	—	—	20,000	20,000	25,000	40,000	35,000	35,000	25,000	30,000	30,000	20,000	280,000
Accounts Receivable collections	—	—	—	—	—	—	—	—	—	—	—	—	—
Total receipts	—	—	20,000	20,000	25,000	40,000	35,000	35,000	25,000	30,000	30,000	20,000	280,000
Disbursements													
Direct expenses except bad debt	100	100	1,407	1,407	1,407	1,407	1,407	1,407	1,407	1,407	1,407	23,950	36,809
G&A except depreciation	19,054	2,704	7,735	8,785	8,785	8,785	8,785	10,185	9,285	8,785	8,785	8,785	110,460
Interest on long-term	—	—	—	—	—	—	—	—	—	—	—	—	—
Total disbursements	19,154	2,804	9,142	10,192	10,192	10,192	10,192	11,592	10,692	10,192	10,192	32,735	147,268
Net cash flow from operations	(19,154)	(2,804)	10,858	9,808	14,808	29,808	24,808	23,408	14,308	19,808	19,808	(12,735)	132,732
Cash flow from investing activities													
Purchase of Land	—	—	—	—	—	—	—	—	—	—	—	—	—
Purchase of Building	—	—	—	—	—	—	—	—	—	—	—	—	—
Purchase of Equipment	(10,000)	—	—	(10,000)	—	(20,000)	—	—	(20,000)	(20,000)	(20,000)	—	(100,000)
Net cash flow from investing activities	(10,000)	—	—	(10,000)	—	(20,000)	—	—	(20,000)	(20,000)	(20,000)	—	(100,000)
Cash flow from financing activities													
Investment by owners	45,000	—	—	—	—	—	—	—	—	—	—	—	45,000
Long-term loan	—	—	—	—	—	—	—	—	—	—	—	—	—
Additions (payments)	—	—	—	—	—	—	—	—	—	—	—	—	—
Net cash flow from long-term financing activities	45,000	—	—	—	—	—	—	—	—	—	—	—	45,000
Net cash increase (decrease)	15,846	(2,804)	10,858	(192)	14,808	29,808	4,808	23,408	(5,692)	(192)	(192)	(12,735)	77,732
Short-term Loan increase (decrease)	—	—	—	—	—	—	—	—	—	—	—	—	—
Beginning cash	—	15,846	13,042	23,901	23,709	38,517	68,326	73,134	96,542	90,851	90,659	90,467	—
Ending cash	15,846	13,042	23,901	23,709	38,517	68,326	73,134	96,542	90,851	90,659	90,467	77,732	77,732

Year 2 Income Statement Accrual Basis

	Month 13	Month 14	Month 15	Month 16	Month 17	Month 18	Month 19	Month 20	Month 21	Month 22	Month 23	Month 24	Total
REVENUES													
Cash sales	30,000	30,000	35,000	40,000	45,000	50,000	50,000	35,000	35,000	500,000	30,000	25,000	905,000
Charge sales	-	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL SALES	30,000	30,000	35,000	40,000	45,000	50,000	50,000	35,000	35,000	500,000	30,000	25,000	905,000
DIRECT EXPENSES													
Direct Costs	-	-	-	-	-	-	-	-	-	-	-	-	-
Salaries	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	60,000
Benefits	933	933	933	933	933	933	933	933	933	933	933	933	11,190
Rent	800	800	800	800	800	800	800	800	800	800	800	800	9,600
Utilities	150	150	150	150	150	150	150	150	150	150	150	150	1,800
Telephone	120	120	120	120	120	120	120	120	120	120	120	120	1,440
Transportation	100	100	100	100	100	100	100	100	100	100	100	100	1,200
Insurance	200	200	200	200	200	200	200	200	200	200	200	200	2,400
Bad debt expense	-	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL DIRECT EXPENSES	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	87,630
OPERATING MARGIN	22,698	22,698	27,698	32,698	37,698	42,698	42,698	27,698	27,698	492,698	22,698	17,698	817,370
General & Admin. Expenses	9,800	9,800	9,800	9,800	9,800	9,800	9,800	9,800	9,800	9,800	9,800	9,800	117,600
Salaries	1,828	1,828	1,828	1,828	1,828	1,828	1,828	1,828	1,828	1,828	1,828	1,828	21,932
Benefits	-	-	-	-	-	-	-	-	-	-	-	-	-
Rent	-	-	-	-	-	-	-	-	-	-	-	-	-
Utilities	-	-	-	-	-	-	-	-	-	-	-	-	-
Telephone	120	120	120	120	120	120	120	120	120	120	120	120	1,440
Transportation	50	50	50	50	50	50	50	50	50	50	50	50	600
Insurance	1,000	-	-	-	-	-	-	-	-	-	-	-	1,000
Legal & Accounting	200	200	200	200	200	200	200	200	200	200	200	200	2,400
Marketing	2,600	1,600	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	19,200
Office supplies	50	50	50	50	50	50	50	50	50	50	50	50	600
Equipment leases	300	300	300	300	300	300	300	300	300	300	300	300	3,600
Depreciation-Building	-	-	-	-	-	-	-	-	-	-	-	-	-

(Continued)

	Month 13	Month 14	Month 15	Month 16	Month 17	Month 18	Month 19	Month 20	Month 21	Month 22	Month 23	Month 24	Total
Depreciation- Equipment	3,333	3,333	3,889	3,889	4,444	4,444	4,444	4,444	5,000	5,000	5,556	5,556	53,333
TOTAL G&A	19,281	17,281	17,737	17,737	18,292	18,292	18,292	18,292	18,848	18,848	19,403	19,403	221,706
EBIT	3,416	5,416	9,961	14,961	19,405	24,405	24,405	24,405	8,850	473,850	3,294	(1,706)	595,664
Interest Expense	-	-	-	-	-	-	-	-	-	-	-	-	-
EARNINGS BEFORE TAXES	3,416	5,416	9,961	14,961	19,405	24,405	24,405	24,405	8,850	473,850	3,294	(1,706)	595,664
BALANCE SHEET—													
Year 2	Month 12	Month 13	Month 14	Month 15	Month 16	Month 17	Month 18	Month 19	Month 20	Month 21	Month 22	Month 23	Month 24
Cash	77,732	64,482	73,232	67,081	85,931	89,781	118,631	147,481	161,330	155,180	634,030	622,880	626,730
Accounts Receivable	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Current Assets	77,732	64,482	73,232	67,081	85,931	89,781	118,631	147,481	161,330	155,180	634,030	622,880	626,730
Land	-	-	-	-	-	-	-	-	-	-	-	-	-
Building	-	-	-	-	-	-	-	-	-	-	-	-	-
Equipment	100,000	120,000	120,000	140,000	140,000	160,000	160,000	160,000	160,000	180,000	200,000	200,000	200,000
-LESS Accum. Depreciation	(14,167)	(17,500)	(20,833)	(24,722)	(28,611)	(33,056)	(37,500)	(41,944)	(46,389)	(51,389)	(56,389)	(61,944)	(67,500)
Net Fixed Assets	85,833	102,500	99,167	115,278	111,389	126,944	122,500	118,056	113,611	128,611	143,611	138,056	132,500
TOTAL ASSETS	163,565	166,982	172,398	182,359	197,320	216,725	241,131	265,536	274,941	283,791	757,641	760,935	759,230
LIABILITIES													
Accounts payable	-	-	-	-	-	-	-	-	-	-	-	-	-
Short-term loan inc. interest	-	-	-	-	-	-	-	-	-	-	-	-	-
Interest on long-term	-	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL CURRENT	-	-	-	-	-	-	-	-	-	-	-	-	-
Long-term loans	-	-	-	-	-	-	-	-	-	-	-	-	-
Total liabilities	-	-	-	-	-	-	-	-	-	-	-	-	-
OWNERS' EQUITY													
Investment by owner	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000
Retained earnings (loss)	118,565	121,982	127,398	137,359	152,320	171,725	196,131	220,536	229,941	238,791	712,641	715,935	714,230
Net equity	163,565	166,982	172,398	182,359	197,320	216,725	241,131	265,536	274,941	283,791	757,641	760,935	759,230
TOTAL LIAB AND OWNERS	163,565	166,982	172,398	182,359	197,320	216,725	241,131	265,536	274,941	283,791	757,641	760,935	759,230

	Month 13	Month 14	Month 15	Month 16	Month 17	Month 18	Month 19	Month 20	Month 21	Month 22	Month 23	Month 24	Total
30,000	30,000	30,000	35,000	40,000	45,000	50,000	50,000	35,000	35,000	500,000	30,000	25,000	905,000
—	—	—	—	—	—	—	—	—	—	—	—	—	—
30,000	30,000	35,000	40,000	45,000	50,000	50,000	50,000	35,000	35,000	500,000	30,000	25,000	905,000
7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	7,303	87,630
15,948	13,948	13,848	13,848	13,848	13,848	13,848	13,848	13,848	13,848	13,848	13,848	13,848	168,372
—	—	—	—	—	—	—	—	—	—	—	—	—	—
23,250	21,250	21,150	21,150	21,150	21,150	21,150	21,150	21,150	21,150	21,150	21,150	21,150	256,002
6,750	8,750	13,850	18,850	23,850	28,850	28,850	28,850	13,850	13,850	478,850	8,850	3,850	648,998
(20,000)	—	(20,000)	—	(20,000)	—	—	—	(20,000)	—	—	(20,000)	—	(100,000)
(20,000)	—	(20,000)	—	(20,000)	—	—	—	(20,000)	—	—	(20,000)	—	(100,000)
—	—	—	—	—	—	—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—	—	—	—	—	—	—
(13,250)	8,750	(6,150)	18,850	3,850	28,850	28,850	28,850	13,850	(6,150)	478,850	(11,150)	3,850	548,998
—	—	—	—	—	—	—	—	—	—	—	—	—	—
77,732	64,482	73,232	67,081	85,931	89,781	118,631	118,631	147,481	161,330	155,180	634,030	622,880	77,732
64,482	73,232	67,081	85,931	89,781	118,631	147,481	147,481	161,330	155,180	634,030	622,880	626,730	626,730

	Month 25	Month 26	Month 27	Month 28	Month 29	Month 30	Month 31	Month 32	Month 33	Month 34	Month 35	Month 36	Total
REVENUES													
Cash sales	45,000	45,000	45,000	45,000	62,500	62,500	45,000	45,000	50,000	50,000	45,000	50,000	590,000
Charge sales	-	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL SALES	45,000	45,000	45,000	45,000	62,500	62,500	45,000	45,000	50,000	50,000	45,000	50,000	590,000
DIRECT EXPENSES													
Direct Costs													
Salaries	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	72,000
Benefits	1,119	1,119	1,119	1,119	1,119	1,119	1,119	1,119	1,119	1,119	1,119	1,119	13,428
Rent	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	18,000
Utilities	200	200	200	200	200	200	200	200	200	200	200	200	2,400
Telephone	120	120	120	120	120	120	120	120	120	120	120	120	1,440
Transportation	100	100	100	100	100	100	100	100	100	100	100	100	1,200
Insurance	200	200	200	200	200	200	200	200	200	200	200	200	2,400
Bad debt expense	-	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL DIRECT EXPENSES	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	110,868
OPERATING MARGIN	35,761	35,761	35,761	35,761	53,261	53,261	35,761	35,761	40,761	40,761	35,761	40,761	479,132
General & Admin. Expenses													
Salaries	13,200	13,200	13,200	13,200	13,200	13,200	13,200	13,200	13,200	13,200	13,200	13,200	158,400
Benefits	2,462	2,462	2,462	2,462	2,462	2,462	2,462	2,462	2,462	2,462	2,462	2,462	29,542
Rent	-	-	-	-	-	-	-	-	-	-	-	-	-
Utilities	-	-	-	-	-	-	-	-	-	-	-	-	-
Telephone	120	120	120	120	120	120	120	120	120	120	120	120	1,440
Transportation	-	-	-	-	-	-	-	-	-	-	-	-	-
Insurance	1,000	-	-	-	-	-	-	-	-	-	-	-	1,000
Legal & Accounting	250	250	250	250	250	250	250	250	250	250	250	250	3,000
Marketing	2,600	1,600	1,600	1,600	1,600	1,600	1,600	2,600	2,000	1,600	1,600	1,600	21,600
Office supplies	100	50	50	50	50	50	50	50	50	50	50	50	650
Equipment leases	-	-	-	-	-	-	-	-	-	-	-	-	-
Depreciation-Building	-	-	-	-	-	-	-	-	-	-	-	-	-
Depreciation-Equipment	6,172	6,172	6,789	6,789	7,097	7,097	7,097	7,097	7,097	7,097	7,097	7,097	82,700
TOTAL G&A	25,904	23,854	24,471	24,471	24,779	24,779	24,779	25,779	25,179	24,779	24,779	24,779	298,332
EBIT	9,857	11,907	11,290	11,290	28,482	28,482	10,982	9,982	15,582	10,982	10,982	15,982	180,800
Interest Expense	-	-	-	-	-	-	-	-	-	-	-	-	-
EARNINGS BEFORE TAXES	9,857	11,907	11,290	11,290	28,482	28,482	10,982	9,982	15,582	10,982	10,982	15,982	180,800

BALANCE SHEET-

Year 3

	Month 24	Month 25	Month 26	Month 27	Month 28	Month 29	Month 30	Month 31	Month 32	Month 33	Month 34	Month 35	Month 36
Cash	626,730	620,559	638,638	634,517	652,596	677,076	712,655	730,734	747,813	770,492	793,572	811,651	834,730
Accounts Receivable	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Current Assets	626,730	620,559	638,638	634,517	652,596	677,076	712,655	730,734	747,813	770,492	793,572	811,651	834,730
Land	-	-	-	-	-	-	-	-	-	-	-	-	-
Building	-	-	-	-	-	-	-	-	-	-	-	-	-
Equipment	200,000	222,200	222,200	244,400	244,400	255,500	255,500	255,500	255,500	255,500	255,500	255,500	255,500
-LESS Accum. Depreciation	(67,500)	(73,672)	(79,844)	(86,633)	(93,422)	(100,519)	(107,617)	(114,714)	(121,811)	(128,908)	(136,006)	(143,103)	(150,200)
Net Fixed Assets	132,500	148,528	142,356	157,767	150,978	154,981	147,883	140,786	133,689	126,592	119,494	112,397	105,300
TOTAL ASSETS	759,230	769,086	780,993	792,284	803,574	832,056	860,538	871,520	881,502	897,084	913,066	924,048	940,030
LIABILITIES													
Accounts payable	-	-	-	-	-	-	-	-	-	-	-	-	-
Short-term loan inc. interest	-	-	-	-	-	-	-	-	-	-	-	-	-
Interest on long-term	-	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL CURRENT	-	-	-	-	-	-	-	-	-	-	-	-	-
Long-term loans	-	-	-	-	-	-	-	-	-	-	-	-	-
Total liabilities	-	-	-	-	-	-	-	-	-	-	-	-	-
OWNERS' EQUITY													
Investment by owner	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000	45,000
Retained earnings (loss)	714,230	724,086	735,993	747,284	758,574	787,056	815,538	826,520	836,502	852,084	868,066	879,048	895,030
Net equity	759,230	769,086	780,993	792,284	803,574	832,056	860,538	871,520	881,502	897,084	913,066	924,048	940,030
TOTAL LIAB AND OWNERS	759,230	769,086	780,993	792,284	803,574	832,056	860,538	871,520	881,502	897,084	913,066	924,048	940,030

CASH FLOW—Year 3	Month 25	Month 26	Month 27	Month 28	Month 29	Month 30	Month 31	Month 32	Month 33	Month 34	Month 35	Month 36	Total
Cash flow from operations													
Receipts													
Cash sales	45,000	45,000	45,000	45,000	62,500	62,500	45,000	45,000	50,000	50,000	45,000	50,000	590,000
Accounts Receivable collections	-	-	-	-	-	-	-	-	-	-	-	-	-
Total receipts	45,000	45,000	45,000	45,000	62,500	62,500	45,000	45,000	50,000	50,000	45,000	50,000	590,000
Disbursements													
Direct expenses except bad debt	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	9,239	110,868
G&A except depreciation	19,732	17,682	17,682	17,682	17,682	17,682	17,682	18,682	18,082	17,682	17,682	17,682	215,632
Interest on long-term	-	-	-	-	-	-	-	-	-	-	-	-	-
Total disbursements	28,971	26,921	26,921	26,921	26,921	26,921	26,921	27,921	27,321	26,921	26,921	26,921	326,500
Net cash flow from operations	16,029	18,079	18,079	18,079	35,579	35,579	18,079	17,079	22,679	23,079	18,079	23,079	263,500
Cash flow from investing activities													
Purchase of Land	-	-	-	-	-	-	-	-	-	-	-	-	-
Purchase of Building	-	-	-	-	-	-	-	-	-	-	-	-	-
Purchase of Equipment	(22,200)	-	(22,200)	-	(11,100)	-	-	-	-	-	-	-	(55,500)
Net cash flow from investing activities	(22,200)	-	(22,200)	-	(11,100)	-	-	-	-	-	-	-	(55,500)
Cash flow from financing activities													
Investment by owners	-	-	-	-	-	-	-	-	-	-	-	-	-
Long-term loan additions (payments)	-	-	-	-	-	-	-	-	-	-	-	-	-
Net cash flow from long-term financing activities	-	-	-	-	-	-	-	-	-	-	-	-	-
Net cash increase (decrease)	(6,171)	18,079	(4,121)	18,079	24,479	35,579	18,079	17,079	22,679	23,079	18,079	23,079	208,000
Short-term loan increase (decrease)	-	-	-	-	-	-	-	-	-	-	-	-	-
Operating cash ending cash	626,730	620,559	638,638	634,517	652,596	677,076	712,655	730,734	747,813	770,492	793,572	811,651	626,730
	620,559	638,638	634,517	652,596	677,076	712,655	730,734	747,813	770,492	793,572	811,651	834,730	834,730

Case 1

Big Bottom Market

How Can a Small Restaurant and Specialty Food Store Cope with Highly Seasonal Sales?

After Michael Volpatt, co-owner with Kate Larkin of a successful public relations firm, moved to Guerneville, California, a small town in Sonoma County in the heart of the Russian River valley's wine country, he decided to realize his longtime dream of owning a specialty food and wine store. After meeting Crista Luedtke, the owner of two Guerneville businesses, the Boon Hotel and Spa and Boon Eat and Drink, Volpatt convinced Larkin to join him and Luedtke in opening the Big Bottom Market, a restaurant and specialty food and wine store that also sells local crafts. The three entrepreneurs invested \$100,000 of their own money to convert a 1,500-square-foot storefront on Guerneville's Main Street into a restaurant and retail store. They decided to name the restaurant Big Bottom Market after the once-booming logging town's original name, which was inspired by its location in the alluvial flats of the Russian River. "The unique, quirky, and inspiring name fits not only the historical nature of days gone by but also the unique aspects and incredible environment of our restaurant-market," says Volpatt. Originally settled in 1860, the well-to-do town is a now popular destination in the spring, summer, and fall for tourists and visitors who are drawn by the availability of activities on the river, hiking among the giant redwoods in nearby Armstrong Woods, or visiting the valley's many boutique wineries.

Volpatt and Larkin, who are based in New York City, would keep their day jobs but would handle the marketing and finance functions, respectively, for Big Bottom Market. They would count on Luedtke, who has experience in both the food and hospitality industries to manage the business's day-to-day operations.

The renovated storefront features hardwood floors, walls made of barn wood, funky metal chairs at its nine tables, bar stools at the counter, and a "communal table" for large parties or for people who want to mix and mingle. "Think gourmet deli meets farmer's market meets a modern-day general store—now add in 'lumberjack chic' style—that's us," explains Volpatt. Currently, Big Bottom Market serves only breakfast and lunch, but executive chef Tricia Brown, who came to Big Bottom Market from New York City's famous Gramercy Tavern, is pushing the owners to begin offering dinner. Brown's menu is varied and, except for several staple dishes, changes frequently. Some of her most popular dishes include chilled cucumber soup, wild salmon Niçoise salad, green chile cheddar turkey meatloaf, chipotle sweet potatoes, and baguette sandwiches. The Big Bottom Market's signature item is its homemade Big Bottom Biscuits, which come in a multitude of flavors, including regular, cheddar and thyme, ham and cheese, and sea biscuit (house-smoked salmon, capers, and red onions). The biscuit recipe came from

Luedtke's mother, who is one of Big Bottom Market's 20 employees and who oversees their baking.

Big Bottom Market opened in July, and in its first year of operation, sales during the busy summer months were strong, averaging between \$20,000 and \$24,000 per week. In September, sales began tapering off, and by November, sales were down 80 percent. "We thought we'd lose about 30 to 40 percent of our business [in the off-season]," says Volpatt, "but not 80 percent. This is my first time at the rodeo, and we were freaking out." After analyzing their financial statements, their accountant had grim news. "At the rate you're going, you're going to have to close your doors," he said.

Volpatt, Larkin, and Luedtke began to trim Big Bottom Market's expenses immediately. They closed on Mondays and Tuesdays, the slowest days, and trimmed their staff. They gathered their remaining employees and conducted a brainstorming session designed to generate ideas to keep the business afloat during the slow off-season until sales picked up again in the spring. Some of the ideas they came up with included introducing a Big Bottom Market food truck to increase sales and build the company's brand name in the area, adding a catering service, opening for dinner, focusing more on marketing to Guerneville residents, and emphasizing the Big Bottom Market's signature biscuits and selling them through a gourmet wholesaler, such as Bi-Rite in San Francisco.

Questions

- C1-1. What steps do you recommend that the owners of Big Bottom Market take to manage cash flow in their seasonal business?
- C1-2. Identify the advantages and the disadvantages of each of the ideas that the owners and their employees came up with to help Big Bottom Market survive the slow off-season. Based on your analysis, do you recommend that they pursue any of these options? Explain your reasoning.
- C1-3. Identify at least two other options that the owners should consider to get through the slow off-season and the advantages and disadvantages of each one.
- C1-4. Develop a two-page marketing strategy for Big Bottom Market. Which social media tools should the owners use? How, specifically, should they put them to work?

Sources: Based on John Grossman, "A Seasonal Business Aims to Survive the Off-Season," *New York Times*, July 11, 2012, www.nytimes.com/2012/07/12/business/smallbusiness/a-seasonal-business-aims-to-survive-the-off-season.html?pagewanted=all&_r=0; Carey Sweet, "Guerneville's Big Bottom Market Rolls Out Dinner Service," *Inside Scoop SF*, June 8, 2012, <http://insidescoopsf.sfgate.com/blog/2012/06/08/guerneville%E2%80%99s-big-bottom-market-rolls-out-dinner-service>; "About," Big Bottom Market, www.bigbottommarket.com/about.html; John Grossman, "A Tourist-Dependent Business Decides to Reboot," *New York Times*, July 18, 2012, <http://boss.blogs.nytimes.com/2012/07/18/a-tourist-dependant-business-decides-to-reboot/?pagewanted=print>.

Case 2

MyBizHomepage

Can an Online Company that Provides Easy-to-Use Financial Metrics for Small Companies Recover from a Devastating Cyberattack?

A few years after Peter Justen sold the financial services company that he and several cofounders had started to TD Ameritrade, the serial entrepreneur was ready to launch another company. A self-confessed “numbers guy,” Justen recognized that most small business owners struggled to understand their companies’ financial statements and the valuable information that the statements could provide them. Justen’s research also showed that many business owners used the accounting software QuickBooks to manage the financial aspects of their companies. That led Justen to create MyBizHomepage, a free Web-based financial service that includes MyBizDashboard, a free online financial dashboard aimed at small businesses that extracts the necessary data from their QuickBooks records and presents it in an easy-to-understand dashboard that features simple charts and graphs. “My idea was to simplify things for business owners to give them an easy way to see the problems and opportunities in the numbers of their businesses,” he says.

Justen hired a team of programmers and spent the next two years developing the prototype for MyBizHomepage, which uses a series of algorithms to analyze the data extracted from small companies’ QuickBooks records to create performance indicators and comparisons against industry standards. The dashboard was designed to reveal meaningful information that entrepreneurs could use to make better business decisions and that might otherwise stay buried in a company’s financial records. MyBizHomepage automatically pulls the required values from a company’s QuickBooks records and generates easy-to-understand reports on its vital financial components, including accounts payable, accounts receivable, cash available, sales, cost of goods sold, payroll, and working capital. The dashboard also includes alerts that communicate time-sensitive key business indicators to business owners using e-mail and text messaging. “The idea was that by checking the numbers every day, a business owner could see where he was headed,” says Justen.

When MyBizHomepage went live in 2008, the site, which was free to small business owners, attracted a great deal of media attention, driving significant traffic to the company’s Web site. Justen’s business model called for generating a profit by selling advertising to businesses that wanted to reach small business owners using MyBizHomepage. As traffic grew, Justen turned to several private investors, including Joe Silbaugh, a former real estate developer, and Bryan Elicker, an entrepreneur who had recently sold his coffin manufacturing business, to raise the capital he needed to expand the company. The investors also served on the company’s board of directors.

Within a few months, Justen and his board received an offer from a large company to purchase the business for nearly \$100 million, but they declined the offer. “We hadn’t yet tapped the potential of the product, especially among the global audience,” says Justen. At that point, the company had only 6,000 customers, and Justen and the board believed that they could increase that number significantly.

Shortly after declining the offer to purchase the company, Justen learned that his chief technology officer (CTO), with whom he had worked for several years, was working with two other managers at MyBizHomepage to launch a similar, competing company. Furious, Justen fired the men and had his attorney send them a “cease-and-desist” letter about starting the competing company. Almost immediately, MyBizHomepage’s Web site began to crash regularly, causing problems for its small business customers and credibility problems for the company. Someone also hacked into the e-mail accounts of Justen and his board members and sent false e-mails to everyone in their address books accusing them of unethical and improper business practices. The messages implied that MyBizHomepage was defrauding investors. “It hurts your reputation when someone Googles your name and finds that,” says Silbaugh, who had invested more than \$1 million in the company.

Justen contacted authorities about the cyberattacks and told them that he suspected that his former CTO was behind them. Only then did he discover that the former CTO was not the person he claimed to be. In fact, he had no official identity at all. He had no driver’s license and no credit cards in his name and had filed no tax returns—all of which made tracking him down virtually impossible. Justen and his IT staff ultimately determined that the former CTO had built multiple hidden “back-door” entrances into MyBizHomepage’s software that he could exploit undetected whenever he wanted. Justen knew that the only way to make the site and the software safe again was to shut down the company and rebuild the software from scratch, which would require a capital investment, but he was hesitant to go back to his original investors for more money. If he declared bankruptcy, he and his investors would lose all of the money they had put into the business. He also worried about how much information about the incident to make public because his small business customers had trusted his company with very sensitive information about their companies. He was considering simply shutting down MyBizHomepage and walking away.

Questions

- C2-1. Is the way that Peter Justen spotted this business opportunity typical of the way that entrepreneurs come up with creative ideas for the businesses they start?
- C2-2. What steps can online companies such as MyBizHomepage take to minimize the effects of cyberattacks?

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- C2-3. Why did Justen and his board decline the offer from the larger business to purchase MyBizHomepage? Do you think that they made the right decision at the time? Explain.
- C2-4. If Justen decides to rebuild his company's software and start a new company, what sources of financing do you recommend that he use? What steps should he take to attract either debt or equity capital? Which sources of financing do you recommend that he avoid? Explain.

- C2-5. MyBizHomepage's selection process was obviously flawed. What steps should entrepreneurs take to avoid hiring dishonest employees who have the potential to damage or destroy their companies?

Sources: Based on Darren Dahl, "Struggling to Recover from a Cyberattack," *New York Times*, August 22, 2012, www.nytimes.com/2012/08/23/business/small-business/struggling-to-recover-from-a-cyberattack.html?pagewanted=all&_r=0; "MyBizHomepage," Crunchbase, 2013, www.crunchbase.com/company/mybizhomepage; "Five Plus," 2013, www.fiveplus.co.

Case 3

Jacqui LLC

Should a Young Entrepreneur Accept a Potential Investor's Terms that Require Her to Give Up Control of Her Business?

Jacqui Rosshandler grew up in Australia but was drawn to New York City, where she worked as legal counsel for an interior design company. She put in long hours at her job, but her goal was to one day own a business of her own, just like her father did back in Australia. "If I am going to work this hard, I want to do it for myself," she recalls thinking. One New Year's Day, with her mouth feeling less than fresh, Rosshandler recalled Odor-Go, a breath mint sold in Australia that really worked. She had never seen a similar product in the United States and decided to start a company to produce and market one. She realized that the best way to eliminate bad breath was to treat the source of the problem, the stomach, rather than its symptoms, which appear in the mouth, as most breath mints do. Rosshandler decided to launch a company, Jacqui LLC, and began working with a contract manufacturer to develop a unique breath-freshening product. "Parsley has been used for generations to freshen breath," she says, "but freshening the mouth only, especially after consuming pungent foods, doesn't get rid of the smell that comes from the stomach. We found that a combination of concentrated peppermint and parsley oils, when dissolved in the stomach, provides this fresh feeling from within. Your breath actually smells good from deep inside, not just superficially from the mouth."

The result of several months of work was a two-step breath-freshening product that Rosshandler named Eatwhatever to give her product a trendy, fun image. Customers swallow a gel cap filled with an all-natural concentration of peppermint and parsley oils and then pop one of the package's small white mints into their mouths for instantly fresh breath. Rosshandler came up with a clever tagline, "2 Steps to Kissable Breath," aimed squarely at her target audience—young people—and hired a package designer to create a clever package. She began marketing her new breath freshener herself, walking boldly into the flagship C.O. Bigelow apothecary store in Manhattan and asking, "Who does the buying here?" She actually met with a buyer and left the store with her first sale. "I had no idea what I was doing," she recalls with a laugh. A month later, a friend who worked in public relations convinced DailyCandy, a popular Web site that focuses on fashion, food, and fun, to mention Eatwhatever, generating \$20,000 in orders on her Web site in just 12 hours. With a distributor's help, Rosshandler was able to get Eatwhatever in retail stores such as Zitomer, Ricky's, and Joe Coffee in New York City; Collette in Paris; Terry White Chemists in Sydney; and online at Amazon, Victoria Health, an Shopmasc. Sales volume for the company's first three years of operation has surpassed \$40,000.

Rosshandler had used her own money to create her product and bring it to market, but getting widespread distribution and generating significant sales would require a lot more money than she could invest in her small business. The promising business was about to run out of cash, and Rosshandler was considering shutting it down and getting another job. Then, through her network of contacts, Rosshandler met Arthur Shorin, who had recently sold his business, the Topps Company, which is famous for selling bubble gum packaged with collectible baseball cards. Shorin had extensive knowledge and experience in a similar industry and had an impressive network of contacts. Shorin was impressed with Rosshandler and Eatwhatever and offered to invest a minimum of \$250,000 (more if necessary) to propel the company's growth. There was a catch, however, and it was a big one. In return for his investment, Shorin would own 75 percent of Jacqui LLC leaving Rosshandler with minority ownership of just 25 percent. He also offered terms that would allow her to regain 15 percent of the company, bringing her total ownership to 40 percent, if Eatwhatever met certain financial and performance benchmarks. The offer also included a job for Rosshandler at Artuitive, Shorin's business incubator for start-up companies.

Rosshandler talked to several friends about the deal, and they advised her to reject Shorin's offer, citing what one friend called "draconian terms"; even if the company met the performance benchmarks, she would still own just 40 percent of what was once "her company." Another pointed out that by giving up 75 percent of her company for an investment of \$250,000, she was saying that her company was worth just \$333,333 ($\$250,000 \div 75\%$). Rosshandler listened to her friends' advice but kept thinking, "Isn't owning 25 percent of something better than owning 100 percent of nothing?"

Questions

- C3-1. What other potential sources of financing for Jacqui LLC do you recommend Rosshandler explore? Explain.
- C3-2. What are the advantages and the disadvantages of using equity capital and debt capital to finance a small business's growth?
- C3-3. What steps could Rosshandler have taken to avoid her company's cash flow problem?
- C3-4. Should Jacqui Rosshandler accept the investment offer from Arthur Shorin? Explain.

Sources: Based on John Grossman, "Help for a Start-Up, but at a High Price," *New York Times*, January 2, 2013, www.nytimes.com/2013/01/03/business/smallbusiness/a-start-ups-dilemma-a-lack-of-capital-or-lack-of-control.html?_r=0; John Grossman, "Why the Founder of a Start-Up Chose to Give Up Control," *New York Times*, January 9, 2013, <http://boss.blogs.nytimes.com/2013/01/09/why-the-founder-of-a-start-up-chose-to-give-up-control/>; Caroline Dowd-Higgins, Jacqui Rosshandler, "Eatwhatever," Caroline Dowd-Higgins, March 14, 2010, <http://carolinedowdhiggins.com/2011/05/jacqui-rosshandler-eat-whatever-2/>; "Who We Are," Jacqui LLC, www.eatwhatever.com/who/who-we-are.

Case 4

Red Iguana

Should a Family-Owned Restaurant Open a Second Location Nearby to Accommodate the Crowds that Appeared after It Was Featured on the Food Network?

In 1965, Ramón and María Cardenas, immigrants from Mexico, left their jobs in a restaurant in San Francisco and moved to Salt Lake City, Utah, where they purchased a restaurant called Casa Grande. They served authentic Mexican dishes that they learned to make in their native state of Chihuahua, unlike the “Americanized” version of Mexican food that most restaurants serve. “People were not used to their kind of Mexican food,” says Lucy Cardenas, the couple’s daughter, who now runs the family business with her husband, Bill Coker. Initially, sales were slow, but over time, the restaurant built a loyal customer following, and in 1970 Ramón and María moved the restaurant to a downtown location.

By 1985, Casa Grande was struggling, prompting the Cardenases to shutter it and open a new restaurant named Red Iguana in Salt Lake City’s working-class west side. With its moderate prices and enormous—and enormously varied—menu, Red Iguana thrived, generating \$300,000 in sales in its first year. Red Iguana’s sales have increased every year, reaching \$1.9 million in 2003. María died in 2002, and an exhausted Ramón was ready to close the restaurant despite its success. Lucy and Bill were eager to take over the family business, but Ramón’s traditional views made him hesitant to turn the restaurant over to a woman, even if she was his daughter. “My father would have given my brother the business [simply] because he was a man,” recalls Lucy, “but we *bought* it from my Dad. He wanted to sell the business to me, not to me and my husband, because it’s part of the family. It was at times painful.”

After they purchased Red Iguana for \$560,000, Lucy and Bill embarked on a modernization initiative, introduced a computerized restaurant management system, upgraded the electrical system, and purchased the parking lot next door. To improve food consistency across shifts, Lucy had her father cook every dish on the menu in front of her and had the chefs write down every recipe, something that Ramón had never done. By 2008, annual revenue at Red Iguana had reached \$3.8 million. The colorful restaurant, with its green and red walls, mismatched furniture, and plastic floral-print tablecloths, had a distinct family vibe and drew a wide variety of customers, ranging from skiers straight off the slopes and families to businesspeople and hipsters.

In 2008, Guy Fiero featured Red Iguana on his Food Network television show, *Diners, Drive-Ins, and Dives*, and sales accelerated. Crowds pushed the restaurant, with room to seat just 100 people, beyond its capacity. Even in the winter

off-season during the middle of the week, customers often wait for more than an hour to get a table. On winter weekends, the wait stretches to two hours. During the busy summer months, wait times are even longer. On a typical day, about 700 customers eat lunch or dinner at Red Iguana. Longtime local customers began telling Coker that they had stopped coming to the restaurant because of the long wait times and large number of out-of-town diners. “My experience has taught me that that kind of popularity can flip and become a negative,” says Bill.

Lucy and Bill soon learned about another complication for Red Iguana: The city would soon be starting construction on a light rail line, and the bridge on the street on which the restaurant was located that connected the west side of Salt Lake City with the downtown district would be closed for about four months. Because many of their customers, especially businesspeople at lunch, came from downtown and used that bridge to get to the Red Iguana, they estimated that they would lose between 10 and 20 percent of their sales during the construction.

To Lucy and Bill, the solution to their problem was to open a second Red Iguana location. “Anecdotal evidence was that we had gotten too busy, too crowded, and too successful and that [customers] would indeed fill a new restaurant,” says Bill. But where should the second Red Iguana be located? Conventional wisdom said that the couple should choose a site far enough away from the original Red Iguana so that the second location would not cannibalize sales at the original restaurant. That would be relatively easy to do because officials in several nearby towns had approached Lucy and Bill within the last several years about opening locations within their city limits. Several mall owners also had been trying to convince them to open locations in their shopping malls. However, the copreneurs lived only a few blocks from Red Iguana and saw that as a significant advantage. “I love being able to get to my business so fast,” says Lucy. Opening a second location farther away meant giving up some control over its operations.

While investigating potential sites for a second location, Lucy and Bill heard about an old warehouse located just two blocks away from the original Red Iguana that was for sale for \$259,000. They saw a great deal of potential in the old barrel-roofed building, which had a large concrete pad that they could use for patio dining in the warmer months. Preliminary plans indicated that a restaurant in the renovated warehouse could seat 119 diners, slightly more than the original restaurant. However, to purchase the building and renovate it, they would have to convince the Salt Lake City Office of Economic Development and the loan officers at Zions Bank that opening a second location just two blocks from their original restaurant would work. In the initial meeting, the lenders were skeptical.

Questions

- C4-1. What management succession issues do you detect in this case? What steps could Ramón Cardenas have taken to avoid them?
- C4-2. Lucy and Bill eventually were able to purchase Red Iguana from her father for \$560,000. Describe at least three methods that the family could use to establish the value of the business. What factors make placing a value on a business difficult?
- C4-3. Should Lucy and Bill open a second location of Red Iguana? If so, what factors should they consider when selecting a location?
- C4-4. Where should they locate the second restaurant? Explain.

- C4-5. What steps should Lucy and Coker take when they make their loan request to officers at Zions Bank?

Sources: Based on Ian Mount, "Build a Second Restaurant in the First's Shadow?," *New York Times*, August 24, 2011, www.nytimes.com/2011/08/25/business/smallbusiness/red-iguana-facing-disruptions-ponders-opening-a-2nd-restaurant.html?_r=0; Ian Mount, "Why Red Iguana Built Red Iguana 2 Right Next Door," *New York Times*, August 30, 2011, <http://boss.blogs.nytimes.com/2011/08/30/why-red-iguana-built-red-iguana-2-right-next-door>; Ian Mount, "You're the Boss; Second Restaurant: Following Up," *New York Times*, August 30, 2012, <http://boss.blogs.nytimes.com/2012/08/28/a-restaurant-makes-the-most-of-being-forced-to-close>; Larry Olmstead, "Mexican Food in Utah? Red Iguana Is the Real Deal," *USA Today*, March 28, 2013, www.usatoday.com/story/travel/columnist/greatamericanbites/2013/03/28/great-american-bites-mexican-food-utah-red-iguana-real-deal/2027295.

Case 5

Baked in the Sun

Should a Small, Wholesale Baker Offer Employees Health Care Coverage at a Significant Cost or Pay a Penalty and Let Employees Buy Coverage on a Government Exchange?

The Affordable Care Act requires businesses that employ 50 or more full-time-equivalent employees to provide adequate health care insurance to all employees who work at least 30 hours per week. Companies that choose not to provide health care coverage must pay a penalty of \$2,000 for each worker, excluding the first 30 workers. If businesses provide their employees with health care coverage but the insurance fails to meet the law's minimum requirements, they face a penalty of \$3,000 for each worker who gets a federal subsidy through state insurance exchanges. Owners of businesses that have between 50 and 200 full-time-equivalent employees find themselves facing numerous dilemmas: Should they provide health insurance even though they face significant increases in the cost of coverage? Should they forgo offering their employees health insurance, pay the penalty, and allow workers to buy health care coverage on state exchanges? If they fail to provide insurance coverage, will they lose valuable employees? Should they use part-time workers and independent contractors to shrink their workforces enough that their companies fall below the law's 50-employee floor?

Businesses that employ between 50 and 200 employees fall under Affordable Care Act, but their owners say that they lack the purchasing power that large companies have to negotiate the best rates with insurance companies. These entrepreneurs say that they face increasing insurance premiums and declining profits. Rachel Shein and Steve Pilarski, a husband-and-wife team that own Baked in the Sun, a wholesale baker and distributor of fresh pastries located in San Marcos, California, employ 95 workers and must decide what to do about the Affordable Care Act. They estimate that providing health care insurance to their employees could cost an additional \$108,000 per year. "Our [annual] revenues are about \$8 million, but the food business is a low-margin industry," says Shein. Cutting \$108,000 out of our profits, which are just over \$200,000, is a big deal."

Shein and Pilarski purchased Baked in the Sun in 1997 and over time expanded their product line to include more than 200 items, including muffins, croissants, cinnamon rolls, bear claws, Danish, scones, bagels, cookies, brownies, crumb cakes, cupcakes, and breads. Their core coffee shop business contracted during the Great Recession, but the copreneurs attracted new customers, such as hotels and hospitals, to keep their business going. Although the bakery now turns out nearly 20,000 items per day in an 18,500-square-foot modern bakery,

Shein and Pilarski are still working to rebuild Baked in the Sun's profitability. In light of the Affordable Care Act, they are considering three options.

Option 1: Offer Every Employee Health Insurance

Because the company already provides managers with insurance, Shein and Pilarski estimate the cost of covering the bakery's additional workers to be \$108,000, plus the cost of administering the plan or paying a third-party administrator to manage it. Shein and Pilarski estimate that providing coverage would cost \$200 per employee per month, half of which the company would pay and half of which each employee would pay. They suspect that some employees would not sign up for the insurance because they already have coverage through a spouse. "We have offered health insurance to our employees in the past," says Shein. However, many workers chose not to participate in the coverage because they would have had to contribute some of their earnings to cover the premiums. "They are mostly young and healthy," says Shein. "They don't have a lot of extra money, and they would rather have more in their paychecks than health insurance." Covering the additional costs of providing health insurance would require Shein and Pilarski to raise prices by 2 to 4 percent, but they are concerned about the impact of higher prices on sales. Currently, their prices are similar to those of their competitors. Would raising their prices cause a significant decrease in sales?

Option 2: Do Not Provide Health Insurance to Employees and Pay the Penalty

Under this option, Baked in the Sun would pay a \$2,000 penalty for every employee (excluding the first 30 workers) to the federal government as part of an "employer-shared responsibility payment." Employees would purchase health care coverage elsewhere, probably on one of the government-operated exchanges. For Baked in the Sun, the penalty would be \$130,000, but the company would not incur the additional \$10,000 cost of administering an insurance plan. Not providing health insurance goes against the copreneurs' principles, however. Both of them believe that all workers should have health insurance and have wrestled with the problem of providing it for years.

Option 3: Outsource Certain Jobs

By outsourcing work or paying independent contractors to perform certain jobs, Shein and Pilarski could shrink their company enough to fall under the 50-employee threshold and be exempt from the requirements of the Affordable Care Act. "We can outsource the cleaning and make the drivers independent contractors," says Shein. "We can cut the least profitable delivery routes, eliminate the least profitable accounts, or reduce the variety of items we create."

“Our employees will have access to health insurance,” says Shein, “whether we provide it or we pay the penalty and they purchase it using a subsidy on the government exchange.”

Questions

- C5-1. Evaluate the costs and benefits, including both financial and nonfinancial, of each of the three options that Shein and Pilarski have identified.
- C5-2. Which option do you recommend for Baked in the Sun? Explain.
- C5-3. Are there other options that Shein and Pilarski should consider? Explain.

Sources: Based on Emily Maltby and Sarah E. Needleman, “Sizing Up Health Costs,” *Wall Street Journal*, May 30, 2013, pp. B1, B4; Julie Weed, “Questions Abound in Learning to Adjust to Health Care Overhaul,” *New York Times*, March 30, 2013, www.nytimes.com/2013/03/21/business/smallbusiness/a-bakery-with-95-employees-confronts-the-new-health-care-law.html?pagewanted=all; Julie Weed, “Bakery Owner Talks About Coping with Health Insurance Changes,” *New York Times*, March 26, 2013, <http://boss.blogs.nytimes.com/2013/03/26/bakery-owner-talks-about-coping-with-health-insurance-changes>; Nate C. Hindman, “Bakery Owners: Obamacare Will Cut Our Profits in Half,” *Huffington Post*, March 22, 2013, www.huffingtonpost.com/2013/03/22/bakery-obamacare_n_2926322.html.

Case 6

Bluffton Pharmacy—Part 1

What Can Two New Pharmacy Owners Learn about Their Business from Its Financial Statements?

It has been a little more than two years since Angela Crawford and Martin Rodriguez purchased the Bluffton Pharmacy from Frank White, the previous owner and founder, who had started the pharmacy in 1969. The two had spent many long hours in the store and had learned many valuable lessons as business owners that they had not had the opportunity to learn as employees of large chain pharmacies where they had previously worked.

Crawford and Rodriguez just received an e-mail from their accountant that contained the balance sheet and the income statement for Bluffton Pharmacy for the fiscal year that had just ended. The two financial statements appear below.

Bluffton Pharmacy

Balance Sheet, December 31, 20XX

Assets	
CURRENT ASSETS	
Cash	\$74,473
Accounts receivable	\$112,730
Inventory	\$224,870
Supplies	\$21,577
Other assets	<u>\$10,202</u>
Total current assets	\$443,851
FIXED ASSETS	
Autos, net	\$33,156
Equipment, net	\$35,706
Furniture and fixtures, net	<u>\$16,323</u>
Total fixed assets	\$85,185
Total assets	<u>\$529,036</u>
Liabilities	
CURRENT LIABILITIES	
Accounts payable	\$29,585
Notes payable	\$70,902
Line of credit payable	\$32,136
Total current liabilities	\$132,623
LONG-TERM LIABILITIES	
Note payable	\$170,880
Loan	<u>\$93,346</u>
Total long-term liabilities	<u>\$264,226</u>
Owner's Equity	
Crawford and Rodriguez, capital	\$132,187
Total owner's equity	<u>\$529,036</u>

Bluffton Pharmacy

Income Statement December 31, 20XX

Prescription sales revenue	\$2,228,767
All other sales revenue	<u>\$167,757</u>
Total sales	\$2,396,524
COST OF GOODS SOLD	
Beginning inventory, 1/1/xx	\$169,578
+ Purchases	<u>\$1,938,097</u>
Goods available for sale	\$2,107,675
– Ending inventory, 12/31/xx	<u>\$224,870</u>
Cost of goods sold	<u>\$1,882,805</u>
Gross profit	\$513,719
OPERATING EXPENSES	
Utilities	\$10,305
Rent	\$35,948
Advertising	\$9,586
Insurance	\$9,586
Depreciation	\$5,033
Salaries and benefits	\$321,134
Computer and e-commerce	\$11,983
Repairs and maintenance	\$28,758
Travel	\$4,793
Professional fees	\$3,595
Supplies	\$5,991
Total operating expenses	\$446,712
OTHER EXPENSES	
Interest expense	\$24,879
Miscellaneous expense	\$374
Total other expenses	\$25,253
Total expenses	<u>\$471,965</u>
Net income	<u>\$41,754</u>

To see how their pharmacy's financial position has changed since their first full year of operation, they want to calculate 12 financial ratios. They also want to compare Bluffton Pharmacy's ratios to those of the typical small pharmacy in the industry. The table below shows the value of each of the 12 ratios from last year and the industry median for small pharmacies.

Ratio Comparison

Ratio	Bluffton Pharmacy		Pharmacy Industry Median*
	Current Year	Last Year	
LIQUIDITY RATIOS			
Current ratio		3.41	4.71
Quick ratio		1.72	2.42
LEVERAGE RATIOS			
Debt ratio		0.70	0.62
Debt to net worth ratio		2.23	2.1
Times interest earned ratio		3.04	3.9
OPERATING RATIOS			
Average inventory turnover ratio		10.90	11.7 times/year
Average collection period ratio		14.0	15.0 days
Average payable period ratio		5.0	14.0 days
Net sales to total assets ratio		4.75	4.68
PROFITABILITY RATIOS			
Net profit on sales ratio		1.94%	2.9%
Net profit to assets ratio		9.20%	8.2%
Net profit to equity ratio		29.21%	48.0%

* From Risk Management Association Annual Statement Studies and National Community Pharmacists Association.

“Let’s see how our ratios compare to last year’s numbers,” said Angela.

“I hope that we’re headed in the right direction,” said Martin.

“There’s only one way to find out,” said Angela with a slight hint of tension in her voice.

Questions

C6-1. Calculate the 12 ratios for the Bluffton Pharmacy for this year.

C6-2. How do the ratios you calculated for this year compare to those for the pharmacy last year? What factors are most likely to account for those changes?

C6-3. How do the ratios you calculated for this year compare to those of the typical company in the industry? Do you spot any areas that could cause the company problems in the future? Explain.

C6-4. Develop a set of specific recommendations for improving the financial performance of Bluffton Pharmacy using the analysis you conducted in questions 1 to 3.

Case 7

Bluffton Pharmacy—Part 2

How Should the Owners of a Small Pharmacy Create a Cash Flow Forecast for Their Business?

It has been a little more than two years since Angela Crawford and Martin Rodriguez purchased the Bluffton Pharmacy from Frank White, the previous owner and founder, who had started the pharmacy in 1969. Although Crawford and Rodriguez have prepared budgets for Bluffton Pharmacy and have analyzed their financial statements using ratio analysis, they have not created a cash flow forecast. During a recent meeting, their banker explained the importance of a reliable cash flow forecast, telling them that banks traditionally are “cash flow lenders.” Bankers appreciate strong balance sheets and income statements, but

they are most interested in a company’s cash flow because they know that positive cash flow is required to repay a loan.

Crawford and Rodriguez expect sales to increase 4.5 percent next year to \$2,504,368. Credit sales account for 79 percent of total sales, and the company’s collection pattern for credit sales is 11 percent in the same month in which the sale is generated, 63.5 percent in the first month after the sale is generated, and 22 percent in the second month after the sale is generated. The pharmacy’s cost of goods sold is 77.4 percent, and vendors grant “net 30” credit terms, which means that the pharmacy pays for the goods it purchases every month in the following month. Crawford and Rodriguez have been working with their accountant to develop the following estimates for their sales and expenses for the upcoming year:

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Sales	\$230,402	\$237,915	\$215,376	\$177,810	\$175,306	\$172,801	\$162,784	\$167,793	\$197,845	\$247,932	\$255,445	\$262,959
Other cash receipts	105	55	60	75	85	55	65	60	65	85	95	110
Rent	3,083	3,083	3,083	3,083	3,083	3,083	3,083	3,083	3,083	3,083	3,083	3,083
Utilities	1,049	1,083	980	809	798	787	741	764	901	1,129	1,163	1,197
Advertising	1,150	1,188	1,075	888	875	863	813	838	988	1,238	1,275	1,313
Insurance	–	–	2,700	–	–	2,700	–	–	2,700	–	–	2,700
Salaries, wages, and benefits	27,404	27,515	27,182	26,627	26,590	26,553	26,405	26,479	26,923	27,663	27,774	27,885
Computer system and E-commerce	1,042	1,042	1,042	1,042	1,042	1,042	1,042	1,042	1,042	1,042	1,042	1,042
Repairs and maintenance	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000
Travel	–	–	150	–	5,000	–	–	–	200	–	–	–
Professional fees	–	–	–	–	–	–	–	–	–	–	–	3,900
Supplies	644	665	602	497	490	483	455	469	553	693	714	735
Loan payments	2,073	2,073	2,073	2,073	2,073	2,073	2,073	2,073	2,073	2,073	2,073	2,073
Other	50	50	50	40	40	40	40	45	50	50	50	50

Actual sales for the last two months, November and December, were \$272,357 and \$315,458. The company’s cash balance as of January 1 is \$74,473. The interest rate on Bluffton Pharmacy’s current line of credit is 8.25 percent, and whatever the pharmacy borrows must be repaid the following month (with interest), even if it must borrow again in that month. The entrepreneurs have established a minimum cash balance of \$15,000.

Questions

- C7-1. Develop a monthly cash budget for Bluffton Pharmacy for the upcoming year.
- C7-2. What recommendations can you offer Angela Crawford and Martin Rodriguez to improve their pharmacy’s cash flow?
- C7-3. If you were Bluffton Pharmacy’s banker, would you be comfortable extending a line of credit to the pharmacy? Explain.

Case 8

United By Blue

Can an Eco-Friendly Apparel Company Afford to Stay Mission Focused in the Face of High Costs?

Brian Linton grew up in Singapore and Japan and, even as a child, was fascinated by water, particularly the ocean. “I was fortunate to travel the world and go to a lot of different beaches,” he says. “I loved all things aquatic and had about 30 fish tanks in my room. These experiences put me in beautiful locations as well as places that were so littered with trash that you couldn’t see the sand. Seeing trash and polluted oceans was especially discouraging for me.” In 2006, while still a student at Temple University, Linton started Sand Shack, a business that sells beach-themed jewelry to stores along the East Coast (and that he still owns). He donated a portion of the company’s sales to nonprofit organizations dedicated to ocean conservation but wanted to “do something that was more concrete and tangible than giving money to nonprofits,” he says.

In 2010, Linton launched United By Blue, an eco-friendly apparel company, with the idea that this business would be different. The name Linton gave his company is inspired by his belief that water unites all of humankind. “The water of the world is what we all need to live,” he says. “It’s what unites everything, and it’s often the most mistreated part of the world.” In fact, people dump an estimated 14 billion tons of trash into the earth’s oceans each year, and Linton wanted to do something about it. Rather than merely give away money that may or may not accomplish worthy environmental goals, United By Blue, which is based in Philadelphia, would associate a tangible environmental action for every sale that it makes. Linton pledged to sponsor cleanups that would remove one pound of trash (which primarily is plastic) from the world’s oceans and waterways for every product that United By Blue sells. “Our cleanups are the bedrock of our company and allow us to engage with thousands of volunteers and inspire participation in the ‘blue’ movement,” he says. So far, the company has hosted nearly 100 beach or waterway cleanups and has removed more than 140,000 pounds of trash.

Two years after starting United By Blue, Linton was analyzing the company’s financial statements and noticed something alarming: Its wholesale gross profit margin had shrunk from 60 percent to just 15 percent, a pattern that was unsustainable. T-shirts are the company’s best-selling products, and customers who believe in the company’s mission are buying them through retailers such as Urban Outfitters, Whole Foods, and other small, independent shops for a retail price of \$29.50. United By Blue sells the shirts to retailers for \$14.50, but some of the company’s larger customers receive discounts and pay less. The environmentally friendly T-shirts, which are produced

in India, cost more to make and package than standard T-shirts because Linton used softer, more expensive slub cotton rather than the traditional jersey cotton that most companies use to make T-shirts. He also insisted on avoiding the use of plastic in any of the company’s packaging because of its negative impact on the environment, choosing instead to use biodegradable packaging made from banana fiber and paper hangtags made from recycled elephant dung that is infused with bluebell flower seeds so that customers can actually plant the tags and grow flowers. The banana fiber wrapping alone costs 50 cents each—50 times the cost of a plastic bag. In addition, each cleanup that United By Blue sponsored costs between \$2,000 and \$5,000, a significant expense for a small company with annual sales of less than \$1 million.

Linton turned to his spreadsheet and calculated that he would have to raise its wholesale price to \$16.50, which in turn would mean that retailers applying the standard markup would charge customers a final price of \$34 for United By Blue T-shirts. He realized that raising the wholesale price to \$16.50 probably would cause two of the company’s largest customers, Urban Outfitters and Whole Foods, which together account for 25 percent of United By Blue’s sales, to drop the shirts. “Large retailers want discounts to maintain [gross profit] margins around 60 percent,” he says. Losing major retailers also would make selling to small, independent shops more difficult as well. “[Having big-name retailers as customers] helped us build legitimacy,” says Linton. If he raised prices, the company’s small retail shops might drop the line as well. If he did not raise prices, he estimated that United By Blue would run out of cash in less than six months. Another option is to reduce the shirts’ cost by using less expensive plastic bags and hangtags and traditional jersey cotton, which also has a negative impact on the environment. United By Blue has 50 cleanup events planned for the upcoming year, and eliminating them would save between \$100,000 and \$250,000. However, all of these changes would go against the company’s mission and the reason that Linton started United By Blue in the first place. “Our cleanups are the bedrock of our company,” he says. “My grand vision is to use the power of business to leave a positive impact on this world.”

Questions

- C8-1. What risks does United By Blue face if Linton raises the prices of its T-shirts? What risks does the company face if it fails to raise its T-shirt prices?
- C8-2. Should Linton abandon United By Blue’s mission as an active, eco-friendly apparel company to lower the cost of the company’s T-shirts? What are risks of taking this approach?

- C8-3. Should United By Blue raise the wholesale price of its T-shirts from \$14.50 to \$16.50? Explain.
- C8-4. If Linton decides to raise the price of United By Blue's T-shirts, what steps should he take to communicate the price increases to the company's retailers and its final customers?

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Case 9

Socedo

Should an Entrepreneur Close or Sell One of His Businesses to Focus on the Other or Split His Time between the Two Companies?

At age 16, Aseem Badshah showed his entrepreneurial prowess by starting a social networking Web site that allowed students to collaborate on their schoolwork outside the classroom. Several years later, when he graduated from the Foster School of Business at the University of Washington, Badshah collaborated with Kevin Yu, whom he met at a University of Washington entrepreneurship event, to launch Uptown Treehouse, a business based in Los Angeles that creates social media campaigns on Facebook, Twitter, LinkedIn, StumbleUpon, and Outbrain for media and product companies, including several large companies such as Microsoft and Guess. Within three years, Uptown Treehouse had grown to seven employees and was generating a profit of \$300,000 on annual sales of \$1.3 million.

While Badshah and Yu, who serves as Uptown Treehouse's chief technology officer, were building the company, they created cloud-based software that searches social media and other Internet sources to generate potential sales leads for companies. "Our algorithms find relevancy in the unstructured nature of social media content," explains Badshah. The software scours various social media outlets for key words that can identify potential customers; companies then start conversations with those potential customers through social media. The product identifies "the right individuals to build relationships with and helps make a connection with them via social media," says Badshah. Uptown Treehouse's clients were so interested in the software that Badshah and Yu launched another company, Socedo, to market the product. "Inspiration hit us when we executed a social media campaign that relied on building personal relationships with potential customers through a sales pipeline rather than just posting content to social networks," says Badshah. "The results of the campaign far exceeded our expectations, and we knew we were on to something. We quickly realized that the technology to identify and engage with potential customers on social media did not exist yet, and Socedo was born." They selected the name for their company by combining the words "social" and "succeed" to create a short name that they considered easily "brandable." Beta tests indicate that 20 percent of the sales leads that Socedo generates for clients are potential customers.

Badshah is torn between his two companies. He could invest his time solely in building Uptown Treehouse. Doing so involves less risk because the company is established, profitable, and growing. Although Uptown Treehouse does not offer as much growth potential as Socedo does, it would require a smaller capital investment over time and would not need as

Badshah could sell or close Uptown Treehouse and devote his time and energy to building Socedo. This option is riskier because Socedo is a high-tech start-up in the early stage; the company also would require Badshah to invest (and raise) much more capital and hire more employees than Uptown Treehouse. However, Socedo offers the potential of much higher returns than Uptown Treehouse because the company sells a software product that is aimed at businesses and that could achieve large volume quickly rather than a customized service the revenue stream of which is limited by the number of clients it can serve.

Badshah could hire a professional manager to run Uptown Treehouse and use the profits it generates to finance Socedo's growth. There is danger in this option, however, that involves tying the two companies together financially. Losing just one client at Uptown Treehouse could have a serious impact on the financing available for Socedo during a time when the start-up is most vulnerable. Badshah also wonders whether the cash that Uptown Treehouse generates would be sufficient to fuel what he expects will be very rapid growth at Socedo.

The final option that Badshah is considering is raising money from equity investors to finance Socedo's growth so that the company can grow quickly. "We have bootstrapped until now and are currently looking for angel financing," he says. "Angel funding will help us accelerate and take advantage of the huge opportunity in front of us." Raising capital would allow Badshah to reinvest the earnings from Uptown Treehouse back into that company to keep it healthy and growing.

Badshah realizes that he is at an entrepreneurial crossroads. He wonders whether handing the leadership of Uptown Treehouse over to a manager will be good for the company's future. Will he regret putting a successful company at risk to take a chance at making a much riskier venture a success? Will he have the time, energy, and capital to build both companies at the same time?

Questions

- C9-1. Which option should Aseem Badshah pursue? Why?
- C9-2. If he chooses to pursue equity investors to finance Socedo's growth, what steps should he take to find investors and convince them to put equity capital into the company?
- C9-3. What advice can you offer Badshah about his decision?

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Case 10

EasyLunchboxes

How Should an Entrepreneur Use Social Media to Market Her Home-Based Business that Sells Lunch Boxes?

Kelly Lester is a talented singer, actress, wife, mother to three daughters, and entrepreneur. Lester started her first company, a business that sold decorative light switch covers, in 1996 when the Web was in its infancy. Even then, Lester saw the power and the marketing potential that the Web provided businesses, particularly small businesses that lack the massive marketing budgets that their larger rivals have. In addition to selling switch plates through retail shops and museum gift stores, she built a Web site, www.switchplates.com, and began selling online. In those days, competition in e-commerce was slim; when users typed the phrase “switch plate” into a search engine, Lester’s Web site was listed first, a benefit that generated significant online sales for her company.

Lester sold the business, and in 2009, with growing daughters, she was inspired to start a second company. “I’m sad when I see what a lot of kids bring to school for lunch,” she says. “I’m even sadder when I see what school districts offer our kids for ‘school lunch.’” All three of her daughters were in school, and Lester always packed healthy lunches for them but found herself spending too much time preparing and packing lunches. “I’m very concerned about my family’s health and nutrition, but as a busy mom, I like to spend as little time as possible in the kitchen,” says Lester. “I’m all about fresh, healthy, and fast.”

When Lester was in school herself, she often packed lunches for her brothers, but that involved tossing a few cheese sandwiches, potato chips, and Oreo cookies into brown paper bags. Lester wanted something better for her children and to pack the same lunch for all three girls “so I didn’t have to think so hard,” she says. She soon found that washing, filling, and packing nine separate containers (three for each girl) with food every weekday was driving her “absolutely insane.” She began searching store shelves for lunchboxes that made organizing easy but found nothing. Web searches proved no more fruitful. “That’s why I created the EasyLunchbox System,” she says.

She began calling plastics manufacturers in the United States, none of whom showed much interest in her idea. Finally, one manufacturer told her that his company could produce a single-lid bento-style (with compartments) plastic lunchbox, but he would first have to create a mold, which would cost \$75,000. Lester formed a company, EasyLunchboxes, and found an international broker, who began contacting plastic manufacturers in China. There she found a company that would produce the lunchbox she had designed for far less than any of the domestic companies could. “I’m a thrifty shopper,” she explains.

Transactions with the foreign supplier did not always go smoothly, however. Lester had to send one of the first shipments back three times because of quality issues and failure to meet

the Food and Drug Administration’s standards. Today, Lester has an independent company test samples of every shipment to make sure they meet all safety standards. The polypropylene plastic used to manufacture the EasyLunchboxes are BPA free, and the cooler bags that keep items in the lunchboxes cold are tested for lead. Because of the time required to ship products from China and unpredictable interruptions in the supply chain, Lester has learned to keep a large inventory of EasyLunchboxes in a warehouse in the United States. On one occasion, the company that manufactures the lunchboxes was closed for three months. “They just shut the power grid off,” says Lester. No one knew when the power would come back on so that the factory could get finish her order. “It was very stressful,” she says.

Lester decided to use the Web as the primary marketing tool for her company. When Lester launched the Web site for EasyLunchboxes, she quickly discovered that the world of e-commerce had changed dramatically. Her company’s Web site did not appear near the top of any of the major search engines. “If computers had crickets,” she says, “we had crickets.” If you’re not on page one of search engines, you don’t exist. Lester, who bills herself as “Mom and CEO” on the site, is determined to generate “buzz” for her company and believes that social media is one of the best tools for accomplishing that. Her primary target customer is a busy mom with children who are in school. She also wants to build a recognizable brand for EasyLunchboxes. The question in her mind is “How do I go about doing that?”

Questions

- C10-1. Do you believe that Kelly Lester’s business is a candidate for reshoring? Explain.
- C10-2. Develop a social media marketing plan for EasyLunchboxes. On which social media should Lester focus her efforts? Why? What specific tactics should she employ in each one of the social media that you recommend?
- C10-3. What steps should she take to transform EasyLunchboxes into a recognizable brand name?
- C10-4. What bootstrap marketing techniques should Lester use to promote her company?

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Chapter 4

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Chapter 13

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Chapter 23

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