

Entrepreneurship and Small Business Management

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Abbreviations

B2B	-	Business-to-Business
B2C	-	Business-to-Consumer
CRM	-	Customer relationship management
EPS	-	Express Personnel Services
EU	-	European Union
FTC	-	Federal Trade Commission
IBM	-	International Business Machines
IFA	-	International Franchise Association
IRR	-	Internal Rate of Return
LIBOR	-	London Inter-Bank Offered Rate
NAFTA	-	North American Free Trade Agreement
NASAA	-	North American Securities Administrators Association
NFIB	-	National Federation of Independent Business
PSED	-	Panel Study of Entrepreneurial Dynamics
RFID	-	Radio Frequency Identification
SBA	-	Small Business Administration
TQM	-	Total Quality Management
UFOC	-	Uniform Franchise Offering Circular
WFC	-	Women's Franchise Committee

Chapter I

Entrepreneurship and Small Business

Aim

The aim of this chapter is to:

- explain the concept of entrepreneurship
- elaborate the facts of running own business
- discuss the methods to be successful in business

Objectives

The objectives of this chapter are to:

- analyse the types of entrepreneurship and benefits thereto
- discuss the success mantra of many small scale businesses
- explain the requisite attitude for becoming an entrepreneur

Learning outcome

At the end of this chapter, you will be able to:

- understand the factors considered for starting a new business
- know the different rewards of entrepreneurship
- discuss the social responsibilities of business

1.1 Introduction

Everyone has dreams of owning their own business. At one time or another, every body gets ideas of their own business, but not able to make it into a reality. Most of the people get great ideas while in the shower, and forget about them after getting out of the shower. The entrepreneur is the person who gets out of the shower and acts on those ideas. However, chances of success will increase, if one thoroughly understands the motive of starting own business.

The main motives for starting a business are:

- Understanding the basic reason for starting a business
- Analyse the type of business in mind
- Understand the skills required for the business
- Personal qualities required to bring up the business
- Strengths and weaknesses as a business owner

1.2 Who are Entrepreneurs?

Entrepreneurs are those individuals who discover market needs and launch new business to meet those needs. They take risk and provide an impetus for change, innovation, and progress in economic life. If a salaried employee comes up with some business idea, they will be rewarded with a specified compensation and there is no ownership risks associated in such case.

Here, let us consider all active owner-managers to be entrepreneurs. The term entrepreneur is not only limited to founders of business firms; but can be applied to the operators of family-owned firms, franchisees, and owner-managers who have bought out the founders of existing firms. This definition excludes salaried managers of larger corporations, even though sometimes described as entrepreneurs, because of their flair for innovation and willingness to accept risk.

One of the examples of entrepreneurial ventures is Sergey Brin and Larry Page, the founders of Google. If success is having your firm's name outstanding, then these two individuals can without question be claimed to be successful. Google has clearly been a phenomenal success, with a total stock value of over \$140 billion at the end of 2006. But while few of us can relate to Brin and Page's level of success, as their experience teaches us that we will never know what is possible until we try.

1.3 What is Small Business?

A neighbourhood restaurant or bakery is clearly a small business, and Toyota is obviously not. But among small businesses also, there is great diversity in size. Small business may convey the impression that the business is unimportant; however, that impression would be totally incorrect.

The significance of small business in today's society is clearly expressed in this quote from Business Week: 'Small businesses produce 14 times as many patents per employee as large companies do, and they are twice as likely to turn those inventions into successes, according to a Congressional report. They account for half of the private gross domestic product, create more than 60% of net new jobs each year, and pay 44.3% of the private payroll.'

Small businesses are defined mainly using criteria as number of employees, sales volume, and value of assets. Size standards are basically arbitrary, adopted to serve a particular purpose.

In a small business, primary attention is given to businesses that are able to meet the following criteria:

- Financing for the business is provided by one individual or a group of individuals.
- Except for its marketing function, the business's operations are geographically localised.
- Compared to the biggest firms in the industry, the business is small.
- The number of employees in the business is less than 100.

1.4 Rewards of Entrepreneurship

Different individuals have varied reasons and motivations to own their own business. In one study, researchers identified 38 different reasons for self-employment. However, the first goal of an entrepreneur should be to create a product or service that makes the world a better place. For the entrepreneur, the organisation should be important than anything else, so that the new venture will never be discouraging. Another reason for becoming an entrepreneur is to make meaning for all their ventures. Although any attempt to identify all the various attractions may be incomplete.

The figure given below summarises some reasons cited by individuals for becoming entrepreneurs. The reasons are later discussed each in turn.

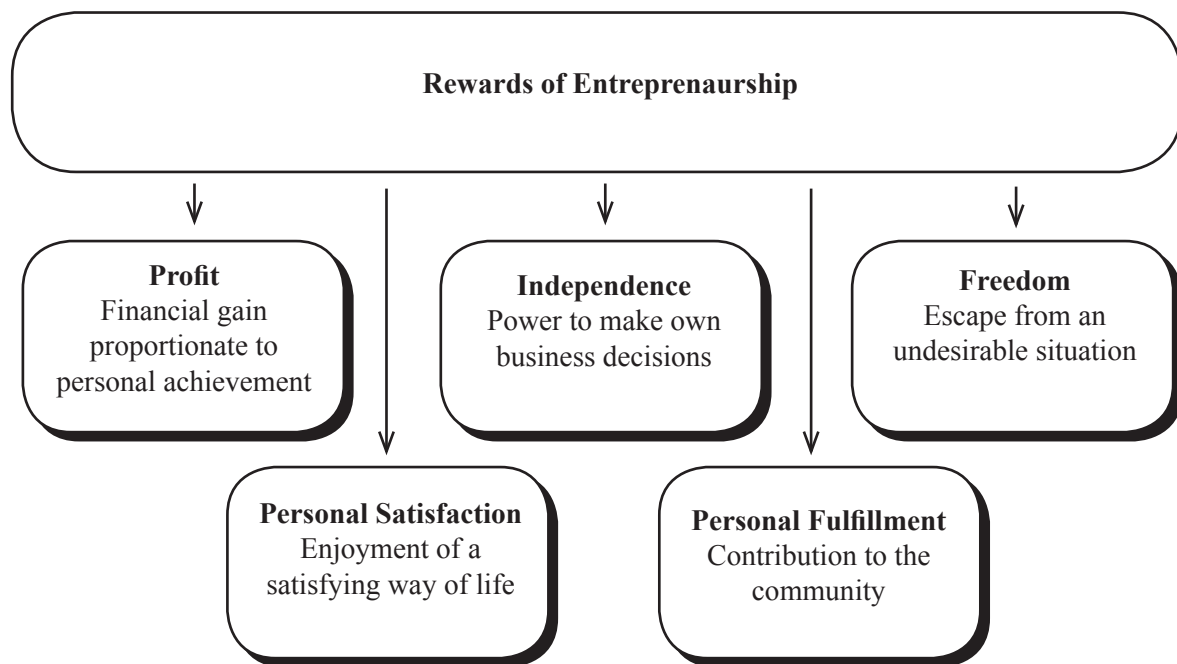


Fig. 1.1 Rewards of entrepreneurship

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

1.4.1 Make Money (Profit)

Like any other job or career, entrepreneurship provides for one's financial needs. Starting one's own business is a way to earn money. Indeed, some entrepreneurs earn lots of money. The self-employed people are generally considered as earning four times more, and are likely to be millionaires than those who work for others.

Some profit is necessary for a firm's survival and an entrepreneur expects in return for starting and running a business. Some entrepreneurs work hard just to have adequate profits to survive, while others receive a modest income for their time and investment. From an economic perspective, the financial return of a business should compensate its owner not only for the investment of personal time (in the form of a salary equivalent), but also for personal money invested in the business (in the form of dividends and increased value of the firm). That is, entrepreneurs should seek a financial return that will compensate them for the time and money they invest and also reward them well for the risks and initiative they take in operating their own businesses.

A significant number of entrepreneurs are highly motivated by the prospect of profits. They have heard the stories about young people who launched dot-com companies and quickly became multimillionaires. While some entrepreneurs do become rich quickly, the majority do not. Instead, the goal should be to get rich slowly. Wealth will come if the business is economically viable and the owner has enough patience and determination to make it happen.

1.4.2 Be Your Own Boss (Independence)

Freedom to operate independently is another reward of entrepreneurship. Its importance is evidenced by the results of one survey of small business owners, in which 38 percent of those who had left jobs at other companies said that their main reason for leaving was that they wanted to be their own boss. Like these entrepreneurs, many people have a strong desire to make their own decisions, take risks, and reap the rewards. Being one's own boss can be an attractive ideal.

The smallest businesses (i.e., part-time businesses and one-person firms), of which there are millions in the United States, probably offer the greatest flexibility to entrepreneurs.

Entrepreneurs always appreciate the independence inherent in their chosen careers. They can do things their own way, reap their own profits, and set their own schedules.

For instance, Karen Taylor started her own public relations firm, Southwest Ink, after working in advertising and public relations much of her career.

Independence does not guarantee an easy life. Most entrepreneurs work very hard for long hours. The basic thing to remember in a business is that the customer is ultimately the boss. But they do have the satisfaction of making their own decisions within the constraints imposed by economic and other environmental factors, including undesirable working conditions.

1.4.3 Escape a Bad Situation (Freedom)

People sometimes use entrepreneurship as an escape hatch, to free themselves from an undesirable situation. Some may wish to leave an unpleasant job situation, while others may seek change out of necessity. Diane D'Agostino-Smith provides one such an example. D'Agostino-Smith was putting in 15-hour days as an oil company executive's assistant. "My work had taken over my life," she said. "I felt like I couldn't even take the 30-minute exercise break my doctor had recommended." When her health began to slip, she knew she had to get out.

After returning to school, she set up a life-coaching practice, to help others to choose new careers. She runs her business out of her home, and values working her own hours. "I took a difficult situation and changed it into something positive for myself and others," she said. "I'm proud of that."

Other individuals become entrepreneurs after being laid off by an employer. Unemployed personnel with experience in professional, managerial, technical, and even relatively unskilled positions often contemplate the possibility of venturing out on their own.

Individuals who have entered business ownership as a result of financial hardship or other severe negative conditions have been described as reluctant entrepreneurs.

Individuals may also flee the bureaucratic environment of a corporation that seems stifling or oppressive to them. Entrepreneurship often provides an attractive alternative for individuals fleeing from such undesirable situations (sometimes called refugees). Take Bob and Cathy Dammeyer, for example. Having become weary of all the travel and meetings associated with their corporate jobs, as well as the politics and bureaucracy, they went into business for themselves, selling Swirl frozen drink distributorships. Three years later, the Dammeyers' company, Culpepper Sales, does several million dollars in business annually. "It rejuvenated us," Cathy said. "We don't worry about corporate minutiae anymore. We only have to satisfy ourselves."

1.4.4 Enjoy a Satisfying Life (Personal Satisfaction)

Entrepreneurs frequently speak of the satisfaction they experience in their own businesses; some even refer to their work as fun. Rick Davis, founder and CEO of DAVACO, says, "There is nothing else I would rather do. I love the challenges, working with others to see our dreams come true, and making a difference in the community. It is fun."

Part of their enjoyment may derive from their independence, but it can also reflect an owner's personal gratification from working with the firm's products and services. Bill Thomas, who bought his first pair of khaki pants at an army surplus store in 1984, sensed a business opportunity when that pair of deep-pocketed World War II uniform pants wore out and he couldn't find another like it. In 1990, he founded Bill's Khakis, which by 2005 had sales of \$9.5 million. Why did he start the business? In his words, 'I felt like I had such a great opportunity to start a business, and it was thanks in part to the generation I was trying to celebrate—my father's generation'.

Most small business owners report satisfaction in their careers. In a poll conducted by the National Federation of Independent Business, small employers rated the level of their personal satisfaction on average as 8 on a scale of 1 (extremely dissatisfied) to 10 (extremely satisfied).¹⁸ A majority (51 percent) also indicated that they spend most of their time doing what they like to do best. The reward can be a pleasurable activity, enjoyable associations, respect in the community, and other aspect of the business. For many entrepreneurs, the life satisfaction they receive is much more important than money or independence.

1.4.5 Contribution to Community (Personal Fulfilment)

Some people are drawn to entrepreneurship by their desire to do good things, to give some positive contribution to their communities. In many cases, this impulse is merely one element in a mix of motivations. In some endeavours, however, it is a particularly strong force behind the thinking of the entrepreneur.

Trey Moore and Cameron Powell (one of the "three success stories" described at the beginning of the chapter) provide a great example of entrepreneurs who want to make a difference in the lives of pregnant women and their babies. As you will recall, their product, Airstrip OB, allows obstetricians to track a mother's labour contractions and her baby's heart rate without having to be at the hospital. If proved effective, it will no doubt reduce the risk during a woman's labour.

1.4.6 Special Niche

If a small business can find a special niche of some type, it competes with great strength in that area. The niche consists of a uniquely specialised service or product, and focus on serving a particular geographical area. After finding a special niche, a small business may avoid intense competition from large corporations.

Lowe's Supermarkets of Littlefield, Texas, provides an example of a family business that followed this path to business success. In 1964, Roger Lowe, Sr., and his father purchased a small supermarket in Olton, Texas. The family business shifted to the next generation in 1973, when Roger Lowe, Jr., joined the firm as vice president and CEO following the death of his grandfather. The business gradually expanded to 58 stores by adding supermarkets, mostly in small rural towns of West Texas and New Mexico. In many towns, Lowe's faces no local competitor. In few locations where it competes with large chains like Wal-Mart, Lowe's Supermarket distinguishes itself by offering product selections to the unique local and ethnic tastes of the neighbourhood population.

1.5 Characteristics of Successful Entrepreneurs

There is no well defined entrepreneurial profile as individual entrepreneurs differ greatly from each other. Knowing this should encourage you if you wish to start your own business. You do not need to fit some prescribed stereotype.

Some qualities, however, are common among entrepreneurs and probably contribute to their success. One of these characteristics is a strong commitment or passion for the business. It is an attitude that results in tenacity in the face of difficulty and a willingness to work hard. Entrepreneurs do not give up easily.

Such individuals are typically confident of their ability to meet the challenges confronting them. This factor of self-confidence was described by psychologist J. B. Rotter as an internal locus of control, and a feeling that success depends on one's own efforts. In contrast, an external locus of control reflects an attitude of dependence on luck or fate for success.

Entrepreneurs are often risk takers. By investing their own money, they assume financial risk. If they leave secure jobs, they risk their careers. The stress and time required to start and run a business may place their families at risk. Even though entrepreneurs assume risk, they are moderate risk takers who accept risks over which they have some control, rather than extreme risk takers, who accept outcomes depending purely on chance.

Timmons and Spinelli have summarised research on entrepreneurial characteristics. They group what they describe as “desirable and acquirable attitudes and behaviours” into the following six categories:

- **Commitment and determination:** Tenacious, decisive, and persistent in problem solving.
- **Leadership:** Self-starters and team builders and focus on honesty in their business relationships.
- **Opportunity obsession:** They are aware of market and customer needs.
- **Tolerance of risk, ambiguity, and uncertainty:** They are risk takers, risk minimisers, and uncertainty tolerators.
- **Creativity, self-reliance, and adaptability:** Open-minded, flexible, uncomfortable with the status quo, and quick learners.
- **Motivation to exceed:** Goal oriented and aware of their weaknesses and strengths.

1.6 Varieties of Entrepreneurship

Entrepreneurship is marked by diversity, as there is great variety both in the people and in the firms termed entrepreneurial. As a potential entrepreneur, one can be encouraged by this diversity; and do not need to fit some narrow stereotype.

1.6.1 Founder Entrepreneurs versus Other Business Owners and Franchisees

They are considered to be “pure” entrepreneurs, as founders may be inventors who initiate businesses on the basis of new or improved products or services. They can be artisans who develop skills and then start their own firm. They can also be enterprising individuals, often with marketing backgrounds, who draw on the ideas of others in starting new firms. Whether acting as individuals or as part of a group, founders bring firms into existence by surveying the market, raising funds, and arranging for the necessary facilities.

After a new firm is established, it may be purchased or taken over by a second-generation family member or another entrepreneur who acts as administrator of the business. These “second-stage” entrepreneurs do not differ greatly from founding entrepreneurs in the way they manage their businesses. Sometimes, their well-established small firms grow rapidly, and their orientation may be more similar to that of a founder than of a manager. Nevertheless, it is helpful to distinguish between entrepreneurs who found or substantially change firms (the “movers and shakers”) and those who direct the continuing operations of established firms.

Another category of entrepreneurs comprises franchisees. Franchisees differ from other business owners in the degree of their independence. Because of the constraints and guidance provided by contractual relationships with franchising organisations, franchisees function as limited entrepreneurs.

1.6.2 High-potential Ventures versus Attractive Small Firms and Micro-businesses

Small businesses differ drastically in their growth potential. According to the researcher Bhidé, promising start-ups are those with the potential for attaining significant size and profitability, where marginal start-ups lack such prospects. The few businesses that have glowing prospects for growth are high potential ventures, or gazelles. Within this group, there is variation in styles of operation and approaches to growth. Some are high-tech start-ups: the kind that once made Silicon Valley in California famous. The success stories often feature a technology wizard with a bright idea, backed by venture capitalists eager to underwrite the next Microsoft.

When such companies prosper, they usually grow at blinding speed and make their founders wealthy by being sold or going public. In contrast to such high-potential ventures, attractive small firms offer substantial financial rewards for their owners. They represent a strong segment of small businesses, which is solid, healthy and which can provide rewarding careers.

The least profitable types of firms, including many service firms such as dry cleaners, beauty shops, and appliance repair shops, which provide only very modest returns to their owners. These micro-businesses and their distinguishing feature is their limited ability to generate significant profits. Entrepreneurs, who devote personal effort to such ventures, receive a profit more than what is expected. Many businesses of this type are also called lifestyle businesses because they permit an owner to follow a desired pattern of living, even though they provide only modest returns. Businesses of this type do not attract investors.

1.6.3 Artisan versus Opportunistic Entrepreneurs

Because of the different backgrounds, entrepreneurs display differences in the degrees of professionalism and in the management styles in their businesses. The ways in which they analyse problems and approach decision making may differ radically. Norman R. Smith has suggested two basic entrepreneurial patterns, exemplified by artisan (or craftsman) entrepreneurs and opportunistic entrepreneurs.

According to Smith, the education of the artisan entrepreneur is limited to technical training. Such entrepreneurs have technical job experience, but lack good communication skills and managerial training. Artisan entrepreneurs' approach to business decision making characterised by the following features:

- They are paternalistic as they guide their businesses much as they might guide their own families.
- They are reluctant to delegate authority.
- They use few (usually only one or two) capital sources to create their firm.
- They define marketing strategy in terms of the traditional components of price, quality, and company reputation.
- Their sales efforts are primarily personal.

Their time orientation may be short, with little planning for future growth or change.

A mechanic who starts an independent garage, a beautician who operates a beauty shop or a painter who opens a studio is an example of an artisan entrepreneur.

In contrast to the artisan entrepreneur, an opportunistic entrepreneur is one who has supplemented his or her technical education by studying such nontechnical subjects as economics, law, or history. Opportunistic entrepreneurs avoid paternalism, delegate authority as necessary for growth, employ various marketing strategies and types of sales efforts, obtain original capitalisation from more sources, and plan for future growth. An example of an opportunistic entrepreneur is a small building contractor and developer who adopt a relatively sophisticated approach to management, which includes careful record keeping and budgeting, precise bidding, and systematic marketing research.

Smith's description of entrepreneurial styles illustrates two extremes:

- At one end is a craftsperson in an entrepreneurial position
- Next is a well-educate and experienced manager.

1.6.4 Women Entrepreneurs

Although entrepreneurship and business in general have been male dominated for decades, the scene is changing rapidly. Between 1997 and 2006, growth in the number of women owned firms was nearly twice that of all U.S. firms (42.3 percent vs. 23.3 percent). As of 2006, there were an estimated 7.7 million women-owned firm, accounting for 30 percent of all businesses in the United States. In 2006, women-owned firm in the United States generated \$1.1 trillion in annual sales and employed 7.2 million people nationwide.²¹ while revenues generated by companies owned by women are still small relative to those of businesses owned by men, women-owned businesses make a significant contribution to the U.S. economy.

The largest share of women-owned firm is in the service sector. More than two-thirds of women-owned firm provide services. An additional 14 percent are in retail trade, and 8 percent are in real estate sales, rental, and leasing. From 1997 to 2006, the greatest growth among women-owned firm was found in the following sectors:

- Wholesale trade (283 percent growth)
- Healthcare and social assistance services (130 percent growth)
- Arts, entertainment, and recreation services (116 percent growth)
- Professional, scientific, and technical services (83 percent growth)

Women who starts firm in non-traditional industries are with ambitious plans for growth and profit. Faced with losing the family farm, Elaine J. Martin started her Nampa, Idaho-based highway construction project company, MarCon Inc., in 1985. To help her get started, Martin's mother put up a \$25,000 certificate of deposit as collateral so that she could borrow \$25,000. At the time, Martin had no construction background. While looking for construction work, she heard about the Idaho Department of Transportation's highway fencing needs. Since she had been raised on a farm and knew how to build fence, she started bidding for highway work. To she went to the state library to study fencing and highway management and, thus, improved her chances. She eventually modified the business by getting into guardrail construction. Today, Martin runs a \$6-million business in a male-dominated industry. In 2002, she was named the Idaho Small Business Person of the Year.

Female entrepreneurs often face problems that are common to all entrepreneurs. However, they must also contend with difficulties associated with their newness in entrepreneurial roles. Lack of access to credit has been a common problem for women who enter business. This is a troublesome area for most small business owners, but women often carry the added burden of discrimination.

Another barrier for some women is the limited opportunity for business relationships with others in similar positions. It takes time and effort to gain full acceptance and to develop informal relationships with others in local, male-dominated business and professional groups.

These conditions have improved in recent years, as women have assumed strong entrepreneurial roles. In a panel discussion of the issue, some women entrepreneurs emphasised the improved business climate, as Cristi Cristich, founder of Cristek Interconnects, Inc. (a maker of connectors and cabling for medical and military applications in Anaheim, California): "Access to capital and the acceptance of women in the workplace and as business owners has improved dramatically over the past 15 years."

Shari L. Parrack, president of Texas Motor Transportation Consultants (a professional registration, tax, and title service company in Houston, Texas): "In 2003, I find that being female does nothing but help me to grow my business. What was once a negative has become a positive?"

Terrie Jones, CEO and owner of AGSI (a provider of Internet technology resource solutions in Atlanta, Georgia): "In 22 years, I've seen the business world evolve tremendously. In a similar way businessmen helped their 'fraternity brothers' in the past, they are more willing to help women today."

Women are definitely making inroads into the entrepreneurial world, and the trend will only accelerate in the future.

1.6.5 Entrepreneurial Teams

Entrepreneurial teams are becoming increasingly common, particularly in ventures of any substantial size. An entrepreneurial team consists of two or more individuals who combine their efforts to function in the capacity of entrepreneurs. In this way, the talents, skills, and resources of two or more entrepreneurs can be concentrated on one endeavour.

1.7 Integrity and Entrepreneurship

Today there are a lot of stories in the news media concerning insider trading, fraud, and bribery usually involve large corporations. In the less-publicised day-to-day activities of small businesses, decision makers regularly face ethical dilemmas and temptations to compromise principles for the sake of business or personal advantage. This strikes at the heart of integrity.

1.7.1 What is Integrity?

The seeds of corporate misdeeds are formed when individuals compromise their personal integrity, as they do not do what they believe to be right and proper. Some acts, such as cheating on taxes, clearly violate this standard, while others are more subtle but just as inappropriate. For example, one entrepreneur who owned a flooring sales business often sold sheets of linoleum at first-quality prices, even though they were graded as “seconds” by the factory. To hide his deception, he developed an ink roller that changed the factory stamp from “SECONDS” to read “SECONDS TO NONE!” Those who caught the inaccuracy probably figured it was a typo never turned back, but unsuspecting customers were paying for first-quality flooring, only to receive imperfect goods. By anyone’s measure, this shady business practice reveals a lack of integrity on the part of the entrepreneur.

The entrepreneurial experience is satisfying, when the entrepreneur understands that the core purpose of the business is to create value for interested customers. This perspective makes clear that relationships are critical and integrity is essential to success. Money is important, but it cannot be the only goal of interest. Excessive focus on financial gain can quickly lead to distortions in business behaviour; and is certainly the root cause of many ethical failings.

If lapses in integrity are discovered, quickly make the headlines when they involve large, high-profile corporations, but the problem does not end there. Small business owners and managers confront situations every day that require them to make ethical decisions. They must decide which course of action will preserve the integrity of the company and safeguard its reputation, a decision that can be especially difficult when doing the right thing runs counter to the immediate financial interests of the business.

1.7.2 Frame Work of Integrity

In order to pinpoint the types of ethical issues that are most troublesome for small companies, small business owners nationwide were asked the following question: “What is the most difficult ethical issue that you have faced in your work?”

These responses provide a general idea of the kinds of issues that challenge the integrity of small business owners. The issues mentioned most often are related to customers and competitors. The second most common category is concerned with the way a company treats its employees, including decisions about layoffs, workplace discrimination, and fairness in promotions. This set of issues received almost as many responses as the first should not be surprising, given the challenges of the current economic climate. This category was near the bottom of the list when entrepreneurs responded to the same survey six years earlier and now times have changed.

The third category is related to the obligations of employees to their employers, focusing on the actions of personnel that may not align with the best interests of their companies. In the fourth place are management processes and relationships. Management relationship issues can be especially disturbing because they reflect the moral fiber or culture of the firm, including weaknesses in managerial actions and commitments.

The entrepreneurs must consider the interests of a number of groups when making decisions, such as owners (or stockholders), customers, employees, the community, and the government. The individuals in these groups are sometimes referred to as stakeholders, indicating that they have a stake in the operation of the business. In essence, stakeholders are those who either can affect the performance of the company or are affected by it.

Because the interests of various stakeholder groups are different, they sometimes conflict; thus, decisions can be very difficult to make. And since there is often no obviously right or wrong position to take, managing the process can be extremely complicated.

1.7.3 Social Responsibility and Small Business

To most people, an ethical business is one that not only treats customers and employees honestly but also acts as a good citizen in its community. These broader obligations of citizenship are called social responsibilities.

Some considers social responsibility as a price of freedom to operate independently in a free economy. They believe that the public has certain social expectations regarding business behaviour, not all of which are required by law. They regard some socially responsible expenditure as proper, even when they are costly.

Companies have increasingly been accepting responsibility to the communities where they do business. Their contribution starts with creating jobs and adding to local tax revenues, but many entrepreneurs feel a duty to give back even more to the community in return for the local support they enjoy and they usually benefit from increased goodwill as a result. It is important that opinions differ and businesses are obligated to engage in socially desirable activities, and the response of small businesses to those obligations also varies. Some emphasise environmentalism, minority contracting, or regional economic development, while others focus their attention on volunteerism, generosity, or even day care for employees 'dependents. Still others give only minimal attention to peripheral social issues.

1.7.4 Governmental Laws and Regulations

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

One glaring example of unethical behaviour by small firm management is fraudulent reporting of income and expenses for income tax purposes. This conduct includes skimming that is, concealing some income as well as improperly claiming personal expenses as business expenses. It does not imply that all or even most small firm engage in such practices. However, tax evasion does occur within small firm, and the practice is widespread enough to be recognised as a general problem.

The Internal Revenue Service regularly uncovers cases of income tax fraud. For example, the John E. Long family, the largest promoter of country folk art shows in the nation, was forced to pay millions in back taxes, and four members of the family were given prison terms for tax law violations. The Longs did not record the cash they collected for admission to their shows. Instead, they deposited into corporate accounts and received from such sources as booth rentals and magazine sales. Unfortunately for the Longs, the IRS discovered 2,000 unreported deposits that members of the family made into 37 different accounts. The Longs had reported that their business was losing money when, in fact, it was doing very well.

The IRS finds many violations like the Longs' every year. However, tax avoidance can be much less flagrant, though nonetheless illegal, and entrepreneurs sometimes come up short on their tax commitments because of casual accounting systems, single-minded focus on their product or service, or both. One student entrepreneur confesses that he had a close brush with the law because he and his friends were creating clothing in his dorm room and selling it on his campus, but the company did not legally exist and he was not keeping track of sales and expenses because he didn't take seriously the obligations and advantages of keeping good records.

Summary

- Entrepreneurs are those individuals who discover market needs and launch new business to meet those needs.
- Different individuals have varied reasons and motivations to own their own business. In one study, researchers identified 38 different reasons for self-employment.
- Freedom to operate independently is another reward of entrepreneurship.
- Starting one's own business is a way to earn money.
- People sometimes use entrepreneurship as an escape hatch, to free themselves from an undesirable situation.
- Entrepreneurs frequently speak of the satisfaction they experience in their own businesses; some even refer to their work as fun.
- Some people are drawn to entrepreneurship by their desire to do good things, to give some positive contribution to their communities.
- Entrepreneurship is marked by diversity, as there is great variety both in the people and in the firms termed entrepreneurial.
- The largest share of women-owned firm is in the service sector.
- The seeds of corporate misdeeds are formed when individuals compromise their personal integrity, as they do not do what they believe to be right and proper.
- An ethical business is one that not only treats customers and employees honestly but also acts as a good citizen in its community.
- Companies have increasingly been accepting responsibility to the communities where they do business.

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Self Assessment

1. Which of the following is not a main motive for starting a business?
 - a. Understanding the basic reason for starting a business
 - b. Analyse the type of business in mind
 - c. Understand the investments required for the business
 - d. Personal qualities required to bring up the business
2. Entrepreneurs are those individuals who discover _____ needs and launch new business to meet those needs.
 - a. market
 - b. individual
 - c. manufacturer
 - d. consumer
3. _____ are defined mainly using criteria as number of employees, sales volume, and value of assets.
 - a. Integrities
 - b. Small businesses
 - c. Niches
 - d. Franchisees
4. _____ has suggested two basic entrepreneurial patterns.
 - a. Norman R. Smith
 - b. Roger Lowe
 - c. Trey Moore
 - d. Cameron Powell
5. Some _____ is necessary for a firm's survival and an entrepreneur expect in return for starting and running a business.
 - a. tax
 - b. profit
 - c. investment
 - d. joint venture
6. In a small business, which of the following is not a criterion for businesses attention?
 - a. Financing for the business is provided by one individual or a group of individuals.
 - b. Except for its marketing function, the business's operations are geographically localised.
 - c. Compared to the biggest firms in the industry, the business is small.
 - d. The number of employees in the business is less than 500.
7. Which of the following is not a reward of entrepreneurship?
 - a. Profit
 - b. Dependence
 - c. Freedom
 - d. Personal satisfaction

8. Which of the following statements is false?
- The self-employed people are generally considered as earning four times more, and are likely to be millionaires than those who work for others.
 - Some entrepreneurs work hard just to have adequate profits to survive, while others receive a modest income for their time and investment.
 - From an economic perspective, the financial return of a business should compensate its owner not only for the investment of personal time, but also for personal money invested in the business.
 - A few entrepreneurs are highly motivated by the prospect of profits.
9. Which of the following statements is true?
- Freedom to operate independently is another reward of entrepreneurship.
 - Independence guarantees an easy life.
 - The basic thing to remember in a business is that the entrepreneur is ultimately the boss.
 - The customer is the person who gets out of the shower and acts on those ideas.

10. Match the following.

1. Entrepreneurs	A. No. of employees in business <100
2. Small business	B. Discover market needs
3. Reward of entrepreneurship	C. Part-time businesses and one-person firms
4. Smallest businesses	D. Independence

- 1-A, 2-D, 3-B, 4-C
- 1-C, 2-D, 3-B, 4-A
- 1-B, 2-A, 3-D, 4-C
- 1-C, 2-B, 3-D, 4-A

Chapter II

The Right Small Business

Aim

The aim of this chapter is to:

- enumerate business objectives
- examine personal objectives
- identify business start up ideas

Objectives

The objectives of this chapter are to:

- analyse how business ideas can get converted to successful business
- explain different business ideas
- discuss the conversion of hobbies to business

Learning outcome

At the end of this chapter, you will be able to:

- explore ways to achieve innovative business ideas
- know the sources of start up ideas
- apply innovative thinking to business ideas

2.1 Introduction

To find right small business to meet your individual strengths, needs, and goals has two components:

- What kind of business is to be started?
Many people who want to start a small business have a pretty good idea of what type of business they want to own. But some only have a general idea, while others don't have any idea at all.
- Should you buy an existing business rather than build from the ground up?
A business or franchise that is already operating can save time and sometimes, money. This brings us at the helm of the question that this chapter discuss about that what or which can be the right small business?

2.2 Examining Your Personal Objectives

Begin with examining why you want to start a business. People come to business ownership for a variety of reasons. They want to “be their own boss”, “follow the American dream”, “earn lot of money”. It is necessary to look closely at why you want to start and run a business and know the motivating factors.

There seems to be two schools of thought regarding business ownership:

- Choose a business with great profit potential
- Choose a business that is of your interest

If profit is your motivation, a business must be able to cover all of its costs, pay for all of its expenses, cover the owner's personal financial needs and have enough net revenue left to allow the business to grow. Another consideration is whether this business provides with a full income or supplements your current income. Before going much further, it is necessary to look at what your personal financial needs are. A personal monthly expense worksheet should be designed to help you to determine your total living expenses as well as your ‘owner equity’ or ‘draw’ .i.e., the cash to be paid out worksheet for your business.

If the business is out of motivation, try to analyse that a market is found according to your dream. It's very important to determine the profitability of your business before you devote time and money to its development.

A successful business allows making a profit while doing work that is enjoyable. With careful research and planning you can develop a business that fills a need, brings you pleasure and pride, and earns enough revenue to meet your personal needs, pay for itself, and provide profits for future growth. The key words here are research and planning. Continue with some research into what you, the owner, will bring to this business.

2.3 Exploring and Identifying Business/Start-up Ideas

Ideas for new businesses come from many sources. A personal interest can be developed into a business. It is possible to make hobbies, volunteer experience, and leisure activities into business. Any specialised knowledge or skill can be turned into a business. It is possible to write a newspaper column, write a book, present workshops, and conduct seminars in your area of expertise. An understanding of the internet can lead to a business of designing, monitoring and updating Web sites. This same knowledge can be used to retrieve information useful to other businesses. Others demographic studies, databases, market surveys, and information resource lists etc.

A business based on equipment is dependent on technology that can be understood. Examples are video recording and photography of special events. Many new businesses are started by individuals who utilise existing skills from their salaried jobs. Accountants, payroll administrators, technical writers, and computer specialists are examples of employees who have marketable skills that can be developed into service businesses. When companies downsize and outsource, new opportunities arise for entrepreneurs.

Any task or responsibility people don't like to do or don't have time to do can be the basis for a service business. Housecleaning, home repairs, gardening, proofreading, gift purchasing, and furniture refinishing may fill needs in your community. Those ideas are taking classes, apprenticeship, or work in an area dealing with your new field of interest. The other fields are food industry, work at a restaurant, and lot of work associated like supplies ordering, handling deliveries, controlling inventories, handling food, handling invoices and orders etc.

An inventive entrepreneur can develop a new product or improve an existing one. New products are usually spawned out of the imagination. If you can't think of something new, remember that many existing products can be improved upon. A welder designed an improved version of a jack used for levelling mobile homes. He used his creative talent in designing the new jack and his welding skill in manufacturing his product. He has created a double need for his talents. His product is timely, and today he is a busy, happy, and prosperous man.

It is very critical to determine whether an idea for a new business actually represents a good opportunity. Many people have ideas about new products or services that seem like winners, but just because something is a good idea does not mean it is a good opportunity. In fact, those who become infatuated with an idea, sometimes underestimates the difficulty of tapping into market interest. To qualify as a good investment opportunity, a product or service must meet a real market need, such as a problem for which the entrepreneur offers a sensible solution. If consumers are convinced that the benefits of a product or service are worth the price they will have to pay to get it, they will likely want to buy it, assuming they know about it and can afford it. All of these factors are critical. Amar Bhidé, an entrepreneurship expert and professor at Columbia University, put it this way: "Start-ups with products that do not serve clear and important needs cannot expect to be 'discovered' by enough customers to make a difference."

Many popular frameworks highlight important factors to consider when deciding whether a new business idea can lead to a promising business opportunity. Some of the more important features of these approaches follow.

- **Market factors:** The product or service must meet a clearly defined market need; furthermore, the timing must be right. Even when the concept is good, success requires an opportunity that remains open long enough for an entrepreneur to take advantage of it. If the window closes before the enterprise can get established, it is unlikely to survive for long.
- **Competitive advantage:** A competitive advantage exists when a firm offers a product or service that customers perceive to be superior to those offered by competitors. It follows that the business must be able to achieve an edge that can withstand challenges from rival businesses. Many start-ups fail as entrepreneurs do not understand the nature and importance of a competitive advantage.
- **Economic:** The venture has to be financially rewarding, allowing for significant profit and growth potential. Its profit potential must be sufficient to allow for errors and mistakes and still offer acceptable economic benefits. At a minimum, the enterprise must offer a reasonable path to profitability—no business can operate for long when it is losing money. And without adequate growth, the business will not be able to provide sufficient returns to attract investors, if they are ever needed.
- **Management capability:** The fit between entrepreneur and opportunity must be good.
- In other words, a business idea is an opportunity only for the entrepreneur who has the appropriate experience, skills, and access to the resources necessary for the venture's launch and growth.
- **Fatal flaws:** There must be no fatal flaw in the venture, that is, no circumstance or development that could, make the business unsuccessful. John Osher, serial innovator and entrepreneur, estimates that nine out of ten entrepreneurs fail because their business concept is deficient. In his words, "They want to be in business so much that they often don't do the work they need to do ahead of time, so everything they do is doomed. They can be very talented, do everything else right, and fail because they have ideas that are flawed."

2.4 Creating a New Business from Scratch

Several motivations lead you to start a business from scratch rather than pursuing other alternatives, such as buying a franchise or an existing business or joining a family business. They include:

- A personal desire to develop the commercial market for a recently invented or newly developed product or service
- Tap into unique resources that are available, such as an ideal location, new equipment technologies, or exceptional employees, suppliers, and bankers
- Avoiding undesirable features of existing companies, including unfavourable cultures, policies, procedures, and legal commitments
- Wanting the challenge of succeeding (or failing) on your own. Assuming you have sound reasons for considering a start-up, you should still address several basic questions before making the commitment:
 - What are some other types of start-up ideas you might consider?
 - What are some sources for additional new business ideas?
 - How can you identify a genuine opportunity that creates value, for both the customer and the company's owner(s)?
 - How should you refine your business idea?
 - What could you do to increase the odds of success in your business?
 - What competitive advantage could your business have over its rivals?

The entrepreneur's ability to carefully and honestly examine questions such as those above will determine the direction to follow. We will examine the issues raised by these questions later in this chapter.

Criteria	Attractiveness	
	Favourable	Unfavourable
Market factors		
Need for the product	Well identified	Unfocused
Customers	Reachable; receptive	Unreachable; strong loyalty to competitor's product or service
Value created for customers	Significant	Not significant
Market structure	Emerging industry; not highly competitive	Mature or declining industry; highly concentrated competition
Market growth rate	Growing by at least 15% a year	Growing by less than 10% a year
Competitive advantage		
Control over prices, costs, and distribution	Moderate to strong	Weak to nonexistent
Barriers to entry		
Proprietary information or regulatory protection	Have or can develop	Not possible
Response/lead time advantage	Competition slow, nonresponsive	Unable to gain an edge

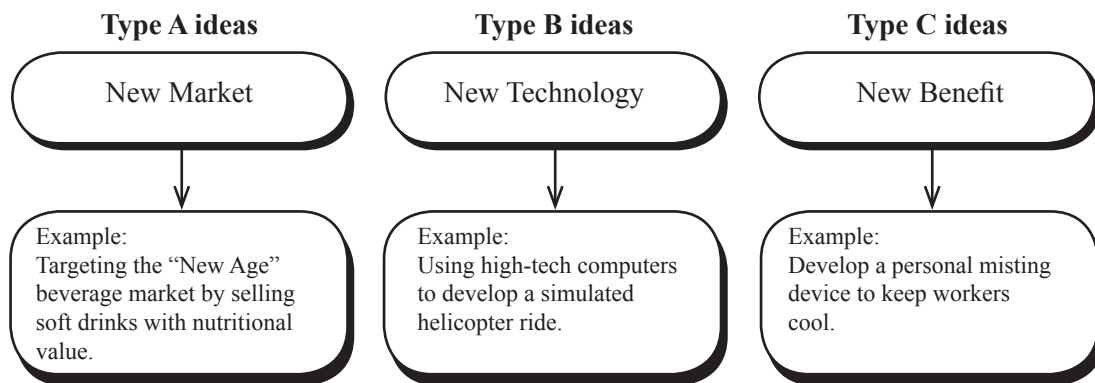
Legal/contractual advantage	Proprietary or exclusive	Nonexistent
Contacts and networks	Well developed; accessible	Poorly developed; limited
Economics		
Return on investment	25% or more; sustainable	Less than 15%; unpredictable
Investment requirements	Small to moderate; easily financed	Large; difficult to finance
Time required to break even or to reach positive cash flows	Under 2 years	More than 4 years
Management capability	Management team with diverse skills and relevant experience	Solo entrepreneur with no related Experience
Fatal flaws	None	One or more

Table 2.1 Selected evaluation criteria for a start-up**2.4.1 Finding Start-up Ideas**

Business ideas are not all equal, and they originate from many different sources. By recognising the nature and origin of start-up ideas, the entrepreneur can broaden the range of new ideas available for his or her consideration.

Types of start-up ideas

The figure given below shows three basic types of ideas that develop into start-ups: ideas to enter new markets, ideas based on new technologies, and ideas to offer new benefits.

**Fig. 2.1 Types of start-up ideas**

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Many start-ups developed from Type A ideas, are those concerned with providing customers with a product or service that does not exist in a particular market. Randall Rothenberg, an author and the director of intellectual capital at consulting powerhouse Booz Allen Hamilton, says that this type of start-up idea may have the greatest potential: "There is ample evidence that some of the biggest businesses are built by taking existing ideas and applying them in a new context." Many small businesses are built on this platform.

Filmmaker Christian D’Andrea was making a documentary on Special Forces when he saw a soldier chomping down an energy bar issued by the United States military, which had been developed specifically to provide the extra boost those in uniform need on the battlefield. D’Andrea recognised an opportunity to take the product, which civilians couldn’t buy, to a whole new market. He and his brother, Mark, signed a deal in 2004 giving them license to use the science behind the product, and they used it to create the Hoorah! Bar, a pick-me-up snack that today sells in thousands of stores and online outlets. Business is good, and growing; in fact, their Los Angeles-based start-up, D’Andrea Brothers LLC, recently expanded its product line to include an energy drink based on the same formulation. With sales poised to cross the \$1 million mark, it is clear that tapping “military intelligence” to take an existing product to the civilian market can yield impressive results.

Very few start-ups are based on Type B ideas, which involve new or relatively new technology. This type of start-up can be high risk because there is usually no model of success to follow, but it can also have tremendous potential. In 1998, Richard Mayer and Malcolm Currie launched Currie Technologies, a Van Nuys, California, venture that produces electric bicycles and scooters. Within five years, the company was employing 40 people and had revenues of \$10 million, but it was only the beginning. With the spike in fuel prices and escalating concerns about global warming, the company’s products make better sense than ever. Perhaps one of Currie’s executives best captured the essence of the business: “Clean, green and no gasoline!”

Type C ideas are those based on offering customers benefits from new and improved ways of performing old functions, probably account for the largest number of start-ups. In fact, most new ventures, especially in the service industry, are founded on “me, too” strategies, as they set themselves apart through features such as superior service or lower prices. Laurie Johnson’s took effort to redefine the common crutch fits into the Type C category.

As founder of LemonAid Crutches, Johnson found a way to take some of the sting out of having to be on crutches after an injury. Her designer crutches were born of experience. While Johnson was recovering from a broken leg sustained in a small-plane crash that took the lives of her husband and two-year-old son, her sister tried to cheer her up some by spray painting her crutches and trimming the handles in fabric. It made her feel better. Deciding to turn life’s lemons into lemonade (hence the name of the company), Johnson decided to run with the concept and help other crutch users feel better, too. In mid-2005, she launched her venture to sell a variety of fashionably functional crutches.

2.4.2 Sources of Start-Up Ideas

There are a number of sources you can turn to for inspiration. And if one source fails to lead to the idea of dreams, its better to keep looking, as inspiration can come from many different places. Several studies have identified sources of ideas for small business start-ups. The figure given below shows the results of one such study by the National Federation of Independent Business (NFIB), which found that prior work experience accounted for 45 percent of new ideas. This finding is consistent with another national study of entrepreneurs, as the Panel Study of Entrepreneurial Dynamics (PSED).

The PSED data also show that entrepreneurs most often consider work experience in a particular industry or market to be the source of their start-up ideas. There are other important sources also. The NFIB study found that personal interests and hobbies represented 16 percent of the total, and chance happenings accounted for 11 percent. Ideas for a start-up can come from virtually anywhere, but we will focus on four possible sources like personal experience, hobbies, accidental discovery, and deliberate search.

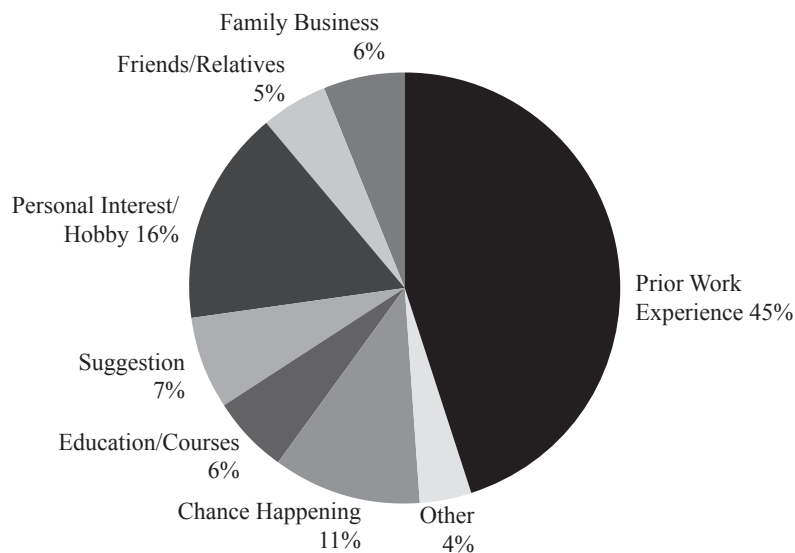


Fig. 2.2 Sources of start-up ideas

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Personal experience

The primary source of start-up ideas is personal experience, either at work or at home. Knowledge gained from a present or former job often allows a person to see possibilities for modifying an existing product, improving a service, or duplicating a business concept in a different location. Personal contacts may open up conversations with suppliers who are interested in working with you or customers who have needs that are not currently being met. These insights may lead you to an opportunity with tremendous potential.

Ken and Jennifer Miller started their outdoor-clothing company, Thousand Mile, based on Ken's personal experience as a lifeguard in Carlsbad, California. The faded swimming trunks of fellow lifeguards inspired Ken and his wife-to-be, Jennifer, to buy material and make 30 pairs of trunks. When the trunks quickly sold to Ken's co-workers, the couple knew their business idea was an attractive start-up opportunity. After several years of development, they now have a complete line of mail-order outdoor wear. Here work experience played a role in the launching of this business, as did close interactions with customers who recognised that Thousand Mile provided a product they could really use.

Hobbies and personal interests

Sometimes hobbies grow beyond being leisure activities and get converted become businesses. For instance, people who love skiing might start a ski equipment rental business as a way to make income from an activity that they enjoy, and those who love books might explore concepts that lead to new bookstore businesses.

Hobbies and personal interests certainly add passion to the start-up process. Kevin Rose was only in his mid-20s when he launched Digg.com in 2004 with two of his buddies, Owen Byrne and Jay Adelson, but his company is off to a fast start. The former UNIX administrator and TechTV personality found inspiration for his company in Slashdot, the wildly popular, community-driven tech news website. Rose described himself as "a big fan" of Slashdot, but he concluded that the website was missing out by restricting the participation of users.

He believed that the user community have complete control of content. This concept that led to the launch of Digg: "a site where users could submit stories that fall into a general queue, and if they were popular enough and if they got enough 'diggings' which are user endorsements, and would be promoted to the home page for everyone to see." This type of "democratic approach to the news" is becoming quite popular, and fast. Generating revenue from advertising is a no-brainer, which plans for expanding the range of features on the site, and it will only enhance the financial performance of the business, which is already a profitable operation with more than 180,000 registered users.

Accidental discovery

Another source of new start-up ideas is accidental discovery which involves something called serendipity, or a gift for making desirable discoveries by accident. Awareness obviously plays a role here, but anyone may stumble across a useful idea in the course of day-to-day living.

This is exactly what happened to Tia Wou, founder of Tote Le Monde, a handbag manufacturer in New York City. Wou had travelled to Bolivia for her friend's wedding in 1989 and loved the rich fabrics she saw in the marketplace. Wou, who was working in fashion at the time, got a creative spark from that trip. A few years later, she travelled to Japan and was on the hunt for the perfect handbag. Not finding what she wanted, Wou recalled the beautiful fabrics in Bolivia. That's when it hit her and she was able to design handbags like the ones she was looking for in Japan, using the materials she'd seen in Bolivia, and sell them in America.

Tote le Monde produces lifestyle brands, selling handbags, house-wares, travel pieces, and personal accessories featuring the company's stylish, environmentally friendly materials. And the entrepreneurial spirit of the business is alive and well, as is Tote le Monde's original mission: "To create innovation where function finds form." While considering the invention of the pocket protector an electrical engineer Gerson Strassberg in 1952. "It happened by accident," Strassberg says. "I was just starting up my company, and we were making the clear plastic covers that cover bankbooks. At that time, ballpoint pens were prone to leaking. One day I cut one side of the plastic longer than the other. The phone rang, so I stuck the plastic in my pocket and thought "Wow, this might make a great product. " Sales for the pocket protector peaked in the late 1960s, but Strassberg still sells close to 30,000 of his nifty "fashion accessories" each year, which now retail at around \$1 apiece.

Deliberate search

Many start-up possibilities emerge from an entrepreneur's deliberate search for new ideas. In fact, this kind of exploration may be especially useful because it stimulates a readiness of mind, and it motivates prospective entrepreneurs to be more receptive to new ideas from any source. A deliberate search often involves looking for change-based opportunities, but it may take a number of other paths.

An eye on change

Change is one of the most important sources of ideas for entrepreneurs. Whereas large firms prefer things to remain the same, entrepreneurs are much more likely to recognise change as an opportunity and to have the creativity and flexibility to adjust to it. Business guru Peter Drucker believed entrepreneurs should consider seven sources of opportunity as they prepare to launch or grow their enterprises, which are explained below.

2.5 Change-Based Sources of Entrepreneurial Opportunities

Drucker suggested that innovation is the means by which the entrepreneur either creates new wealth-producing resources or endows existing resources with enhanced potential for creating wealth. Entrepreneurship harnesses the power of creativity to provide innovative products and services.

Change factor	Definition	Illustration
Industry Factors		
The unexpected	Unanticipated events lead to either enterprise success or failure.	Pet pharmaceuticals have been very successful, with more than 30% of dogs and cats now taking medication.
The incongruous	What is expected is out of line with what will work.	Low-fat ice cream was developed for those trying to lose weight.
Process needs	Current technology is insufficient to address an emerging challenge.	Carmakers offer gas-electric hybrid cars to deal with rising energy costs.
Structural change	Changes in technology, markets, etc., alter industry dynamics.	Growth in the use of the Internet for e-commerce has been dramatic.
Human and economic factors		
Demographics	Shifts in population size, age structure, ethnicity, and income distribution impact product demand.	Many baby boomers are still in their prime income-earning years and are saving for retirement, promoting an increase in the need for financial planning.
Changes in perception	Perceptual variations determine product demand.	Perceived security threats have led to development of gated communities.
New knowledge	Learning opens the door to new product opportunities with commercial potential	Increased knowledge of the Internet has fuelled the growth of online investment firms.

Table 2.2 Change-based sources of entrepreneurial opportunities

Other idea leads

If analysing emerging changes does not reveal the specific entrepreneurial opportunity that is right for you, other sources of leads are available. The following have been useful to many entrepreneurs:

Tapping personal contacts with potential customers and suppliers, professors, patent attorneys, former or current employees or co-workers, venture capitalists, and chambers of commerce Visiting trade shows, production facilities, universities, and research institutes. Observing trends related to material limitations and energy shortages, emerging technologies, recreation, fads, pollution problems, personal security, and social movements.

Reading trade publications, bankruptcy announcements, Commerce Department publications, and business classifieds, Inc., Entrepreneur, My Business, and other periodicals are excellent sources of start-up ideas, as they provide articles on the creativity of entrepreneurs and various business opportunities.

Visiting the library and even looking through the Yellow Pages in other cities can spark new ideas as well. Travelling to other cities to visit entrepreneurs in your field of interest can also be extremely helpful. Of course, the Internet provides an unlimited amount of information regarding the start-up process and even specific opportunities.

2.6 Applying Innovative Thinking to Business Ideas

A creative person can find out useful ideas in many different places. It is important to commit to a lifestyle of creative thinking so that everyday thoughts can work in your favour. Although the following suggestions are designed to help guide your search for that one great idea for a start-up, they can also help keep an existing business fresh, alive, and moving forward.

- When it comes to ideas, borrow heavily from existing products and services or other industries. “Good artists borrow; great artists steal,” said Pablo Picasso or T. S. Eliot or Salvador Dali—no one seems to know for sure. This principle was launched Apple Computer on the road to greatness when its founder Steve Jobs identified technologies that Xerox had developed but was not using. Explore ideas and practices that come across, and think deeply about how you might put them to work in launching a start-up or accelerating the growth of an existing business. Research shows that this is a powerful starting place for innovation.
- Combine two businesses into one to create a market opening. A revolutionary concept is exceptionally practical for patrons. Many times have it would have happened like, rushed through dinner to get to the theatre, only to find that the movie you wanted to see was already sold out. That won’t happen at this Glens Falls, New York, start-up after they combined the restaurant and the theatre. After a leisurely dinner, when the lights begin to dim, sit back in cushioned comfort and enjoy the show. The restaurant business is often ruthless, and the theatre industry is even more competitive, but bringing the two together puts Aimie’s in a unique position.
- At some point, it make sense to start (or buy) more than one business (although not necessarily merging their operations as closely as Aimie’s Dinner and Movie), through a strategy known as diversification. To see how this can work and be advantageous, consider the outdoor lighting company that Derek Norwood and his father have who owned for more than a decade. Their business had done pretty well over the years, but they found that the severe weather in Chicago (where they are located) typically hit their winter revenues hard. Norwood found a bright solution to the problem: He then launched a new company that offers holiday lighting supplies. Now the revenue lag has disappeared, and since many of Norwood’s outdoor lighting customers are buying holiday lighting from him as well, cross-selling advantages are also helping to boost the bottom line. Experts warn, however, that becoming too diversified can sometimes cause an entrepreneur to lose focus, which can drag down performance on all fronts. It clearly pays to think through the pros and cons very carefully.
- Begin with a problem in mind. Bankable business ideas usually address problems that people have. It is sufficient to think about a significant problem, dissect it, chart it out on a sheet of paper, roll it over and over in your mind, and consider possible solutions. Sometimes amazing business ideas will come quickly to mind. For example, so many migratory birds were passing through Texas cities and settling on trees and buildings, becoming a nuisance, and making an incredible mess that they spawned their own pest-control industry. Numerous small companies started up to address this particular problem, using flashing lights, explosions, and even falcons to drive the winged menaces from urban areas. And though the problem is obviously a seasonal one, their services are very much in demand.
- Recognise a hot trend and ride the wave. Fads can lead to serious, though sometimes short-lived, money-making opportunities, but trends provide a much stronger foundation for businesses because they are connected to a larger change in society. Even more powerful is the product or service that builds on three or four trends as they come together. For example, one entrepreneurship expert observed that the iPod’s outrageous success is the result of multiple merging trends: the desire for increased mobility, instant gratification, and customisation, all melded together with the natural pull toward fashion. But if the wave has already crashed on the shore, it is necessary to look for countertrends and every trend has one. For example, even as wireless technologies extend the reach of communication, people pay more to travel to destinations beyond the reach of their Black Berries. To identify a countertrend, make it a habit to ask those who resist a trend (like the coffee drinker who refuses to go to Starbucks) what products or services would appeal to them, and then see what possibilities come to mind. It is necessary to try to set aside your preconceived notions of necessary things and get into the minds of those who resist the flow. Trend can be used as a starting point, you will know better where to look for the countertrend, and that’s where you can get ahead of the game.

- Study an existing product or service and explore ways to improve its function. Products or services that work can be improved so that they work even better. TissueKups is a tissue dispenser shaped so that it fits perfectly in a car cup holder. Lorraine Santoli came up with the seed of the idea in her car after struggling with a tissue box that kept sliding away from her. She knew there had to be a solution, and there was. The company was launched online in 2003 and reached sales of around \$3 million within two years. The simplicity of the product may be its best feature.
- Think of possibilities that would streamline a customer's activities. Many people are busy, so they look for firms that can bear some of the burdens of life for them. That's what keeps businesses like dry cleaner and grocery delivery services going. Take some time to ponder the day-to-day experience of people in the market segment you would like to serve.
- Consider ways to adapt a product or service to meet customer needs in a different way. Darren Hitz realised that bachelor parties could be about more than just serious drinking and exotic dancers. That's when he came up with the idea to launch Adventure Bachelor Party, a company that brings thrills to bachelor parties by taking guys on packaged adventures like white-water rafting trips. The start-up has only been around since 2004, but Hitz already offers over 20 adventures, including cattle herding in Texas and fishing off the California coast. He also provides trips for bachelorette parties. In his words, "I enjoy being able to provide a service where everyone has a great time and is happy."
- Imagine the market for a product or service could be expanded. Jane Silber's 9-year-old daughter had a weight problem, and Silber found that few gyms allow children to use their facilities. Matching this information with the trend toward increased childhood obesity (up 300 percent since 1980), Silber realised that she had identified a wonderful business opportunity. In August of 2006, she opened Generation Now Fitness in Chatsworth, California, to expand the reach of fitness services to tweens and teens. Though this story is focused on one industry, the principle will apply to any market that may be of interest to you.
- It is necessary to keep an eye on new technologies. New technologies often open up potential for start-ups, but only those who take note of the possibilities can reap the rewards. Read widely, talk to industry experts, consult government offices that promote new technologies, go to a nearby research university and visit with faculty who work at the cutting edge of their fields, and there are so many sources of insight available. It is regardless of where you look, be sure to research innovations that have commercial value, particularly for new ventures. Chris Savarese is an avid golfer who wanted to find a way to use new technology to track golf balls hacked off into the rough and high brush. He searched a patent library (a good place to start) and found several possible approaches, but the answer to his question came from a trip to a department store. He observed that the security tags that stores attach to apparel items and other goods and figured they might work for his golf ball concept. Sure enough, they did!
- The radio frequency identification (RFID) technology that keeps track of an item's location (for example, a sweater that a shoplifter might like to walk away with) can also be used as a homing device in golf balls, allowing them to be detected from as far away as 100 feet. Savarese's company, RadarGolf, now packages a dozen radio-tagged balls with a locator to find them for \$250, and the market really likes his innovation. His business is growing 30 percent a year, with revenues about to hit the \$1 million mark. New technology was clearly the key that got the ball rolling for Savarese. It can be encouraged to seek and size up new venture ideas in whatever circumstances you find yourself. Then, by considering a number of internal and external factors, you should be able to bring together the pieces of the opportunity puzzle.

Summary

- If profit is your motivation, a business must be able to cover all of its costs, pay for all of its expenses, cover the owner's personal financial needs and have enough net revenue left to allow the business to grow.
- A successful business allows making a profit while doing work that is enjoyable.
- A business based on equipment is dependent on technology that can be understood.
- Any task or responsibility people don't like to do or don't have time to do can be the basis for a service business.
- An inventive entrepreneur can develop a new product or improve an existing one.
- It is very critical to determine whether an idea for a new business actually represents a good opportunity.
- Several motivations lead you to start a business from scratch rather than pursuing other alternatives, such as buying a franchise or an existing business or joining a family business.
- The primary source of start-up ideas is personal experience, either at work or at home.
- A creative person can find out useful ideas in many different places.

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Self Assessment

1. A successful business allows making _____ while doing work that is enjoyable.
 - a. profit
 - b. investment
 - c. research
 - d. planning

2. A business _____ is an opportunity only for the entrepreneur who has the appropriate experience, skills, and access to the resources necessary for the venture's launch and growth.
 - a. idea
 - b. profit
 - c. venture
 - d. organisation

3. Many start-ups fail as _____ do not understand the nature and importance of a competitive advantage.
 - a. organisations
 - b. entrepreneurs
 - c. individuals
 - d. customers

4. A business based on _____ is dependent on technology that can be understood.
 - a. internet
 - b. equipment
 - c. resources
 - d. inventory

5. Many start-ups developed from _____ ideas, are those concerned with providing customers with a product or service that does not exist in a particular market.
 - a. Type A
 - b. Type B
 - c. Type C
 - d. Type D

6. _____ ideas are those based on offering customers benefits from new and improved ways of performing old functions, probably account for the largest number of start-ups.
 - a. Type A
 - b. Type B
 - c. Type C
 - d. Type D

7. _____ ideas involve new or relatively new technology.
 - a. Type A
 - b. Type B
 - c. Type C
 - d. Type D

8. Which of the following statements is true?
- To qualify as a good investment opportunity, a product or service must meet a real customer need.
 - The primary source of start-up ideas is accidental discovery, either at work or at home.
 - Hobbies and personal interests do not add passion to the start-up process.
 - Without adequate growth, the business will not be able to provide sufficient returns to attract investors, if they are ever needed.
9. Which of the following statements is false?
- A source of new start-up ideas is personal experience which involves something called serendipity, or a gift for making desirable discoveries by accident.
 - Personal contacts may open up conversations with suppliers who are interested in working with customers who have needs that are not currently being met.
 - A deliberate search often involves looking for change-based opportunities, but it may take a number of other paths.
 - Change is one of the most important sources of ideas for entrepreneurs.
10. Match the following.

1. Primary source for business	A. Largest number of start-ups
2. Accidental discovery	B. Serendipity
3. Type B ideas	C. New technology
4. Type C ideas	D. Personal experience

- 1-A, 2-D, 3-B, 4-C
- 1-C, 2-D, 3-B, 4-A
- 1-B, 2-A, 3-D, 4-C
- 1-D, 2-B, 3-C, 4-A

Chapter III

Franchises and Buyouts

Aim

The aim of this chapter is to:

- explain franchising options and structure of the industry
- discuss the benefits of being a franchisee
- illustrate the advantages and disadvantages of a franchise

Objectives

The objectives of this chapter are to:

- understand franchises and buyouts
- identify the business opportunity by opening a franchise
- recognise the methods to acquire an established business

Learning outcome

At the end of this chapter, you will be able to:

- identify major pros and cons of franchising
- describe the process for evaluating a franchise opportunity
- understand the benefits of buying an existing business

3.1 Introduction

Franchises are also known as chain stores. They operate business under a special arrangement. Franchises are moderated industries that follow a set business model, which includes a name, an image, and a set of support services. The buyout process usually begins when an interested purchaser or group of purchasers makes a formal buyout offer to a company's board of directors, who are the representatives of the company's shareholders. Negotiations and tender offers ensue, and the board of directors eventually either recommends that the shareholders sell their shares to the purchaser or discourages the shareholders from doing so.

3.2 Pros and Cons of Franchising

"Look before you leap" is an old adage that should be followed by entrepreneurs considering franchising. Entrepreneurs should not let their enthusiasm blind them to the realities of franchising, both good and bad. Weighing the purchase of a franchise against alternative paths to starting a business is an important task, which requires careful consideration of many factors. The table given below illustrates the major advantages and disadvantages of franchising.

Advantages	Disadvantages
Greater likelihood of success Formalised training Financial assistance Proven marketing methods Managerial assistance Quicker start-up time	Franchise fees Royalties Restrictions on growth Less independence in operations Franchisor may be sole supplier of some supplies Termination/renewal clauses

Table 3.1 Advantages and disadvantages of franchising

Among different personal goals and circumstances of individuals, franchising will not be the ideal choice for all prospective entrepreneurs. However, many people find a franchise to be the best alternative for owning a business. When you are evaluating future entrepreneurial opportunities, it is better to carefully weigh the pros and cons of franchising presented in this chapter. In the current context, a broad definition of franchising is necessary to encompass the term's diversity. Franchising is a marketing system revolving around a two-party legal agreement whereby one party (the franchisee) is granted the privilege to sell a product or service and conduct business as an individual owner, but is required to operate according to methods and terms specified by the other party (the franchisor). For example, Subway (the franchisor) franchises quick-service, fast-food outlets to local owners (franchisees).

3.2.1 Other Advantages of Franchising

Buying a franchise can be attractive for a variety of reasons. The greatest overall advantage by far is the probability of success. Franchisors offer a business model with proven success. Business data on failures of franchises are difficult to find and evaluate. Nevertheless, the success rate for franchises seems to be much higher than that for non-franchised businesses.

One explanation for the lower failure rate is that most franchisors are highly selective when granting franchises. Many potential franchisees who qualify financially are still rejected.

There are three additional, and more specific, reasons why a franchise opportunity is appealing. A franchise is typically attractive because it offers training, financial assistance, and operating benefits that are not readily available to the entrepreneur starting a business from scratch. Naturally, different franchises vary in the depth of support they provide for each of these forms of assistance. For example, McDonald's offers excellent training but no financing.

3.2.2 Training

The training given by franchisors is invaluable to many small entrepreneurs because it compensates for weaknesses in their managerial skills. Training by the franchisor often begins with an initial period of a few days or a few weeks at a central training school or another established location and then continues at a franchise site. McDonald's is widely recognised for its off-site franchisee training effort at Hamburger University.

The training by Kwik Kopy Printing, another famous franchisor, is extensively covering the technical aspects of running a printing business as well as the standard topics of accounting, computer purchasing and use, and leadership. Its training facility, located in the picturesque city of Northwest Forest, a few miles from Houston, Texas, looks like an amusement park, with a full-size replica of the Alamo. However, franchise trainees quickly realise that the three-week training program is very demanding. Classes start at 7:00 A.M. and conclude at 6:00 P.M., Monday through Friday, and they continue for a half-day on Saturday. Express Personnel Services (EPS) is also a strong believer in initial training for prospective franchisees. Consider this description of EPS's new franchisee training system: Franchisees and their staff attend and get benefitted from this intensive three-week start-up training.

Our curriculum involves three levels of learning. Cursory learning that provides an overview of materials. Working knowledge provides thorough understanding without performing tasks and the competency level involves performing the task, through role plays to enhance understanding and retention of knowledge. The first two weeks of learning are held at Express Personnel's international headquarters in Oklahoma City. This allows the students an opportunity to learn and practice the key functions they will be performing within their offices. The students are involved in various role-play scenarios, group exercises and classroom discussions to learn the three pillars of our business:

- Sales
- Recruiting
- Service

The first two weeks of training focus on inside sales, outside sales and business management. Third week allows the new franchisee to perform the major business functions in an Express University certified extension office. These offices are model offices that provide an avenue for the new franchisee to truly acquire live experience prior to their opening week.

3.2.3 Financial Assistance

The costs of starting an independent business are often high, and the typical entrepreneur's sources of capital are quite limited. The entrepreneur's standing as a prospective borrower is weakest at this point. By teaming up with a franchising organisation, the aspiring franchisee may enhance her or his likelihood of obtaining financial assistance.

If the franchising organisation considers the applicant to be a suitable prospect with a high probability of success, it frequently extends a helping hand financially. The franchisee is seldom required to pay upfront the complete cost of establishing the business. In addition, the beginning franchisee is normally given a payment schedule that can be met through successful operation. For example, in the early days of the Jiffy Lube franchise, the franchisor would loan the franchisee funds to purchase the real estate for a store. Also, the franchisor may permit the franchisee to delay payments for products or supplies obtained from the parent organisation, thus increasing the franchisee's working capital.

It is good to get associated with a well-established franchisor may also improve a new franchisee's credit standing with a bank. The reputation of the franchising organisation and the managerial and financial controls that it provides serve to recommend the new franchisee to a banker. Also, the franchisor will frequently co-sign a note with a local bank, thus, guaranteeing the franchisee's loan.

The U.S. Small Business Administration (SBA) has introduced the Franchise Registry (<http://www.franchiseregistry.com>), that expedites loan processing for small business franchisees. The Registry “enables lenders and SBA local office and verifies a franchise system’s lending eligibility through the Internet. This reduces red tape, time, and cost for all concerned.” Listing on this registry means that the SBA has found that the particular franchise agreement does not impose unacceptable control provisions on the franchisee. Therefore, loan applications for registered franchises can be reviewed and processed more quickly.

3.2.4 Operating Benefits

Most franchised products and services are widely known and accepted. For example, consumers will readily buy Baskin-Robbins ice cream or use PIP Printing services because they are aware of the reputation these businesses have.

Travellers will recognise a restaurant or a motel because of its name or type of roof or some other feature such as the “Golden Arches” of McDonald’s. They may turn into a Denny’s restaurant or a Holiday Inn because of their previous experiences with the chain and their knowledge that they can depend on the food and service these outlets provide. Thus, franchising offers both a proven line of business and product/service identification.

An entrepreneur who enters into a franchising agreement acquires the right to use the franchisor’s nationally advertised trademark or brand name. This serves to identify the local enterprise with the widely recognised product or service. Of course, the value of product identification depends on the type of product or service and the extent to which it has been promoted. In any case, the franchisor must maintain the value of its name by continued advertising and promotion.

Franchisors also offer well-developed and thoroughly tested methods of marketing and management. The manuals and procedures supplied to franchisees enable them to function more efficiently from the start. This is one reason of franchisors insist on the observance of high quality methods of operation and performance. If one franchise were allowed to operate at a substandard level, it could easily destroy customers’ confidence in the entire system.

The existence of proven products and methods, however, does not guarantee that a franchise will succeed. For example, a location that the franchisor’s marketing research shows to be satisfactory may turn out to be inferior. Or the franchisee may lack ambition or perseverance. But the fact that a franchisor has a record of successful operation proves that the system can work, because it has worked elsewhere.

3.2.5 Limitations of Franchising

Franchising is like a coin, which has two sides. We have presented the positive side of franchising, but it is important that you also learn about its negative side. Four shortcomings, in particular, permeate the franchise form of business:

- The costs associated with the franchise
- The operating restrictions that can be a part of the franchise agreement
- The loss of entrepreneurial independence
- A lack of franchisor support

3.2.6 Franchise Costs

Higher costs characterise the better known and more successful franchises. Franchise costs have several components, all of which need to be recognised and considered.

- **Initial franchise fee:** The total cost of a franchise begins with an initial franchise fee, which may range from several hundred to many thousands of dollars. The initial fee for a Wing Zone, a takeout/delivery restaurant is \$20,000–\$25,000; McDonald’s initial fee is \$45,000.
- **Investment costs:** Significant costs may be involved in renting or building an outlet and stocking it with inventory and other equipment. Also, certain insurance premiums, legal fees, and other start-up expenses must be paid. It is often recommended that funds be available to cover personal expenses and emergencies for at least

six months. A reputable franchisor will always provide a detailed estimate of investment costs; The table given below shows the information provided by Wing Zone. Curves for Women, a women's workout facility, charges between \$30,000 and \$40,000 for a franchise, workout equipment included. The total net worth requirement for a KFC restaurant exceeds \$1,000,000, and the prospective franchise must have cash and other personal assets worth this amount.

	Low	High
Franchise fee	\$ 20,000	\$ 25,000
Leasehold improvements	50,000	80,000
Equipment (excludes sales tax)	48,000	53,000
Signs	6,000	8,000
Computer P. O.S. system	18000	18,000
Office equipment/phone system	3,000	3,500
Drop safe and lock	1,000	1,500
Digital security system	0	3,000
Initial inventory	4,000	4,000
Start up marketing	3,000	3,000
Grand-opening fund	5,000	5,000
Insurance (down-payment)	3,000	3,500
Initial training expenses	2,000	3,000
Uniforms	1,000	1,000
Utility deposits	1,000	2,500
Architectural plans	5,000	8,000
Real estate cost	4,000	7,000
Working capital	15,000	20,000
Total Investment	\$189,000	\$249,000

Table 3.2 An estimate of investment costs by wing zone

- **Royalty payments:** A common practice is for the franchisor to receive continuing royalty payments, calculated as a percentage of the franchisee's gross income. McAlister's Deli, for example, charges a 5 percent royalty fee. McDonald's currently charges a "service fee" of 4 percent of monthly sales plus the greater of (a) a monthly base rent or (b) a percentage rent based on monthly sales.
- **Advertising costs:** Many franchisors require that franchisees to contribute an advertising fund so as to promote the franchise. These fees are generally 1 to 2 percent of sales or even more. If entrepreneurs could generate the same level of sales by setting up an independent business, they would save the franchise fee and some of the other costs. However, if the franchisor provides the benefits previously described, the money franchisees pay for their relationship with the franchisor may prove to be a very good investment.

3.2.7 Restrictions on Business Operations

Franchisors are concerned about the image of their businesses; make every effort to control how franchisees conduct certain aspects of the franchise business. Thus, the franchisee is restricted in her or his ability to use personal business judgment. The following types of control are frequently exercised by a franchisor:

- Restricting sales territories
- Requiring site approval for the retail outlet and imposing requirements regarding outlet appearance
- Restricting goods and services offered for sale
- Restricting advertising and hours of operation

3.2.8 Loss of Independence

Frequently, individuals leave salaried employment for entrepreneurship because they dislike working under the direct supervision and control of others. But when they enter into a franchise relationship, such individuals may find that a different pattern of supervision has taken over. The franchisee surrenders a considerable amount of independence in signing a franchise agreement.

Even though the franchisor's influence on business operations may be helpful in ensuring success, the level of control exerted may be unpleasant to an entrepreneur who cherishes independence. In addition, some franchise contracts go to extremes, covering unimportant details or specifying practices that are more helpful to others in the chain than to the local operation. For example, a food franchise may be prevented from selling a non-approved product in a local market.

Entrepreneurs should recognise that they can lose the right to a franchise if they do not abide by performance standards or fail to pay royalties. Additionally, there is no guarantee that a franchise will be renewed beyond the contracted time, which is typically 15 to 20 years.

3.2.9 Lack of Franchisor Support

Just like a marriage, a franchisor/franchisee relationship can experience stress, which may lead to a breakup. Perceived lack of franchisor support sometimes creates disputes, especially when the franchisee believes the franchisor is not honouring its commitments. Disputes may revolve around a lack of continued training, poor promotional support, or other issues. Once a communication breakdown occurs between the two parties, the well-being of the franchise is in jeopardy. Entrepreneurs who are considering purchasing a franchise should recognise this inherent disadvantage of franchising.

3.3 Franchising Options

The term franchising was derived from a French word meaning “freedom” or “exemption from duties.” In business, franchising describes a unique type of business option that offers entrepreneurs the possibility of reducing the overall risk associated with buying an independent business or starting a business from scratch. The franchise arrangement allows new business operators to benefit from the accumulated business experience of all members of the franchise system.

The potential value of a franchising arrangement is defined by the rights contained in a legal agreement known as the franchise contract; the rights it conveys are called the franchise. The extent and importance of these rights may be quite varied. When the main benefit the franchisee receives is the privilege of using a widely recognised product name, the arrangement between the franchisor (supplier) and the franchisee (buyer) is called product and trade name franchising. Automobile tire outlets carrying the Goodyear brand name and soft drink bottlers distributing Dr Pepper are both engaged in this type of franchising.

Alternatively, entrepreneurs who receive an entire marketing and management system are participating in a broader type of arrangement referred to as business format franchising. Fast-food outlets (for example, Burger King), hotels and motels (for example, Radisson), and business services (for example, Mail Boxes) typically engage in this type of franchising. The volume of sales and the number of franchise units associated with business format franchising have increased steadily over the years.

A master licensee is a firm or individual which have a continuing contractual relationship with a franchisor to sell its franchises. This independent company or businessperson is a type of middleman or sales agent. Master licensees are responsible for finding new franchisees within a specified territory. Sometimes, they even provide support services such as training and warehousing, which are more traditionally provided by the franchisor. Also gaining widespread usage is multiple-unit ownership, in which a single franchisee owns more than one unit of the franchised business. Some of these franchisees are area developers, individuals or firms that obtain the legal right to open several outlets in a given area.

Piggyback franchising refers to the operation of a retail franchise within the physical facilities of a host store. Examples of piggyback franchising include a cookie franchise doing business inside an Arby's fast-food outlet and a Krispy Kreme donut franchise operating within a Wal-Mart store. A new trend in piggyback franchising is locating walk-in health clinics in Wal-Marts, Target stores, drugstores, and other retail outlets. This form of franchising benefits both parties. The host store is able to add a new product line, and the franchisee obtains a location near prospective customers.

3.4 Structure of Franchising Industry

Franchisors and franchisees are the two main parties in the franchise industry. A franchisor may be a manufacturer or another channel member (a wholesaler or retailer) that has an attractive business concept worthy of duplication. As shown in the figure given below, a franchise can be sold by the franchisor directly to individual franchisees or marketed through master licensees or area developers. Most franchisors also own one or more outlets that are not franchised. These outlets are referred to as company-owned stores.

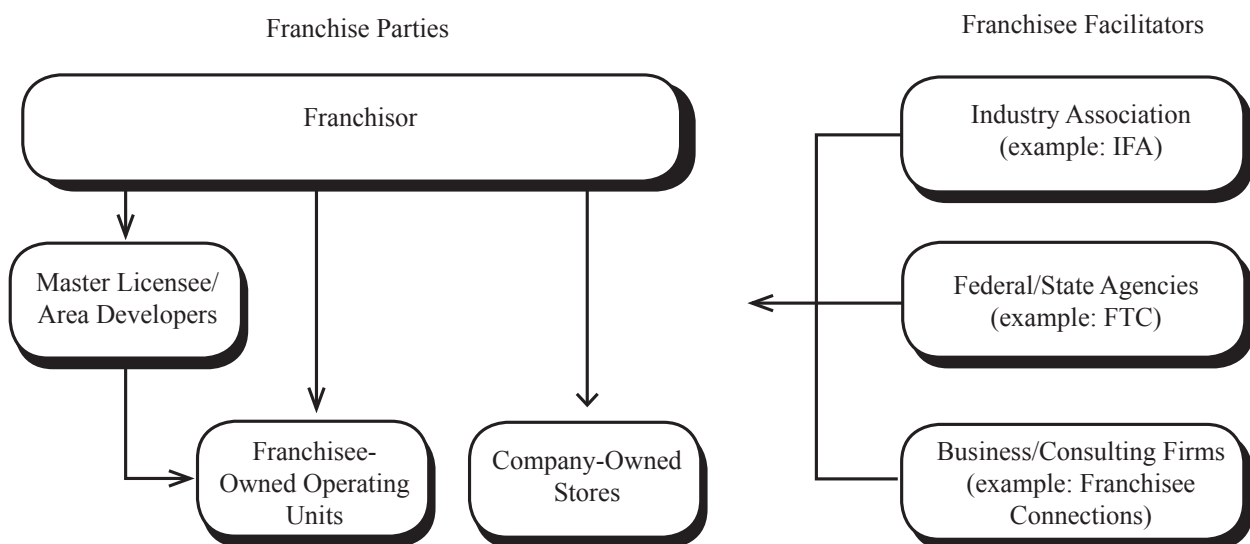


Fig. 3.1 The structure of franchising

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

In addition to these parties, the franchising industry contains other important groups called facilitators. Facilitators include industry associations, governmental agencies and private businesses.

The International Franchise Association (<http://www.franchise.org>), or IFA, is an important industry association that serves franchise members by attempting to safeguard and enhance the business and regulatory environment of the industry. It has over 30,000 members—franchisors, franchisees, and suppliers—that operate in more than 100 countries. Nevertheless, the IFA is highly selective, and not all companies applying for membership are accepted. Referring to itself as “The Voice of Franchising,” the IFA sponsors legal and government affairs conferences, franchise management workshops, seminars on franchisor/franchisee relations, and trade shows. The IFA also champions the causes of minority business groups. For example, the Women’s Franchise Committee (WFC), formed in 1996, provides leadership conferences, mentoring programs, a network of professionals, and other services for women franchisees.

Numerous federal and state agencies are involved in the franchise industry. Agencies such as the Federal Trade Commission (<http://www.ftc.gov>), or FTC, provide information on franchise opportunities and enforce franchising laws and regulations. Presale franchise disclosure practices are subject to special scrutiny by these agencies.

A third category of facilitators includes private businesses providing franchise information and consulting services to franchisors and franchisees. For example, Franchise Connections (<http://www.franchiseconnections.com>) and The Franchise Company (<http://www.thefranchisecompany.com>) are two businesses that assist with franchising evaluation and offer development services.

3.5 Evaluating Franchise Opportunities

After making a decision to pursue a franchising opportunity, the prospective franchisee must identify a franchise candidate and investigate it completely. As we discuss the investigation process, we will continue to use examples involving Wing Zone, a takeout/ delivery restaurant franchise featuring buffalo wings.

3.5.1 Selecting a Franchise

With the growth of franchising over the years, the task of selecting an appropriate franchise has become easier. Personal observation frequently sparks interest, or awareness may begin with exposure to an advertisement in a newspaper or magazine or on the Internet. The headlines of these advertisements usually highlight the financial and personal rewards sought by the entrepreneur. Inc., Entrepreneur, and the Wall Street Journal are three examples of publications that include advertisements of franchisors.

3.5.2 Investigating the Potential Franchise

The nature of the commitment required in franchising justifies careful investigation of information on franchising. Basically, three sources of information should be tapped:

Independent third-party sources of information

- State and federal agencies are valuable sources of franchising information. Since most states require registration of franchises, a prospective franchisee should not overlook state offices as a source of assistance. The Federal Trade Commission publishes the Franchise Opportunities Handbook, which is a useful directory of hundreds of franchisors. Also, a comprehensive listing of franchisors can be found in the Franchise Opportunities Guide, which is published by the International Franchise Association. Launching a franchised business typically requires a substantial financial investment, usually many thousands of dollars. Furthermore, the business relationship generally continues over a period of years.
- The evaluation process is a two-way process. The franchisor wishes to investigate the franchisee, and the franchisee obviously wishes to evaluate the franchisor and the type of opportunity being offered. Time is required for this kind of analysis. It should be sceptical of a franchisor pressurising to sign a contract without time for proper investigation.

The franchisor as a source of information

- Obviously, the franchisor being evaluated is a primary source of information. However, information provided by a franchisor must be viewed in light of its purpose—to promote the franchise.
- One way to obtain information about franchisors is to communicate directly with them. For example, when we decided to investigate the franchise Wing Zone, we first accessed its home page. Request was given for the information, and within a few days packet containing an attractive brochure and various marketing materials reached. The brochure included such information as start-up costs and franchisees' testimonials.
- It is important for potential franchisees that many of the financial figures provided in the franchisor's information packet are only estimates. While profit claims are becoming more common, reputable franchisors are careful not to misrepresent what a franchisee can expect to attain in terms of sales, gross income, and profits. The importance of earnings to a prospective franchisee makes the subject of profit claims a particularly sensitive one.
- After an entrepreneur has expressed further interest in a franchise by completing the application form and the franchisor has tentatively qualified the potential franchisee, a meeting is usually arranged to discuss the disclosure document. A disclosure document is a detailed statement of such information as the franchisor's finances, experience, size, and involvement in litigation. The document must inform potential franchisees of any restrictions, costs, and provisions for renewal or cancellation of the franchise.

Existing and previous franchisees as sources of information

- There is better source of franchise facts than existing franchisees. Sometimes, however, the distant location of other franchisees precludes a visit to their place of business. In that case, a simple telephone call can elicit that person's viewpoint. If possible, talk also with franchisees that left the business; they can offer valuable insights into their decision to give up the franchise.

3.5.3 Finding Global Franchising Opportunities

A great opportunity continues to exist for small business firms in the United States to franchise internationally. Traditionally, U.S. franchisors did most of their international franchising in Canada because of that country's proximity and language similarity. This, however, has changed. A combination of events, including the structuring of the European Union (EU) and the passage of the North American Free Trade Agreement (NAFTA), has opened other foreign markets to U.S. franchisors.

Although the appeal of foreign markets is substantial, the task of franchising abroad is not easy. The challenges of international franchising are described on the website of Gaebler Ventures in the following way: International franchising is more risky than domestic franchising, but there's a world of opportunity out there. Whether you are a franchisor or a franchisee, international franchising could put you on track to achieve your business and personal goals beyond your wildest dreams. But, be sure you understand some of the differences between international franchising and domestic franchising. Unlike domestic franchising, international franchising requires an added level of expertise, primarily around issues involved with doing business in an unfamiliar cultural context.

The good news is that the challenges of international franchising are not insurmountable. Regardless of whether you are a current business owner exploring the possibility of franchising your company internationally or a potential new business owner interested in opening a franchise abroad, you can take advantage of opportunities in international franchising by addressing a few issues upfront.

Many sources of international franchising information are available to entrepreneurs. Many U.S. government publications are helpful, as is the information on several websites, such as that of the International Herald-Tribune. Also, individual foreign countries may host websites that contain useful information about franchising opportunities in that country; the British Franchising Association's site at <http://british-franchise.org> is one example.

3.5.4 Legal Issues in Franchising

Last but not the least, one must consider the legal issues in franchising.

The franchise contract

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

In particular, he or she should discuss the franchise proposal with a banker, going over it in as much detail as possible. The prospective franchisee should also obtain the services of a professional accounting firm in examining the franchisor's statements of projected sales, operating expenses, and net income. An accountant can help in evaluating the quality of these estimates and in identifying projections that may be unlikely to be realised.

One of the most important features of the franchise contract is the condition relating to termination and transfer of the franchise. Some franchisors have been accused of devising agreements that permit arbitrary cancellation of the franchise relationship. Of course, it is reasonable for the franchisor to have legal protection in the event that a franchisee fails to obtain an appropriate level of operation or to maintain satisfactory quality standards.

The prospective franchisee should be wary of contract provisions that contain overly strict cancellation policies. Similarly, the rights of the franchisee to sell the business to a third party should be clearly stipulated. A franchisor who can restrict the sale of the business to a third party could potentially assume ownership of the business at an unreasonably low price. The right of the franchisee to renew the contract after the business has been built up to a successful operating level should also be clearly stated in the contract.

Franchise disclosure requirements

The offer and sale of a franchise are regulated by both state and federal laws. At the federal level, the minimum disclosure standards are specified by Rule 436 of the Federal Trade Commission (FTC). The rule, formally entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," went into effect in October of 1979.

A guide to the rule can be found on the Federal Trade Commission's website at <http://www.ftc.gov/bcp/franchise/netrule.htm>. Addresses of the state offices administering franchise disclosure laws can be found at <http://www.ftc.gov/bcp/franchise/netdiscl.htm>.

A document called the Uniform Franchise Offering Circular (UFOC) provides the accepted format for satisfying the franchise disclosure requirements of the FTC. The original UFOC format was amended in April 1993 by its creator, the North American Securities Administrators Association (NASAA). On January 1, 1996, all franchisors using the UFOC disclosure format were obliged to abide by the new amendments.

The UFOC disclosure must include information on a variety of items, including litigation and bankruptcy history, investment requirements, and conditions that would affect renewal, termination, or sale of the franchise. Most franchise experts recommend that a franchisee's attorney and accountant review the document. Another option for the entrepreneur seeking to make his or her dream a reality is buying an existing business. In the next section, we discuss some of the issues facing the individual who chooses this alternative.

3.6 Buying an Existing Business

For would-be entrepreneurs, one alternative to starting from scratch or buying a franchise is to buy an established business. The decision to purchase an existing business should be made only after careful consideration of the advantages and disadvantages.

3.6.1 Reasons for Buying an Existing Business

The reasons for buying an existing business can be condensed into the following four general categories:

- To reduce some of the uncertainties and unknowns that must be faced in starting a business from the ground up
- To acquire a business with ongoing operations and established relationships with customers and suppliers
- To obtain an established business at a price below what it would cost to start a new business or to buy a franchise
- To begin a business more quickly than by starting from scratch

Reduction of uncertainties

A successful business has already demonstrated its ability to attract customers, manage costs, and make a profit. Although future operations may be different, the firm's past record shows what it can do under actual market conditions. For example, just the fact that the location must be satisfactory eliminates one major uncertainty. Although traffic counts are useful in assessing the value of a potential location, the acid test comes when a business opens its doors at that location. This test has already been met in the case of an existing firm. The results are available in the form of sales and profit data. Non-compete agreements are needed, however, to discourage the seller from starting a new company that will compete directly with the one being sold.

Acquisition of ongoing operations and relationships

The buyer of an existing business typically acquires its personnel, inventories, physical facilities, established banking connections, and ongoing relationships with trade suppliers and customers. Extensive time and effort would be required to build these elements from scratch. Of course, the advantage derived from buying an established firm's assets depends on the nature of the assets. For example, a firm's skilled, experienced employees constitute a valuable asset only if they will continue to work for the new owner. The physical facilities must not be obsolete, and the firm's relationships with banks, suppliers, and customers must be healthy. In any case, new agreements will probably have to be negotiated with current vendors and leaseholders.

A new business owner who fails to carefully consider the nature of the assets may face some unpleasant surprises. Consider the experience of Norman Savage. Shortly after buying a small mortgage company in Fort Wayne, Indiana, Savage learned that the seller had given some employees 20 percent pay increases after the deal was made, effectively buying for himself credit for being a generous boss and leaving the cost of that generosity for Savage to pay. In addition, some of the firm's business licenses were about to expire, and Savage had difficulty locating the necessary documents to renew them. To top it off, one of the office computers needed to be replaced.

On the other hand, Thomas J. Cerri encountered no such problems when he bought Mill Valley Lumber Company in Mill Valley, California. He recalls, "When we took over, eight key employees stayed on with us, and it really made all the difference." The sales staff had nearly 100 years of experience among them and "seemed to be friends with everyone in the area." With a well-connected sales staff and other key employees staying on the job, Mill Valley Lumber continued to enjoy a close relationship with its customers, despite the invasion of giant competitors like Home Depot.

A bargain price

If the seller is more eager to sell than the buyer is to buy, an existing business may be available at what seems to be a low price. Whether it is actually a good buy, however, must be determined by the prospective new owner. Several factors could make a “bargain price” anything but a bargain. For example, the business may be losing money, the neighbourhood location may be deteriorating, or the seller may intend to open a competing business nearby. On the other hand, if research indicates that the business indeed is a bargain, purchasing it is likely to turn out to be a wise investment.

A quick start

Most entrepreneurs are eager to easily jump in their new business and may not be comfortable waiting the months and years sometimes required to launch a business from scratch. Buying an existing business may be an excellent way to begin operations much more quickly.

3.6.2 Finding a Business to Buy

Sometimes, in the course of day-to-day living and working, a would-be buyer comes across an opportunity to buy an existing business. For example, a sales representative for a manufacturer or a wholesaler may be offered an opportunity to buy a customer’s retail business. In other cases, the prospective buyer needs to search for a business to buy.

Sources of leads about businesses available for purchase include suppliers, distributors, trade associations, and even bankers. Realtors particularly those who specialise in the sale of business firms and business properties can also provide leads.

In addition, there are specialised brokers, called matchmakers, who handle all the arrangements for closing a buyout. A large number of matchmakers, such as Certified Business Brokers (<http://www.certifiedbb.com>) in Houston, Texas, deal with mergers and acquisitions of small and mid-sized companies in the United States. Entrepreneurs need to be wary of potential conflicts of interest with matchmakers, however. For example, if matchmakers are paid only if a buy–sell transaction occurs, they may be tempted to do whatever it takes to close the deal, even if doing so is detrimental to the buyer.

3.6.3 Investigating and Evaluating Available Businesses

Regardless of the source of the lead, a business opportunity requires careful evaluation— what some call due diligence. As a preliminary step, the buyer needs to acquire background information about the business, some of which can be obtained through personal observation or discussion with the seller. Talking with other informed parties, such as suppliers, bankers, employees, and customers of the business, is also important.

Relying on professionals

Although some aspects of due diligence require personal checking, a buyer can also seek the help of outside experts. The two most valuable sources of outside assistance are accountants and lawyers. It is also wise to seek out others who have acquired a business, in order to learn from their experience. Their perspective will be different from that of a consultant, and it will bring some balance to the counsel received.

The time and money spent on securing professional help in investigating a business can pay big dividends, especially when the buyer is inexperienced. However, the final consequences of a business purchase, good and bad, are borne by the buyer, and thus the prospective buyer should never leave the final decision to the experts. For one thing, it is a mistake to assume that professionals’ help is either unbiased or infallible, particularly when their fees may be greater if the business is acquired. Prospective buyers should seek advice and counsel, but they must make the final decision themselves, as it is too important to entrust to someone else.

Finding out why the business is for sale

The seller's real reasons for selling may or may not be the stated ones. When a business is for sale, always question the owner's reasons for selling. There is a real possibility that the firm is not doing well or that underlying problems exist that will affect its future performance. The buyer will be different; therefore it is better to take the seller's explanations at face value.

Here are some of the most common reasons that owners offer their businesses for sale:

- Old age or illness
- Desire to relocate to a different part of the country
- Decision to accept a position with another company
- Unprofitability of the business
- Loss of an exclusive sales franchise
- Maturing of the industry and lack of growth potential

A prospective buyer cannot be certain that the seller-owner will be honest in presenting all the facts about the business, especially concerning financial matters. Too frequently, sellers have "cooked the books" or taken unreported cash out of the business.

The only way for the buyer to avoid an unpleasant surprise later is to do his or her best to determine whether the seller is an ethical person. The following story highlights the importance of investigating the honesty of people selling a business:

An employee at a private equity firm (a company that buys or invests in other companies) was responsible for expansion into Eastern Europe. He discovered an opportunity to invest in a manufacturing company that had been formerly owned by the government and recently privatised. The chief executive officer of this company was likable and highly competent. However, as the negotiations carried on for months, it was discovered that the CEO had been convicted of embezzling money from his former employer and had ties to organised crime. In light of this discovery, negotiations with the CEO were terminated immediately.

The important lesson in this story is that background checks on key personnel should be the first action performed when conducting due diligence.

Examining the financial data

The first stage in evaluating the financial health of a firm is to review the financial statements and tax returns for the past five years or for as many years as they are available. This first stage helps determine whether the buyer and the seller are in the same ballpark. If so, the parties move on to the second stage (discussed in the next section) valuing the firm.

To determine the history of the business and the direction in which it is moving the buyer, must examine financial data pertaining to the company's operation. If financial statements are available for the past five years, the buyer can use these to get some idea of trends for the business. As an ethical matter, the prospective buyer is obligated to show the financial statements to others, such as a potential lender or legal advisor, only on a need-to-know basis. To do otherwise is a violation of trust and confidentiality.

The buyer should recognise that financial statements can be misleading and may require normalising to yield a realistic picture of the business. For example, business owners sometimes understate business income in an effort to minimise taxable income. On the other hand, expenses for such entries as employee training and advertising may be reduced to abnormally low levels in an effort to make the income look good in the hope of selling the business.

Other financial entries that may need adjustment include personal expenses and wage or salary payments. For example, costs related to personal use of business vehicles frequently appear as a business expense. Family members may receive excessive compensation or none at all. All entries must be examined to ensure that they relate to the business and are appropriate.

The buyer should also scrutinise the seller's balance sheet to see whether asset book values are realistic. Property often appreciates in value after it is recorded on the books. In contrast, physical facilities, inventory, and receivables may decline in value, so their actual worth is less than their accounting book value. Although these changes in value are generally not reflected in the accountant's records, they should be considered by the prospective buyer.

Valuing the business

Once the initial investigation and evaluation have been completed, the buyer must arrive at a fair value for the firm. Valuing a business is not easy or exact, even in the best of circumstances. Despite the fact that buyers prefer audited financial statements, many firms operate without them. In valuing such firms, the buyer will have to rely on federal tax returns and state sales tax statements. It may also be helpful to scrutinise invoices and receipts of customers and suppliers as well as the firm's bank statements.

Although numerous techniques are used for valuing a company, they are typically derivations of three basic approaches:

- Asset-based valuation
- Market-comparable valuation
- Cash flow based valuation

3.6.4 Non-quantitative Factors in Valuing a Business

There are a lot of factors for evaluating the current business. These factors include:

- **Competition:** The prospective buyer should look into the extent, intensity, and location of competing businesses. In particular, the buyer should check to see whether the business in question is gaining or losing in its race with competitors. Additionally, new competitors to the marketplace (for example, Wal-Mart) may dramatically change an existing firm's likelihood of success. Past performance is no guarantee of future performance.
- **Market:** The ability of the market to support all competing business units, including the one to be purchased, should be determined. This requires marketing research, study of census data, and personal, on-the-spot observation at each competitor's place of business.
- **Future community development:** Examples of future developments in the community that could have an indirect impact on a business include a change in zoning ordinances already enacted but not yet in effect, a change from a two-way traffic flow to a one-way traffic flow, and the widening of a road or construction of an overpass.
- **Legal commitments:** Legal commitments may include contingent liabilities, unsettled lawsuits, delinquent tax payments, missed payrolls, overdue rent or instalment payments, and mortgages of record against any of the real property acquired.
- **Union contracts:** The prospective buyer should determine what type of labour agreement, if any, is in force, as well as the quality of the firm's employee relations. Private conversations with key employees and rank-and-file workers can be helpful in determining their job satisfaction and the company's likelihood of success.
- **Buildings:** The quality of the buildings housing the business should be checked, with particular attention paid to any fire hazards. In addition, the buyer should determine whether there are any restrictions on access to the buildings.
- **Product prices:** The prospective owner should compare the prices of the seller's products with those listed in manufacturers' or wholesalers' catalogues and also with the prices of competing products in the locality. This is necessary to ensure full and fair pricing of goods whose sales are reported on the seller's financial statements.

3.6.5 Negotiating and Closing the Deal

The purchase price of a business is determined by negotiation between buyer and seller. Although the calculated value may not be the price eventually paid for the business, it gives the buyer an estimated value to use when negotiating price. Typically, the buyer tries to purchase the firm for something less than the full estimated value; of course, the seller tries to get more than that value.

In some cases, the buyer may have the option of purchasing the assets only, rather than the business as a whole. When a business is purchased as a total entity, the buyer takes control of the assets but also assumes any outstanding debt, including any hidden or unknown liabilities. Even if the financial records are audited, such debts may not surface.

If the buyer instead purchases only the assets, then the seller is responsible for settling any outstanding debts previously incurred. An indemnification clause in the sales contract may serve a similar function, protecting the buyer from liability for unreported debt.

An important part of the negotiation process is the terms of purchase. In many cases, the buyer is unable to pay the full price in cash and must seek extended terms. At the same time, the seller may be concerned about taxes on the profit from the sale. Terms may become more attractive to the buyer and the seller as the amount of the down payment is reduced and/or the length of the repayment period is extended. Like a purchase of real estate, the purchase of a business is closed at a specific time. A title company or an attorney usually handles the closing. Preferably, the closing occurs under the direction of an independent third party. If the seller's attorney is the closing agent, the buyer should exercise caution—a buyer should never go through a closing without the aid of an experienced attorney who represents only the buyer.

A number of important documents are completed during the closing. These include a bill of sale, certifications as to taxing and other government regulations, and agreements pertaining to future payments and related guarantees to the seller. The buyer should apply for new federal and state tax identification numbers to avoid being held responsible for past obligations associated with the old numbers.

Summary

- Franchises are also known as chain stores. They operate business under a special arrangement.
- The buyout process usually begins when an interested purchaser or group of purchasers makes a formal buyout offer to a company's board of directors, who are the representatives of the company's shareholders.
- The training given by franchisors is invaluable to many small entrepreneurs because it compensates for weaknesses in their managerial skills.
- The costs of starting an independent business are often high, and the typical entrepreneur's sources of capital are quite limited.
- Most franchised products and services are widely known and accepted.
- Higher costs characterise the better known and more successful franchises.
- Franchisors are concerned about the image of their businesses; make every effort to control how franchisees conduct certain aspects of the franchise business.
- Frequently, individuals leave salaried employment for entrepreneurship because they dislike working under the direct supervision and control of others.
- The potential value of a franchising arrangement is defined by the rights contained in a legal agreement known as the franchise contract; the rights it conveys are called the franchise.
- The basic features of the relationship between the franchisor and the franchisee are included in the franchise contract.
- A successful business has already demonstrated its ability to attract customers, manage costs, and make a profit.
- Most entrepreneurs are eager to easily jump in their new business and may not be comfortable waiting the months and years sometimes required to launch a business from scratch.
- Although some aspects of due diligence require personal checking, a buyer can also seek the help of outside experts.

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Self Assessment

1. The purchase price of a business is determined by _____ between buyer and seller.
 - a. negotiation
 - b. closure of the deal
 - c. competition
 - d. relationship

2. _____ may include contingent liabilities, unsettled lawsuits, delinquent tax payments, missed payrolls, overdue rent or instalment payments, and mortgages of record against any of the real property acquired.
 - a. Legal commitments
 - b. Union contracts
 - c. Competition
 - d. Community development

3. Franchises are also known as _____.
 - a. legal commitments
 - b. chain stores
 - c. union contracts
 - d. legal agreement

4. Which of the following is not the source of information tapped for investigating the potential franchise?
 - a. Independent third-party sources
 - b. The franchisors themselves
 - c. Existing and previous franchisees
 - d. Negotiation between buyer and supplier

5. Which of the following is the first step for evaluating a franchisee opportunity?
 - a. Selecting a franchise
 - b. Investigating the potential franchise
 - c. Finding global franchising opportunities
 - d. Considering legal issues in franchising

6. Which of the following statements is false?
 - a. After making a decision to pursue a franchising opportunity, the prospective franchisee must identify a franchise candidate and investigate it completely.
 - b. With the growth of franchising over the years, the task of selecting an appropriate franchise has become difficult.
 - c. Piggyback franchising refers to the operation of a retail franchise within the physical facilities of a host store.
 - d. A master licensee is a firm or individual which have a continuing contractual relationship with a franchisor to sell its franchises.

7. Which of the following statements is false?
- Master licensees are responsible for finding new franchisees within a specified territory.
 - The potential value of a franchising arrangement is defined by the rights contained in a legal agreement known as the franchise contract.
 - The rights conveyed by franchise contract are called the franchisor.
 - In business, franchising describes a unique type of business option that offers entrepreneurs the possibility of reducing the overall risk associated with buying an independent business or starting a business from scratch.
8. A _____ may be a manufacturer or another channel member (a wholesaler or retailer) that has an attractive business concept worthy of duplication.
- franchisor
 - customer
 - distributor
 - businessman
9. Which of the following is not a franchise facilitator?
- Industry associations
 - State agencies
 - Consulting firms
 - National agencies

10. Match the following.

1. Franchise party	A. Primary source of information
2. Franchise facilitator	B. Serendipity
3. Evaluation process	C. Two-way process
4. Franchisor	D. Company-owned stores

- 1-A, 2-D, 3-B, 4-C
- 1-C, 2-D, 3-B, 4-A
- 1-B, 2-A, 3-D, 4-C
- 1-D, 2-B, 3-C, 4-A

Chapter IV

Developing the New Venture Business Plan

Aim

The aim of this chapter is to:

- introduce the purpose of business plan in small business
- recognise importance of selecting a good location for small scale business
- identify financing options available for small business

Objectives

The objectives of this chapter are to:

- analyse the business plans for small scale industry
- explain the type of loans available for small scale business
- discuss the need for financial considerations

Learning outcome

At the end of this chapter, you will be able to:

- understand the need and purpose of a business plan
- know the different financial options
- discuss the benefits of a good location for small scale industry

4.1 Introduction

A business plan is a formal statement of a set of business goals, which are believed to be attainable, and the plan for reaching those goals. It may also contain background information about the organisation or team attempting to reach those goals. Business plans may also target changes in perception and branding by the customer, client, tax-payer, or larger community. When the existing business is to assume a major change or when planning a new venture a 3 to 5 year business plan is required, since investors will look for their annual return in the 3 to 5 year time.

4.2 The Purpose of a Business Plan

There is no one correct formula for a business plan. After all, no one plan will work in all situations. But, in general, a business plan is a document that outlines the basic idea underlying a business and describes related start-up considerations. A business plan is an entrepreneur's game plan; it crystallises the dreams and hopes that motivate an entrepreneur to take the start-up plunge. The business plan should lay out your basic idea for the venture and include descriptions of where you are now, where you want to go, and how you intend to get there.

David Gumpert, who headed up the MIT Enterprise Forum, offers a concise and practical definition of a business plan, "It's a document that convincingly demonstrates that your business can sell enough of its product or service to make a satisfactory profit and to be attractive to potential backers." For Gumpert, the business plan is essentially a selling document used to convince key individuals, both inside and outside the firm, that the venture has real potential. Equally important, it is an opportunity to convince yourself, the entrepreneur, that what appears to be a good idea is also a good investment opportunity, both economically and in terms of your personal goals.

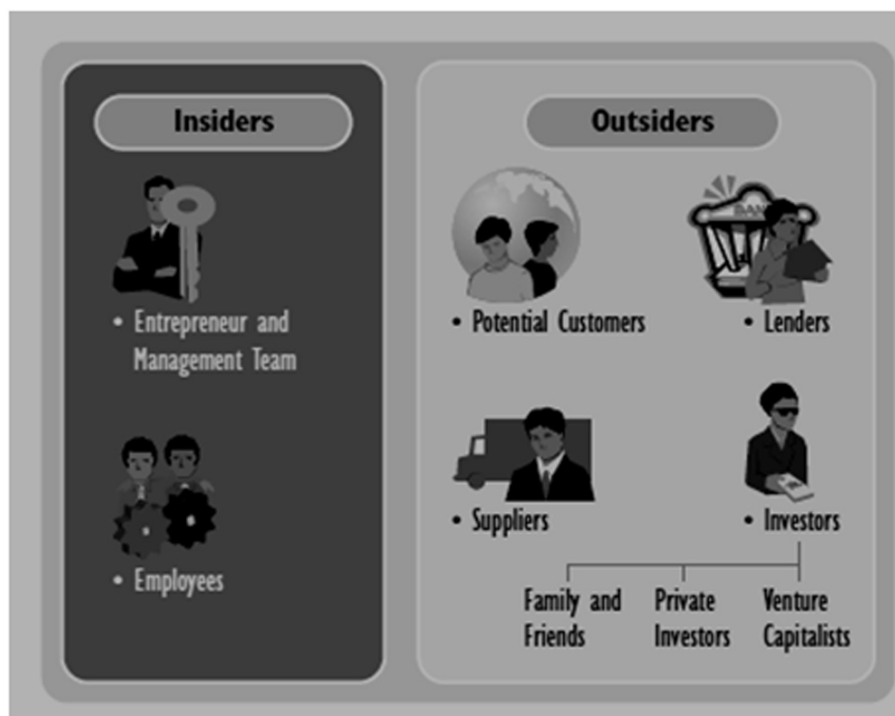


Fig. 4.1 Users of business plan

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

For the entrepreneur starting a new venture, a business plan has three basic objectives:

- To identify the nature and the context of the business opportunity i.e., why does such an opportunity exist
- To present the approach the entrepreneur plans to use to exploit the opportunity
- To recognise factors that will determine whether the venture will be successful

The figure given above provides an overview of those who might have an interest in a business plan for a new venture.

The first group consists of the internal users of the plan:

- The entrepreneur
- The new firm's management and employees

The second group consists of outsiders who are critical to the firm's success:

- Its prospective customers
- Suppliers
- Lenders
- Investors

4.2.1 Need of Business Plan

The justification used for not writing a business plan goes something like this: "Companies that start up based on business plans are no more successful than those that do not." It is true that studies attempting to measure the success of entrepreneurs with business plans against the success of those without have produced mixed results.

Given what we know about Apple, Calvin Klein, and other businesses started without business plans, clearly having a business plan is not a prerequisite for success. This simply tells us that the business plan is not the business. It may well be that some entrepreneurs spend untold hours writing a 60-page business plan with another 50 pages of appendixes but never follow the plan.

In such cases, writing the plan was a waste of time. If the plan is not going to lead to action, there is no need to bother to write it. Only if you execute the business plan, it has a good chance of making a difference. Thomas Stemberg, the founder of Staples who later became a venture capitalist, says it well.

4.3 Marketing of Small Business

Marketing is always different things to different people. Some entrepreneurs view marketing as simply selling a product or service. Others see marketing as those activities directing the flow of goods and services from producer to consumer or user. In reality, small business marketing is much broader. It consists of many activities, some of which occur even before a product is produced and made ready for distribution and sale.

A comprehensive definition of small business marketing helps to convey its true scope to entrepreneurs. Small business marketing consists of those business activities that direct the creation, development, and delivery of a bundle of satisfaction from the creator to the targeted user and that satisfy the targeted user. It should be noticed that this definition emphasises the concept of a bundle of satisfaction, i.e., a core product and or service plus all its important extras. It may be helpful to view a product/service as having three levels as seen in the figure given below.

- Core product/service
- Actual product/service
- Augmented product/ service

The core product/service is the fundamental benefit or solution sought by customers. The actual product/service is the basic physical product/service that delivers those benefits. The augmented product/service is the basic product/service plus extra or unsolicited benefits to the consumer that may prompt a purchase.

In the case of television, for example, the core product is entertainment and/or information (the news); the actual product is the physical television set. The augmented product might include the ability to vote on acts that appear on American Idol or the ability to watch a live sports event.

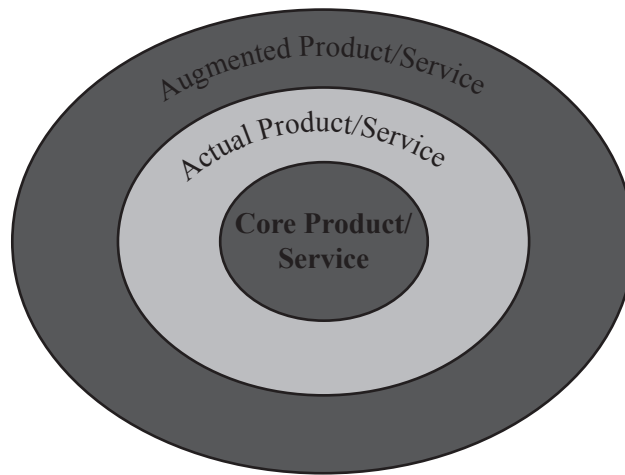


Fig. 4.2 The three levels of a product/service

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Ultimately, a business provides satisfaction to its customers, not merely the tangible product or intangible service that is the focus of the exchange. Let us consider Blue Nile Incorporated, which sells engagement rings and other jewellery through website. Although Jewellery is its core product, the bundle of satisfaction the firm provides includes more than jewellery. In keeping with the company's strong commitment to helping customers make the right purchase, Blue Nile's website provides a great deal of extra information. This assistance, along with competitive prices and free shipping, is part of the bundle of satisfaction offered. And it appears to be working well.

4.3.1 Marketing Plan

After the entrepreneur's idea has been examined and judged to be a viable opportunity, whether he or she is ready to prepare the formal marketing plan. Each business venture is different; therefore, each marketing plan is unique. An entrepreneur should not feel it necessary to develop a cloned version of a plan created by someone else i.e., even the one suggested by the authors of this textbook. Nevertheless, most marketing plans should cover market analysis, the competition, and marketing strategy.



Fig. 4.3 Marketing plan and supporting marketing activities

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

4.3.2 Market Analysis

In the market analysis section of the marketing plan, the entrepreneur describes the target market. This description of potential customers is commonly called a customer profile.

Marketing research information, compiled from both secondary and primary data, can be used to construct this profile. A detailed discussion of the major benefits to customers provided by the new product or service should also be included in this section of the plan. Obviously, these benefits must be reasonable and consistent with statements in the product/service section of the plan. The review the following excerpt from the “Market Needs” section of the marketing plan of Adorable Pet Photography, a home-based business located in Atlanta, Georgia.

If an entrepreneur envisions several target markets, each segment must have a corresponding customer profile. Likewise, different target markets may call for an equal number of related marketing strategies. Typically, however, a new venture will initially concentrate on a select few target markets or even just one. Another major component of market analysis is the actual sales forecast. It is usually desirable to include three sales forecasts covering the “most likely,” “pessimistic,” and “optimistic” scenarios. These scenarios provide investors and the entrepreneur with different numbers on which to base their decisions.

4.3.3 Competition

Frequently, entrepreneurs ignore the reality of competition for new ventures, believing that the marketplace contains no close substitutes or that their success will not attract other entrepreneurs. This is simply not realistic. Existing competitors should be studied carefully, and their key management personnel profiled. A brief discussion of competitors’ overall strengths and weaknesses should be a part of the competition section of the plan. Also, related products currently being marketed or tested by competitors should be noted.

An assessment should be made of the likelihood that any of these firms will enter the entrepreneur’s target market. A SWOT analysis is always a good idea. It is important that your company have a clear understanding of what it does well (strengths), what it doesn’t do so well (weaknesses), available market opportunities, and threats from competitors as well as from changes in the company’s operating environment (social, technological, economic, political, and other environmental variables).

4.3.4 Marketing Strategy

A well-prepared market analysis and competition discussions are important to the formal marketing plan. But the information on marketing strategy forms the most detailed section of the marketing plan and, in many respects, is subject to the closest scrutiny from potential investors. Such a strategy plots the course of the marketing actions that will make or break the entrepreneur’s vision.

Four areas of marketing strategy that should be addressed include:

- Product decisions that will transform the basic product or service idea into a bundle of satisfaction
- Distribution activities regarding the delivery of the product to customers
- Pricing decisions that will set an acceptable exchange value on the total product or service
- Promotion activities that will communicate the necessary information to target markets

4.4 Location Plan

An entrepreneur has several options when deciding where to locate his or her business either:

- In a brick-and- mortar building
- At home
- On the Web
- In some combination of the above places

The Internet has radically transformed how business is conducted; it is now the location of choice for many entrepreneurs. The online auction site eBay is a shining example of what's possible on the Internet.

The entrepreneur when decides to purchase a franchise or an existing business usually receives considerable location guidance from the franchisor or members of the existing firm. But for the entrepreneur who chooses to start a venture from scratch, the location decision is very time consuming. Regardless of how the decision is made, all location intentions should be described in the business plan.

In many cases, the choice of a location is a one-time decision. However, an entrepreneur may later consider relocating the business to reduce operating costs or gain other advantages. Here consideration is required for three primary options for the initial location decision, a traditional physical building, the entrepreneur's home, and a website on the Internet.

Although we recognise that the Internet can be an integral part of operations for both a traditional and a home-based business, we treat e-commerce ventures in a separate category because of the Internet's significance as a sole sales outlet for these small businesses. The figure given below depicts the three location options.

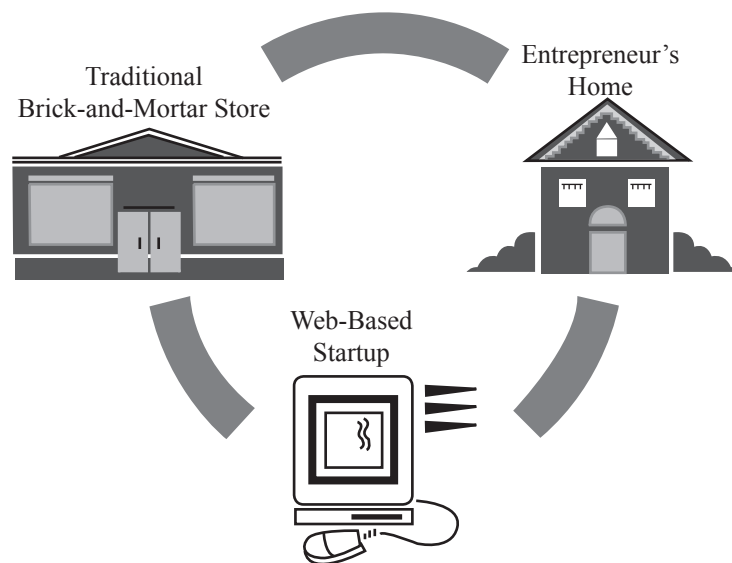


Fig. 4.4 Location options for the start-up

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

4.4.1 Importance of Location Decision

The importance of the initial decision is where to locate a traditional physical building, a brick-and-mortar store which is underscored by both the high cost of such a store and the hassle of pulling up stakes and moving an established business. Also, if the site is particularly poor, the business may never become successful, even with adequate financing and superior managerial ability. The importance of location is so clearly recognised by national chains that they spend thousands of dollars investigating sites before establishing new stores.

The choice of a good location is much more vital to some businesses than to others. For example, the site chosen for a dress shop can make or break the business because it must be convenient for customers. In contrast, the physical location of the office of a painting contractor is of less importance, since customers do not need frequent access to the facility. Even painting contractors, however, may suffer if their business site is poorly chosen.

4.4.2 Factors in Selecting a Good Location

Five key factors are shown in figure given below to guide the location selection process:

- Customer accessibility
- Business environment conditions
- Availability of resources
- The entrepreneur's personal preference
- Site availability and costs

Other factors relevant to location include neighbour mix, security and safety, services, past tenants' fate, and the life-cycle stage of the area. In this particular situation, one factor may carry more weight than others. However, each of the five key factors should always have some influence on the final location decision.

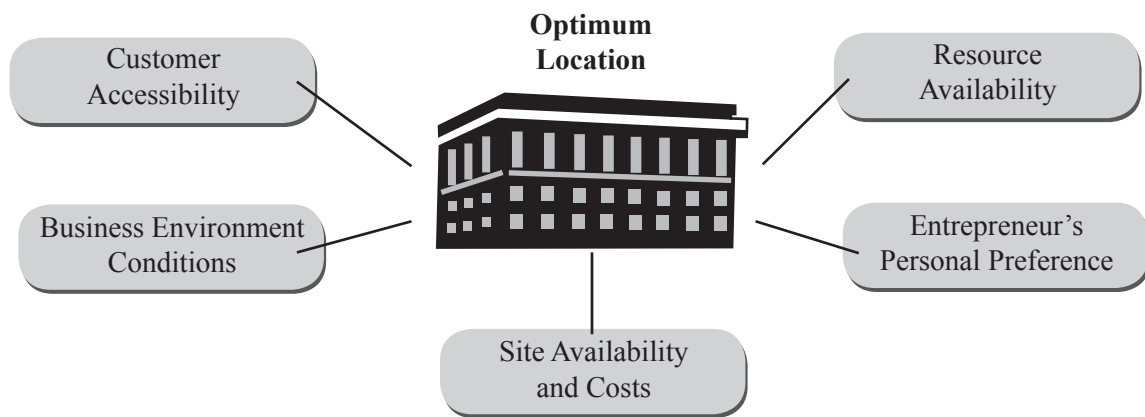


Fig. 4.5 Five key factors in determining a good business location

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Customer accessibility

Customer accessibility is an important consideration in selecting a location. Retail outlets and service firms are typical examples of businesses that must be located so as to make access convenient for target customers. Rarely will customers be willing to regularly travel long distances to shop. Many products, such as snack foods and gasoline, are convenience goods, which require a retail location close to target customers; otherwise, consumers will substitute competitive brands when a need arises. Services such as tire repair and hair styling also require a location readily accessible to customers.

Choosing the best location for a retail store used to be a hit-or-miss proposition. The recent emergence of site-selection software has removed much of the guesswork from finding a good location. Its popularity has taken off as the software has become more sophisticated and user-friendly.

Site-selection software programs can now give users access to demographic information such as age, income, and race for specific neighbourhoods, as well as information on other businesses located nearby, climate, traffic flow, and more. Convenient access for customers is one reason small businesses have successfully created such a strong presence on the Internet. With the appropriate computer connection, customers can access a small business's home page from anywhere in the world.

Business environment conditions

A start-up business is affected in a number of ways by the environment in which it operates. Environmental conditions can hinder or promote success. Weather is one important environmental factor that influences the location decision, as well as the demand for many products such as air conditioners and outdoor swimming pools. Environmental issues were particularly important to entrepreneur Tsering Gyalzen, who planned to build a cybercafé, containing eight laptop computers and solar-powered generators, at the 17,400-foot-high base camp of Mount Everest. He will be forced to construct a temporary structure because the base camp sits on a glacier that moves several inches each day.

Competition, legal requirements, and tax structure are a few of the other critical environmental factors. Every entrepreneur seeks profits; therefore, all factors affecting the financial picture are of great concern. State and local governments can help or hinder a new business by forgiving or levying taxes. Obviously, the best time to evaluate environmental conditions is prior to making a location commitment.

While most efforts of state and city governments are designed to support start-ups, most cities have regulations that restrict new business operations under certain circumstances.

For example, cities have zoning ordinances that may limit the operations of home-based businesses. Limitations typically relate to vehicular traffic and parking, signage, nonrelated employees working in a home, the use of a home more as a business than as a residence, the sale of retail goods to the public, and the storage of hazardous materials and work-related equipment.

Availability of resources

The availability of resources associated with producing a product and operating a business should be considered in selecting a location. Raw materials, labour supply, and transportation are some of the factors that have a bearing on location. Nearness to raw materials and suitability of labour supply are particularly critical considerations in the location of a manufacturing business.

- **Suitability of labour supply:** A manufacturer's labour requirements depend on the nature of its production process. Availability of workers, wage rates, labour productivity, and a history of peaceful relations with employees are all particularly important considerations for labour-intensive firms. In some cases, the need for semiskilled or unskilled labour justifies locating in an area with surplus labour. In other cases, firms find it desirable to seek a pool of highly skilled labour.
- **Availability of transportation:** Access to good transportation is important to almost all firms. For example, good highways and bus systems provide customers with convenient access to retail stores. For small manufacturers, quality transportation is especially vital. They must carefully evaluate all the trucking routes that support their transportation needs, considering the costs of both transporting supplies to the manufacturing location and shipping the finished product to customers. It is critical that they know whether these costs will allow their product to be competitively priced.

Personal preference of the entrepreneur

As a practical matter, many entrepreneurs discount customer accessibility, business environment conditions, and resource availability and consider only their personal preference in locating a business. Often, their personal preference is to stay in their home community; the possibility of locating elsewhere never enters their mind. On the other hand, locating a business in one's home community is not necessarily illogical. In fact, it offers certain advantages.

From a personal standpoint, the entrepreneur generally appreciates and feels comfortable with the atmosphere of the home community, whether it is a small town or a large city. From a practical business standpoint, the entrepreneur can more easily establish credit. Hometown bankers can be dealt with more confidently, and other businesspersons may be of great service in helping evaluate a given opportunity.

Site availability and costs

Once an entrepreneur has settled on a certain area of the country, a specific site must still be chosen. The availability of potential sites and the costs associated with obtaining them must be investigated. Site availability should be after evaluating a site for his new business, one entrepreneur is said to have exclaimed, “It must be a good site, I know of four businesses that have been there in the last two years!” Fortunately, such a misguided approach to site evaluation is not typical of entrepreneurs, many of whom recognise the value of seeking professional assistance in determining site availability and appropriateness.

If an entrepreneur’s top choices are unavailable, other options must be considered. One choice is shared facilities. In recent years, business incubators have sprung up in all areas of the country. A business incubator is a facility that rents space to new businesses or to people wishing to start businesses. Incubators are often located in recycled buildings, such as abandoned warehouses or schools. They serve fledgling businesses by making space available, offering management advice, and providing clerical assistance, all of which help lower operating costs. An incubator tenant can be fully operational the day after moving in, without buying phones, renting a copier, or hiring office employees.

Ultimately, the site selection process must depend on evaluation of relevant costs. The costs involved in building on a new site may be prohibitive, or the purchase price of an existing structure may exceed the entrepreneur’s budget. Assuming that a suitable building is available, the entrepreneur must decide whether to lease or buy. Although ownership confers greater freedom in the modification and use of a building, the advantages of leasing usually outweigh these benefits. We recommend that most new firms lease for two reasons:

- A large cash outlay is avoided. This is important for a new small firm, which typically lacks adequate financial resources.
- Risk is reduced by avoiding substantial investment and by postponing commitments for space until the success of the business is assured and the nature of building requirements is better known.

When entering into a leasing agreement, the entrepreneur should check the landlord’s insurance policies to be sure there is proper coverage for various types of risks. If not, the lessee should seek coverage under his or her own policy. It is important to have the terms of the leasing agreement reviewed by an attorney.

4.4.3 Attraction of Home-Based Business

The main attractions of a home-based business relate to financial and family lifestyle considerations as given in figure below.

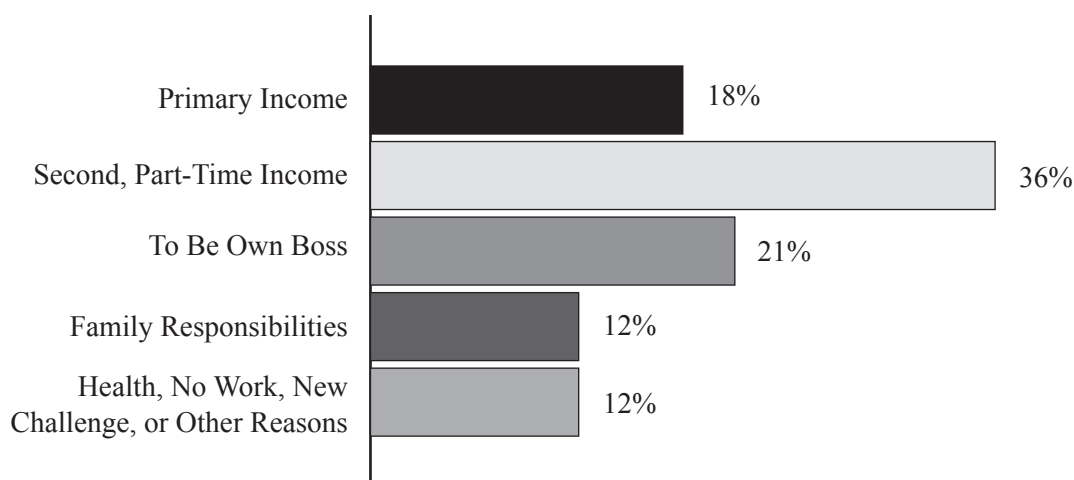


Fig. 4.6 Entrepreneurs’ reasons for operating a home-based business

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Financial considerations

Like most business ventures, a home-based business has an important goal, earning money and locating at home helps increase profits by reducing costs. This was the motivation of Bianca Wright, who does freelance writing for magazines. She needed a computer, office supplies, and an Internet connection for her home-based business venture. With the ups and downs of the advertising industry, Donovan Andrews, 31, and Stephen Smyk, 35, thought it would be best to start their fledgling advertising agency in their home.

Receiving full compensation for her work was Rose Anne Raphael's motivation for starting a home-based business. Her boyfriend noticed that her employer was billing clients more than seven times as much as Raphael was earning. "I was getting paid \$17 an hour and the company was billing clients at \$125 an hour for my work. That's when I thought I had the opportunity to become self-employed," says Raphael. She's been running a public-relations firm out of a one-bedroom apartment.

Family lifestyle considerations

Many young entrepreneurs remain in a family business because of close family ties. Similarly, entrepreneurs who locate business operations in the home are frequently motivated by the desire to spend more time with family members. Consider the following examples.

Joyce Thomas, 47, owns Chino Hills, California-based Medical Reimbursement Specialists (MRS), a Medicare-compliance company. MRS started out handling electronic claims for local physicians. After two years, Thomas decided to use her experience to train other women to process claims from their homes. She helped start 500 affiliate businesses across the country and won contracts with hospitals nationwide.

4.4.4 Technology and Challenges of Home-Based Business

The challenges of home-based businesses are mainly on their location. Advancements in business-application technology are a major catalyst in the rapid growth of home-based businesses. Personal computers, fax machines, voice mail, and e-mail are among the technological tools that help the home-based business compete effectively with commercial-site businesses. Such technology makes it possible to operate many types of businesses almost anywhere. One important technological tool available to home-based businesses is the Internet. Millions of small firms, which are based at home, are using websites to sell products and services. Virtually every product sold in traditional retail outlets is now sold over the Internet.

Just as most businesses located at commercial sites have their problems; home-based businesses face special challenges attributable to their location. We will briefly examine two of these challenges, business image and legal considerations.

Business image

Maintaining an image of professionalism, while working at home is a major challenge for home-based entrepreneurs. Allowing young children to answer the telephone, for example, may undermine a professional image. Likewise, a baby crying or a dog barking in the background during a phone call can be distracting to a client.

If clients or salespeople visit the home-based business, it is critical that a professional office area be maintained. Space limitations sometimes make this difficult.

Legal considerations

Some local laws pose a problem for home-based businesses. Zoning ordinances, for example, regulate the types of enterprises permitted in various geographical areas. Some cities outlaw any type of home-based business within city limits. Many zoning laws, dating as far back as the 1930s, have never been updated. The intent of such laws is to protect a neighbourhood's residential quality by preventing commercial signs and parking problems. There is also tax issues related to a home-based business. Generally, a separate space must be clearly devoted to business activities in order for the entrepreneur to claim a tax deduction. A certified public accountant can be helpful in explaining these tax regulations. Insurance considerations may also affect a home-based business. An entrepreneur's homeowner's policy is not likely to cover business activities, liabilities, and equipment.

4.4.5 Start-Up Business on Internet

We currently live in a digital economy fuelled by the tremendous growth of the Internet. Access to the Internet continues to transform the way we live and the way business is conducted. It is important for aspiring entrepreneurs to learn as much as they can about cyberspace because there's opportunity online.

Few primary questions to be addressed include:

- What is the Internet and how does it support e-commerce?
- What benefits does e-commerce offer the start-up?
- What business models reflect an e-commerce strategy?

4.4.6 E-Commerce Business Model

E-commerce means electronic commerce, or the paperless exchange of business information via the Internet. It is an alternative means of conducting business transactions that traditionally have been carried out by telephone, by mail, or face to face in brick-and-mortar stores. It is logical to study the circumstances surrounding e-commerce in order to uncover the opportunities the Internet offers as a start-up location.

Let's begin by examining some existing e-commerce business models. The term business model describes a group of shared characteristics, behaviours, and goals that a firm follows in a particular business situation. Online business firms differ in their decisions concerning which customers to serve, how best to become profitable, and what to include on their websites. The real world of e-commerce contains endless combinations of business models. However, it is important to keep in mind that a poorly devised business model can be a major factor in business failure.

Type of customers served

Marketing theory classifies traditional brick-and mortar firms as manufacturers, wholesalers, or retailers, depending on the customers they serve. E-commerce businesses also are commonly distinguished according to customer focus. There are three major categories of e-commerce business models:

- Business-to-business models
 - (B2B) model (selling to business customers) are significantly greater than those for firms with a business-to-consumer (B2C) model (selling to final consumers). Because B2B success stories generally receive less publicity than B2C ventures do, the potential of a B2B opportunity may be overlooked. Aspiring entrepreneurs should be sure to consider the B2B model. All B2B firms do not look alike. One form of B2B strategy emphasises sales transactions. By using online capabilities, a B2B firm can achieve greater efficiency in its selling and buying. International Business Machines (IBM) is a good example. By dealing directly with its corporate customers online, it is able to build its computer systems and related products to meet the specific needs of its customers. As much as IBM relies on the Internet to deliver its business solution, it also has an extensive sales force and consulting services to deliver value to its many customers worldwide.
- Business-to-consumer models
 - In contrast to a B2B model, a business-to-consumer (B2C) model has final consumers as customers. In the traditional retail setting, customers generally approach a business location (a brick-and-mortar store) with the intent of shopping or purchasing. Alternatively, customers might purchase via telephone or mail order, using a printed catalogue. The B2C model introduces another alternative for consumers for buying online.
- Auction site models
 - Here, some entrepreneurs sell their wares over the Internet without either a website or a storefront, by means of e-commerce sites based on the auction site model. Internet auction sites are Web-based businesses offering participants the final consumers and businesses, the ability to list products for bidding by potential buyers. Revenues to the auction site are derived from listing fees and commissions on sales.

4.5 Financial Forecasting

Using the basic financial information discussed helps an owner-manager can develop pro forma financial statements, or projected financial statements. The necessity of financial forecasting is described quite aptly by small business consultant Paul A. Broni:

The purpose of pro forma financial statements is to answer three questions:

- How profitable can the firm be expected to be, given the projected sales levels and the expected sales–expense relationships?
- How much and what type of financing (debt or equity) will be used?
- Will the firm have adequate cash flows? If so, how will they be used; if not, where will the additional cash come from?

Preparing historical financial statements, such as income statements, balance sheets, and cash flow statements, is not a difficult task; accountants have perfected that process. Projecting the financials for a new company is another matter, however, and presents a real challenge.

Forecasting profitability

Profits reward an owner for investing in a company and constitute a primary source of financing for future growth. Therefore, it is critical for an entrepreneur to understand the factors that drive profits. A firm's net income is dependent on five variables:

- **Amount of sales:** The dollar amount of sales equals the price of the product or service times the number of units sold or the amount of service rendered.
- **Cost of goods sold:** Cost of goods sold is the cost of producing or purchasing the firm's products or services. These costs can be either fixed (those that do not vary with a change in sales volume) or variable (those that change proportionally with sales).
- **Operating expenses:** These expenses relate to marketing and distributing the product, general and administrative expenses, and depreciation expenses. As with cost of goods sold, operating expenses can be fixed or variable in nature.
- **Interest expense:** An entrepreneur who borrows money agrees to pay interest on the loan principal. For example, a loan of \$25,000 for a full year at a 12 percent interest rate results in an interest expense of \$3,000 for the year ($0.12 \times \$25,000$).
- **Taxes:** A firm's income taxes are figured as a percentage of taxable income (earnings before taxes).

4.6 Sources of Financing

When initially financing a small business, an entrepreneur will rely on personal savings and then seek financing from family and friends. If these sources are inadequate, the entrepreneur may then turn to more formal channels of financing, such as banks and outside investors.

The figure below gives an overview of the sources of financing of smaller companies. As indicated, some sources of financing, such as banks, business suppliers, asset-based lenders, and the government which are essentially limited to providing debt financing. Equity financing for most entrepreneurs comes from personal savings and, in rare instances, from selling stock to the public. Other sources including friends and family, other individual investors, venture capitalists, and large corporations may provide either debt or equity financing, depending on the situation. Keep in mind that the use of these and other sources of funds are not limited to a start-up's initial financing. Such sources may also be used to finance a firm's day-to-day operations and business expansions.

In presenting the different sources of financing for smaller companies, we will look at

- Sources “close to home”—personal savings, friends and family, and credit cards
- Bank financing, which becomes a primary financing source as the firm grows
- Business suppliers and asset-based lenders
- Private equity investors
- The government
- Large companies and stock sales

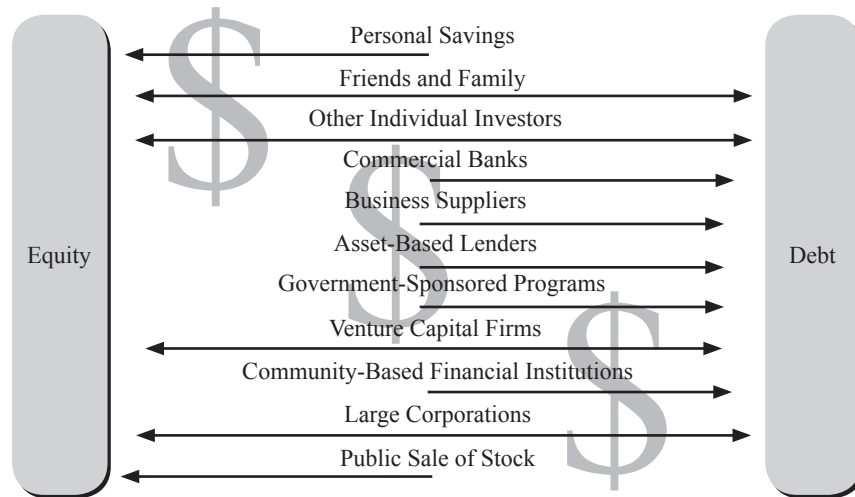


Fig. 4.7 Sources of funds

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

4.6.1 Sources Close to Home

The search for financial support usually begins close to home. The aspiring entrepreneur basically has three sources of early financing: personal savings, friends and family, and credit cards.

Personal savings

It is imperative for an entrepreneur to have some personal investment in the business, which typically comes from personal savings. Indeed, personal savings is by far the most common source of equity financing used in starting a new business. With few exceptions, the entrepreneur must provide an equity base. A new business needs equity to allow for a margin of error. In its first few years, a firm can ill afford large fixed outlays for debt repayment. Also, a banker—or anyone else for that matter—is unlikely to loan venture money if the entrepreneur does not have his or her own money at risk, which is sometimes referred to as “having skin in the game.”

Friends and family

Personal savings is the primary source of financing for most small business start-ups, with friends and family following in a distant second place. The figure given below shows that friends, close family, and other relatives provide almost 80 percent of start-up capital from personal sources beyond the entrepreneur’s personal savings. Entrepreneurs who acquire financing from friends and family are putting more than just their financial futures on the line as they’re putting important personal relationships in jeopardy, too.

However, friends and relatives who provide business loans sometimes feel that they have the right to offer suggestions concerning the management of the business. Also, hard business times may strain the relationship. But if relatives and friends are the only available source of financing, the entrepreneur has no alternative. To minimise the chance of damaging important personal relationships, the entrepreneur should plan to repay such loans as soon as possible. In addition, any agreements made should be put in writing, as memories tend to become fussy over time.

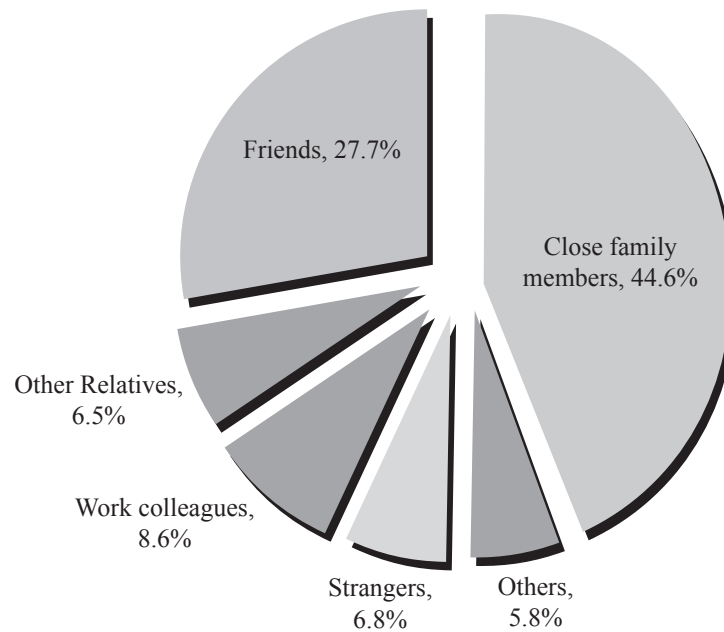


Fig. 4.8 Sources of personal capital for small firms

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

For someone who cannot acquire more traditional financing, such as a bank loan, credit card financing may be an option, but a necessary one. The interest costs can become overwhelming over time, especially because of the tendency to borrow beyond the ability to repay. So it is essential that an entrepreneur using credit card financing be extremely self-disciplined to avoid becoming over-extended.

4.6.2 Bank Financing

Commercial banks are the primary providers of debt capital to small companies. However, banks tend to limit their lending to providing for the working-capital needs of established firms, specifically for financing accounts receivable and inventory. Quite simply, they want firms with proven track records and preferably plenty of collateral in the form of hard assets. Bankers are reluctant to loan money to finance losses, research and development expenses, marketing campaigns, and other “soft” assets. Such expenditures should be financed by equity sources. Nevertheless, it is wise to cultivate a relationship with a banker sooner rather than later, and well in advance of making a loan request.

Types of loans

Bankers primarily make business loans in one of three forms: lines of credit, term loans, and mortgages.

- **Lines of credit:** A line of credit is an informal agreement or understanding between the borrower and the bank as to the maximum amount of credit the bank will provide the borrower at any one time. Under this type of agreement, the bank has no legal obligation to provide the stated capital. The entrepreneur should arrange for a line of credit in advance of an actual need because banks extend credit only in situations about which they are well informed. Attempts to obtain a loan on a spur-of-the-moment basis are generally ineffective.
- **Term loans:** Under certain circumstances, banks will loan money on a 5- to 10-year term. Such term loans are generally used to finance equipment with a useful life corresponding to the loan’s term. Since the economic benefits of investing in such equipment extend beyond a single year, banks can be persuaded to lend on terms that more closely match the cash flows to be received from the investment.
- **Mortgages:** Mortgages, which represent a long-term source of debt capital, can be one of two types: chattel mortgages and real estate mortgages. A chattel mortgage is a loan for which certain items of inventory or other movable property serve as collateral. The borrower retains title to the inventory but cannot sell it without the banker’s consent. A real estate mortgage is a loan for which real property, such as land or a building provides the collateral. Typically, these mortgages extend over 25 or 30 years.

Understanding banker's perspective

To be effective in acquiring a loan, an entrepreneur needs to understand a banker's perspective about making loans. All bankers have two fundamental concerns when they make a loan:

- How much income the loan will provide the bank, both in interest income and in other forms of income such as fees?
- The likelihood is that the borrower will default on the loan. A banker is not rewarded adequately to assume large amounts of risk and will, therefore, design loan agreements so as to reduce the risk to the bank.

In making a loan decision, a banker always considers the "five C's of credit":

- The borrower's character
- The borrower's capacity to repay the loan
- The capital being invested in the venture by the borrower
- The conditions of the industry and economy
- The collateral available to secure the loan

When seeking a loan, an entrepreneur will be required to provide certain information in support of the loan request. Failure to provide such information in an effective manner will almost certainly result in rejection by the banker. Thus, the goal is not merely to present the needed information, but to make an effective presentation. Providing inaccurate information or not being able to justify assumptions made in forecasting financial results is sure to make the banker question the entrepreneur's business acumen.

Selecting a banker

The wide variety of services provided by banks makes choosing a bank a critical decision. For a typical small firm, the provision of checking-account facilities and the extension of short-term (and possibly long-term) loans are the two most important services of a bank. Normally, loans are negotiated with the same bank in which the firm maintains its checking account. In addition, the firm may use the bank's safe-deposit vault or its services in collecting notes or securing credit information. An experienced banker can also provide management advice, particularly in financial matters, to a new entrepreneur. The location factor limits the range of possible choices of banks. For convenience in making deposits and conferring about loans and other matters, a bank should be located in the same general vicinity as the firm. All banks are interested in their home communities and, therefore, tend to be sympathetic to the needs of local business firms. Except in very small communities, two or more local banks are usually available, thus permitting some freedom of choice.

Negotiating the loan

In negotiating a bank loan, the owner must consider the terms that will accompany the loan. Four key terms are included in all loan agreements: the interest rate, the loan maturity date, the repayment schedule, and the loan covenants.

Interest rate

The interest rate charged by banks is usually stated in terms of either the prime rate or the LIBOR. The prime rate is the rate of interest charged by banks on loans to their most creditworthy customers. The LIBOR (London Inter-Bank Offered Rate) is the interest rate that London-based banks charge other banks in London, which is considerably lower than the prime rate. This rate is published each day in the Wall Street Journal.

Although a small firm should always seek a competitive interest rate, concern about the interest rate should not override consideration of the loan's maturity date, its repayment schedule, and any loan covenants.

Loan maturity date

A loan's term should coincide with the use of the money; short-term needs require short-term financing, while long-term needs demand long-term financing. For example, since a line of credit is intended to help a firm with only its short-term needs, it is generally limited to one year. Some banks require that a firm "clean up" a line of credit one month each year. Because such a loan can be outstanding for only 11 months, the borrower can use the money to finance seasonal needs but cannot use it to provide permanent increases in working capital, such as accounts receivable and inventories.

Repayment schedule

With a term loan, the loan is set to be repaid over 5 to 10 years, depending on the type of assets used for collateral. However, the banker may have the option of imposing a balloon payment, i.e., a very large payment that the borrower is required to make at a specified point about halfway through the term over which the payments were calculated, repaying the rest of the loan in full. However, if the lender has the option of imposing a balloon payment whereby the rest of the loan comes due in full in three years rather than seven years, the lender can reassess the quality of the loan and decide whether to collect the balance or to renew the loan.

Loan covenants

In addition to setting the interest rate and specifying when and how the loan is to be repaid, a bank normally imposes other restrictions, such as loan covenants, on the borrower. Loan covenants require certain activities (positive covenants) and limit other activities (negative covenants) of the borrower to increase the chance that the borrower will be able to repay the loan. Some types of loan covenants a borrower might encounter include the following:

- A bank will usually require that the business provide financial statements on a monthly basis or, at the very least, quarterly.
- A way to restrict a firm's management from siphoning cash out of the business, the bank may limit managers' salaries. It also may prohibit any personal loans from the business to the owners.
- A bank may put limits on various financial ratios to make certain that a firm can handle its loan payments. Or the bank might limit the amount of debt the firm can borrow in the future, as measured by the ratio of total debt to the firm's total assets.
- The borrower will normally be required to personally guarantee the firm's loan. A banker wants the right to use both the firm's assets and the owner's personal assets as collateral. If a business is structured as a corporation, the owner and the corporation are separate legal entities and the owner can escape personal liability for the firm's debts—that is, the owner has limited liability. However, most banks are not willing to lend money to any small business without the owner's personal guarantee as well.

4.6.3 Business Suppliers and Asset-Based Lenders

Companies that have business dealings with a new firm are possible sources of funds for financing inventories and equipment. Both wholesalers and equipment manufacturers/suppliers can provide trade credit (accounts payable) or equipment loans and leases.

Accounts payable (trade credit)

Credit extended by suppliers is very important to a start-up. In fact, trade (or mercantile) credit is the source of short-term funds most widely used by small firms. Accounts payable (trade credit) are of short duration of 30 days is the customary credit period. Most commonly, this type of credit involves an unsecured, open-book account. The supplier (seller) sends merchandise to the purchasing firm; the buyer then sets up an account payable for the amount of the purchase. The amount of trade credit available to a new company depends on the type of business and the supplier's confidence in the firm.

More often, however, a firm has to pay its suppliers prior to receiving cash from its customers. In fact, this can be a serious problem for many small firms, particularly those that sell to large companies.

Equipment loans and leases

Some small businesses, such as restaurants, use equipment that is purchased on an instalment basis through an equipment loan. A down payment of 25 to 35 percent is usually required, and the contract period normally runs from three to five years. The equipment manufacturer or supplier typically extends credit on the basis of a conditional sales contract (or mortgage) on the equipment. During the loan period, the equipment cannot serve as collateral for another loan. Instead of borrowing money from suppliers to purchase equipment, an increasing number of small businesses are beginning to lease equipment, especially computers, photocopiers, and fax machines.

Three reasons are commonly given for the increasing popularity of leasing:

- The firm's cash remains free for other purpose
- Available lines of credit (a form of bank loan) can be used for other purposes
- Leasing provides a hedge against equipment obsolescence

While leasing is certainly an option to be considered for financing the acquisition of needed equipment, an entrepreneur should not simply assume that leasing is always the right decision. A business owner can make a good choice only after carefully comparing the interest charged on a loan to the implied interest cost of a lease, calculating the tax consequences of leasing versus borrowing, and examining the significance of the obsolescence factor. Also, the owner must be careful about contracting for so much equipment that it becomes difficult to meet instalment or lease payments.

Asset-based lending

As its name implies, an asset-based loan is a line of credit secured primarily by assets, such as receivables, inventory, or both. The lender cushions its risk by advancing only a percentage of the value of a firm's assets, generally, 65 to 85 percent against receivables and up to 55 percent against inventory. Of the several categories of asset-based lending, the most frequently used is factoring. Factoring is an option that makes cash available to a business before accounts receivable payments are received from customers.

4.6.4 Private Equity Investors

Over the past decade, private equity markets have been the fastest growing source of financing for entrepreneurial ventures that have potential for becoming significant businesses.

For an entrepreneur, these sources fall into two categories: business angels and venture capitalists.

Business angels

Business angels are private individuals who invest in early stage companies. They are the oldest and largest source of early-stage equity capital for entrepreneurs. The term angel originated in the early 1900s, referring to investors on Broadway who made risky investments to support theatrical productions. This type of financing has come to be known as informal venture capital because no established marketplace exists in which business angels regularly invest.

The majority of these individuals are self-made millionaires who have substantial business and entrepreneurial experience. Business angels generally make investments that are relatively small, over 80 percent of business angels invest in start-up firms with fewer than 20 employees. They invest locally, usually no more than 50 miles from their homes. Some limit their investments to industries in which they have had experience, while others invest in a wide variety of business sectors.

Along with providing needed money, private investors frequently contribute knowhow to new businesses. Because many of these individuals invest only in the types of businesses in which they have had experience, they can be very demanding. Also, they base their investment decision primarily on the potential risk and return of the investment, rather than on their personal relationship with the entrepreneur, unlike friends and family. Thus, the entrepreneur must be careful in structuring the terms of any such investors' involvement.

Venture capitalists

In addition to business angels who provide informal venture capital, small businesses also may seek out formal venture capitalists, groups of individuals who form limited partnerships for the purpose of raising capital from large institutional investors, such as pension plans and university endowments. Within the group, a venture capitalist serves as the general partner, with other investors constituting the limited partners. As limited partners, such investors have the benefit of limited liability. The venture capitalist raises a predetermined amount of money, called a fund. Once the money has been committed by the investors, the venture capitalist screens and evaluates investment opportunities in high-potential start-ups and existing firms.

For the investment, the venture capitalist receives the right to own a percentage of the entrepreneur's business. Reaching agreement on the exact percentage of ownership often involves considerable negotiation. The primary issues are the firm's expected profits in future years and the venture capitalist's required rate of return. Once an investment has been made, the venture capitalist carefully monitors the company, usually through a representative who serves on the firm's board.

Most often, investments by venture capitalists take the form of convertible debt or convertible preferred stock. In this way, venture capitalists ensure themselves senior claim over the owners and other equity investors in the event the firm is liquidated, but they can convert to stock and participate in the increased value of the business if it is successful. Although venture capital as a source of financing receives significant coverage in the business media, few small companies, especially start-ups, ever receive this kind of funding. No more than 1 or 2 percent of the business plans received by any venture capitalist are eventually funded—not exactly an encouraging statistic. Failure to receive funding from a venture capitalist, however, does not indicate that the venture lacks potential. Often, the venture is simply not a good fit for the investor. So, before trying to compete for venture capital financing, an entrepreneur should assess whether the firm and the management team are a good fit for a particular investor.

Summary

- A business plan is a formal statement of a set of business goals, which are believed to be attainable, and the plan for reaching those goals.
- A business plan is an entrepreneur's game plan; it crystallises the dreams and hopes that motivate an entrepreneur to take the start-up plunge.
- Marketing is always different things to different people. Some entrepreneurs view marketing as simply selling a product or service.
- Small business marketing consists of those business activities that direct the creation, development, and delivery of a bundle of satisfaction from the creator to the targeted user and that satisfy the targeted user.
- The core product/service is the fundamental benefit or solution sought by customers.
- In the market analysis section of the marketing plan, the entrepreneur describes the target market.
- A well-prepared market analysis and competition discussions are important to the formal marketing plan.
- The Internet has radically transformed how business is conducted; it is now the location of choice for many entrepreneurs.
- The choice of a good location is much more vital to some businesses than to others.
- Customer accessibility is an important consideration in selecting a location.
- A start-up business is affected in a number of ways by the environment in which it operates.
- Weather is one important environmental factor that influences the location decision, as well as the demand for many products such as air conditioners and outdoor swimming pools.
- The availability of resources associated with producing a product and operating a business should be considered in selecting a location.
- Once an entrepreneur has settled on a certain area of the country, a specific site must still be chosen.
- (B2B) model (selling to business customers) are significantly greater than those for firms with a business-to-consumer (B2C) model (selling to final consumers).
- In contrast to a B2B model, a business-to-consumer (B2C) model has final consumers as customers.
- Profits reward an owner for investing in a company and constitute a primary source of financing for future growth.
- Personal savings is the primary source of financing for most small business start-ups, with friends and family following in a distant second place.
- Commercial banks are the primary providers of debt capital to small companies.
- The interest rate charged by banks is usually stated in terms of either the prime rate or the LIBOR.
- Credit extended by suppliers is very important to a start-up.
- Business angels are private individuals who invest in early stage companies. They
- Within the group, a venture capitalist serves as the general partner, with other investors constituting the limited partners.

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- Stokes, D. & Wilson, N., 2006. *Small business management and entrepreneurship*, 5th ed., Cengage Learning EMEA, p.479.
- Keown, A. J., 2003. *Foundations of finance: the logic and practice of financial management*, 4th ed.

Self Assessment

1. A business _____ is a formal statement of a set of business goals, which are believed to be attainable, and the plan for reaching those goals.
 - a. plan
 - b. document
 - c. agreement
 - d. policy
2. Which of the following is not included in the second group in business plan which consists of outsiders critical to the firm's success?
 - a. Customers
 - b. Suppliers
 - c. Lenders
 - d. Brokers
3. The _____ is the fundamental benefit or solution sought by customers.
 - a. core product/service
 - b. actual product/service
 - c. augmented product/ service
 - d. product accessibility
4. Which among the following is the paperless exchange of business information via Internet?
 - a. E-commerce
 - b. Business angels
 - c. Voice mail
 - d. Fax machine
5. Which of the following is the cost of producing or purchasing the firm's products or services?
 - a. Cost of goods sold
 - b. Amount of sales
 - c. Operating expenses
 - d. Interest expense
6. Which expenses relates to marketing and distributing the product, general and administrative expenses, and depreciation expenses?
 - a. Cost of goods sold
 - b. Amount of sales
 - c. Operating expenses
 - d. Interest expense
7. A firm's _____ are figured as a percentage of taxable.
 - a. income taxes
 - b. amount of sales
 - c. operating expenses
 - d. interest expense

8. Which of the following statements is false?
- a. The search for financial support usually begins close to home.
 - b. Personal savings is the primary source of financing for most small business start-ups, with friends and family following in a distant second place.
 - c. Commercial banks are the primary providers of debt capital to small companies.
 - d. A term loan is an informal agreement or understanding between the borrower and the bank as to the maximum amount of credit the bank will provide the borrower at any one time.
9. Which of the following statements is false?
- a. Lines of credit represent a long-term source of debt capital.
 - b. Under certain circumstances, banks will loan money on a 5- to 10-year term.
 - c. A chattel mortgage is a loan for which certain items of inventory or other movable property serve as collateral.
 - d. A real estate mortgage is a loan for which real property, such as land or a building provides the collateral.
10. Match the following.

1. Accounts payable	A. Private individuals
2. Lines of credit	B. LIBOR
3. Interest rate	C. Trade credit
4. Business angels	D. A form of bank loan

- a. 1-A, 2-D, 3-B, 4-C
- b. 1-C, 2-D, 3-B, 4-A
- c. 1-B, 2-A, 3-D, 4-C
- d. 1-D, 2-B, 3-C, 4-A

Chapter V

Focusing on the Customer

Aim

The aim of this chapter is to:

- introduce customer relationship
- explain product life cycle
- illustrate the new product development process

Objectives

The objectives of this chapter are to:

- elucidate promotional planning
- explain supply chain management
- describe the strategy options for global firms

Learning outcome

At the end of this chapter, you will be able to:

- understand the channels of distribution
- recognise the steps in promotional planning
- identify the processes involved in product life cycle

5.1 Introduction

A customer (also known as a client, buyer, or purchaser) is usually used to refer to a current or potential buyer or user of the products of an individual or organisation, called the supplier, seller, or vendor. This is typically through purchasing or renting goods or services. However, in certain contexts, the term customer also includes by extension any entity that uses or experiences the services of another. A customer may also be a viewer of the product or service that is being sold despite deciding not to buy them. The general distinction between a customer and a client is that a customer purchases products, whereas a client purchases services.

5.2 Building Customer Relationship

Customer relationship management (CRM) means different things to different firms. It is symbolised by simple smiles or comments such as “thank you” and “come again”, as communicated by employees to customers who have just made a purchase. For others, CRM embodies a much broader marketing effort, leading to nothing short of complete customisation of products and/or services to fit individual customer needs. The goals of a CRM program, when a small company is concerned, fall somewhere between these two perspectives.

Regardless of the level of a firm’s commitment to customer relationship management, the central message of every CRM program is “Court customers for more than a one-time sale.” A firm that strongly commits to this idea will appreciate the many benefits a CRM program can offer. Customer relationship management (CRM) can be defined as a “company-wide business strategy designed to optimise profitability and customer satisfaction, by focusing on highly defined and precise customer groups.” It is the implementation of customer-centric strategies, which put customers first so that the firm can succeed. CRM involves treating customers the way the entrepreneur would want to be treated if he or she were a customer, the business version of the Golden Rule. For decades, entrepreneurs have recognised the importance of treating customers well; “the customer is king” is an old adage. Modern CRM focuses on:

- Customers rather than products
- Changes in company: processes, systems, and culture
- All channels and media involved in the marketing effort, from the Internet to field sales.

The forerunners of many modern CRM techniques were developed in the 1960s by marketers such as Sears and various book clubs. They simply stored information about their customers in computers for reasons other than invoicing. Their goal was to teach who their customers are, what they wanted, and what sort of interests they had. Then along came marketers with ideas about the potential benefits of adopting a customer orientation, followed by the rise of the Internet.

It should be noted that CRM, in its purest form, has nothing to do with technology, although Internet technology has definitely been a major force in CRM’s development. Just as putting on the latest \$300 pair of technologically designed basketball shoes doesn’t make the wearer a WNBA or NBA player, buying or developing CRM computer software does not, in itself, lead to higher customer retention. But it can help if it is used properly. Most importantly, there must be company-wide commitment to the concept if CRM is to be productive.

5.2.1 The Importance of CRM to Small Firms

The importance of CRM to the small firm as depicted in the following figure, a firm’s next sale comes from one of two sources, a current customer or a new customer. Obviously, both current and potential customers are valued by a small firm, but sometimes current customers are taken for granted and ignored.

While marketing efforts devoted to bringing new customers into the fold are obviously important, keeping existing customers happy is given a higher priority. A CRM program addresses this priority. Some firms, however, appear not to recognise this simple truth, and this results in different levels of CRM initiatives. One interesting study of CRM involvement among family and nonfamily firms concluded that non-family businesses are ahead of family-owned companies with respect to starting and completing CRM initiatives.”

Brian Vellmure of Initium Technology, a provider of CRM solutions to small firms, has identified five economic benefits of maintaining relationships with current customers:

- Acquisition costs for new customers are huge
- Long-time customers spend more money than new ones
- Happy customers refer their friends and colleagues
- Order-processing costs are higher for new customers
- Old customers will pay more for products

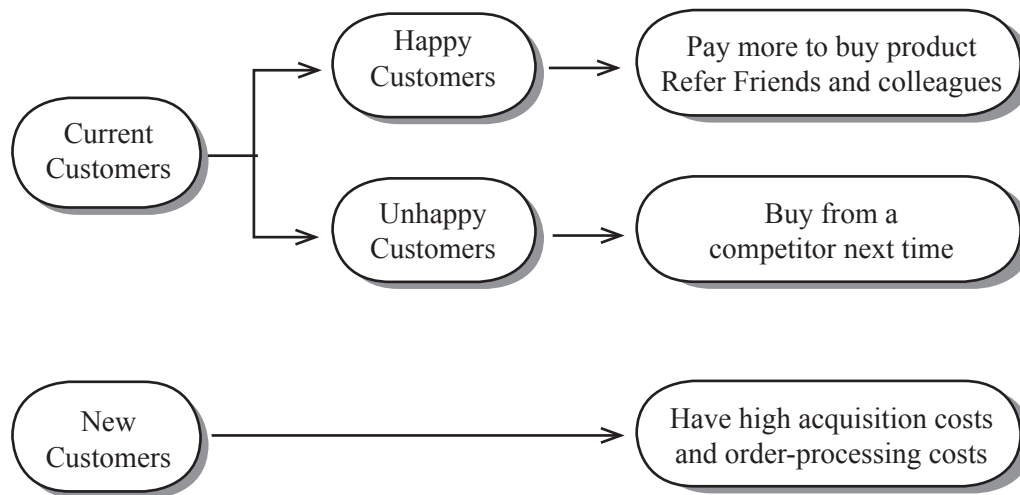


Fig. 5.1 Sources of the next sale

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

5.2.2 Components of Customer Satisfaction

A number of factors under a firm's control results in customer satisfaction. One classic article identifies the following four elements as keys to customer satisfaction:

- Providing the most basic benefits of the product and/or service the elements that customers expect all competitors to deliver
- Offering general support services, such as customer assistance
- Setting up a system to counteract any bad experiences customers may experience
- Delivering extraordinary services that excel in meeting customers' preferences and make the product and/or service seem customised

Small firms are in a unique position to offer extraordinary service. Relationship marketing advocate Patrick Daly, who oversees a customer relations program for a company in Redwood City, California, suggests the following ways to provide extraordinary service: Naming names. In today's detached, "just give me your account number" world, nothing is more well received than individual, personalised attention. Being a courteous and friendly to customers, greeting them by name is valued 10 times more on the "worthy of loyalty" scale.

In customer care, customers pretty much know what they do and don't want from your company. If you remember what they want on an individual basis, even if it's something as simple as knowing a dry cleaning customer likes light starch in his collars then you have mastered one of the key elements of a strong loyalty program.

Boo-boo research is done if part of any customer loyalty program is taking the time to reach out to lost customers to learn why they went elsewhere. In many cases, just contacting them and showing them that you really care about getting their business will win them back along with their contribution to your profits.

5.2.3 Understanding Psychological and Sociological Influences on Customers

For understanding the psychological and sociological influences on customers, it is important to understand consumer behaviour model. The four psychological influences that have the greatest relevance to small businesses are needs, perceptions, motivations, and attitudes.

Needs

Needs are described as the starting point for all behaviour. Without needs, there would be no behaviour. Although consumer needs are innumerable, they can be identified as falling into four categories physiological, social, psychological, and spiritual. Consumers' needs are never fully satisfied, thereby ensuring the continued existence of business. One of the more complex characteristics of needs is the way in which they function together in generating behaviour. In other words, various needs operate simultaneously, making it difficult to determine which need is being satisfied by a specific product or service. Nevertheless, careful assessment of the needs-behaviour connection can be very helpful in developing marketing strategy. Different purchases of the same product satisfy different needs. A needs-based strategy would result in a different marketing approach in each of these situations.

Perceptions

A second psychological factor, which is called perception, encompasses those individual processes that ultimately give meaning to the stimuli consumers encounter. When this meaning is severely distorted or entirely blocked, consumer perception can cloud a small firm's marketing effort and make it ineffective. For example, a retailer may mark its fashion clothing "on sale" to communicate a price reduction from usual levels, but customers' perceptions may be that "these clothes are out of style."

Perception is considered as two-sided coin. It depends on the characteristics of both the stimulus and the perceiver. Consumers attempt to manage huge quantities of incoming stimuli through perceptual categorisation, a process by which things that are similar are perceived as belonging together. Therefore, if a small business wishes to position its product alongside an existing brand and have it accepted as comparable, the marketing mix should reflect an awareness of perceptual categorisation. Similar quality can be communicated through similar prices or through a package design with a colour scheme similar to that of an existing brand. These help a consumer fit the new product into the desired product category.

Small firms that use an existing brand name for a new product are relying on perceptual categorisation to pre-sell the new product. On the other hand, if the new product is physically different or of a different quality, a brand name should be selected to create a distinctive perceptual categorisation by the consumer. If a consumer has strong brand loyalty to a product, it is difficult for other brands to penetrate his or her perceptual barriers. That individual is likely to have distorted images of competing brands because of a pre-existing attitude. Consumers' perceptions thus present a unique communication challenge.

Motivations

Unsatisfied needs always create tension within an individual. When this tension reaches a certain level, the individual becomes uncomfortable and is motivated to reduce the tension. Everyone is familiar with hunger pains, which are manifestations of the tension created by an unsatisfied physiological need. Motivations are goal directed forces that organise and give direction to tension caused by unsatisfied needs. Marketers cannot create needs, but they can offer unique motivations to consumers.

If an acceptable reason for purchasing a product or service is provided, it will probably be internalised by the consumer as a motivating force. The key for the marketer is to determine which motivations the consumer will perceive as acceptable in a given situation. The consumer behaviour variables such as physiological needs, the other three classes of needs social, psychological, and spiritual can be similarly connected to behaviour through motivations.

For example, when incomplete satisfaction of a person's social needs is creating tension, a firm may show how its product can full fill those social needs by providing acceptable motivations to that person. A campus clothing store might promote styles that communicate that the college student wearing those clothes has obtained membership in a group such as a fraternity or sorority. Understanding motivations is not easy. Several motivations may be present in any situation, and they are often subconscious. However, they must be investigated in order for the marketing effort to be successful.

Attitudes

Like the other psychological variables, attitudes are not to be observed, but everyone has them. An attitude is an enduring opinion, based on a combination of knowledge, feeling, and behavioural tendency. An attitude may act as an obstacle or a catalyst in bringing a customer to a product. For example, consumers with the belief that a local, family-run grocery store has higher prices than a national supermarket chain may avoid the local store. Armed with an understanding of the structure of a particular attitude, a marketer can approach the consumer more intelligently.

5.3 Product Life Cycle and New Product Development

Our discussion of growth and innovation illustrated how entrepreneurial firms can be part of the development of new products for the marketplace. It is necessary to ask some questions, to focus our discussion more narrowly, to answer two additional questions:

- What creates the need for innovation in a specific business?
- And how can innovation are managed?

Examining these questions by looking at the product life cycle concept and a four-stage approach, leads to new product development.

5.3.1 Product Life Cycle

An important concept underlying sound product strategy is the product life cycle, which allows us to visualise the sales and profits of a product from the time it is introduced until it is no longer on the market. The product life cycle provides a detailed picture of what happens to an individual product's or service's sales and profits; it has a shape similar to that of the competitive advantage life cycle, depicted the following figure. Progressing along the product life cycle (sales) curve in, it can see that the initial stages are characterised by a slow and, ideally, upward movement. The stay at the top is exciting but relatively brief. Then, suddenly, the decline begins, and downward movement can be rapid. It is to be noted that the shape of the typical profit curve as shown in the figure. The introductory stage is dominated by losses, with profits peaking in the growth stage. The product life cycle concept is important to the small business owner for three reasons.

- First, it helps the entrepreneur to understand that promotion, pricing, and distribution policies should all be adjusted to reflect a product's position on the curve.
- Second, it highlights the importance of rejuvenating product lines, whenever possible, before they die.
- Third, it is a continuing reminder that the natural life cycle of a product follows the classic normal curve and, therefore that innovation is necessary for a firm's survival.

Good business practice entails beginning a new curve before the existing curve of the product life cycle peaks.

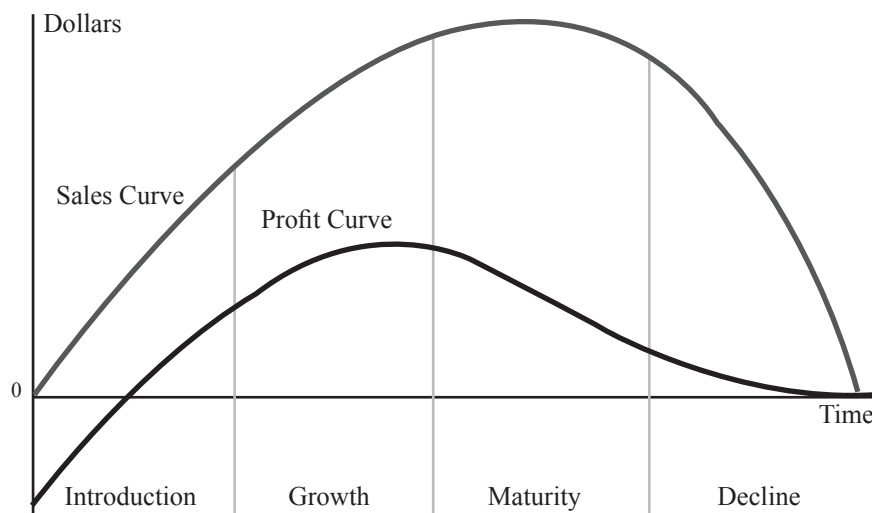


Fig. 5.2 The product life cycle

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

5.3.2 New Product Development Process

A major responsibility of the entrepreneur is to find, evaluate, and introduce new products. This responsibility requires that the entrepreneur to establish a process for developing new products. In big businesses, committees or entire departments are created for that purpose.

Even in small firms, however, new product development needs to be a formalised process. Entrepreneurs tend to treat new product development as a mountainous task and it usually is. Many find that the four-stage, structured approach, described below, is the most effective way to tackle new product development.

Idea accumulation

The first stage of the new product development process, idea accumulation, involves increasing the pool of ideas under consideration. New products start with ideas, and these ideas have varied origins. These are sales, engineering, or other personnel within the firm Government-owned patents, which are generally available on a royalty-free basis privately, owned patents listed by the U.S. Patent Office. Other small companies that may be available for acquisition or merger competitors' products and advertising requests and suggestions from customers brainstorming marketing research (primary and secondary).

Business analysis

Business analysis is the second stage in new product development. Every new product idea must be carefully studied in relation to several financial considerations. Costs and revenues are estimated and analysed with techniques such as break-even analysis. Any idea failing to show that it can be profitable is discarded during the business analysis stage. Four key factors need to be considered in conducting a business analysis:

- **The product's relationship is an existing product line:** Some firms add very different products to their product mix. In most cases, any product item or product line added should be consistent with or somehow related to the existing product mix. If the product is completely new, it should have at least a family relationship to existing products. Otherwise, the new product may call for drastic and costly changes in manufacturing methods, distribution channels, type of promotion, and/or sales strategy.
- **Cost of development and introduction:** One problem in adding new products is its cost of their development and introduction. Considerable capital outlays may be necessary, including expenditures for design and development, marketing research to establish sales potential, advertising and sales promotion, patents, and additional equipment. One to three years may pass before profits are realised on the sale of a new product.

- **Available personnel and facilities:** Obviously, having adequate skilled personnel and production equipment is preferable to having to add employees and buy equipment. Thus, introducing new products is typically more appealing if the personnel and the required equipment are already available.
- **Competition and market acceptance:** Still another factor to be considered in a business analysis is the potential competition facing a proposed product in its target market. Competition must not be too severe. The ideal solution is to offer a product that is sufficiently different from existing products or that is in a cost and price bracket where it avoids direct competition.

Development of product

The next stage of new product development entails sketching out the plan for branding, packaging, and other supporting efforts, such as pricing and promotion. An actual prototype may be needed at this stage. After these components have been evaluated, the new product idea may be judged a misfit and discarded or passed on to the next stage for further consideration.

Product testing

The last step in the product development process is product testing. The physical product should be proven acceptable through testing. While the product can be evaluated in a laboratory setting, a limited test of market reaction should also be conducted

5.4 Supply Chain Management

Supply chain management is a system of management which integrates and coordinates the ways in which a firm finds the raw materials and necessary components to produce a product or service, builds the actual product or service, and then delivers it to customers. Recent attention directed toward supply chain management has motivated attempts by both small and large firms to create a more competitive, customer-driven supply system.

In other words, effective supply chain management can potentially lower the costs of inventory, transportation, warehousing, and packaging while increasing customer satisfaction. The Internet and available software are major drivers of current developments in supply chain management. Pre-Internet communication between parties in the supply chain was slow or nonexistent. But the Internet, with its simple, universally accepted communication standards, has brought suppliers and customers together in a way never before thought possible.

Entrepreneurs often regard distribution as the least glamorous marketing activity. Nevertheless, an effective distribution system is just as important as a unique package, a clever name, or a creative promotional campaign. Thus, a small business owner should understand the basic principles of distribution, which apply to both domestic and international distribution activities.

In marketing, distribution encompasses both the physical movement of products and the establishment of intermediary (middleman) relationships to achieve product movement. The activities involved in physically moving a product are called physical distribution (logistics); the system of relationships established to guide the movement of a product is called the channel of distribution.

Distribution is essential for both tangible and intangible goods. Since distribution activities are more visible for tangible goods (products), it is necessary to focus primarily on products. Most intangible goods (services) are delivered directly to the user. An income tax preparer and a barber, for example, serve clients directly. Marketing a person's labour can involve channel intermediaries. An employment agency, for example, provides an employer with temporary personnel.

5.4.1 Intermediaries

Intermediaries can often perform marketing functions better than the producer of a product can. A producer can perform its own distribution functions including delivery, if the geographic area of the market is small, customers' needs are specialised, and risk levels are low, as they might be for a producer of doughnuts. Intermediaries generally provide more efficient means of distribution if customers are widely dispersed or if special packaging and storage are needed. Many types of small firms, such as retail stores, function as intermediaries.

Some intermediaries, called merchant middlemen, take title to the goods they distribute, thereby helping a firm to share or totally shift business risk. Other intermediaries, such as agents and brokers, do not take title to goods and, therefore, assume less market risk than do merchant middlemen.

5.4.2 Channels of Distribution

A channel of distribution can be either direct or indirect. In a direct channel, there are no intermediaries, as the product goes directly from producer to user. An indirect channel of distribution has one or more intermediaries between producer and user. Figure given below depicts the various options available for structuring a channel of distribution.

E-commerce (online merchandising) and mail-order marketing is direct channel systems for distributing consumer goods. Amazon.com is an example of an online merchandiser that uses a direct channel to final consumers. Industrial purchasers are equally familiar with industrial distributors. Channels with two or three stages of intermediaries are probably the ones most typically used by small firms producing products with geographically large markets. It is important to note that a small firm may use more than one channel of distribution, a practice called dual distribution.

Firms that successfully employ a single distribution channel may switch to dual distribution if they find that an additional channel will improve overall profitability. A logical starting point in structuring a distribution system is to observe systems used by competing businesses. Such an analysis should reveal some practical alternatives, which can then be evaluated. The three main considerations in evaluating a channel of distribution are costs, coverage, and control.

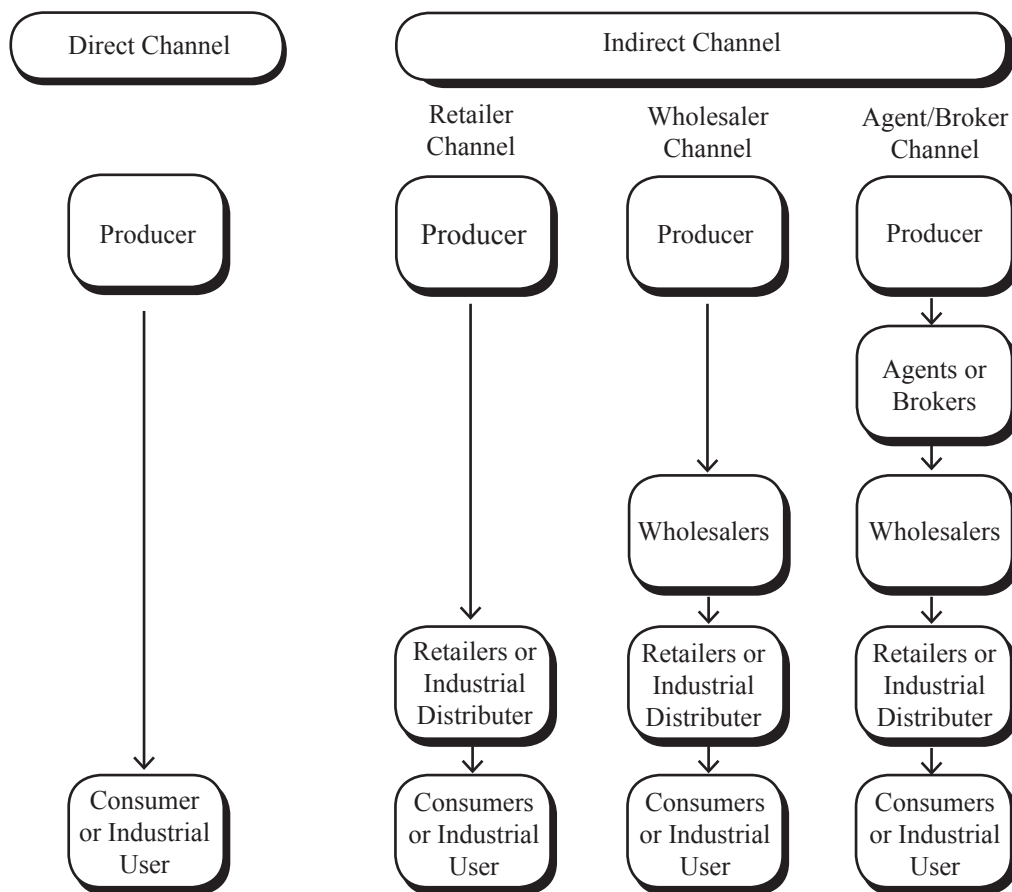


Fig. 5.3 Alternative channels of distribution

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Costs

The absence of intermediaries does not make a direct channel inherently less expensive than an indirect channel. The least expensive channel may be indirect. For example, a firm producing handmade dolls need not purchase trucks and warehouses to distribute its product directly to customers, but it can instead rely on established intermediaries that own such facilities. Small firms should look at distribution costs as an investment spending money in order to make money. They should ask themselves whether the amount of money they “invest” in intermediaries would still get the job done if they used direct distribution.

Coverage

Small firms can often use indirect channels of distribution to increase market coverage. Suppose a small manufacturer’s internal sales force can make 10 contacts a week with final users of the firm’s product. Creating an indirect channel with 10 industrial distributors, each making 10 contacts a week could expose the product to 100 final users a week.

Control

A direct channel of distribution is at times preferable because it provides more control. Intermediaries may not market a product as desired. An entrepreneur must carefully select intermediaries that provide the desired support. A small business that chooses to use intermediaries to help distribute and market its product must be sure that the intermediaries have a good understanding of how the product is best used and why it’s better than competitors’ offerings. Additionally, if a wholesaler carries competing products, an entrepreneur must be sure that her or his product gets its fair share of marketing efforts. Distributors must know what makes the product special and how best to market it. Sloppy marketing efforts and insufficient product knowledge by intermediaries can undermine the success of even the best product.

5.4.3 Scope of Physical Distribution

In addition to the intermediary relationships that make up a channel, there must also be a system of physical distribution. The main component of physical distribution is transportation. Additional components include storage, materials handling, delivery terms, and inventory management.

Transportation

The major decision regarding physical transportation of a product is which method to use. Available modes of transportation are traditionally classified as airplanes, trucks, railroads, pipelines, and waterways. Each mode has unique advantages and disadvantages. The choice of a specific mode of transportation is based on several criteria: relative cost, transit time, reliability, capability, accessibility, and traceability.

Transportation intermediaries legally classified as common carriers, contract carriers, and private carriers. Common carriers, which are available for hire to the general public, and contract carriers, which engage in individual contracts with shippers, are subject to regulation by federal and/or state agencies. Lines of transport owned by the shippers are called private carriers.

Storage

Lack of space is a common problem for small businesses. When a channel system uses merchant middlemen or wholesalers, title to the goods is transferred, as is responsibility for the storage function. On other occasions, the small business must plan for its own warehousing. If a firm is too small to own a private warehouse, it can rent space in a public warehouse. If storage requirements are simple and do not involve much special handling equipment, a public warehouse can provide economical storage.

Materials handling

A damaged product in the right place at the right time is worth little. Therefore, a physical distribution system must arrange for suitable materials handling methods and equipment. Forklifts, as well as special containers and packaging, are part of a materials-handling system.

Delivery terms

A small but important part of a physical distribution system is the delivery terms, specifying which party is responsible for several aspects of the distribution:

- Paying the freight costs
- Selecting the carriers
- Bearing the risk of damage in transit
- Selecting the modes of transport

The simplest delivery term and the one most advantageous to a small business as seller is F.O.B. (free on board) origin, freight collect. This shifts all the responsibility for freight costs to the buyer. Title to the goods and risk of loss also pass to the buyer at the time the goods are shipped.

Logistics companies specialise in transportation and distribution services, providing trucking, packaging, and warehousing services for small and medium-sized companies with limited in-house staff. Many small businesses believe that using these third-party logistics firms is more cost effective than carrying out the same functions in-house. Effective management of a company's products requires attention to both maintaining existing products and developing new products.

Like people, products pass through life cycle stages and face different obstacles at each stage. A successful entrepreneur must have a carefully planned product strategy. Managing your supply chain requires planning how and from, the components are obtained for your products and how the delivery of the finished product to your customers. Various channels of distribution exist to deliver your product to your customers, but the advantages and disadvantages of each must be considered carefully.

5.5 Pricing Decisions

Pricing and credit decisions are vital because they influence the relationship between the business and its customers. These decisions also directly affect both revenue and cash flow. Of course, customers dislike price increases and restrictive credit policies; therefore, the entrepreneur needs to set prices and design credit policies as wisely as possible, to avoid the need for frequent changes.

Because a value must be placed on a product or service by the provider before it can be sold, pricing decisions are a critical issue in small business marketing. The price of a product or service specifies what the seller requires for giving up ownership or use of that product or service. Often, the seller must extend credit to the buyer in order to make the exchange happen. Credit is simply an agreement between buyer and seller that payment for a product or service will be received at some later date. This chapter examines both the pricing decisions and the credit decisions of small firms.

5.5.1 Setting a Price

In setting a price, the entrepreneur decides on the most appropriate value for the product or service being offered for sale. This task might seem easy, but it isn't. It is essential to remember that total sales revenue depends on just two components, i.e., sales volume and price and even a small change in price can drastically influence revenue. Pricing is also important because it indirectly affects sales quantity. Setting a price too high may result in lower quantities sold, reducing total revenue. In the above example, quantity sold was assumed to be independent of price and it very well may be for such a small change in price.

However, a larger increase or decrease might substantially affect the quantity sold. Pricing, therefore, has a dual influence on total sales revenue. It is important directly as part of the gross revenue equation and indirectly through its impact on demand. Before beginning a more detailed analysis of pricing, we should note that services are generally more difficult to price than products because of their intangible nature.

However, the impact of price on revenue and profits is the same. Because estimating the cost of providing a service and the demand for that service is a more complex process, the following discussions will focus on product pricing.

5.5.2 Selecting a Price Strategy

Although techniques like break-even analysis yield a good idea of a feasible price for a specific product, their seemingly precise nature can be very misleading. Such analyses are only one kind of tool for pricing and should not by themselves determine the final price. Price determination must also consider market characteristics and the firm's current marketing strategy. Pricing strategies that reflect these additional considerations include penetration pricing, skimming pricing, follow-the-leader pricing, variable pricing, price lining, and pricing at what the market will bear.

Penetration pricing

A firm that uses a penetration pricing strategy prices a product or service at less than its normal, long-range market price in order to gain more rapid market acceptance or to increase existing market share. This strategy at times discourages new competitors from entering a market niche if they mistakenly view the penetration price as a long-range price. Obviously, a firm that uses this strategy sacrifices some profit margin to achieve market penetration.

Skimming pricing

A skimming price strategy sets prices for products or services at high levels for a limited period of time before reducing prices to lower, more competitive levels. This strategy assumes that certain customers will pay a higher price because they view a product or service as a prestige item. Use of a skimming price is most practical when there is little threat of short-term competition or when start-up costs must be recovered rapidly.

Follow-the-leader pricing

A follow-the-leader pricing strategy uses a particular competitor as a model in setting a price for a product or service. The probable reaction of competitors is a critical factor in determining whether to cut prices below a prevailing level. In a small business, a competition with larger firms is seldom in a position to consider it the price leader. If competitors view a small firm's pricing as relatively unimportant, they may not respond to a price differential. On the other hand, some competitors may view a smaller price-cutter as a direct threat and counter with reductions of their own. In such a case, the use of a follow the-leader pricing strategy accomplishes very little.

Variable pricing

Some businesses use a variable pricing strategy to offer price concessions to certain customers, even though they may advertise a uniform price. Lower prices are offered for various reasons, including a customer's knowledge and bargaining strength. In some fields of business, therefore, firms make two-part pricing decisions: They set a standard list price but offer a range of price concessions to particular buyers, for example, those that purchase large quantities of their product.

Sellers using a type of variable pricing strategy called a dynamic (personalised) pricing strategy charge more than the standard price after gauging a customer's financial means and desire for the product. The information-gathering capability of the Internet has allowed such retailers as Amazon.com to use dynamic pricing.

Price lining

A price lining strategy establishes distinct price categories at which similar items of retail merchandise are offered for sale. The amount of inventory stocked at different quality levels would depend on the income levels and buying desires of a store's customers. A price lining strategy has the advantage of simplifying the selection process for the customer and reducing the necessary minimum inventory.

Pricing at what the market will bear

The strategy of pricing on the basis of what the market will bear can be used only when the seller has little or no competition. Obviously, this strategy will work only for non-standardised products. For example, a food store might offer egg roll wrappers that its competitors do not carry. Busy consumers who want to fix egg rolls but have neither the time nor the knowledge to prepare the wrappers themselves will buy them at any reasonable price.

Some final notes on pricing strategies

In some situations, local, state, and federal laws have to be considered in setting prices. When a small business markets a line of products, some of which may compete with each other, and pricing decisions must take into account the effects of a single product price on the rest of the line. Continually adjusting a price to meet changing marketing conditions can be both costly to the seller and confusing to buyers. An alternative approach is to use a system of discounting designed to reflect a variety of needs. For example, a seller may offer a trade discount to a particular buyer (such as a wholesaler) because that buyer performs a certain marketing function for the seller (such as distribution). The stated, or list, price is unchanged, but the seller offers a lower actual price by means of a discount. Small firms should not treat bad pricing decisions as un-correctable mistakes.

5.6 Promotional Planning

For starting up a business, it is necessary to be bold enough to shout about it. Whether you call it audacious advertising or guerilla, street-level, or in-your-face marketing, it's all about breaking through the clutter and getting the attention of your target consumers. A thorough understanding of your customer is the key to the success of any such marketing attempts. Knowing that his customers attend such events as the NBA All-Star game and the Super Bowl, Brauner plans to take his Bald Guyz street team to those cities during the festivities.

5.6.1 Determining the Promotional Budget

There are four commonsense approaches to budgeting funds for small business promotion:

- Allocating a percentage of sales
 - Often, the simplest method of determining how much to budget for promotion is to earmark promotional dollars based on a percentage of sales. A firm's past experiences should be evaluated to establish a promotion-to-sales ratio. If 2 percent of sales, for example, have historically been spent on promotion with good results, the firm should budget 2 percent of forecasted sales for future promotion. Secondary data on industry averages can be used for comparison.
- Deciding how much can be spared
 - Another piecemeal approach to promotional budgeting widely used by small firms is spending whatever left over when all other activities have been funded. The decision about promotional spending might be made only when a media representative sells an owner on a special deal that the business can afford. Such an approach to promotional spending should be avoided because it ignores promotional goals.
- Spending as much as the competition does
 - Sometimes, a small firm builds a promotional budget is based on an analysis of competitors' budgets. By duplicating the promotional efforts of close competitors, the business hopes to reach the same customers and will at least be spending as much as the competition. If the competitor is a large business, this method is clearly not feasible; however, it can be used to react to short-run promotional tactics by small competitors. Unfortunately, this approach results in the copying of competitors' mistakes as well as their successes.
- Determining what it will take to do the job
 - The preferred approach to estimating promotional expenditures is to decide the job to be done. This method requires a comprehensive analysis of the market and the firm's goals. If these estimates are reasonably accurate, the entrepreneur can determine the total amount that needs to be spent. In many cases, the best way for a small business to set promotional expenditures incorporates all four approaches. In other words, compare the four estimated amounts and set the promotional budget at a level that is somewhere between the maximum and minimum amounts. After the budget has been determined, the entrepreneur must then decide how dollars will be spent on the various promotional methods. Which methods are chosen depends on a number of factors. We will now examine personal selling, a frequent choice for small firms.

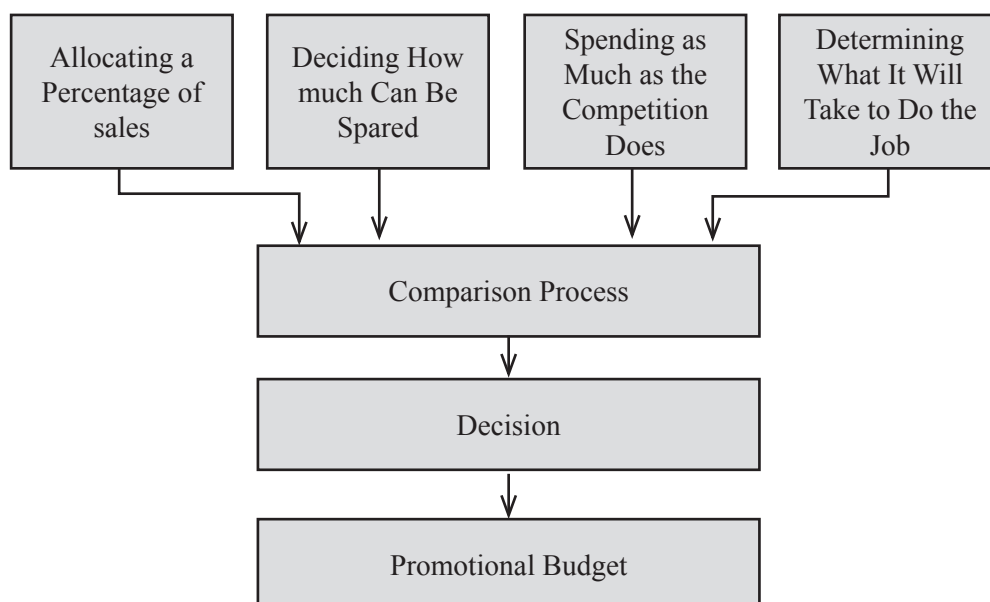


Fig. 5.4 Four-step method for determining a promotional budget

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

5.6.2 Advertising Practices for Small Firms

Another significant promotional expenditure for the small firm is advertising. Advertising results in the impersonal presentation of an idea that is identified with a business sponsor. Ideas in advertising are communicated to consumers through media such as television, radio, magazines, newspapers, billboards, and the Internet.

Advertising objectives

Its primary goal is informing, persuading, and reminding customers of the availability or superiority of a firm's product or service. To be successful, it must rest on a foundation of positive features such as product quality and efficient service. It is important to remember that advertising can bring no more than temporary success to an otherwise second-rate product. Advertising must be viewed as a complement to a good product and never as a replacement for a bad product. The entrepreneur must avoid creating false expectations with advertising, as such expectations are likely to disappoint customers and leave them dissatisfied.

Types of advertising

The two basic types of advertising are product advertising and institutional advertising. Product advertising is designed to make potential customers aware of a particular product or service and create a desire for it. Institutional advertising, on the other hand, conveys information about the business itself. It is intended to make the public aware of the company and enhance its image so that its product advertising will be more credible and effective.

Obtaining assistance with advertising

Most small businesses rely on others' expertise to create their promotional messages. There are several sources for this specialised assistance, including advertising agencies, suppliers, trade associations, and advertising media. Advertising agencies can provide the following services:

- Furnish design, artwork, and copy for specific advertisements and/or commercials
- Evaluate and recommend the advertising media with the greatest "pulling power"
- Evaluate the effectiveness of different advertising appeals
- Advise on sales promotions and merchandise displays
- Conduct market-sampling studies to evaluate product acceptance or determine
- The sales potential of a specific geographic area
- Furnish mailing lists

Since advertising agencies charge fees for their services, an entrepreneur must make sure that the return from those services will be greater than the fees paid. Quality advertising assistance can best be provided by a competent agency. With a high level of computer technology currently available, creating print advertising in-house is becoming increasingly common among small firms. Other outside sources may assist in formulating and carrying out promotional programs. Suppliers often furnish display aids and even entire advertising programs to their dealers. Trade associations also provide helpful assistance. In addition, the advertising media can provide some of the same services offered by an ad agency.

Frequency of advertising

It is necessary to determine advertising as an important and highly complex issue for a small business. Advertising should be done regularly, and attempts to stimulate interest in a firm's products or services should be part of an ongoing promotional program. One-shot advertisements that are not part of a well-planned promotional effort lose much of their effectiveness in a short period. Of course, some non continuous advertising may be justified, such as advertising to prepare consumers for acceptance of a new product. Such advertising may also be used to suggest to customers new uses for established products or to promote special sales. Deciding on the frequency of advertising involves a host of factors, both objective and subjective, and a wise entrepreneur will seek professional advice.

Where to advertise

Most small firms restrict their advertising, either geographically or by customer type. Advertising media should reach a firm's present or desired target market. From among the many media available, a small business entrepreneur must choose those that will provide the greatest return for the advertising dollar. The most appropriate combination of advertising media depends on the type of business and its current circumstances. A real estate sales firm, for example, may rely almost exclusively on classified advertisements in the local newspaper, supplemented by institutional advertising in the Yellow Pages of the telephone directory.

A transfer-and-storage firm may use a combination of radio, billboard, and Yellow Pages advertising to reach individuals planning to move household furniture. A small toy manufacturer may emphasise television advertisements and participation in trade fairs. A local retail store may concentrate on display advertisements in the local newspaper. The selection of media should be based not only on tradition but also on a careful evaluation of the various methods that are available to cover a firm's particular market.

A good way to build a media mix is to talk with representatives from each medium. A small firm will usually find these representatives willing to recommend an assortment of media, not just the ones they represent. Before meeting with these representatives, the entrepreneur should learn about the strengths and weaknesses of each medium.

5.6.3 Sales Promotional Tools

Sales promotion can serve as an inducement to buy a certain product while typically offering value to prospective customers. Generally, sales promotion includes any promotional technique, other than personal selling or advertising that stimulates the purchase of a particular good or service. Three of the most widely used options: specialties, trade show exhibits, and publicity.

Specialties

The most widely used specialty item is a calendar. Other popular specialty items are pens, key chains, coffee mugs, and shirts. Almost anything can be used as a specialty promotion, as long as each item is imprinted with the firm's name or other identifying slogan. The distinguishing characteristics of specialties are their enduring nature and tangible value. Specialties are referred to as the "lasting medium." As functional products, they are worth something to recipients. Specialties can be used to promote a product directly or to create goodwill for a firm; they are excellent reminders of a firm's existence.

Trade show exhibits

Advertising often cannot substitute for trial experiences with a product, and a customer's place of business is not always the best environment for product demonstrations. Trade show exhibits allow potential customers to get hands-on experience with a product. Trade show exhibits are of particular value to manufacturers. The greatest benefit of these exhibits is the potential cost savings over personal selling. Trade show groups claim that the cost of an exhibit is less than one-fourth the cost of sales calls, and many small manufacturers agree that exhibits are more cost-effective than advertising.

Publicity

Of particular importance to small firms is publicity, which provides visibility for a business at little or no cost. Publicity can be used to promote both a product and a firm's image; it is a vital part of public relations for the small business. A good publicity program requires regular contacts with the news media. Although publicity is not always free, the return on a relatively small investment can be substantial. Other examples of publicity efforts that entail some expense include involvement with school yearbooks and youth athletic programs. While the benefits are difficult to measure, publicity is nevertheless important to a small business and should be used at every opportunity.

When to use sales promotion

A small firm uses sales promotion to accomplish various objectives. For example, small manufacturers can use it to stimulate channel members, retailers and wholesalers to market their product. Wholesalers can use sales promotion to induce retailers to buy inventories earlier than they normally would, and retailers, with similar promotional tools, may be able to persuade customers to make a purchase.

The source (a small business) must send out its message in such a way that intended recipients (in the target market) receive it, understand it, and are moved to respond to it. But this is no simple exercise. Many decisions must be made along the way mainly for decisions regarding the size of the promotional budget, the promotional mix, the nature and placement of advertising, the identification of high-potential prospects, participation in trade shows, and the list goes on.

5.7 Global Marketing

More than a million automobiles are stolen in the United States each year. The business world is undergoing profound change. There was a time when national economies were isolated by trade and investment barriers, differences in language and culture, distinctive business practices, and various government regulations. However, these dissimilarities are fading over time as market preferences converge, trade barriers fall, and national economies integrate to form a global economic system. This process is the essence of globalisation. Though the trend toward convergence has been developing for some time, the pace is quickening, creating global opportunities that did not exist even a few years ago. And with the astounding rate of economic growth in countries such as China and India, it would be unwise to ignore overseas opportunities.

5.7.1 Small Business as Global Enterprises

As global communication systems can be made more efficient and trade agreements pry open national markets to foreign competition, while entrepreneurs are focusing more on international business. Today's sophisticated technologies are expensive to develop and can be quickly replaced; therefore, it is important to recover research and development costs over a larger market and in less time by taking advantage of international sales. Small firms may decide to go global by having opportunities expansion in mind, or they may be forced to enter foreign markets in order to compete with those firms in their industry that have already done so.

Differences in types of trading systems and import requirements can also make international trade challenging. A small manufacturer of diagnostic and surgical eye care equipment discovered that a global company must regularly modify its products to meet rigid design specifications, which vary from country to country.

5.7.2 Forces Driving Global Business

At one time, most entrepreneurs in the United States were content to position their start-ups for the home market and look forward to the day when international sales might materialise. With untapped market potential at home and few overseas competitors, many small business owners used this strategy successfully. Today, more small businesses are planning from the start to penetrate all available markets, both domestic and foreign.

In other words, many small firms are looking to do more than simply expand a profitable market when they get involved in international business. No longer insulated from global challengers, they must consider the dynamics of the new competitive environment.

One way to adjust to these emerging realities is through innovation. In many industries, innovation is essential to competitiveness, giving a small company an advantage over its large-firm counterparts. Small businesses that invest heavily in research and development often outperform their large competitors. When R&D costs rise, they often cannot be recovered from domestic sales alone. Increasing sales in international markets is the only viable way to recover the firm's investment. In some cases, this may require identifying dynamic markets that are beginning to open around the world and locating in or near those markets.

The basic forces behind global expansion can be divided into four general categories as seen in the following figure, i.e., expanding markets, gaining access to resources, cutting costs, and capitalising on special features of location. Within each category fall some tried and true motivations, as well as some new angles that have emerged with the global economy.

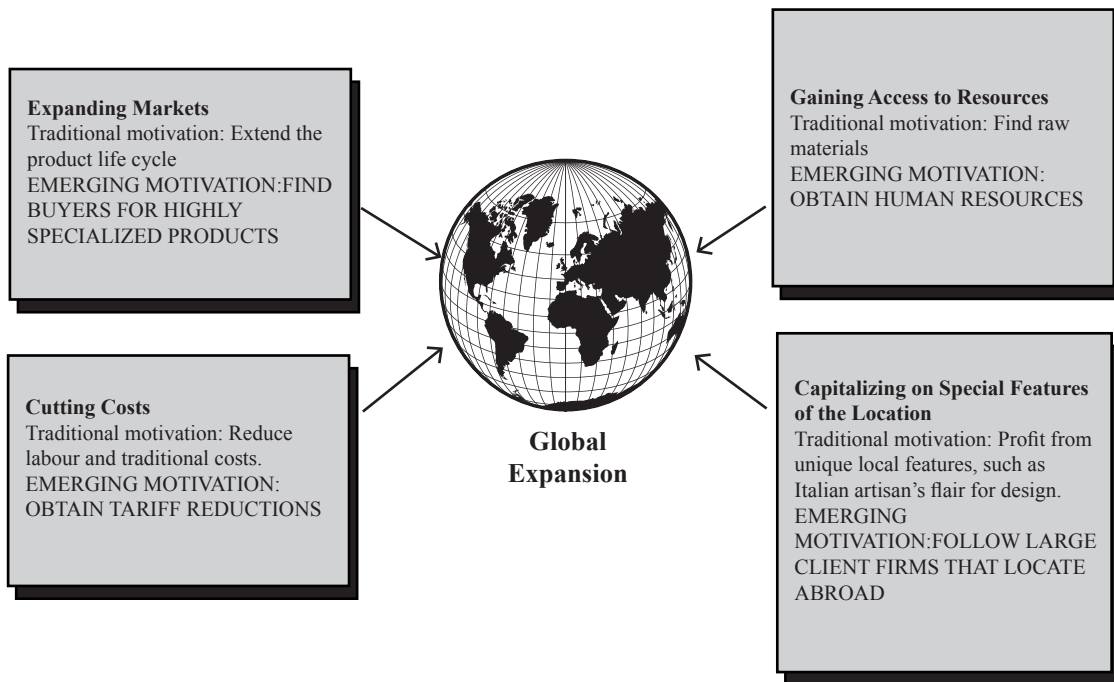


Fig. 5.5 Basic forces driving global enterprises

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Strategy options for global firms

Once an entrepreneur has decided to go global, the next step is to plan a strategy that matches the potential of the firm. Throughout most of the 20th century, many small companies were hesitant to step into the world of global trade. Today, such firms are showing signs of accelerated internationalisation. In case of some industries, even the smallest and newest of companies must globalise just to survive. For most of the small businesses, the first step toward globalisation is a decision to export a product to other countries or to import goods from abroad to sell in the domestic market. These initial efforts are often followed by more sophisticated non-export strategies, such as licensing, franchising, forming strategic alliances with international partners, or even locating facilities abroad as seen in the following figure.

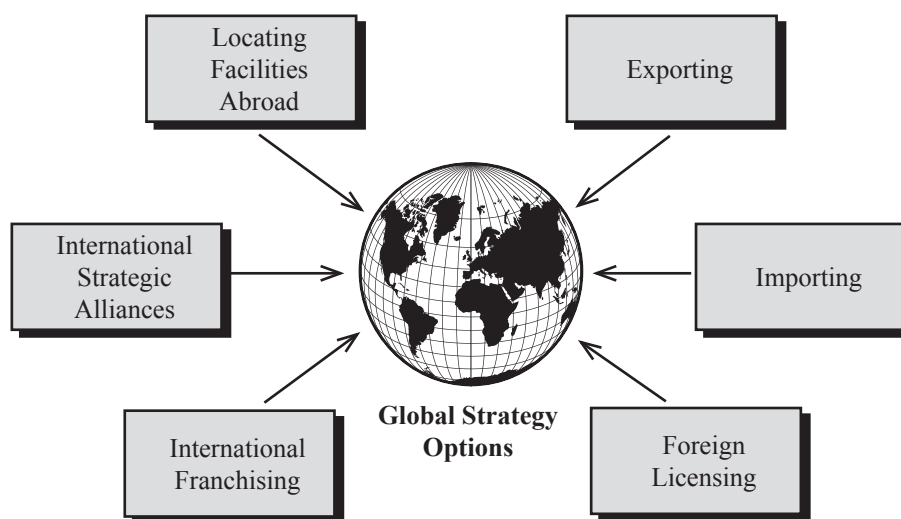


Fig. 5.6 Strategy options for global enterprises

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Exporting

Exporting involves the sale of products produced in the home country to customers in other nations. Exporting is popular among small businesses because it provides a low-cost way of expanding into the international arena: Put another way, small export companies can market and distribute their products in other countries without incurring the expense of supporting costly operations in those markets. If the financial benefits from international sales more than offset shipping costs and tariffs, exporting is a favourable option.

In one way small companies can look into an export program is to join a trade mission, i.e., a trip organised to help small business owners meet potential buyers abroad and navigate cultural and regulatory obstacles in foreign markets. In some cases, exporting to international markets may actually promote business in the domestic market, especially when seasonal demand in the home market offsets that from abroad.

The rise of the Internet has fuelled vigorous growth in export activity. Small firms now see the Internet as a powerful tool for increasing their international visibility, allowing them to connect with customers who were previously beyond their reach.

Of course, selling goods to international customers is seldom a “walk in the park.” Products may have to be modified to meet government standards or the unique interests of buyers abroad, language barriers and a lack of government connections can put a company at a great disadvantage in negotiations, and unfair exchange rates can make it next to impossible to offer products at competitive prices. And some countries’ markets can be difficult to enter unless a company is willing to reveal the specifics of its core technologies, which are often the bedrock of its competitive advantage. Nonetheless, small companies are proving that export success is within reach.

Importing

The flip side of exporting is importing, involves selling goods from abroad in the firm’s home market. When a small company finds a product abroad that has market potential at home or identifies a product that would sell at home but cannot find a domestic producer, an import strategy may be the best solution. Rich Birnbaum is the founder of ProWorth, a bare-bones operation in Englewood Cliffs, New Jersey, which also employs his brother, as well as several high school students and retirees part-time.

Birnbaum sells exquisite Swiss brand-name watches and diamond jewellery through eBay, other online auction services, and the firm’s website. Birnbaum decided to use eBay because the customer acquisition costs are limited to the cost of a listing, which allows him to keep prices low. The venture has been very successful. Launched in January 1999, the company racked up \$1 million in sales by that year’s end, allowing Birnbaum to pay himself a salary of about \$100,000 and still break even.³⁷ Not a bad start—and business at ProWorth continues to build over time.

Foreign licensing

Importing and exporting are the most popular international strategies among small firms, but there are also other options. Because of limited resources, many small firms are hesitant to go global. One way to deal with this constraint is to follow a licensing strategy. Foreign licensing allows a company in another country to purchase the rights to manufacture and sell a firm’s products in overseas markets. The firm buying these rights is called the licensee. The licensee makes payments to the licensor, or the firm selling those rights, normally in the form of royalties, i.e., a fee paid for each unit produced.

International licensing always have drawbacks. The licensee makes all the production and marketing decisions, and the licensor must share returns from sales with the licensee. However, foreign licensing is the least expensive way to go global, since the licensee bears all the cost and risk of setting up a foreign operation. MSS Global uses a foreign licensing strategy; the company has sold more than 40,000 licenses around the globe.

The small company could never have achieved such rapid expansion if it had had to set up its own offices abroad, learn the culture and tax laws, and establish a market position in each country in which it did business. Licensing agreements with major computer hardware manufacturers covering the South and Central American markets have paid off. MSS Global may not have a marketing team, a direct sales staff, or even venture capital, but the company makes money every time a licensee sells its product to a foreign retailer. This is the beauty of foreign licensing.

Small companies tend to think of products when they explore international licensing options, but licensing intangible assets such as proprietary technologies, copyrights, and trademarks may offer even greater potential returns. Just as Disney licenses its famous Mickey Mouse character to manufacturers around the world, a small retailer called Peace Frogs has used licensing to introduce its copyrighted designs in Spain. Foreign licensing can also be used to protect against counterfeit activity, or the unauthorised use of intellectual property. Licensing rights to a firm in a foreign market provides a local champion to ensure that other firms do not use protected assets in an inappropriate way.

International franchising

International franchising is a variation on the licensing theme. The franchisor offers a standard package of products, systems, and management services to the franchisee, which provides capital, market insight, and hands-on management. Though international franchising was not widely used before the 1970s, today it is the fastest-growing market-entry strategy of U.S. firms, with Canada as the dominant market (followed by Japan and the United Kingdom, in that order). This approach is especially popular with U.S. restaurant chains that want to establish a global presence. McDonald's, for example, has raised its famous golden arches in more than 121 countries around the world. But international franchising is useful to small companies as well.

Danny Benususan, the owner of Blue Note, a premier jazz club in Manhattan that opened its doors in 1981. Considered one of the top venues in the world for jazz and other forms of music, this club has attracted the attention of international businesspeople who have established franchises abroad. The Tokyo location was opened in 1988, followed by clubs in Osaka, Fukuoka, and Nagoya, Japan. The first European club, in Milan, Italy, was added to the Blue Note family in March of 2003, and that was followed by another Asian franchise in Seoul, South Korea. As a result of these international extensions, the club has successfully established itself as the world's only franchised jazz club network. Blue Note has proved that there is more than one way for a small business to globalise.

Summary

- A customer (also known as a client, buyer, or purchaser) is usually used to refer to a current or potential buyer or user of the products of an individual or organisation, called the supplier, seller, or vendor. This is typically through purchasing or renting goods or services.
- Customer relationship management (CRM) means different things to different firms. It is symbolised by simple smiles or comments such as “thank you” and “come again”, as communicated by employees to customers who have just made a purchase.
- Needs are described as the starting point for all behaviour. Without needs, there would be no behaviour.
- An important concept underlying sound product strategy is the product life cycle, which allows us to visualise the sales and profits of a product from the time it is introduced until it is no longer on the market.
- A major responsibility of the entrepreneur is to find, evaluate, and introduce new products.
- Supply chain management is a system of management which integrates and coordinates the ways in which a firm finds the raw materials and necessary components to produce a product or service, builds the actual product or service, and then delivers it to customers.
- Intermediaries can often perform marketing functions better than the producer of a product can.
- A channel of distribution can be either direct or indirect. In a direct channel, there are no intermediaries, as the product goes directly from producer to user. An indirect channel of distribution has one or more intermediaries between producer and user.
- In setting a price, the entrepreneur decides on the most appropriate value for the product or service being offered for sale.
- The two basic types of advertising are product advertising and institutional advertising.
- As global communication systems can be made more efficient and trade agreements pry open national markets to foreign competition, entrepreneurs focusing more on international business.

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Self Assessment

1. Which of these do not refer to a current or potential buyer or user of the products of an individual or organisation?
 - a. Customer
 - b. Client
 - c. Buyer
 - d. Supplier
2. Major responsibilities of the _____ is to find, evaluate, and introduce new products.
 - a. customer
 - b. client
 - c. buyer
 - d. entrepreneur
3. _____ can often perform marketing functions better than the producer of a product can.
 - a. intermediaries
 - b. customers
 - c. clients
 - d. vendors
4. _____ are described as the starting point for all behaviour.
 - a. Needs
 - b. Perceptions
 - c. Motivations
 - d. Attitudes
5. Which is an enduring opinion, based on a combination of knowledge, feeling, and behavioural tendency?
 - a. Need
 - b. Perception
 - c. Motivation
 - d. Attitude
6. _____ are goal directed forces that organise and give direction to tension caused by unsatisfied needs.
 - a. Needs
 - b. Perceptions
 - c. Motivations
 - d. Attitudes
7. Which phase of the product life cycle includes sales?
 - a. Introduction
 - b. Growth
 - c. Maturity
 - d. Decline

8. Which of the following statements is false?
- A major responsibility of the entrepreneur is to find, evaluate, and introduce new products.
 - The first stage of the new product development process, idea accumulation, involves increasing the pool of ideas under consideration.
 - New products start with ideas, and these ideas have varied origins.
 - Idea accumulation is the second stage in new product development.
9. Which of the following statements is false?
- The Internet and available software are major drivers of current developments in supply chain management.
 - Distribution is essential only for intangible goods.
 - In marketing, distribution encompasses both the physical movement of products and the establishment of intermediary (middleman) relationships to achieve product movement.
 - A channel of distribution can be either direct or indirect.
10. Match the following.

1. Online merchandising	A. Direct or indirect
2. Channel of distribution	B. E-commerce
3. Tangible goods	C. Services
4. Intangible goods	D. Products

- 1-A, 2-D, 3-B, 4-C
- 1-C, 2-D, 3-B, 4-A
- 1-B, 2-A, 3-D, 4-C
- 1-D, 2-B, 3-C, 4-A

Chapter VI

Managing Growth in Small Businesses

Aim

The aim of this chapter is to:

- highlight the importance of entrepreneurial leadership
- explain the sources of employees
- enlist different risk management options

Objectives

The objectives of this chapter are to:

- elucidate human resource management
- explain organisational culture and total quality management
- describe risk management in small scale business

Learning outcome

At the end of this chapter, you will be able to:

- understand the importance of improving productivity
- recognise different business risks
- identify the method to manage operations

6.1 Introduction

Marketing of small businesses is a basic thing that helps any small business to grow. Good marketing directly affects both revenues and profits to deliver sustainable growth. Effective small business marketing requires specific techniques. The “Business Growth Solutions” website is full of proven low-cost solutions and techniques that achieve rapid growth in income and profits. Creating a high-performance company takes leadership. The key to building that team has been collaboration.

6.2 Entrepreneurial Leadership

Leadership roles differ greatly depending on the size of the business and its stage of development. A business that is just beginning, for example, faces problems and uncertainties unlike those of a family firm that has been functioning well over several generations. Therefore, with the recognition that leadership cannot be reduced to simple rules or processes that fit all situations.

6.2.1 Leadership

Leadership is far more focused on the destination than on the details of getting to the target. Entrepreneurs must convey their vision of the firm’s future to other participants in the business, so that everyone involved can contribute most effectively to the accomplishment of the mission. Although leaders must also engage in some of the more mundane processes of management, particularly as the business grows, the first task of the entrepreneur is to create and communicate the vision.

6.2.2 Leaders Shape the Culture of the Organisation

Over time, an organisation tends to take on a life of its own. That is, an organisational culture begins to emerge, that helps employees understand the business stands and their work. You Organisational culture are the factor that determines the “feel” of a business. It tends to be the “silent teacher” that sets the tone for employee conduct, even when managers are not present. A company’s culture does not emerge overnight; it unfolds over the lifetime of the business and usually reflects the character and style of the founder.

Because of its power to shape how business is conducted, the culture of the organisation should not be left to chance. If a founder is honest in his or her dealings, supportive of employees, and quick to communicate, he or she will likely set a standard that others will follow. An entrepreneur can create an innovative cultural environment by setting aside his or her ego and opening up to the ideas of others, supporting experimentation through the elimination of unnecessary penalties for failure, and looking for and tapping into the unique gifts of all employees. Like empowerment, creating a culture that fosters innovation tends to draw employees into the work of the company and often provides a boost to commitment and employee morale.

The above-mentioned actions are largely symbolic, focusing attention on the thrust of the business and its purpose. However, deliberate physical design efforts can also influence the culture, shaping the way people in the organisation interact and what they achieve together. Joe Anthony owns New York City–based Vital Marketing, a company that brings in around \$20 million a year doing multicultural and youth marketing. Anthony and his management team have taken very intentional steps to set the tone of business and generate specific results. In Anthony’s words, “We group our project teams together ... [and] create these bullpens so people will always be able to turn around and troubleshoot.” Jonathan Vohar, senior partner of New and Improved, an innovation training and development company in Evanston, Illinois, offers more design suggestions. He notes that an entrepreneur can spur creativity by sprinkling all work spaces with visually stimulating features, including idea-inspiring artwork; video monitors, and well positioned windows that open up the view to other environments.

It is also possible to encourage communication, by positioning work spaces far away from bathroom facilities, which naturally creates occasions for employees to run into one another and start idea-generating conversations. These are relatively simple concepts for setting up physical space, but they can have a profound effect on the mind-set employees assume when they come to work. One feature that every leader should strive to incorporate into the organisational culture is a positive, “can-do” attitude. It is possible to work on one’s own attitude and inspire others to follow your lead.

Some practical steps you can take to become more positive in your outlook are given below.

- Recognise accomplishments at the end of each day. Take a moment to celebrate the day's achievements, knowing that you are one step closer to achieving your business ambitions. Don't dwell on the fact that some things remain undone that is just the adventure left for the next day.
- At the close of business, take time to set goals for the next day. Establishing priorities for the next day will increase your focus and boost your motivation. Write them down and e-mail them to yourself. Then relax, knowing that you have already gotten a head start on tomorrow's tasks.
- Take care of yourself. Tend to your health. Eat nourishing food, and get appropriate exercise. Find activities that you enjoy and spend time doing them. Change up your life from time to time to avoid falling into a rut and lapsing into boredom.
- Spend time with friends who are upbeat. It's difficult to maintain a positive frame of mind if everyone around you is breathing the fire of doom and gloom. Optimism is contagious. Catch it, and spread it!
- Imagine your way to success. Mind-set alone will not lead the way to results, but neither will a good game plan encumbered by flagging motivation and a negative frame of mind. Envision positive outcomes, such as customers being satisfied as they use your products.
- Use thoughts of failure as a signal to turn your attention back to achievement. You will have setbacks, but it's time to move on (mentally) once you have addressed the root problem. Adventure calls from the business opportunities that lie before you.

Attitude matters in everything, whether an event is mentally framed as a setback or a positive life experience is entirely up to you.

6.3 Managing Human Resources

Finding the right employees for your business is always critical, but keeping them is just very important. Once Goldberg figured out that entertainers made good cleaners, he had to find a way to hire them and then to keep them from quitting. Hiring them was easy because many entertainers are always looking for work. To retain these multi-talented employees, Goldberg himself had to be creative and flexible. The artistic endeavours should take priority, so the company adapts to rehearsal schedules and travel commitments by allowing employees to complete their work when they can. Every business is different, but the "people factor" cannot be ignored if success is the goal. Goldberg understands this and knows how to find the employees his company needs. After that, it's just a matter of "care and feeding" for those hired. In the big picture, it really is that simple.

6.3.1 Need for Quality Employees

In a classic study of good-to-great companies (companies that advanced from being really good to become truly great), Jim Collins observed that the great companies first "got the right people on the bus." This reasoning is particularly relevant to personnel in key positions, as the right people in the right places provide a strong foundation for any business. In a broad sense, this concept is applicable to all employees, in view of their direct and indirect impact on business success.

Employees affect profitability in many ways. In most small firms, salespeople's attitudes and their ability to serve customer needs directly affect sales revenue. Also, payroll is one of the largest expense categories for most businesses, having a direct impact on the bottom line. By recruiting the best possible personnel, a firm can improve its return on each payroll dollar. Recruitment and selection of employees establish a foundation for a firm's ongoing human relationships. In a sense, the quality of a firm's employees determines its potential. A solid, effective organisation can be built only with a talented, ambitious workforce.

6.3.2 Lure of Entrepreneurial Firms

Competing for well-qualified business talent requires small firms to recognise their distinctive advantages, especially when recruiting outstanding prospects for managerial and professional positions. There are many good reasons to work for an entrepreneurial business. This is especially true of growing enterprises led by individuals or teams with a compelling vision of a desirable and attainable future. The work itself should attract talented prospects. The opportunity to make decisions and to obtain general management or professional experience at a significant level is appealing to many individuals. Rather than toiling in obscure, low-level, specialised positions during their early years, capable newcomers can quickly move into positions of responsibility in a well-managed small business.

In such positions, they can see the fruits of their labour and they make a difference in the success of the company. Small firms can structure the work environment to offer professional, managerial, and technical personnel greater freedom than they would normally have in a larger business. In this type of environment, individual contributions can be recognised rather than hidden under numerous layers of bureaucracy. In addition, compensation packages can be designed to create powerful incentives. Flexibility in work scheduling and job-sharing arrangements are other potential advantages.

For a business called THQ Inc., attracting bright and capable people is the name of the game. The company started in 1990 with several dozen employees and has proven itself a tough competitor in the video game market. THQ uses its small size as a selling point. According to CEO Brian Farrell, “We let people know, ‘You’ll be a big fish in a somewhat smaller pond here at THQ.’” And this approach is definitely working attracting brilliant game developers has been one of the firm’s secret weapons.

These high-potential employees are lured with a combination of creative freedom and financial incentives. They get to share in the firm’s successes, because anyone who designs a great game at THQ is noticed and given greater responsibility. And their jobs are structured in such a way that they can avoid the drudgery of bureaucratic or otherwise unpleasant tasks they might have to endure at other businesses. Even though THQ is not the largest player in the industry, its success has not escaped the notice of competitors. When it comes to video games, THQ is definitely a force to be reckoned with.

6.3.3 Sources of Employees

To recruit effectively, it is essential for the small business manager to know where and how to find qualified applicants. Sources are numerous, and it is impossible to generalise about the best source in view of the differences in companies’ personnel needs and the quality of the sources from one locality to another. The following discussion describes some sources of employees most popular among small firms.

- **Help-wanted advertising:** Hanging a “Help Wanted” sign in the window is one traditional form of recruiting used by some small firms. A similar but more aggressive form of recruiting consists of advertising in the classifieds section of local newspapers. For some technical, professional, and managerial positions, firms may advertise in trade and professional journals. Although the effectiveness of help-wanted advertising has been questioned by some, many small businesses recruit in this way.
- **Walk-ins:** A firm may receive unsolicited applications from individuals who walk into the place of business to seek employment. Walk-ins are an inexpensive source of personnel, particularly for hourly work, but the quality of applicants varies. If qualified applicants cannot be hired immediately, their applications should be kept on file for future reference. In the interest of good community relations, all applicants should be treated courteously, whether or not they are offered jobs.
- **Schools:** Secondary schools, trade schools, colleges, and universities are desirable sources of personnel for certain positions, particularly those requiring no specific work experience. Some secondary schools and colleges have internship programs that enable students to gain practical experience in business firms. Applicants from secondary and trade schools often have useful educational backgrounds to offer a small business. Colleges and universities can supply candidates for positions in management and in various technical and professional fields. In addition, many colleges are excellent sources of part-time employees.

- **Public employment offices:** Employment offices in each state offer information on applicants who are actively seeking employment and administer the state's unemployment insurance program. These offices, located in all major cities, are for the most part a useful source of clerical workers, unskilled labourers, production workers, and technicians. They do not actively recruit but only counsel and assist those who come in. Although public employment offices can be a source of good employees, the individuals they work with are, for the most part, untrained or only marginally qualified.
- **Private employment agencies:** Numerous private firms offer their services as employment agencies. In some cases, employers receive these services without cost because the applicants pay a fee to the agency; however, more often, the hiring firms are responsible for the agency fee. Private employment agencies tend to specialise in people with specific skills, such as accountants, computer operators, and managers.
- **Executive search firms:** For filling key positions, small firms sometimes turn to executive search firms, often called head-hunters, to locate qualified candidates. The key positions for which such firms seek applicants are those paying a minimum of \$50,000 to \$70,000 per year. The cost to the employer may run from 30 to 40 percent of the first year's salary. Because of the high cost, use of head-hunters may seem unreasonable for small, entrepreneurial firms. At times, however, the need for a manager who can help a firm "move to the next level" justifies the use of an executive search firm. A head-hunter is usually better able than the small firm to conduct a wide-ranging search for individuals who possess the right combination of talents for the available position.
- **Employee referrals:** Employee recommendations of suitable candidates may provide excellent prospects. Ordinarily, employees will hesitate to recommend applicants unless they believe in their ability to do the job. Many small business owners say that this source accounts for more new hires than any other. A few employers go so far as to offer financial rewards for employee referrals that result in the hiring of new employees.
- **Internet recruiting:** Recruiters are increasingly seeking applicants via the Internet. A variety of websites, such as <http://www.careerbuilder.com>, <http://www.monster.com>, and <http://www.hotjobs.com> etc, which allow applicants to submit their résumés and permit potential employers to search those résumés for qualified applicants. And as the Internet is becoming more and more popular as a source of applicants, many firms are posting job openings on their own websites.
- **Temporary help agencies:** These help industry, which is growing rapidly, supplies employees (or temps) such as word processors, clerks, accountants, engineers, nurses, and sales clerks for short periods of time. By using an agency such as Kelly Services or Manpower Inc., small firms can deal with seasonal fluctuations and absences caused by vacation or illness. For example, a temporary replacement might be obtained to fill the position of an employee who is taking leave following the birth of a child, a type of family leave now mandated by law for some employees. In addition, the use of temporary employees provides management with an introduction to individuals whose performance justifies an offer of permanent employment. Staffing with temporary employees is less practical when extensive training is required or continuity is important.

6.3.4 Diversity in Workforce

Over time, the composition of the workforce has changed with respect to race, ethnicity, gender, and age. In 1990, for example, 76 percent of the workforce was White; by 2000, only 69 percent was White. Much of this change can be attributed to the growing proportion of Hispanic workers. The balance is shifting rapidly toward greater workforce diversity, not only because of increased participation of racial minorities, but also because of higher proportions of women and older workers entering the labour force.

The main challenge for human resource management is to adapt to a more diverse pool of potential employees. To remain fully competitive, business owners need to step up recruitment of women and minorities and be open to innovative ways to access the available pool of applicants. When Dick Snow found it difficult to recruit American teenagers for summer work at his six East Coast Ben and Jerry's ice cream stores, his solution was to hire 12 British ice cream scoopers through the British Universities North American Club.

Other small businesses have tapped immigrants as a source of workers. In fact, small companies are more likely to employ immigrants than larger firms. Approximately 17 percent of small company workers are immigrants (citizens and noncitizens), which works out to nearly one out of every five employees. Of the nearly 20 million immigrants employed in the United States, around two-thirds work for small companies—about 3.3 million of these in companies with fewer than 10 employees.

Though it discourage entrepreneurs from hiring illegal or undocumented workers, it is important to cast the employment net as broadly as possible to find the best people available. By developing an awareness of the potential in various parts of the talent pool, small firms can improve the effectiveness of their recruitment methods. Adapting to diversity is important not only because the workforce is becoming more diverse but also because diversity in itself can be a good thing, through the innovation it introduces to the workplace and the positive effect it has on problem solving. Researchers at North-western University recently studied the value of diversity by asking 50 groups of subjects to solve a murder mystery. Groups included individuals from different social backgrounds, were more likely to solve the case; homogeneous groups were both more often wrong and more confident that they were right.

Venture capitalists are very much aware of this phenomenon and thus are less likely to invest in a company where the management team more closely resembles the results of a cloning experiment than a group of individuals who bring unique perspectives to bear on business challenges. Evidence suggests that various forms of diversity (based on gender and ethnicity, as well as more subtle forms of variation related to personality, sensibility, work style, and the like) are beneficial, especially when innovation is important to a firm's competitiveness.

6.4 Managing Operations

Every business uses operations processes to create products or services for its customers. This process consists of the activities involved in creating value for customers and earning their dollars. A bakery, for example, purchases ingredients, combines and bakes them, and makes bakery products available to customers at some appropriate location. For a service business such as a hair salon, the operations process includes the purchase of supplies and the shampooing, haircutting, and other procedures involved in serving its clients.

Such operations are at the heart of any business; indeed, they are the reasons for its very existence. It should come as no surprise, then, that their design and effectiveness can determine the success of a business. Though we initially focus on quality issues in this chapter, operations management goes well beyond this one very important feature. Here methods of work improvement that can increase productivity and boost the performance of a company are mentioned.

We also address the importance of establishing suitable purchasing policies, as well as introducing ways to control inventory and minimise the cost of inputs. Simply put, the thrust of this chapter is to examine ways a business can function economically and profitably, providing a high-quality product or service that keeps customers coming back for more. Most significantly, operations management is an important means of building a firm's competitive strength in the marketplace.

6.4.1 Organisational Culture and Total Quality Management

A crucial element of effective quality management is a supportive organisational culture. The values, beliefs, and traditional practices followed by members of a business firm constitute its organisational culture. Some firms are mainly concerned with quality levels that they will refund money if a service or product is unsatisfactory or will schedule overtime work to avoid disappointing a customer.

Quality is a primary value in a business's organisational culture. Quality oriented culture is necessary if a firm is to achieve outstanding success. Time and training are required to build a TQM program that elicits the best efforts of everyone in the organisation in producing a superior-quality product or service. A small business that adopts a total quality management philosophy commits itself to the pursuit of excellence in all aspects of its operations. Dedication to quality on an organisation-wide basis is sometimes described as a cultural phenomenon.

Total quality management always goes beyond merely ensuring that existing standards are met. Its objective is continuous quality improvement, which is an ongoing effort to improve quality. For example, if a production process has been improved to a level where there is only 1 defect in 100 products, the process must then be shifted to the next level and a new goal set of no more than 1 defect in 200 or even 500 products. The ultimate goal is zero defects, a target that has been popularised by many quality improvement programs.

Continuous quality improvement efforts may include benchmarking, which is the process of identifying the best products, services, and practices of other businesses; carefully studying those examples; and using any insights gained to improve one's own operations. A simple type of benchmarking occurs when owner-managers eat in competitors' restaurants or shop in competitors' stores and then use what they learn to make improvements in their own businesses.

6.4.2 Importance of Improving Productivity

To remain competitive, a firm should continually try to improve its productivity as improvement efforts vary greatly. Some involve major reorganisations or changes in technology, while others merely upgrade existing operations. A business firm's productivity may be expressed as follows:

$$\text{Productivity} = \frac{\text{Output}}{\text{Input}}$$

$$= \frac{\text{Products and/or services}}{(\text{Labour} + \text{Energy} + \text{Cash} + \text{Raw materials} + \text{Equipment} + \text{Information})}$$

A firm improves its productivity by doing more with less by increasing outputs and/or decreasing inputs. This can be accomplished in many different ways. For example, a small restaurant may improve its pastry making by sending the chef to cooking school, buying better ingredients, getting a more efficient oven, or redesigning the kitchen. At one time, productivity and quality were viewed as potentially conflicting.

However, production at a high-quality level reduces scrap and rework. Therefore, quality enhancement, automation, and other improvements in operations methods can also boost productivity. Improving productivity in the labour-intensive service sector is especially difficult, since managers have less opportunity to take advantage of automation. Small service firms always find ways to become more efficient. At one time, for example, customers in barber shops wasted time waiting for barbers who took them on a first-come, first-served basis.

To improve the system, many shops now use an appointment schedule. A drop-in customer can still get service immediately if a barber isn't busy or else sign up for the first convenient appointment. Such a system provides continuity in the barber's work schedule and reduces delays and frustration for customers.

6.4.3 The Importance of Purchasing

The quality of a finished product usually depends on the quality of the raw materials used. If a product must be made with great precision and close tolerances, the manufacturer must acquire high-quality materials and component parts. Then, if the manufacturer uses a well-managed production process, excellent products will result. Similarly, the acquisition of high-quality merchandise makes a retailer's sales to customers easy and it also reduces the number of necessary markdowns and merchandise returns.

Purchasing also contributes to profitable operations by ensuring that goods are delivered when they are needed. Failure to receive materials, parts, or equipment on schedule can cause costly interruptions in production operations. In a retail business, failure to receive merchandise on schedule may mean a loss of sales and, possibly, a permanent loss of customers who were disappointed.

Another aspect of effective purchasing is securing the best possible price. Cost savings go directly to the bottom line, and purchasing practices that seek out the best prices can have a major impact on the financial health of a business. Note, however, that the importance of the purchasing function varies according to the type of business. In a small, labour-intensive service businesses such as accounting firm purchases of supplies are responsible for a very small part of the total operating costs. Such businesses are more concerned with labour costs than with the cost of supplies or other materials they may require in their operations process.

6.4.4 Objectives of Inventory Management

Both purchasing and inventory management share the same objective: to have the right goods in the right quantities at the right time and place. As shown in the figure below, achieving this general objective requires pursuing more specific sub goals of inventory control- ensuring continuous operations, maximising sales, protecting assets, and minimising inventory costs.

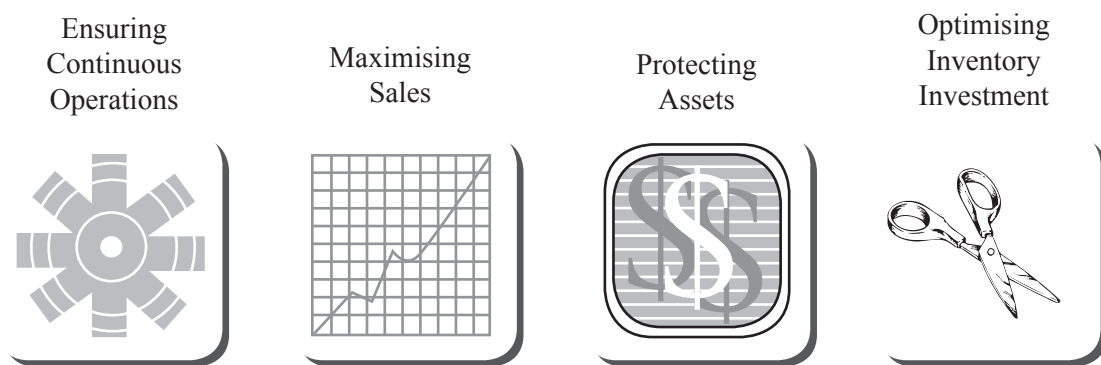


Fig. 6.1 Objectives of inventory management

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Ensuring continuous operations is particularly important in manufacturing, as delays caused by lack of materials or parts can be costly. Furthermore, sales can be maximised by completing production in a timely manner and by stocking an appropriate assortment of merchandise in retail stores and wholesale establishments. Protecting inventory from theft, shrinkage, and deterioration and optimising investments likewise contribute to operational efficiency and business profits.

6.5 Managing Risk

Risk is the possibility of suffering harm or loss. In business, risk is the possibility of losses associated with the assets and the earnings potential of the firm. The term assets include not only inventory and equipment but also such factors as the firm's employees, its customers, and its reputation. Business risks can be classified into two broad categories: market risk and pure risk. Market risk is the uncertainty associated with an investment decision.

An entrepreneur who invests in a new business hopes for a gain but realises that the eventual outcome may be a loss. Only after identifying the investment opportunity, developing strategies, and committing resources will she or he find out whether the final result is a gain or a loss. Pure risk is a situation where only loss or no loss can occur, where there is no potential gain. Owning property, for instance, creates the possibility of loss due to fire or severe weather; the only outcomes are loss or no loss. As a general rule, only pure risk is insurable. That is, insurance is not intended to protect investors from market risks, where the chances of both gain and loss exist.

6.5.1 Classification of Business Risk

The pure risks faced by a business can be put into the following categories: property risks, liability risks, and personnel risks. Let's take a look at these risks, related to the physical, legal, and human aspects of a business.

Property risks

In the course of establishing a business, an owner acquires property that will be necessary to provide the goods and services of the company. If this property is damaged or destroyed, the business sustains a loss. In addition, the temporary loss of use of the property can add to the negative financial impact on the business. Several characteristics of business property and the risks associated with it are worthy of attention. There are two general types of property, real property and personal property.

Real property consists of land and anything that is physically attached to land, such as buildings. Some business owners purchase land and buildings, while others choose to lease necessary real property. It is important to note, however, that some leases make the lessee responsible for any damage or loss to the leased premises. Personal property can be defined simply as any property other than real property. Personal property includes machinery, equipment (such as computers), furniture, fixtures, stock, and vehicles. While the location of real property is fixed, personal property can be moved from place to place. Among the risks to the personal property of the small firm are the security threats to their computers posed by hackers and spyware, for example see the below given figure.

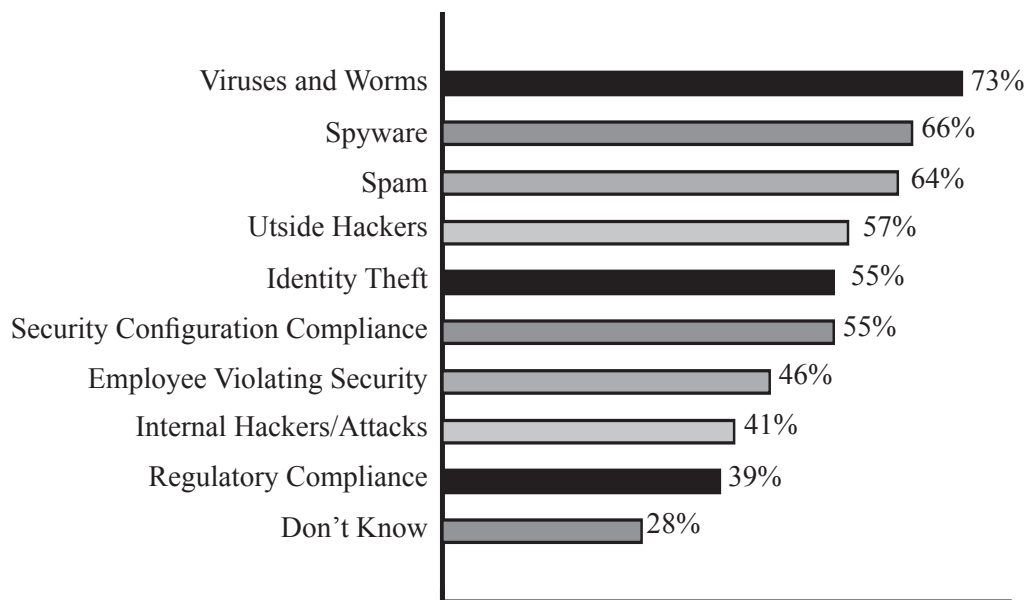


Fig. 6.2 Security threats to computers

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Property can be valued in a number of ways. The replacement value of property is the cost to replace or recreate the property at today's prices. For example, a building that was constructed 10 years ago at a cost of \$200,000 may have a current replacement value of \$250,000 because of the rising costs of materials and labour. The actual cash value (ACV) of a property can be very different from its replacement value; this insurance term refers to the depreciated value of a property.

Perils

A peril is a cause of loss. Some perils are naturally occurring events, such as windstorms, floods, earthquakes, and lightning. The location of property may increase the likelihood of its loss from certain perils, for example, coastal properties are more susceptible to wind damage and flooding, and properties near fault lines are more prone to damage from earthquakes.

Not all perils, however, are natural events; some are related to the actions of people. Perils such as robbery and employee dishonesty involve criminal acts performed by people against business owners. The rapid growth of electronic commerce (e-commerce) has led to new forms of dishonest acts, such as hacking, denial of access, and improper use of confidential information.

Losses

Property loss can be a direct loss, in which physical damage to property reduces its value to the property owner. The direct loss of property as a result of windstorm, fire, or explosion is obvious to everyone and has the potential to significantly hinder any business.

A less obvious type of property loss is an indirect loss, which arises from inability to carry on normal operations due to a direct loss. For example, if a delivery truck is damaged in an accident, the resulting loss of use can impair the ability of a business to get its goods to customers. The indirect loss component of this event may cause a reduction in revenue or an increase in expense (from having to outsource the delivery function), either of which will have an adverse impact on business income.

It should be pointed out that business income can also be reduced by events or conditions that are not related to direct losses. For example, a strike by UPS employees a few years ago created serious logistical problems for many of its business customers, which were unable to receive goods from suppliers or deliver goods to customers. The financial impact of such a labour action may be just as real to a business as physical damage to property, but the insurance protection available for indirect losses applies only when *direct* damage events trigger the loss of use. More will be said on this issue later in the chapter.

Liability risks

A growing business risk today is the legal liability that may arise from various business activities. A society creates laws to govern interactions among its members. Individual rights and freedoms are protected by these laws. If a business or any of its agents violates these protected rights, the business can be held accountable for any resulting loss or damage to the affected party. Legal liability may arise from statutory liability, contractual liability, or tort liability.

Personnel risks

It refers to risks to a company's operations that either concern or are caused by its personnel. These risks could mean a company completely losing the input of a key employee, or an employee deliberately acting against a company's interests.

Such risks include:

- Fatigue and exhaustion
- Accidents and illnesses
- Obsolete professional skills
- Personal or employment-related disputes
- Unintentional human error
- Information leaks or thefts

6.5.2 Risk Management

The term risk management covers all efforts to preserve the assets and earning power of a business. Since risk management has grown out of insurance management, the two terms are often used interchangeably. However, risk management has a much broader meaning, covering both insurable and uninsurable risks and including non-insurance approaches to reducing all types of risk. Risk management involves more than trying to obtain the most insurance for each dollar spent; it is concerned with finding the best way possible to reduce the cost of dealing with risk. Insurance is only one of several approaches to minimising the pure risks a firm is sure to encounter.

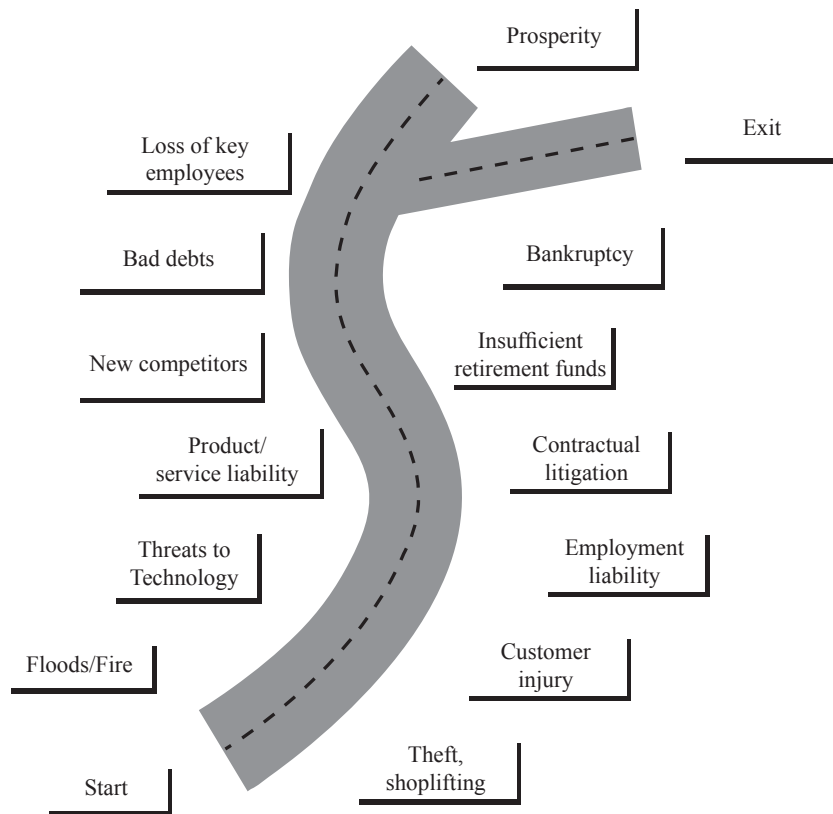


Fig. 6.3 Risk on a road of success

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

The process of risk management

Five steps are required to develop and implement a risk management program.

- **Identify and understand risks:** It is necessary that a business owner need to be aware of the risks the firm faces on the road to success. To reduce the chance of overlooking important risks, a business should adopt a systematic approach to identifying risks. Useful identification methods include insurance policy checklists, questionnaires, analysis of financial statements, and careful analysis of a firm's operations, customers, and facilities.
- **Evaluate risks:** Once the risks are identified, they must be evaluated in terms of the potential size of each loss and the probability that it will occur. At a minimum, risks should be classified into three groups: critical (losses that could result in bankruptcy), extremely important (losses that would require investment of additional capital to continue operations), and moderately important (losses that can be covered with current income or existing assets).
- **Select methods to manage risk:** The two approaches used in dealing with risk are risk control and risk financing. Selection of the method totally depends on the situation.
- **Implement the decision:** Once the decision has been made to use a particular technique or techniques to manage a firm's risks, this decision must be followed by action, such as purchasing insurance and setting aside dedicated funds to cope with any risks that have been retained. Failure to act—or even simple procrastination—could be fatal.
- **Evaluate and review:** Evaluation and review of the risk management technique are essential because conditions change, new risks arise and old ones disappear. Also, reviewing earlier decisions to use specific methods may identify mistakes made previously.

6.5.3 Risk Management and Small Business

Regardless of the nature of the business, risk management is always a serious issue for small companies, as well as large corporations. Too often, small businesses pay insufficient attention to analysing potential risk. “Small companies often spend more time planning their company picnics than for an event that could put them out of business,” says Katherine Heaviside, a partner in Epoch , a Huntington, New York, public relations firm that specialises in crisis communication. To avoid the business to have an unexpected development, the small business owner must take an active role in managing the risks of her or his firm. Risk management in a small business differs from that in a large firm in several ways.

First, insurance companies are not always eager to insure small companies and may even turn them down in some cases. In a large firm, the responsibilities of risk management are frequently assigned to a specialised staff manager. It is more difficult for a small company to cope with risk management since its risk manager is usually the owner and the owner wears so many hats. Furthermore, risk management is not that requires immediate attention until something happens. A prudent small business owner will take the time to identify the different types of risks faced by the firm and find ways to cope with them, through either risk control or risk financing.

Risk control

Risk control involves minimising loss through prevention, avoidance, and/or reduction. Loss prevention focuses on stopping loss from happening. For example, if a mail-order business finds that goods are being damaged in the delivery process, it may switch to a more secure and reliable delivery service, thus eliminating property damage and customer dissatisfaction.

Loss avoidance is achieved by choosing not to engage in a hazardous activity. For instance, the risk of losing critical computer records can be avoided by storing backup files at a different physical location. Loss reduction addresses the potential frequency, severity, or unpredictability of loss, thereby lessening the impact of the loss on the business. Crisis planning is a form of loss reduction in that it always provides a template to follow in the case of a catastrophic loss. Installing automatic sprinkler systems in a building is another good example of a loss reduction strategy. If a fire occurs in a building with an automatic sprinkler system, the sprinklers will be activated, thus minimising the amount of fire damage to the building.

Risk financing

Risk financing facilitates the funds for losses that cannot be eliminated by risk control; it involves transferring the risk or retaining the risk. Risk transfer is accomplished largely through buying insurance but can also be achieved by making other contractual arrangements that transfer the risk to others. Contractual arrangements, for example, can include subcontracting an activity or purchasing fidelity bond to protect against employee fraud. Risk retention entails financing loss through operating revenues or retained earnings.

One common form of risk retention is self-insurance, in which part of a firm’s earnings is designated as a cushion against possible future losses. Self-insurance can take a general or a specific form. In its general form, a part of the firm’s earnings is earmarked for a contingency fund against possible future losses, regardless of the source. In its specific form, a self-insurance program designates funds to individual loss categories such as property, health care, or workers’ compensation. Some firms have started to rely heavily on self-insurance, particularly in the area of medical coverage for employees.

Summary

- Marketing of small businesses is a basic thing that helps any small business to grow. Good marketing directly affects both revenues and profits to deliver sustainable growth.
- Leadership roles differ greatly depending on the size of the business and its stage of development.
- Finding the right employees for your business is always critical, but keeping them is just very important.
- To recruit effectively, it is essential for the small business manager to know where and how to find qualified applicants.
- A firm may receive unsolicited applications from individuals who walk into the place of business to seek employment.
- Employment offices in each state offer information on applicants who are actively seeking employment and administer the state's unemployment insurance program.
- Numerous private firms offer their services as employment agencies.
- Employee recommendations of suitable candidates may provide excellent prospects.
- Every business uses operations processes to create products or services for its customers.
- A crucial element of effective quality management is a supportive organisational culture. The values, beliefs, and traditional practices followed by members of a business firm constitute its organisational culture.
- The quality of a finished product usually depends on the quality of the raw materials used.
- Risk is the possibility of suffering harm or loss.
- The pure risks faced by a business can be put into the following categories: property risks, liability risks, and personnel risks.
- Property loss can be a direct loss, in which physical damage to property reduces its value to the property owner.
- A growing business risk today is the legal liability that may arise from various business activity
- The term risk management covers all efforts to preserve the assets and earning power of a business.

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Recommended Reading

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- Longenecker, J. G. & Loeza, E. T., 2010. *Small business management*, 14th ed., Cengage Learning.
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Self Assessment

1. _____ roles differ greatly depending on the size of the business and its stage of development.
 - a. Leadership
 - b. Marketing
 - c. Management
 - d. Human resources
2. _____ are an inexpensive source of personnel.
 - a. Walk-ins
 - b. Help-wanted advertising
 - c. Schools
 - d. Executive search firms
3. Recruiters are increasingly seeking applicants via the _____.
 - a. Internet
 - b. agencies
 - c. firms
 - d. referrals
4. Every business uses operations processes to create products or services for its _____.
 - a. customers
 - b. entrepreneurs
 - c. manufactures
 - d. distributors
5. _____ is a primary value in a business's organisational culture.
 - a. Quality
 - b. Quantity
 - c. Management
 - d. Productivity
6. Which of the following does not include the objective shared both by purchasing and inventory management?
 - a. To have the right goods
 - b. To have goods in right quantities
 - c. To have goods in at the right time and place
 - d. To have goods in right quality
7. Business risks can be classified into _____ broad categories.
 - a. Two
 - b. Three
 - c. Four
 - d. Five

8. Which of the following statements is false?
- Risk is the possibility of suffering harm or loss.
 - In business, risk is the possibility of losses associated with the assets and the earnings potential of the firm.
 - The term assets include not only inventory and equipment but also such factors as the firm's employees, its customers, and its reputation.
 - Business risk is the uncertainty associated with an investment decision.
9. Which of the following statements is false?
- Real property consists of land and anything that is physically attached to land, such as buildings.
 - Real property includes machinery, equipment (such as computers), furniture, fixtures, stock, and vehicles.
 - A peril is a cause of loss.
 - Perils such as robbery and employee dishonesty involve criminal acts performed by people against business owners.
10. Match the following.

1. Personnel risks	A. Minimising loss
2. Risk control	B. Fatigue and exhaustion
3. Critical risks	C. Direct or indirect
4. Property loss	D. Bankruptcy

- 1-A, 2-D, 3-B, 4-C
- 1-C, 2-D, 3-B, 4-A
- 1-B, 2-A, 3-D, 4-C
- 1-D, 2-B, 3-C, 4-A

Chapter VII

Managing Firm's Assets

Aim

The aim of this chapter is to:

- introduce the term assets
- describe working capital cycle
- enlist the types of capital budgeting techniques

Objectives

The objectives of this chapter are to:

- elucidate cash flow and cash budget
- explain inventory management
- describe techniques such as, discount cash flow

Learning outcome

At the end of this chapter, you will be able to:

- understand working capital management
- recognise various techniques of capital budgeting
- identify importance of managing assets for small business

7.1 Introduction

Any item of economic value owned by an individual or corporation, especially which could be converted to cash is termed as an asset. Assets are commonly defined as “what the company owns”. Some examples of assets are cash, savings accounts, accounts receivable, inventory, prepaid expenses and fixed assets. Asset accounts are presented on the Balance Sheet, not on the Income Statement.

7.2 Working Capital Cycle

Ask the owner of a small business about financial management and you will likely hear about the joys and tribulations of managing cash, accounts receivable, inventories, and accounts payable. Working-capital management—managing short-term assets (current assets) and short-term sources of financing (current liabilities)—is extremely important to most small companies.¹ In fact, financial discipline is of utmost importance for the successful running of the business. Good business opportunities can be irreparably damaged by ineffective management of a firm’s short-term assets and liabilities. A firm’s working-capital cycle is the flow of resources through the company’s accounts as part of its day-to-day operations. The steps in a firm’s working capital cycle are as follows:

- **Step 1:** Purchase or produce inventory for sale, which increases accounts payable—assuming the purchase is a credit purchase—and increases inventories on hand.
- **Step 2:** Either sell the inventory for cash, which increases cash, or sell the inventory on credit, which increases accounts receivable.
- **Step 3:** Pay the accounts payable, which decreases accounts payable and decreases cash.
- Or pay operating expenses and taxes, which decreases cash.
- **Step 4:** Collect the accounts receivable when due, which decreases accounts receivable and increases cash.
- **Step 5:** Begin the cycle again. Depending on the industry, the working-capital cycle may be long or short. For example, it is only a few days in the grocery business; it is longer, most likely months, in an automobile dealership. Whatever the industry, however, management should be working continuously to shorten the cycle.

Depending on the industry, the working-capital cycle may be long or short. For example, it is only a few days in the grocery business; it is longer, most likely months, in an automobile dealership. Whatever the industry, however, management should be working continuously to shorten the cycle.

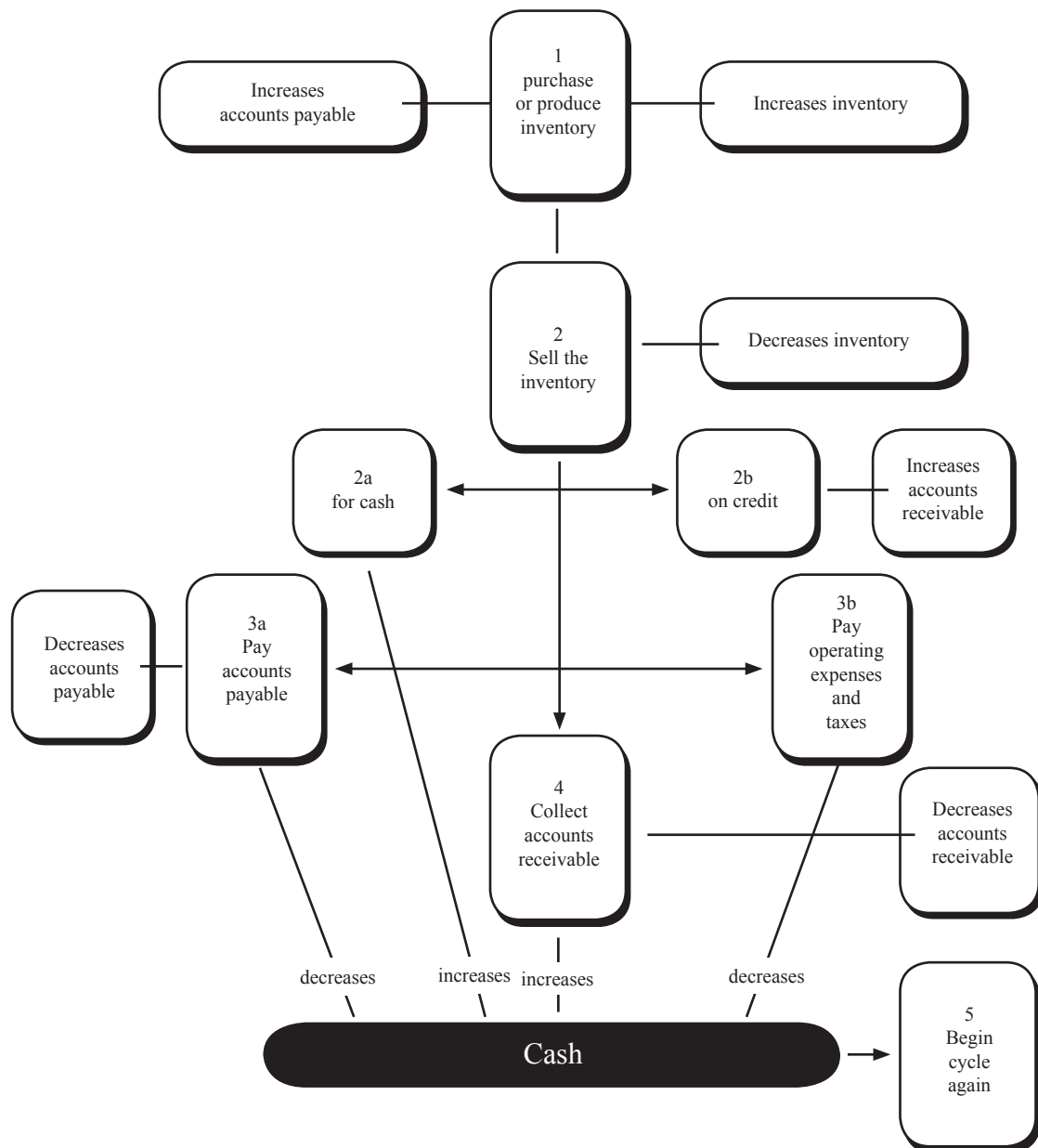


Fig. 7.1 Working capital cycle

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

7.2.1 Timing and Size of Working-Capital Investments

The owners of small business companies need to understand the working-capital cycle, in terms of both the timing of investments and the size of the investment required (for example, the amounts necessary to maintain inventories and accounts receivable). The owner's failure to understand these relationships results in many financial problems of small companies. It has been noticed that too many entrepreneurs wait until a problem arises to deal with working capital. The figure below shows the chronological sequence of a hypothetical working-capital cycle. The time line reflects the order in which events unfold, beginning with an investment in inventory and ending with collection of accounts receivable. The key dates in the exhibit are as follows:

Day a: Inventory is ordered in anticipation of future sales.

Day b: Inventory is received.

Day c: Inventory is sold on credit.

Day d: Accounts payable come due and are paid.

Day e: Accounts receivables are collected.

The investing and financing implications of the working-capital cycle reflected in the figure below are as follows: Money is invested in inventory from day *b* to day *c*. The supplier provides financing for the inventories from day *b* to day *d*. Money is invested in accounts receivable from day *c* to day *e*.

Financing of the firm's investment in accounts receivable must be provided from day *d* to day *e*. This time span, called the cash conversion period, represents the number of days required to complete the working-capital cycle, which ends with the conversion of accounts receivable into cash. During this period, the firm no longer has the benefit of supplier financing (accounts payable). The longer this period lasts, the greater the potential cash flow problems for the firm.

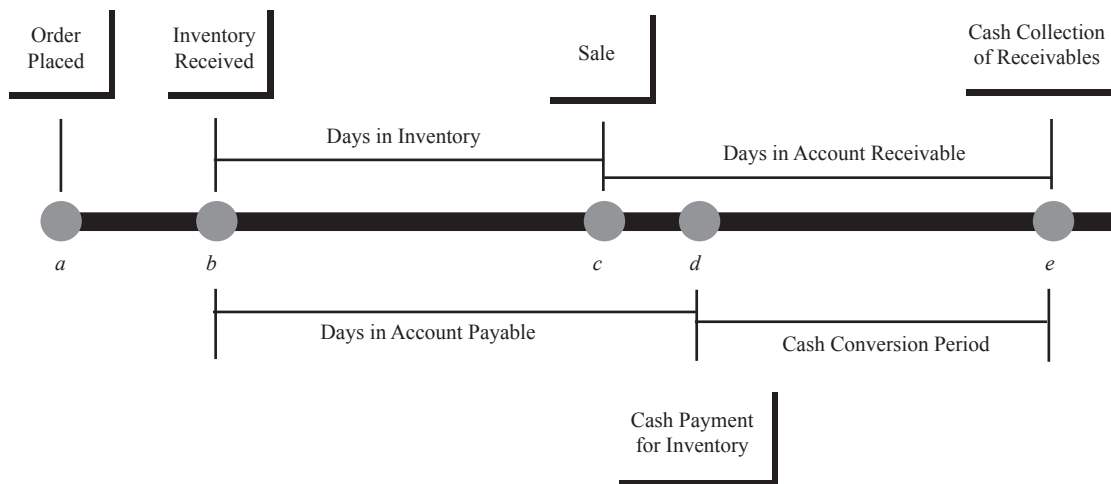


Fig. 7.2 Working capital time line

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

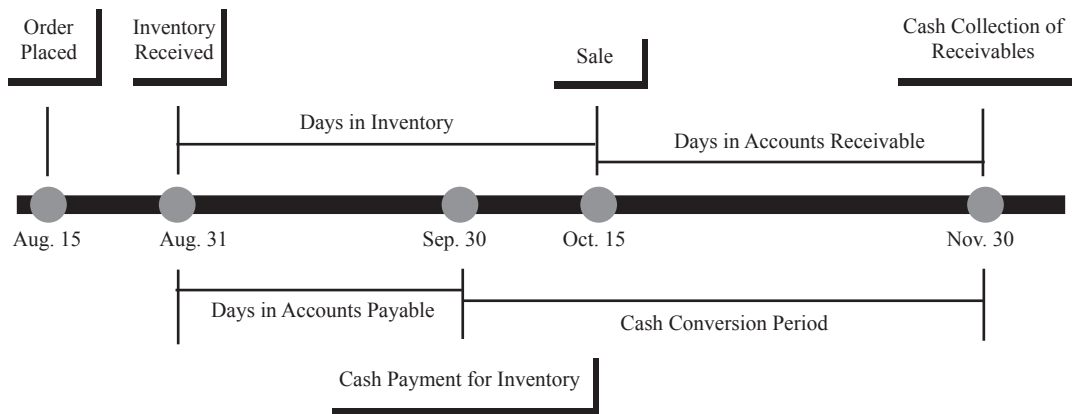
Examples of working-capital management

The figure below offers two examples of working-capital management by firms with contrasting working-capital cycles: Pokey, Inc., and Quick Turn Company. On August 15, both firms buy inventory that they receive on August 31, but the similarity ends there. Pokey, Inc., must pay its supplier for the inventory on September 30, before eventually reselling it on October 15. It collects from its customers on November 30.

As you can see, Pokey, Inc., must pay for the inventory two months prior to collecting from its customers. Its cash conversion period—the time required to convert the paid-for inventories and accounts receivable into cash—is 60 days. The firm's managers must find a way to finance this investment in inventories and accounts receivable, or else they will experience cash flow problems. Furthermore, although increased sales should produce higher profits, they will compound the cash flow problem because the company will have to finance the investment in inventory until the accounts receivable are collected 60 days later.

Now consider Quick Turn Company's working-capital cycle, shown in the bottom portion of the figure. Compared to Pokey, Quick Turn Company has an enviable working-capital position. By the time Quick Turn must pay for its inventory purchases (October 31), it has sold its product (September 30) and collected from its customers (October 31). Thus, there is no cash conversion period because the supplier is essentially financing Quick Turn's working-capital needs.

Pokey, Inc.



Quick Turn Company

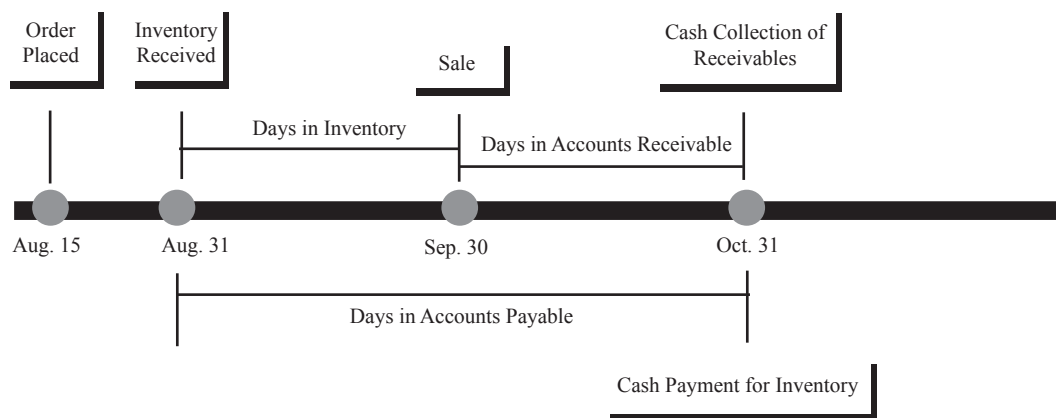


Fig. 7.3 Working-capital time lines for Pokey, Inc. and Quick Turn Company

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

7.3 Managing Cash Flows

It should be clear by now that the core of working-capital management is monitoring cash flows. Cash is continually moving through a business. It flows in as customers pay for products or services, and it flows out as payments are made to other businesses and individuals who provide products and services to the firm, such as employees and suppliers. The typically uneven nature of cash inflows and outflows makes it imperative that they be properly understood and managed. Keith Lowe, an experienced entrepreneur and co-founder of the Alabama Information Technology Association, expresses it this way:

7.3.1 Nature of Cash Flows Revisited

A firm's net cash flow may be determined quite simply by examining its bank account. Monthly cash deposits less checks written during the same period equal a firm's net cash flow. If deposits for a month add up to \$100,000 and checks total \$80,000, the firm has a net positive cash flow of \$20,000. The cash balance at the end of the month is \$20,000 higher than it was at the beginning of the month.

The figure below graphically represents the flow of cash through a business. It includes not only the cash flows that arise as part of the firm's working-capital cycle but other cash flows as well, such as those from purchasing fixed assets and issuing stock. More specifically, cash sales, collection of accounts receivable, payment of expenses, and payment for inventory reflect the inflows and outflows of cash that relate to the working-capital cycle, while the other items in the figure below represent other, longer-term cash flows.

As has been emphasised on several occasions, calculating cash flow requires that we distinguish between sales revenue and cash receipts—they are seldom the same. Revenue is recorded at the time a sale is made but does not affect cash flow at that time unless the sale is a cash sale. Cash receipts, on the other hand, are recorded when money actually flows into the firm, often a month or two after the sale.

Similarly, it is necessary to distinguish between expenses and disbursements. Expenses occur when materials, labour, or other items are used. Payments (disbursements) for these expense items may be made later, when checks are issued. Depreciation, while shown as an expense, is not a cash outflow. Given the difference between cash flows and profits, it is absolutely essential that the entrepreneur develop a cash budget to anticipate when cash will enter and leave the business. In the next section, we will describe and illustrate the cash budgeting process.

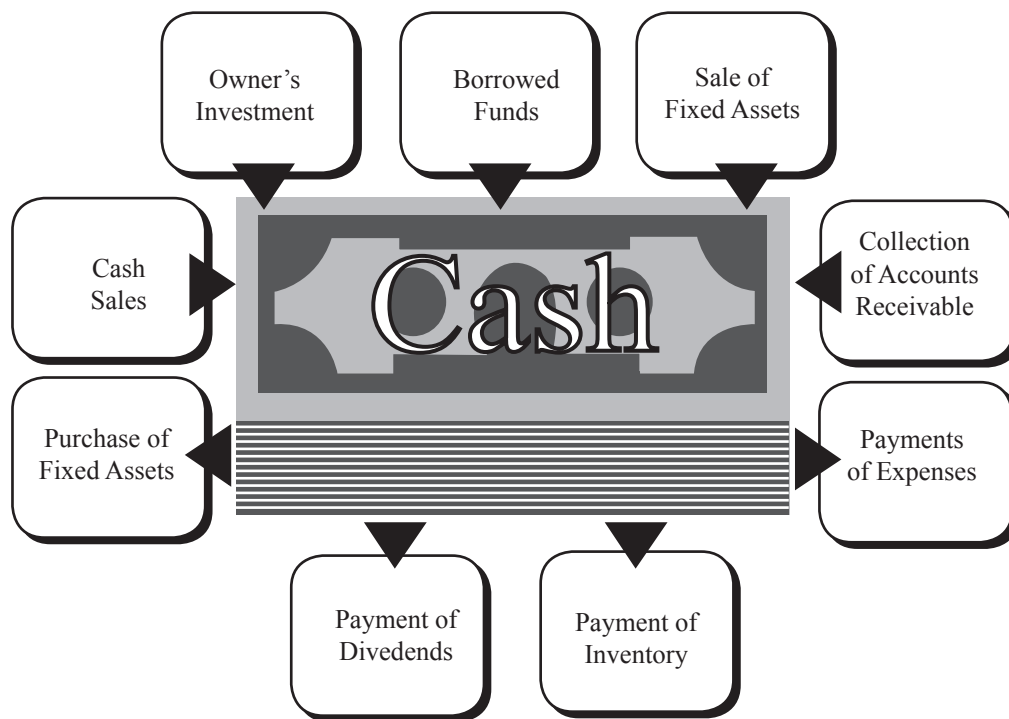


Fig. 7.4 Flow of cash through a business

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

7.3.2 Cash Budget

The cash budget is a primary tool for managing cash flows. The budget is concerned specifically with dollars received and paid out. In contrast, the income statement takes items into consideration before they affect cash—for example, expenses that have been incurred but not yet paid and income earned but not yet received. By using a cash budget, an entrepreneur can predict and plan the cash flows of a business.

No single planning document is more important in the life of a small company, either for avoiding cash flow problems when cash runs short or for anticipating short-term investment opportunities if excess cash becomes available.

To better understand the process of preparing a cash budget, consider the example of the Davies Corporation, a manufacturer of food storage containers. Its owner, Peggy Davies, wishes to develop a monthly cash budget for the next quarter (July through September) and has made the following forecasts.

7.4 Managing Accounts Receivables

How accounts receivable affect cash? This has to be understood. Granting credit to customers, although primarily a marketing decision, directly affects a firm's cash account. By selling on credit and thus allowing customers to delay payment, the selling firm delays the inflow of cash. The total amount of customers' credit balances is carried on the balance sheet as accounts receivable—one of the firm's current assets. Of all noncash assets, accounts receivable are closest to becoming cash. Sometimes called near cash, or receivables, accounts receivable typically are collected and become cash within 30 to 60 days following a sale.

7.5 Managing Inventories

Inventory is a “necessary evil” in the financial management system. It is “necessary” because supply and demand cannot be managed to coincide precisely with day-to-day operations; it is an “evil” because it ties up funds that are not actively productive.

7.5.1 Reducing Inventory to Free Cash

Inventory is a bigger problem for some small businesses than for others. The inventory of many service companies, for example, consists of only a few supplies. A manufacturer, on the other hand, has several inventories: raw materials, work in process, and finished goods. Retailers and wholesalers—especially those with high inventory turnover rates, such as firms in grocery distribution—are continually involved in solving inventory management problems. Chapter 20 discussed several ideas related to purchasing and inventory management that are designed to minimise inventory-carrying costs and processing costs. The emphasis in this section is on practices that will minimise average inventory levels, thereby releasing funds for other uses. The correct minimum level of inventory is the level needed to maintain desired production schedules and/or a certain level of customer service. A concerted effort to manage inventory can trim excess inventory and pay handsome dividends.

7.5.2 Monitoring Inventory

One of the first steps in managing inventory is to discover what's in inventory and how long it's been there. Too often, items are purchased, warehoused, and essentially forgotten. A yearly inventory for accounting purposes is inadequate for proper inventory control. Items that are slow movers may sit in a retailer's inventory beyond the time when markdowns should have been applied. Computers can provide assistance in inventory identification and control. Although physical inventories may still be required, their use will only serve to supplement the computerised system.

7.5.3 Controlling Stockpiles

Small business managers tend to overbuy inventory for several reasons. First, an entrepreneur's enthusiasm may lead him or her to forecast greater demand than is realistic. Second, the personalisation of the business–customer relationship may motivate a manager to stock everything customers want. Third, a price-conscious manager may be overly susceptible to a vendor's appeal to “buy now, because prices are going up.” Managers must exercise restraint when stockpiling. Improperly managed and uncontrolled stockpiling may greatly increase inventory-carrying costs and place a heavy drain on the funds of a small business.

7.6 Managing Accounts Payable

Cash flow management and accounts payable management are intertwined. As long as a payable is outstanding, the buying firm can keep cash equal to that amount in its own checking account. When payment is made, however, that firm's cash account is reduced accordingly. Although payables are legal obligations, they can be paid at various times or even renegotiated in some cases. Therefore, financial management of accounts payable hinges on negotiation and timing.

Negotiation

Any business is subject to emergency situations and may find it necessary to ask creditors to postpone its payable obligations. Usually, creditors will cooperate in working out a solution because it's in their best interest for a client firm to succeed.

Timing

“Buy now, pay later” is the motto of many entrepreneurs. By buying on credit, a small business is using creditors’ funds to supply short-term cash needs. The longer creditors’ funds can be borrowed, the better. Payment, therefore, should be delayed as long as acceptable under the agreement.

Typically, accounts payable (trade credit) involves payment terms that include a cash discount. With trade-discount terms, paying later may be inappropriate. For example, terms of 3/10, net 30 offer a 3 percent potential discount. Exhibit 22-6 shows the possible settlement costs over the credit period of 30 days. Note that for a \$20,000 purchase, a settlement of only \$19,400 is required if payment is made within the first 10 days (\$20,000 less the 3 percent discount of \$600). Between day 11 and day 30, the full settlement of \$20,000 is required. After 30 days, the settlement cost may exceed the original amount, as late-payment fees are added.

7.7 Capital Budgeting

Capital budgeting analysis helps managers make decisions about long-term investments. In order to develop a new product line, for example, a firm needs to expand its manufacturing capabilities and to buy the inventory required to make the product. That is, it makes investments today with an expectation of receiving profits or cash flows in the future, possibly over 5 or 10 years. Some capital budgeting decisions that might be made by a small firm include the following:

- Develop and introduce a new product that shows promise but requires additional study and improvement.
- Replace a firm’s delivery trucks with newer models.
- Expand sales activity into a new territory.
- Construct a new building.
- Hire several additional salespersons to intensify selling in the existing market.

7.7.1 Capital Budgeting Techniques

The three major techniques for making capital budgeting decisions are: (1) the accounting return on investment technique, (2) the payback period technique, and (3) the discounted cash flow technique, using either net present value or internal rate of return. They all attempt to answer the same basic question: Do the future benefits from an investment exceed the cost of making the investment? However, each technique addresses this general question by focusing on a different specific question. The specific question each addresses can be stated as follows:

- **Accounting return on investment:** How many dollars in average profits are generated per dollar of average investment?
- **Payback period:** How long will it take to recover the original investment outlay?
- **Discounted cash flows:** How does the present value of future benefits from the investment compare to the investment outlay?

Three simple rules are used in judging the merits of an investment. Although they may seem trite, the rules state in simple terms the best thinking about the attractiveness of an investment.

- The investor prefers more cash rather than less cash.
- The investor prefers cash sooner rather than later.
- The investor prefers less risk rather than more risk.

With these criteria in mind, let’s now look at each of the three capital budgeting techniques in detail.

Accounting return on investment

A small business invests to earn profits. The accounting return on investment technique compares the average annual after-tax profits a firm expects to receive with the average book value of the investment:

$$\text{Accounting return on investment} = \frac{\text{Average annual after-tax profit}}{\text{Average book value of the investment}}$$

Payback period

The payback period technique, as the name suggests, measures how long it will take to recover the initial cash outlay of an investment. It deals with cash flows as opposed to accounting profits. The merits of a project are judged on whether the initial investment outlay can be recovered in less time than some maximum acceptable payback period. For example, an owner may not want to invest in any project that will require more than five years to recoup the original investment.

Discounted cash flows

Managers can avoid the deficiencies of the accounting return on investment and payback period techniques by using discounted cash flow analysis. Discounted cash flow techniques take into consideration the fact that cash received today is more valuable than cash received one year from now (called the time value of money). For example, interest can be earned on cash that is available for immediate investment; this is not true for cash to be received at some future date.

Discounted cash flow (DCF) techniques compare the present value of future cash flows with the investment outlay. Such an analysis may take either of two forms: net present value or internal rate of return. The net present value (NPV) method estimates the current value of the cash that will flow into the firm from the project in the future and deducts the amount of the initial outlay.

To find the present value of expected future cash flows, we discount them back to the present at the firm's cost of capital, where the cost of capital is equal to the investors' required rate of return. If the net present value of the investment is positive (that is, if the present value of future cash flows discounted at the rate of return required to satisfy the firm's investors exceeds the initial outlay), the project is acceptable.

The internal rate of return (IRR) method estimates the rate of return that can be expected from a contemplated investment. For the investment outlay to be attractive the internal rate of return must exceed the firm's cost of capital—the rate of return required to satisfy the firm's investors. Discounted cash flow techniques can generally be trusted to provide a more reliable basis for decisions than can the accounting return on investment or the payback period technique.

7.7.2 Capital Budgeting Analysis in Small Firms

Historically, few small business owners have relied on any type of quantitative analysis in making capital budgeting decisions. The decision to buy new equipment or expand facilities has been based more on intuition and instinct than on economic analysis. And those who do conduct some kind of quantitative analysis rarely use discounted cash flow techniques, neither net present value nor internal rate of return.

In the study cited earlier, the National Federation of Independent Business asked entrepreneurs to indicate the method(s) they used in analysing capital investments. The results were encouraging. We could conclude that the small business owners surveyed were not very sophisticated about using theoretically sound financial methods, given that only 12 percent said they use discounted cash flow analyses. However, the cause of their limited use of DCF tools probably has more to do with the nature of the small business itself than with the owners' unwillingness to learn. Several more important reasons might explain these findings, including the following:

For many owners of small firms, the business is an extension of their lives—that is, business events affect them personally. The same is true in reverse: What happens to the owners personally affects their decisions about the firm. The firm and its owners are inseparable. We cannot fully understand decisions made about a company without being aware of the personal events in the owners' lives. Consequently, nonfinancial variables may play a significant part in owners' decisions. For example, the desire to be viewed as a respected part of the community may be more important to an owner than the present value of a business decision. The undercapitalisation and liquidity problems of a small business can directly affect the decision-making process, and survival often becomes the top priority.

Long-term planning is, therefore, not viewed by the owners as a high priority in the total scheme of things. The greater uncertainty of cash flows within small firms makes long-term forecasting and planning seem unappealing and even a waste of time. The owners simply have no confidence in their ability to predict cash flows beyond two or three years. Thus, calculating the cash flows for the entire life of a project is viewed as a futile effort. The value of a closely held firm is less easily observed than that of a publicly held firm whose securities are actively traded in the marketplace.

Therefore, the owner of a small firm may consider the market-value rule of maximising net present values irrelevant. Estimating the cost of capital is also much more difficult for a small company than for a large firm. The smaller size of a small firm's projects may make net present value computations less feasible in a practical sense. The time and expense required to analyse a capital investment are generally the same, whether the project is large or small. Therefore, it is relatively more costly for a small firm to conduct such a study.

Management talent within a small firm is a scarce resource. Also, the owner-manager frequently has a technical background, as opposed to a business or finance orientation. The perspective of owners is influenced greatly by their backgrounds. The foregoing characteristics of a small business and its owner have a significant effect on the decision-making process within the firm. The result is often a short-term mind-set, caused partly by necessity and partly by choice. However, the owner of a small firm should make every effort to use discounted cash flow techniques and to be certain that contemplated investments will, in fact, provide returns that exceed the firm's cost of capital.

Summary

- Assets are commonly defined as “what the company owns”.
- Working-capital management—managing short-term assets (current assets) and short-term sources of financing (current liabilities)—is extremely important to most small companies.
- The owners of small business companies need to understand the working-capital cycle, in terms of both the timing of investments and the size of the investment required.
- The core of working-capital management is monitoring cash flows.
- Cash budget is concerned specifically with dollars received and paid out.
- Capital budgeting analysis helps managers make decisions about long-term investments.
- The three major techniques for making capital budgeting decisions are the accounting return on investment technique, the payback period technique, and the discounted cash flow technique, using either net present value or internal rate of return.
- Discounted cash flow (DCF) techniques compare the present value of future cash flows with the investment outlay.
- The correct minimum level of inventory is the level needed to maintain desired production schedules and/or a certain level of customer service.
- The payback period technique, as the name suggests, measures how long it will take to recover the initial cash outlay of an investment.

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Recommended Reading

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Self Assessment

1. Which of the following is an example of asset?
 - a. Cash
 - b. Customer
 - c. Taxes
 - d. Wages
2. Working-capital management deals with current assets and _____.
 - a. fixed assets
 - b. current liabilities
 - c. long-term liabilities
 - d. intangible assets
3. To calculate cash flow, one must distinguish between sales revenue and _____.
 - a. wages
 - b. rent
 - c. goodwill
 - d. cash receipts
4. Which of the following is recorded at the time a sale is made?
 - a. Revenue
 - b. Sale
 - c. Expenses
 - d. Collection
5. Which of the following statements is true?
 - a. The cash budget is a tool for managing cash flows.
 - b. Income statement and cash budget are same in nature.
 - c. Capital budgeting analysis helps managers make decisions about short-term investments.
 - d. Income statement is a primary tool for managing cash flows.
6. _____ is an important technique of capital budgeting.
 - a. cash flow
 - b. managing inventory
 - c. accounting return on investment
 - d. controlling stockpiles
7. Which method estimates the current value of the cash that will flow into the firm from the project in the future and deducts the amount of the initial outlay?
 - a. NPV
 - b. IRR
 - c. Payback period technique
 - d. Accounting return on investment

8. What does IRR stands for?
 - a. Internal rate of return
 - b. Initial rate of return
 - c. Investment's rate of return
 - d. Insider's rate of return

9. Owners of small businesses need to understand the working-capital cycle, in terms of both the timing of investments and the _____ of the investment required.
 - a. sources
 - b. rate
 - c. quality
 - d. size

10. Accounts receivable typically are collected and become cash within _____ days following a sale.
 - a. 40-60
 - b. 30 to 60
 - c. 20-50
 - d. 30-70

Chapter VIII

Evaluating Financial Performance

Aim

The aim of this chapter is to:

- introduce accounting activities in small firms
- describe record keeping system
- enlist the requirements for accounting systems

Objectives

The objectives of this chapter are to:

- elucidate alternative accounting options
- explain internal accounting controls
- describe the types of internal accounting records

Learning outcome

At the end of this chapter, you will be able to:

- evaluate the firm's financial performance
- describe different types of accounting options
- identify different financial ratios

8.1 Introduction

Financial performance is the means of measuring the results of a firm's policies and operations in monetary terms. These results are reflected in the firm's return on investment, return on assets, value added, etc.

Accounting activities in small firms

Managers must have accurate, meaningful, and timely information if they are to make good decisions. This is particularly true of financial information about a firm's operations. An inadequate accounting system is a primary factor in small business failures. Owner-managers of small companies sometimes believe that they have less need for financial information because of their personal involvement in day-to-day operations, but they are only deceiving themselves. Rarely are small business owner-managers expert accountants—nor should they expect to be or even want to be. But every one of them should know enough about the accounting process, including developing and interpreting financial statements, to recognise which accounting methods are best for their company.

8.2 Basic Requirements for Accounting Systems

An accounting system structures the flow of financial information to provide a complete picture of a firm's financial activities. Conceivably, a few very small firms may not require formal financial statements. Most, however, need at least monthly financial statements, which should be computer-generated. The benefits of using a computer in developing financial information are so great and the costs so low that it makes absolutely no sense to do otherwise.

- Regardless of its level of sophistication, an accounting system for a small business should accomplish the following objectives:
- Provide an accurate, thorough picture of operating results
- Permit a quick comparison of current data with prior years' operating results and budgetary goals
- Offer financial statements for use by management, bankers, and prospective creditors. Facilitate prompt filing of reports and tax returns to regulatory and tax-collecting government agencies.
- Reveal employee fraud, theft, waste, and record-keeping errors

8.2.1 Record-Keeping System

An accounting system provides the framework for managerial control of a firm. Its effectiveness rests on a well-designed and well-managed record-keeping system. In addition to the financial statements intended for external use with bankers and investors (balance sheets, income statements, and cash flow statements), internal accounting records should be kept. The major types of internal accounting records are as follows:

- **Accounts receivable records.** Records of receivables are vital not only for making decisions on credit extension but also for billing accurately and maintaining good customer relations. An analysis of these records will reveal the effectiveness of a firm's credit and collection policies.
- **Accounts payable records.** Records of liabilities show what the firm owes to suppliers, facilitate the taking of cash discounts, and allow payments to be made when due.
- **Inventory records.** Adequate records are essential for the control and security of inventory items. Inventory records supply information for use in making purchases, maintaining adequate stock levels, and computing turnover ratios.
- **Payroll records.** Payroll records show the total salaries paid to employees and provide a base for computing and paying payroll taxes.
- **Cash records.** Carefully maintained records showing all receipts and disbursements are necessary to safeguard cash. They provide essential information about cash flows and cash balances.
- **Fixed asset records.** Fixed asset records show the original cost of each asset and the depreciation taken to date, along with other information such as the condition of the asset.
- **Other accounting records.** Among the other accounting records that are vital to the efficient operation of a small business are the insurance register (showing all policies in force), records of leaseholds, and records of the firm's investments outside its business.

8.2.2 Computer Software Packages

Software packages can be used to generate the required accounting records. Most computer software packages include the following features:

- A check book that automatically calculates a firm's cash balance, prints checks, and reconciles the account with the bank statement at month's end
- Automatic preparation of income statements, balance sheets, and statements of cash flows
- A cash budget that compares actual expenditures with budgeted expenditures
- Preparation of subsidiary journal accounts—accounts receivable, accounts payable, and other high-activity accounts

8.2.3 Outside Accounting Services

Instead of having an employee or a member of the owner's family keep records, a firm may have its financial records kept by a certified public accountant or by a bookkeeping firm or service bureau that caters to small businesses. Very small companies often find it convenient to have the same person or agency keep their books and prepare their financial statements and tax returns.

8.3 Alternative Accounting Options

Accounting records can be kept in just about any form as long as they provide users with needed data to meet legal requirements. Very small companies have choices when selecting accounting methods and accounting systems. Two such options—cash versus accrual accounting and single-entry versus double-entry systems—reflect the most basic issues in an accounting system.

8.3.1 Cash versus Accrual Accounting

The major distinction between cash-basis and accrual-basis accounting is in the point at which a firm reports revenue and expenses. The cash method of accounting is easier to use; revenue and expenses are reported only when cash is received or a payment is made. In contrast, the accrual method of accounting reports revenue and expenses when they are incurred, regardless of when the cash is received or payment is made. The cash method of accounting is sometimes selected by very small firms, as well as by firms with slow-moving receivables that want to improve their cash flows by avoiding the payment of taxes on income not yet received.

However, the cash method does not ultimately provide an accurate matching of revenue and expenses. The accrual method, although it involves more record keeping, is preferable because it provides a more realistic measure of profitability within an accounting period. The accrual method of accounting matches revenue against expenses incurred in obtaining that revenue. Alternating between a cash method and an accrual method of accounting is unacceptable, because it violates the accounting principle of consistency.

8.3.2 Single-Entry versus Double-Entry Systems

A single-entry record-keeping system is occasionally still found in very small businesses. It is not, however, a system recommended for firms that are striving to grow and achieve effective financial planning. A single entry system neither incorporates a balance sheet nor directly generates an income statement.

A single-entry system is basically a check book system of receipts and disbursements. Most introductory accounting textbooks provide information on setting up a double entry system.

This type of accounting system provides a self-balancing mechanism in the form of two counterbalancing entries for each transaction recorded. It can be done with the record-keeping journals and ledgers found in most office supply retail stores. However, the relatively simple accounting software programs designed for small companies are preferable.

8.4 Internal Accounting Controls

As already noted, an effective accounting system is vital to a firm's success. Without the information it provides, management cannot make informed decisions. However, the quality of a company's accounting system is dependent on the effectiveness of the controls that exist within the firm. Internal control is a system of checks and balances that plays a key role in safeguarding a firm's assets and in enhancing the accuracy and reliability of its financial statements. The importance of internal control has long been recognised in large corporations.

Some owners of smaller companies, concerned about the cost or relevance of a system of internal control for their business, do not appreciate its value—but they should. Building internal controls may be difficult within a small company, but it is no less important than within a large corporation. The absence of internal controls significantly increases the chances not only of fraud and theft but also of bad decisions based on inaccurate and untimely accounting information. Effective internal controls are also necessary for an audit by independent accountants. Certified public accountants are unwilling to express an opinion about a firm's financial statements if the firm lacks adequate internal controls.

Although a complete description of an internal control system is beyond the scope of this textbook, it is important to understand the concept. An example of an internal control is separation of employees' duties so that the individual maintaining control over an asset is not the same person recording transactions in the accounting ledgers. That is, to discourage fraud or financial mismanagement, the employee who collects cash from customers should not be allowed to reconcile the bank statement. Here are some other examples of internal control:

- Designating the types of transactions that require the owner's approval.
- Requiring that checks presented for signature be accompanied by complete supporting documentation
- Limiting access to accounting records
- Sending bank statements directly to the owner
- Safeguarding blank checks
- Requiring all employees to take regular vacations so that any irregularity is likely to be revealed

The importance of developing an effective system of internal control cannot be overemphasised. Extra effort may be needed to implement internal controls in a small company, in which business procedures may be informal and segregation of duties is difficult because of the limited number of employees. Even so, it is best to try to develop such controls. An accountant may be of assistance in minimising the problems that can result from the absence of internal controls.

8.5 Evaluating a Firm's Financial Performance

Once an effective accounting system is in place, a firm's owner must determine how to use the data it generates most productively. Mark Twain said, "He who does not read is no better off than he who cannot read." An owner who has a good accounting system but doesn't use it is similarly disadvantaged. This section provides a framework for interpreting financial statements, designed to clarify these statements for individuals with various levels of accounting knowledge and experience.

An owner needs to understand the financial effect—positive or negative—that management decisions may have. Ultimately, the results of operating decisions appear in a firm's financial statements.

The exact methods used to interpret financial statements can vary, with the perspective of the interpreter determining which figures are emphasised. For example, if a banker and an entrepreneur were analysing the same financial statements, they might focus on different data. But whatever perspective is taken, the most important issues are fundamentally the same and are captured in the following four questions:

- Can the firm pay its bills as they come due? In other words, does the company have the capacity to meet its short-term (one year or less) financial commitments?
- Is the business providing a good rate of return on its assets? There is no more important question when it comes to determining if a business is strong economically.
- How much debt is the firm using, compared to its equity financing?
- Are the owners getting a good rate of return on their equity investment? Here we want to know whether the combined effect on the owners of all financial decisions is positive or negative.

Answering these questions requires restating the data from the income statement and the balance sheet in relative terms, or financial ratios. Only in this way can comparisons be made with other firms, with industry averages, and across time. Typically, the industry averages or norms used for comparison purposes are those published by companies such as Dun & Bradstreet, Robert Morris Associates, and Standard & Poor's.

The table given below shows the industry norms for the computer and software retailing industry for 2006–2007, as reported by Robert Morris Associates, which compiles financial ratios for banks to use in their analyses of firms seeking loans. As shown in the table, the ratios are reported by firm size. We can best demonstrate the use of financial ratios to evaluate a firm's performance by looking at the financial statements for Trimble & Associates Leasing, Inc. The firm's income statement and balance sheets are shown in the tables given below. Using these financial statements to compute the firm's ratios and relying on industry norms selected by the firm's management, we can answer the four fundamental questions regarding Trimble's financial performance.

FIRM SIZE BY TOTAL ASSETS			
	Less than \$500,000	\$5,00,000 to \$2 Million	\$ 2 Million to \$ 10 Million
Current Ratio	1.0	1.2	1.3
Accounts receivable turnover	20.8	12.8	7.7
Inventory turnover	23.1	15.8	25.9
Return on assets	-1.34%	7.4%	18.4%
Operating profit margin	-0.2%	2.0%	5.1%
Fixed asset turnover	46.5	63.2	34.2
Total asset turnover	6.7	3.7	3.6
Debt/total assets	132.6%	74.9%	76.1%
Return on equity (before tax)	NA*	22.8%	45.5%

*Not applicable. Firms in this group have a negative equity on average, preventing computation of return on equity

Note: RMA cautions that the Studies be regarded only as a general guideline and not as an absolute industry norm. This is due to limited samples within categories, the categorization of companies by their primary Standard Industrial Classification(SIC) number only, and different methods of operations by companies within the same industry. For these reasons, RMA recommends that the figures be used only as general guidelines in addition to other methods of financial analysis.

Source: Adapted from RMA 2006-2007 Annual Statement Studies, published by Robert Morris Association, Philadelphia, Pa. Copyright Robert Morris Associates, 2007.

Table 8.1 Financial ratios for retail computer and software stores, 2006-2007

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

8.5.1 Evaluate a Firm's Ability to Pay Bills

A business—or a person, for that matter—that has enough money to pay off any debt owed is described as being highly liquid. In other words, the liquidity of a business depends on the availability to the firm of cash to meet maturing debt obligations. Measuring liquidity answers the question “Does the firm now have or will it have in the future the resources to pay creditors when debts come due?”

This question can be answered in either two ways:

- By comparing the firm's assets that are relatively liquid in nature with the debt coming due in the near term, or
- By examining the timeliness with which liquid assets, primarily accounts receivable and inventories, are being converted into cash

Sales	\$850,000
Cost of goods sold	550,000
Gross profit on sales	\$300,000
Operating expenses:	
Marketing expenses	\$90,000
General and administrative expenses	80,000
Depreciation expense	30,000
Total operating expenses	\$200,000
Operating income	\$100,000
Interest expense	20,000
Earning before taxes	\$80,000
Income tax(25%)	20,000
Net Income	\$ 60,000

Table 8.2 Income statement for Trimble & Associates Leasing Inc. for the year ending Dec 31, 2007
(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Assets	
Current Assets:	
Cash	\$50,000
Accounts receivable	80,000
Inventories	<u>220,000</u>
Total current assets	\$350,000
Fixed Assets:	
Gross fixed assets	\$960,000
Accumulated depreciation	<u>(390,000)</u>
Net fixed assets	<u>\$570,000</u>
TOTAL ASSETS	<u><u>\$920,000</u></u>
Debt (liabilities) and Equity	
Current liabilities:	
Accounts payable	\$20,000
Short-Term notes	<u>80,000</u>
Total current liabilities(debt)	\$100,000
Long-Term debt	<u>200,000</u>
Total Debt	\$300,000
Owner's equity:	
Common Stock	\$300,000
Retained earnings	<u>320,000</u>
Total ownership equity	<u>\$6,20,000</u>
TOTAL DEBT AND EQUITY	<u><u>\$920,000</u></u>

Table 8.3 Balance sheet for Trimble & Associates Leasing Inc. for December 31, 2007

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

The first approach to measuring liquidity is to compare cash and the assets that should be converted into cash within the year against the debt (liabilities) that is coming due and will be payable within the year. The liquid assets within a firm are its current assets, and the maturing debt consists of the current liabilities shown in the balance sheet.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$350,000}{\$100,000} = 3.50$$

Based on Dun & Bradstreet data, the industry norm for the current ratio is 2.70. Thus, Trimble & Associates would appear to be more liquid than the average firm in its industry. Trimble has \$3.50 in current assets for every \$1 in current liabilities (debt), compared to \$2.70 for a 'typical' firm in the industry.

The second view of liquidity examines a firm's ability to convert accounts receivable and inventory into cash on a timely basis. The ability to convert accounts receivable into cash may be measured by computing how quickly the firm is collecting its receivables. This can be determined by measuring the number of times that accounts receivable are "rolled over" during a year, or the accounts receivable turnover. The accounts receivable turnover is computed as follows:

$$\text{Accounts receivable turnover} = \frac{\text{Credit sales}}{\text{Accounts receivable}}$$

If we assume that Trimble & Associates' sale are all credit sales, as opposed to cash sales, the accounts receivable turnover for Trimble & Associates in 2007 is 10.63 days. The computation is as follows:

$$\text{Accounts receivable turnover} = \frac{\text{Credit sales}}{\text{Accounts receivable}} = \frac{\$850,000}{\$80,000} = 10.63$$

The industry norm for accounts receivable turnover is 10.4. Thus, we may conclude that Trimble & Associates is comparable to the average firm in the industry in terms of its collection of receivables.

To gain some insight into the liquidity of Trimble's inventories, we now need to determine how many times the firm is turning over its inventories during the year. The inventory turnover is calculated as follows:

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Inventory}}$$

Note that in this ratio sales are shown at the firm's cost, as opposed to the full market value when sold. Since inventory (the denominator) is at cost, it is desirable to measure sales (the numerator) on a cost basis also in order to avoid a biased answer.

The inventory turnover for Trimble & Associates is calculated as follows:

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Inventory}} = \frac{\$550,000}{\$220,000} = 2.50$$

The industry norm for inventory turnover is 4.0, which reveals a significant problem of Trimble & Associates. The firm is carrying excessive inventory, possibly even some obsolete inventory. It is generating only \$2.50 in sales at cost for every \$1 of inventory, compared to \$4.00 in sales at cost for the average firm.

8.5.2 Assess a Firm's Overall Profitability

A vitally important question to a firm's owners and investors is whether the company's operating profits are sufficient relative to the total amount of assets invested in the company. The figure below provides a graphical representation of the drivers of a firm's return on assets. As shown in the exhibit, a firm's assets are invested for the express purpose of producing operating profits. A comparison of operating profits to total invested assets reveals the rate of return that is being earned on the entire firm's capital. For Trimble & Associates, we compute the return on assets as follows:

$$\text{Return on assets} = \frac{\text{Operating income}}{\text{Total assets}} = \frac{\$100,000}{\$920,000} = 0.1087, \text{ or } 10.87 \%$$

The firm's return on assets is less than the industry norm of 13.2 percent. For some reason, Trimble & Associates is generating less operating income on each dollar of assets than are its competitors.

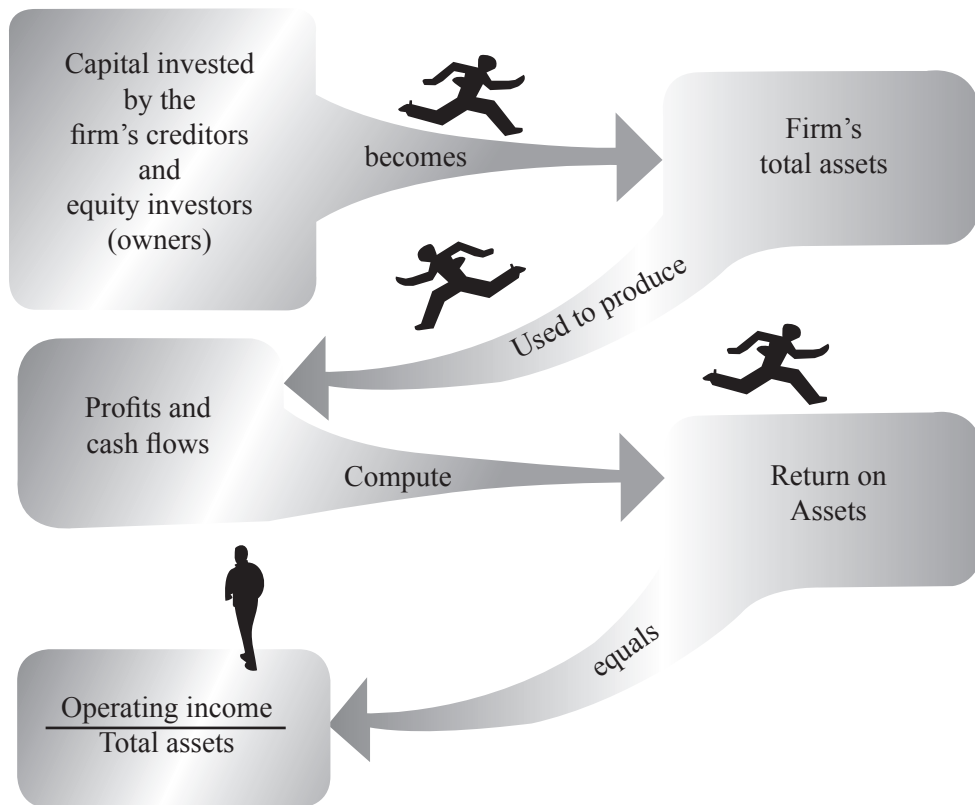


Fig. 8.1 Return on assets: An overview

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

The owners of Trimble & Associates should not be satisfied with merely knowing that they are not earning a competitive return on the firm's assets. They should also want to know *why* the return is below average. To gain more understanding, the owners could separate the return on assets into its two components:

- Operating profit margin
- Total asset turnover

Separating the return on assets into its two factors better isolates a firm's strengths and weaknesses when it is attempting to identify ways to earn a competitive rate of return on its total invested capital. The equation for the return on assets can be restated as follows:

$$\text{Return on assets} = \frac{\text{Operating income}}{\text{Total assets}} = \frac{\text{Operating Profit Margin}}{\text{Sales}} \times \frac{\text{Total Asset Turnover}}{\text{Total assets}}$$

The first component of the expanded equation, the operating profit margin, shows how well a firm is managing its operations, as reflected in the income statement. There are five factors, or driving forces, that affect the operating profit margin and, in turn, the return on assets:

- The number of units of product or service sold (volume)
- The average selling price for each product or service unit (sales price)
- The cost of manufacturing or acquiring the firm's product (cost of goods sold)
- The ability to control general and administrative expenses (operating expenses)
- The ability to control expenses in marketing and distributing the firm's product
- (operating expenses)

The second component of a firm's return on assets, the total asset turnover, indicates how efficiently management is using the firm's assets to generate sales—that is, how well the firm is managing its balance sheet. If Company A can generate \$3 in sales with \$1 in assets while Company B generates \$2 in sales per asset dollar, then Company A is using its assets more efficiently in generating sales. This is a major determinant in the firm's return on investment.

For Trimble & Associates, the operating profit margin and total asset turnover can be computed as follows:

$$\text{Operating profit margin} = \frac{\text{Operating profits}}{\text{Sales}} = \frac{\$100,000}{\$850,000} = 0.1176 \text{ or } 11.76 \%$$

$$\text{Total asset turnover} = \frac{\text{Sales}}{\text{Total assets}} = \frac{\$850,000}{\$920,000} = 0.92$$

The industry norm for the two ratios is as follows:

Industry norm for operating profit margin = 11%

Industry norm for total assets turnover = 1.20

Thus, comparing Trimble & Associates to the industry, we have

	Operating Profit Margin	Total Asset Turnover	Return on Assets
Return on assets _{Trimble}	11.76 %	X 0.92	10.82 %
Return on assets _{Industry}	11.0 %	X 1.20	13.2 %

Table 8.4 Industry norms

Clearly, Trimble & Associates is competitive when it comes to managing its income statement – keeping costs and expenses in line relative to sales – as reflected by the operating profit margin. In other words, its managers are performing satisfactorily in controlling the five driving forces of the operating profit margin. However, Trimble & Associates' total asset turnover shows why the firm is not earning a good return on its assets. The firm is not using its assets efficiently; the balance sheet is not being managed well. Trimble's problem is that it generates \$0.92 in sales per dollar of assets, while the competition produces \$1.20 in sales from every dollar in assets.

The analysis should not stop here, however. It is clear that Trimble's assets are not being used efficiently, but the next question should be "Which assets are the problem?" Is this firm overinvested in all assets or mainly in accounts receivable or inventory or fixed assets? To answer this question, we must examine the turnover ratio for each asset. The first two ratios- accounts receivable turnover and inventory turnover- were calculated earlier. The third ratio, fixed asset turnover, is found by dividing sales by net sales.

Thus, the three turnover ratios are as follows:

Turnover ratios	Trimble & Associates	Industry norm
$\text{Accounts receivable turnover} = \frac{\text{Credit sales}}{\text{Accounts receivable}} = \frac{\$850,000}{\$80,000}$	10.63	10.4
$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Inventory}} = \frac{\$550,000}{\$220,000}$	2.50	4.0
$\text{Fixed asset turnover} = \frac{\$850,000}{\$570,000}$	1.49	2.5

Table 8.5 Turnover ratios

Trimble's problem can now be better understood. The firm has excessive inventories, as evident earlier. Also, it is too heavily invested in fixed assets for the sales being produced. It appears that these two asset categories are not being managed well. Consequently, Trimble & Associates is experiencing a lower-than-average return on assets.

Till now, we have seen the firm's ability to earn satisfactory rate of return on its total invested capital. To this point, we don't know the firm's decisions as to whether to use debt or equity financing and the consequences of such decisions on the owner's return on the equity investment. So let's examine how Trimble & Associates finances its assets.

8.5.3 Measure a Firm's Use of Debt and Equity Financing

Financial leverage can increase a firm's return on equity, but with some financial risk. Are Trimble's assets financed to a greater extent by debt or by equity? One of two ratios is generally used to answer this question (although many others could be used). The debt ratio, which is total debt divided by total assets, was discussed in Chapter 10; it tells us what percentage of the firm's assets is financed by debt—both short-term and long-term. (The remaining percentage must be financed by equity.) The *debt-equity ratio* is total debt divided by total equity, rather than total assets. Either ratio leads to the same conclusion.

For Trimble & Associates in 2007, debt as a percentage of total assets is 33 %, compared to an industry norm of 40 %. The computation is as follows:

$$\text{Debt ratio} = \frac{\text{Total debt}}{\text{Total assets}} = \frac{\$300,000}{\$920,000} = 0.33 \text{ or } 33\%$$

Thus, Trimble & Associates uses somewhat less debt than the average firm in the industry, which means that it has less financial risk.

A second perspective on firm's financing decisions can be gained by looking at the income statement. When a firm borrows money, it is required, at a minimum, to pay the interest on the debt. Thus, determining the amount of operating income available to pay the interest provides a firm with valuable information. Stated as a ratio, the computation shows the number of times the firm earns its interest. The times interest earned ratio, which is commonly used in examining a firm's debt position, is calculated as follows:

$$\text{Times interest earned ratio} = \frac{\text{Operating income}}{\text{Interest expense}}$$

For Trimble & Associates, the times interest ratio earned ratio is as follows:

$$\$ \frac{\$100,000}{\$20,000} = 5.00 \frac{\$100,000}{\$20,000} = 5.00$$

The industry norm for the times interest ratio earned is 4.0. Thus, Trimble & Associates is better able to service its interest expense than most comparable firms. Remember, however, the interest is paid not with income but with cash. Also, the firm may be required to repay some of the debt principal, as well as the interest. Thus, the times interest earned ratio is only a crude measure of firm's capacity to service debt. Nevertheless, it gives a general indication of the firm's debt capacity.

8.5.4 Evaluate the Rate of Return Earned on Owner's Investment

The last question looks at the accounting return on the owners' investment, or return on equity. We must determine whether the earnings available to the firm's owners (or stockholders) are attractive when compared to the returns of owners of similar companies in the same industry. The return on equity for Trimble & Associates in 2007 is as follows:

$$\text{Return on equity} = \frac{\text{Net income}}{\text{Owner's equity}} = \frac{\$60,000}{\$620,000} = 0.097 \text{ or } 9.7 \%$$

The industry norm for return on equity is 12.5 percent. Thus, it appears that the owners of Trimble & Associates are not receiving a return on their investment equivalent to that of owners of competing businesses. Why not? To answer this question, we have to understand the following:

- The return on equity will increase as the difference between the return on assets and the interest rate paid for the use of debt financing increases; that is, as (return on assets _ interest rate) increases, return on equity increases. But, if the difference between the return on assets and the interest rate decreases, then the return on equity will also decrease.
- As a firm's debt ratio (total debt _ total assets) increases, return on equity will increase if the return on assets is greater than the interest rate, but return on equity will decrease if the return on assets is less than the interest rate.

It is important for an entrepreneur to understand the foregoing relationships. In case of Trimble & Associates, we see that firm has a lower return on equity in part because it is not as profitable in its operation as its competitors are. (Its return on assets is 10.87 compared to 13.2 % for the industry.) Also, the company uses less debt than the average firm in the industry, causing its return on equity to be lower than the other firms – provided, of course, that these firms are earning a return on their investments that exceeds the cost of debt (the interest rate). However, we should recognise that the use of less debt does reduce the Trimble's risk.

Inventories are used for more than one purpose. These ratios have implications for both the firm's liquidity and its profitability; thus, they are listed in both areas. In any case, it should be apparent by now that the numbers tell a clear story about a company's health and performance. Those who know how to read that story will always have an advantage over competitors that are unable to sort this out—and that can make all the difference!

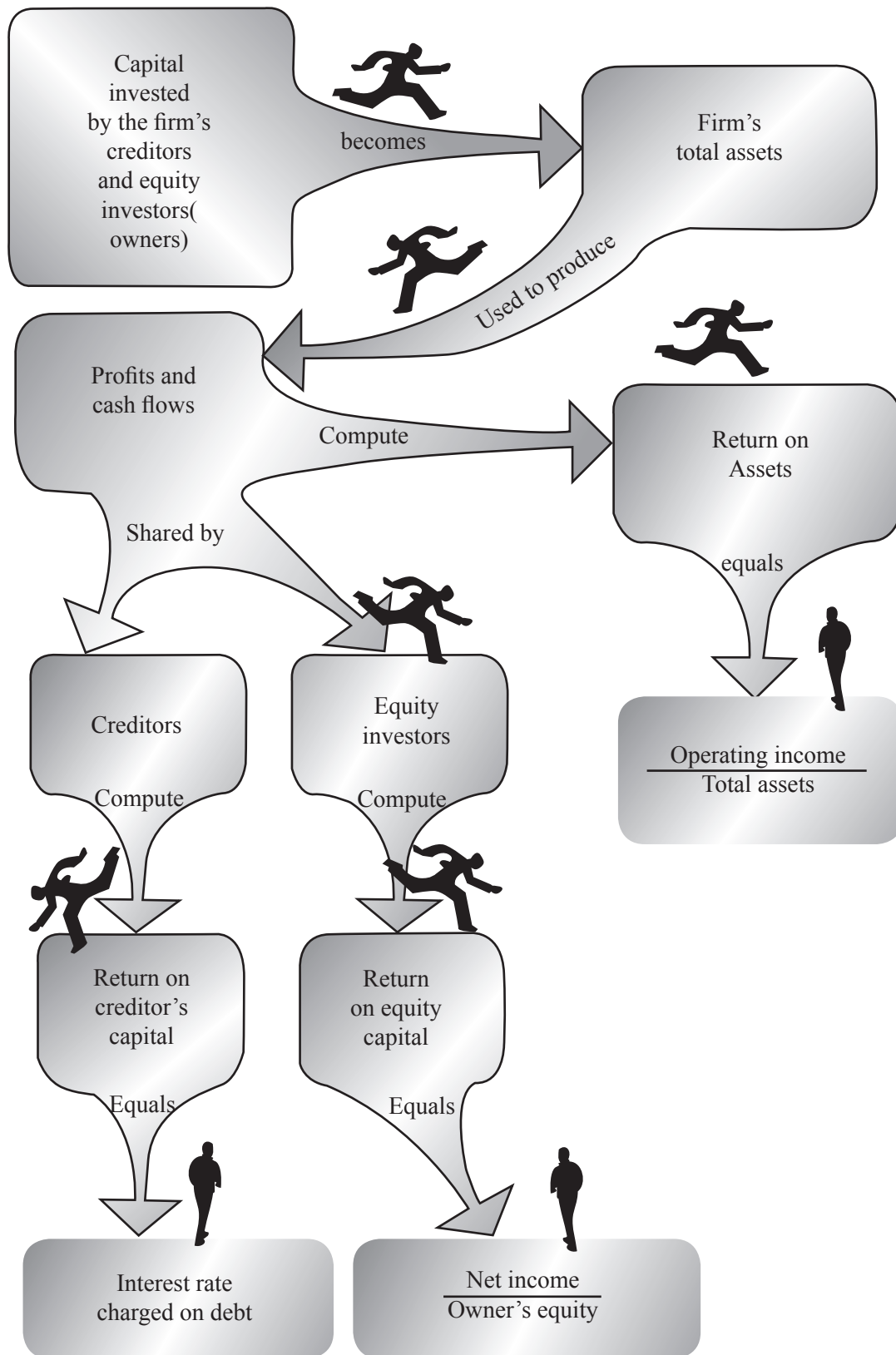


Fig. 8.2 Return on equity: An overview

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Financial Ratios	Trimble and associates	Industry Norm
1.Firm liquidity		
Current Ratio= $\frac{\text{Current Assets}}{\text{Current liabilities}}$	$\frac{\$350,000}{\$100,000} = 3.50$	2.70
Accounts receivable turnover= $\frac{\text{Credit Sales}}{\text{Accounts receivable}}$	$\frac{\$850,000}{\$80,000} = 10.63$	10.43
Inventory turnover= $\frac{\text{Costs of goods sold}}{\text{Inventory}}$	$\frac{\$550,00}{\$220,000} = 2.50$	4.00
2. Operating profitability		
Return on assets= $\frac{\text{Operating income}}{\text{Total Assets}}$	$\frac{\$1,00,000}{\$920,000} = 10.87\%$	13.2%
Operating profit margin= $\frac{\text{Operating profits}}{\text{Sales}}$	$\frac{\$100,000}{\$8,50,000} = 11.76\%$	11.0%
Total asset turnover= $\frac{\text{Sales}}{\text{Total assets}}$	$\frac{\$850,000}{\$920,000} = 0.92$	1.20
Account receivable turnover= $\frac{\text{Credit sales}}{\text{Accounts receivable}}$	$\frac{\$850,000}{\$80,000} = 10.63$	10.43
Inventory turnover= $\frac{\text{Cost of Goods Sold}}{\text{Inventory}}$	$\frac{\$550,000}{\$220,000} = 2.50$	4.00
Fixed asset turnover= $\frac{\text{Sales}}{\text{Net Fixed assets}}$	$\frac{\$850,000}{\$570,000} = 1.49$	2.50
3. Financing		
Debt Ratio= $\frac{\text{Total Debt}}{\text{Total assets}}$	$\frac{\$300,000}{\$920,000} = 33.00\%$	40.0%
Times interest earned ratio= $\frac{\text{Operating income}}{\text{Interest expense}}$	$\frac{\$100,000}{\$20,000} = 5.00$	4.00
4. Return on equity	$\frac{\$60,000}{\$620,000} = 9.70\%$	12.5%
Return on equity= $\frac{\text{Net income}}{\text{Owner's equity}}$		

Table 8.6 Financial ratio analysis for Trimble & Associates Leasing Inc.

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Summary

- An accounting system provides the framework for managerial control of a firm. Its effectiveness rests on a well-designed and well-managed record-keeping system.
- The major types of internal accounting records are Accounts receivable records, Accounts payable records, inventory records, payroll records, cash records, fixed asset records etc.
- Accounting records can be kept in just about any form as long as they provide users with needed data to meet legal requirements.
- The cash method of accounting is easier to use; revenue and expenses are reported only when cash is received or a payment is made.
- The accrual method of accounting reports revenue and expenses when they are incurred, regardless of when the cash is received or payment is made.
- Alternating between a cash method and an accrual method of accounting is unacceptable, because it violates the accounting principle of consistency.
- A single-entry system is basically a check book system of receipts and disbursements.
- A single entry system neither incorporates a balance sheet nor directly generates an income statement.
- Double entry system provides a self-balancing mechanism in the form of two counterbalancing entries for each transaction recorded.
- Internal control is a system of checks and balances that plays a key role in safeguarding a firm's assets and in enhancing the accuracy and reliability of its financial statements.
- Once an effective accounting system is in place, an owner needs to understand the financial effect—positive or negative—that management decisions may have.
- The results of operating decisions appear in a firm's financial statements.
- The liquidity of a business depends on the availability to the firm of cash to meet maturing debt obligations.
- The first approach to measuring liquidity is to compare cash and the assets that should be converted into cash within the year against the debt (liabilities) that is coming due and will be payable within the year.
- Financial leverage can increase a firm's return on equity, but with some financial risk.

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Recommended Reading

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Self Assessment

1. Which of the following is a type of internal accounting records?
 - a. Double entry recording
 - b. Payroll records
 - c. Special ledger
 - d. Consolidation
2. Which of the following statements is true?
 - a. Alternating between a cash method and an accrual method of accounting is unacceptable, because it violates the accounting principle of consistency.
 - b. You can easily shift between cash method and accrual method of accounting while maintaining books of accounts.
 - c. A single entry system incorporates a balance sheet.
 - d. Financial leverage can increase a firm's return on equity and with no financial risk.
3. Double entry system provides a self-balancing mechanism in the form of _____ counterbalancing entries for each transaction recorded.
 - a. one
 - b. three
 - c. two
 - d. two or three
4. Current ratio is derived by dividing current assets by _____.
 - a. fixed assets
 - b. current liabilities
 - c. income
 - d. sales
5. The major distinction between cash-basis and accrual-basis accounting is in the point at which a firm reports _____ and _____.
 - a. revenue, expenses
 - b. sales, receipt
 - c. income, profit
 - d. profit, loss
6. What is the industry norm for return of asset?
 - a. 13 %
 - b. 10 %
 - c. 10.82 %
 - d. 11.8 %

7. What is the ratio for accounts receivable turnover?

- a. *ounts receivable turnover* = $\frac{\text{Sales}}{\text{Accounts receivable}}$
- b. *ounts receivable turnover* = $\frac{\text{Credit}}{\text{Accounts receivable}}$
- c. *ounts receivable turnover* = $\frac{\text{Cash sales}}{\text{Accounts receivable}}$
- d. *ounts receivable turnover* = $\frac{\text{Credit sales}}{\text{Accounts receivable}}$

8. _____ helps in calculating a firm's liquidity.

- a. Debt ratio
- b. Current ratio
- c. Return on assets
- d. Inventory turnover

9. _____ can be done with the record-keeping journals and ledgers found in most office supply retail stores.

- a. Single entry system
- b. Double entry system
- c. Accrual method
- d. Cash method

10. The _____ of a business depends on the availability to the firm of cash to meet maturing debt obligations.

- a. liquidity
- b. cash flow
- c. profitability
- d. investment

Case Study I

Fabindia Overseas Private Limited

Introduction

In July 2007, a TNN reporter broke the news that a private investment fund led by the former World Bank President James Wolfensohn, had picked up a 6% stake in Fabindia, an Indian ethnic wear company, for \$11 million. That put the value of the company at around \$183 million or Rs.730 crore. Fabindia, in fact, was approached by a number of potential investors but they chose to go with the investment vehicle promoted by Wolfensohn because they were keen to choose an investor who shared their values.

Various reports mentioned that the funds so raised by Fabindia would be used for financing the expansion plans of the company. The fund would also be used to develop support structure particularly for providing advanced technology and training to the artisans, who were the prime suppliers of fabrics and other raw materials to the company.

Origin

John Bissell who founded Fabindia was born in Hartford in Connecticut and was educated at the Brooks School in North Andover, Massachusetts, and at Yale. He was introduced to India by his father, who told him stories of his time in India when he was posted there during the Second World War.

John Bissell worked as a buyer for the American departmental store, Macy's. In 1958, under a programme run by the Ford Foundation, he came to India to advise the Central Cottage Industries Corporation which was formed by the Indian government mainly to showcase Indian handlooms and handicrafts. His role was to advise on issues relating to marketing Indian handicrafts.

He was new to India and he did not know any Indian language. In spite of these inconveniences, he travelled extensively over India and met several craftsmen. He came across a lot of skill, but he could see that the talented craftsmen had no idea about marketing their products and they were in no position to access distant urban or international markets. He liked his experiences in India and kept coming back.

His experience in the retail business allowed him to recognise an entrepreneurial opportunity and he decided to set up a business based on Indian crafts, particularly traditional weaving and handlooms.

Initially his goal was to export to the US and to other western countries. With that aim in mind, he incorporated Fabindia in 1960. The company operated from Bissell's residence in the posh Golf Greens locality in New Delhi. The company was mainly into exporting and initially its business was concentrated on upholstery fabrics, durries and rugs. Growth was slow for the company and in 1965 the company moved out of his house and into a proper office. By then, Fabindia had an annual turnover of rupees 20 lakh. Most of this turnover was accounted for by a single buyer and a single supplier. A.

S. Khera made durries and other home furnishings in his workshop in Panipat and most of the output was purchased by the UK based Habitat, which was founded by a famous interior designer, Sir Terence Conran.

The start of retail

Bissell's business continued without much of change in its approach till about 1976, when he opened the first Fabindia retail outlet in the Greater Kailash market, an upmarket shopping area in South Delhi. During the early days, merchandising was not a planned activity. Whenever Bissell saw something of interest, he procured it for display at the store. Sometimes he would invite the craftsmen also, to display the products and assist in the sale. This orientation of customer relationship later became a part of the culture in the company.

Bissell's Greater Kailash shop was a success and he attracted a distinct type of visitors to his shop. But in spite of such success in its direct retail business, Fabindia remained dependent on exporting and Habitat continued to be their single major buyer. In the early 80's, Fabindia made a significant addition to their range by adding ready to wear garments in their retail offerings. From late 70's, Bissell had thought of marketing readymade garments. In an interview in 1977, he had said, "The greatest thing that happened to our business was the move in Europe and America a few years back to the natural look -natural textures, natural fibres -and away from things like polyester and nylon". Similarly, in India, a distinct group was emerging like in Europe and America. Some of India's new young politicians patronised Fabindia and were able to provide Fabindia with nationwide exposure for its products. In spite of all that, their domestic retail business grew slowly and they continued to focus their primary efforts on their export business.

Break-up with habitat and subsequent growth

All that changed in 1992. An unexpected development came as a shock to Bissell. Habitat, with whom a close business relationship had grown over the last more than 30 years, was acquired by a larger firm and the new entity abruptly ended the long buying arrangement with Fabindia. Fabindia had not tried to develop any strong relationships with other foreign buyers and even in the face of such a crisis, it was unable to find any bulk buyer, who could provide an alternative buying support.

One viable option was to aggressively develop their domestic retail operations. But, before Bissell could come up with a strategy for his business, he suffered a paralytic stroke. This led to William Bissell, his son, to step in to run Fabindia. Very quickly, he was able to set Fabindia on the path towards domestic expansion. Eighteen years after opening their first store, Fabindia opened their second store in Delhi in 1994.

John Bissell's bad health continued and in 1998, he succumbed to aneurism -a disease related to blood vessels. In 1999, at the age of 32, William formally took over as the Managing Director of Fabindia. The Company's domestic expansion had been spectacular after William's taking over. By 2001, Fabindia had six stores concentrated in the metro cities. By the end of 2004, these had increased to 20, and the company was seriously considering expanding its stores into the tier-II and tier-III cities as well as overseas. By the end of 2007 Fabindia had 75 retail stores across India and in addition stores in Dubai, Rome and Guangzhou in China.

Products and product mix

The products of Fabindia in the initial years consisted of only upholstery fabrics for export to overseas markets. Then in the early part of 1980s readymade garments were added to its product line and in 2004 organic products were added. In 2006 body care products were introduced. Thus, the product mix of Fabindia could be divided into three broad groups, namely Garments, Home Products and Organics.

Garments

Though Fabindia was the supplier of upholstery fabrics initially, it gained popularity as a retailer of readymade garments. It started with men's wear which occupied a shelf in some select stores. Gradually a whole corner was occupied with men's wear, women's wear and kid's wear in all the stores. In October 2007 teen's wear was also launched which comprised camisoles in beautiful prints, khadi salwar sets in vibrant colours and kalamkari skirts. In 2006 70% of the Fabindia's revenue came from garments segment. Along with readymade garments Fabindia stores have a wide collection of accessories like dupattas in a variety of colours, weaves, fabrics and prints, scarves and stoles in silk and cotton, neck ties and shawls.

Fabindia's garments were known for their ethnic look. These garments used vegetable-based and other natural dyes and were generally in soft colours. There was a fine-tuned balance between tradition and modernity. Hand block printed short kurtas, mix and match churidar kurta sets with or without dupattas, straight skirts in raw cotton, long crinkled skirts and white cotton or chanderi dupattas were some of the very popular items among garments. Some Fabindia customers who used Fabindia garments said that these were very comfortable to wear and were fine combinations of Indian aesthetics and western design sensibility.

Home products

In India there were hardly any organised outlets for home furnishings be it upholstery, curtains, linens or home furniture. Mostly the local carpenters dealt with the local demand where furniture was made as per customer specification. Similar was the case with curtains and linens. There were local showrooms which catered to the need. Fabindia was one of the first retailers in India that offered a “complete home solution”. The Fabindia range of home products comprised upholstery, curtain fabric and readymade curtains and bed linens. Home furnishings comprised furniture made of only wood and metal, which went well with the philosophy of Fabindia.

Fabindia was into almost all elements of home décor and furnishing. A web story on a website popular in the Middle East rated Fabindia very highly, saying ‘If I can tempt you away from the malls for just one visit – then I urge you to put Fabindia on your list’

Organics

Fabindia entered into the Organic product market with full commitment in 2004. Its product range comprised ready to eat items like dry fruits, cereals, honey, jams, pickles and coffee. In 2006 it added a range of body care products to its product mix. It included shampoos, soaps, hair oils, moisturizers, body scrubs, face packs, hair conditioners and skin care products.

Fabindia promoted its products, mostly through posters, word of mouth and events. The youth leaders who patronised Fabindia garments were like brand ambassadors for Fabindia. The news reports also to a certain extent worked as advertisement for Fabindia. One such news item which described the organic products is given in Box 1.

Stores and their management

Most Fabindia stores are owned or leased by Fabindia and Fabindia operated the stores. There are a few exceptions like the joint venture in Rome and the franchise outlet in China. The number of Fabindia stores has increased over the years, particularly under William Bissell. From three stores in 1996 it has gone up to 75 stores in 2007. The growth can be seen from Fig. 1. The growth in sales and profit are shown in Fig. 2.

Fabindia has primarily three different kinds of stores, namely, premium stores, regular stores and concept stores. Both premium and regular stores carried the full range of merchandise but in premium stores, the proportion of high end goods is much more than in the case of regular stores. Concept stores have been opened to test new markets. These are typically small stores with very few types of products in stock. Overall, Fabindia dealt in over 150,000 stock keeping units (SKU's). However, no single store carried all the items.

Fabindia stores focused on creating the right ambience. Many of these stores are located in famous historical landmarks, such as in Jeroo in Mumbai, Ilford House in Chennai and Charles Correa's house in Bangaluru. The stores themselves have décor and layouts that highlight their traditional and natural focus. Even store personnel are encouraged to wear clothes that reflect the Fabindia ethos of traditional and natural look.

With regard to the management of stores, the managers are given a lot of independence in the way they operate. They are given budgets for buying and for operational costs. Store budgets are set centrally after consultations with the store managers. Budgets are determined primarily on the basis of previous year's sales, next year's forecasts and other external factors.

Store managers interact continuously with merchandisers to stay abreast of anticipated new styles and trends. Managers regularly go for field visits to explore new possibilities. They also attend regular training programmes where the accent is on learning modern methods of retail management as well as remaining true to Bissell's vision for the firm. The ‘mystery shopper’ technique is used to keep a watch on operations in stores.

Design

Fabindia made its first foray towards incorporating contemporary design in 1977, when it invited the designer, Riten Mazumdar, to design and make calligraphy-based home furnishings collection. This was a highly successful endeavour and it encouraged the company to bring about new innovations in its products. This practice of inviting designers has continued to this day. Very often, weavers and craftsmen are invited to interact with the designers and to hold demonstrations and exhibitions in Fabindia stores.

In a recent buyer-seller meet in Varanasi, representatives of Fabindia met local weavers and traders. A small display and demonstration of local weaves and crafts was organised. The Fabindia representatives gave inputs on current market trends and emerging designs. They stressed on the importance of product innovation and diversification.

Taking this further, Fabindia suggested a prototype development project. Merchandisers from Fabindia indicated their preferences and the local weavers' cooperative worked with a designer from the National Institute of Design (NID) to develop samples as per Fabindia's specifications. The project was very successful and Fabindia placed an initial order for fabric worth Rs.24 lakh.

Supply chain

Fabindia's supply chain is uniquely designed keeping in mind its unique business model and its ideology. Most of its suppliers are based in rural India. For fabrics, the suppliers are mainly weavers but there are also a few larger fabricators. Fabindia sourced its organic products from farmers, small scale manufacturers and non government organisations (NGO).

As many of its suppliers are uneducated, much of Fabindia's purchasing is carried out without written contracts. The system operates on trust and verbal commitments.

On the other hand, Fabindia is far more flexible and forgiving than many other procurers, especially from the West. Fabindia understands the limitations of its weavers and small suppliers. So if there are some minor changes in the originally agreed upon design, the goods are not rejected or returned. The procurement team talks with others in the organisation and tries to find some way to gainfully use the fabric.

Also a number of times the supplies are delayed. This can play havoc with centralised planning, especially when sales and demand patterns are heavily dependent on the prevailing season. Getting a delayed supply of fabric, meant for winter, could mean storing it for almost a year, that is till the next winter. In spite of such issues, Fabindia does not turn away suppliers who deliver late.

Till recently, Fabindia used to make spot payments for all deliveries. Now they pay within 15 days of delivery. Many old employees at Fabindia resented this move and said that this is not in keeping with the ideology of Fabindia. William was able to convince them that for such a large organisation, business sense dictated a change in their established practice. He reiterated that Fabindia was a 'for profit' organisation with social motives.

There are some practices in Fabindia which might seem like ad hoc procedures. Weavers sent their fabric in 'thaans'. A thaana was a roll of fabric that could be 20 to 25 metres long. The weaver's statement regarding the length was generally accepted and only random checks were occasionally carried out to cross check the statements.

Philosophy

Fabindia believes that it does more than just collect and sell handicrafts. It sees itself as an enabler of a certain way of life. By doing its business in a certain way, it is trying to demonstrate that the urban living model is not the only path to development for a society. It is trying to prove that old patterns of living do not have to be sacrificed for the sake of modernisation and development.

Gandhiji had a vision of an India built around its villages but the model of development followed in India and elsewhere led to the growth of an urban centric economy. Fabindia is trying to present an alternate vision. Growth of urban areas does not necessarily mean the death of the village. One is not necessarily better than the other. Both

need each other. There exists a symbiotic relationship.

Long before corporate social responsibility and eco-friendly business practices were seriously talked about in management, Fabindia practised these concepts. Production of organic products, bringing out the village based skills which were hitherto hidden from the world, providing equitable employment to traditional artisans and market for their products, enabling the rural craftsmen to form self sustaining community based organisations and promoting natural dyes, natural fabrics, etc, were some of its activities symbolic of its socially responsible and ecofriendly practices.

Community-owned enterprise

Fabindia is trying to establish community owned enterprises in which artisans will be the shareholders of newly formed companies. *The small and medium scale artisans, who quite often run short of funds could trade their shares to obtain funds for running their businesses in the times of need.*

This is in line with the company philosophy and mission.

The company has tied up with ICICI Bank's Sandhi Craft Foundation, which will provide Rs.100 crores over five years to Artisans Micro Finance Private limited (AMFPL), which will help establish these community owned companies. Fabindia will guarantee 8% of the 100 crores through a bank guarantee of 4% and an FDR for the other 4%.

The companies will be of varying sizes and 49 % of their equity will be held by AMFPL, 15% by outside investors and the balance 36% by the local craftspersons. The companies will have access to a maximum investment of two crores rupees and they can avail a loan of another one crore rupees. AMFPL will also work to establish a new trading system, to enable shareholders to buy or sell their shares a few times a year. Providing a market for trading shares will enhance the value of their shareholding. A corporate structure will help artisans to raise funds for working capital. AMFPL has a long term goal of establishing 100 community owned enterprises. The first 20 are targeted to be set up in the first 18 months itself. Within a few months of its launch in 2007, AMFPL had already established nine companies in Faridabad, Jodhpur, Jaipur, Bikaner and Bhuj.

Apart from finance, Fabindia also hopes to improve quality standards and supply technological know-how. A design panel was to be set up to help artisans to create designs in sync with market demand. Also, heads of the companies were to undergo a course on business administration in a leading business school.

The inspiration to set up AMFPL came from the success of Delhi Artisans Handicrafts Pvt. Ltd. It was established in the early 90's and it currently has a turnover of Rs.10-15 crore. Artisans held shares and the share prices had seen a 25-fold increase over this period.

Awards and accolades

Fabindia is very careful to maintain its brand and its brand has won a number of accolades. Fabindia won the 'Best Indian Retail Brand' in 2005 and 2006. It has also won awards for 'Designer Promoting Indian Craft or Technique' at the Idea Zee Fashion Awards.

Competition

Fabindia's main competitors are the ethnic wear retailers like Khadder, W and Good Things, who are also expanding at a rapid pace. W, for example, has well over 30 exclusive stores now, in addition to being available at some multi-brand outlets.. There is also severe competition from the ethnic wear labels of modern Indian retail chains, such as Shoppers Stop and Pantaloons. Stand alone stores like Shristi and Biba in Bangalore, Prapti in Kolkata and Sadka and Shoma in Delhi have been doing well for a while and could pose a challenge by expanding.

New competition is expected from overseas retailers also. The government has already permitted single brand retailers to set up shop and others like Carrefour, Walmart and Metro have devised ways to get into the Indian market. Powerful Indian business houses like Tata, Reliance and Birla are expanding their retail businesses.

Future

From a turnover of 36 crore rupees in 2000-01, Fabindia has grown to having a turnover of Rs.130 crore in 2005-06. It registered a CAGR of about 38% in the period 2002-06. Such phenomenal growth has not come at the cost of profits. The profitability has been maintained at a rate of 6% for the entire period (See Fig. 2). For Fabindia William Bissell has set a very ambitious target of reaching 250 stores and a turnover of Rs.1000 crore by 2011.

The growth is expected to come from new stores as well as increase in sales from existing stores. That increase will be achieved by increased emphasis on premium products. Also, Fabindia has attempted to decrease its dependence on fabric based businesses by increasing its other product lines. Currently organic foods, body care products and handicrafts form a significant part of its total sales. Growth in locations was expected to come from expansion in promising overseas markets as well as a greater penetration of the markets in smaller towns in India. Fabindia planned to expand significantly in tier-II and tier-III cities in India.

India has a flourishing retail business but most of it is in the unorganised sector. There are estimated to be over 120 lakh stores in the country. Of this, organised retail is only 3% but is growing at the rate of 18%. This organised retail sector is vying for a share of the spending of India's rapidly growing middle class whose purchasing power is estimated to be around Rs. 10 lakh crore. An estimate made by a professional demand forecaster shows that out of the total retail business potential, the Indian market for ethnic wear is likely to be a about Rs. 9000 crore.

(Source: Mohanty, B. & Roy, R., XIMB, *Fabindia Overseas Private Limited* [Online] Available at: <<http://www.nenonline.org/case-studies>> [Accessed 9 December 2011].)

Questions

1. Explain the product range of Fabindia.

Answer

The product mix of Fabindia included garments, home products and organics. Though Fabindia was the supplier of upholstery fabrics initially, it gained popularity as a retailer of readymade garments.

- **Garments:** It started with men's wear which gradually shifted to women's wear and kid's wear in all the stores. Along with readymade garments Fabindia stores have a wide collection of accessories like dupattas in a variety of colours, weaves, fabrics and prints, scarves and stoles in silk and cotton, neck ties and shawls. Fabindia's garments were known for their ethnic look. These garments used vegetable-based and other natural dyes and were generally in soft colours. There was a fine-tuned balance between tradition and modernity. Hand block printed short kurtas, mix and match churidar kurta sets with or without dupattas, straight skirts in raw cotton, long crinkled skirts and white cotton or chanderi dupattas were some of the very popular items among garments. Some Fabindia customers who used Fabindia garments said that these were very comfortable to wear and were fine combinations of Indian aesthetics and western design sensibility.
- **Home products:** Fabindia was one of the first retailers in India that offered a "complete home solution". The Fabindia range of home products comprised upholstery, curtain fabric and readymade curtains and bed linens. Home furnishings comprised furniture made of only wood and metal, which went well with the philosophy of Fabindia. Fabindia was into almost all elements of home décor and furnishing.
- **Organics:** Fabindia entered into the Organic product market with full commitment in 2004. Its product range comprised ready to eat items like dry fruits, cereals, honey, jams, pickles and coffee. In 2006 it added a range of body care products to its product mix. It included shampoos, soaps, hair oils, moisturizers, body scrubs, face packs, hair conditioners and skin care products.

2. What is the store management strategy of Fabindia?

Answer

Fabindia has primarily three different kinds of stores, namely, premium stores, regular stores and concept stores. Both premium and regular stores carried the full range of merchandise but in premium stores, the proportion of high end goods is much more than in the case of regular stores. Concept stores have been opened to test new markets. These are typically small stores with very few types of products in stock. Overall, Fabindia dealt in over 150,000 stock keeping units (SKU's). However, no single store carried all the items.

- Fabindia stores focused on creating the right ambience. Many of these stores are located in famous historical landmarks, such as in Jeroo in Mumbai, Ilford House in Chennai and Charles Correa's house in Bangaluru. The stores themselves have décor and layouts that highlight their traditional and natural focus. Even store personnel are encouraged to wear clothes that reflect the Fabindia ethos of traditional and natural look.
- With regard to the management of stores, the managers are given a lot of independence in the way they operate. They are given budgets for buying and for operational costs. Store budgets are set centrally after consultations with the store managers. Budgets are determined primarily on the basis of previous year's sales, next year's forecasts and other external factors.
- Store managers interact continuously with merchandisers to stay abreast of anticipated new styles and trends.
- Managers regularly go for field visits to explore new possibilities. They also attend regular training programmes where the accent is on learning modern methods of retail management as well as remaining true to Bissell's vision for the firm. The 'mystery shopper' technique is used to keep a watch on operations in stores.

3. In which way Fabindia is promoting community owned enterprise?

Answer

Fabindia is trying to establish community owned enterprises where artisans will be the shareholders of newly formed companies. The small and medium scale artisans, who quite often run short of funds could trade their shares to obtain funds for running their businesses in the times of need.

The company has tied up with ICICI Bank's Sandhi Craft Foundation, which will provide Rs.100 crores over five years to Artisans Micro Finance Private limited (AMFPL), which will help establish these community owned companies. Fabindia will guarantee 8% of the 100 crores through a bank guarantee of 4% and an FDR for the other 4%.

The companies will be of varying sizes and 49 % of their equity will be held by AMFPL, 15% by outside investors and the balance 36% by the local craftspersons. The companies will have access to a maximum investment of two crores rupees and they can avail a loan of another one crore rupees. AMFPL will also work to establish a new trading system, to enable shareholders to buy or sell their shares a few times a year. Providing a market for trading shares will enhance the value of their shareholding. A corporate structure will help artisans to raise funds for working capital.

Case Study II

Innovative Entrepreneurship: The Key DNA for a Successful Turnaround in the Hospitality Business

With specific reference to the hospitality sector: Small and medium sized hotels in Mumbai

Abstract

As the business environment is becoming increasingly more complex, accompanied by intensified competition, rapid advances in technology and most critically, rising churn, be it customer or employees, there is an unprecedented rise in corporate failures today. And, just as amazing as the increasing number of failures, is the fact that most of the companies that attempt a recovery, also fail. Against this backdrop, it makes sense for companies to understand the reasons for their decline, in their performances, and find ways to avoid a potential bankruptcy situation.

However, sickness is not restricted to corporates only. The same factors that cause sickness in corporates are also reasons for sickness in small and medium sized businesses. However, the gravity of the factors may vary and it would be pertinent to say that the study of failure and turnaround for small and medium businesses should be separately undertaken as the rules of the game for the large corporate houses need not necessarily be the same for the small and medium sized entrepreneurs. The Hotel Business or the Restaurant business is one category, which deserves special interest. These categories of hotels and restaurants are typically called as UDIPI HOTELS which primarily serve SOUTH INDIAN DISHES like *Dosas*, *Idlis* etc. Many have diversified into serving the NORTH INDIAN DISHES like *Parathas* etc.

Surprisingly several such UDIPI hotels are not able to match the onslaught of the changing demands of the Indian customers especially in terms of new dishes, Chinese and other oriental dishes etc. The net effect has been that some of them have fallen by the wayside – a sick company. The problem for these small and business enterprises gets compounded when one realises that the SICA and BIFR (Sick Industries Act and Bureau of Financial Reconstruction) are not in a position to help these organisations.

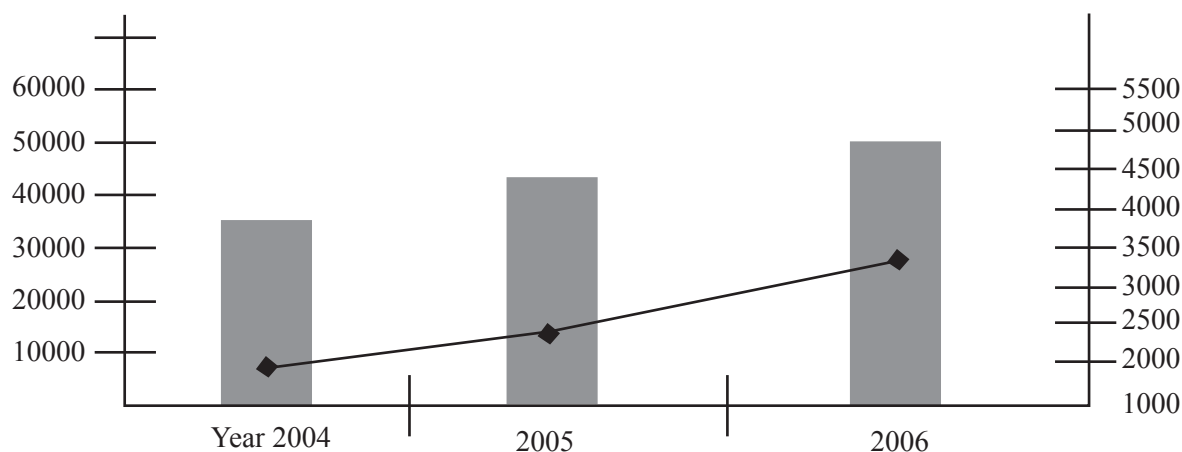
The restaurant business category contributes substantially to the GDP of the country. The issue is what are the reasons for sickness in this category and what is the role that the entrepreneur plays in the successful turnaround of ailing restaurants. Can Innovation play an important role in nurturing these units back to their original glory? This paper aims to study the various strategies that have been used by the hotel sector in order to turn themselves from a sick organisation to one of the topmost organisation in their field. The study was limited to the hotel industry in Mumbai due to cost and time constraints.

Introduction

The Indian restaurant services sector is estimated to be worth Rs. 57,000 crore, out of which only Rs. 3,940 crore or 6.9 percent is accounted for by the organised sector. The vast unorganised segment mainly comprises street-side stalls/kiosks constituting the majority of consumer food-service units and is characterised by intense fragmentation and a virtual absence of standardisation of operations. This segment was Rs. 35,000 crore in 2004, which grew by about 18 per cent to Rs. 41,400 crore in 2005 and in 2006 the segment recorded a growth of nearly 19% over previous year and stood at Rs. 49,200 Crore. (basis: constant prices – 2003-04 price base). Fig. 1 gives the details of the growth of the Indian Restaurant.

Size of Indian Restaurant & Catering (F&B) Services (value in Rs. Crore at 2003-04 prices)

The following table shows growth of restaurants in the organised sector.



*Source: India Retail Report-2007, India Retail Forum 2007

The following table shows growth of restaurants in the organised sector.

Fig. 1

Growth of Restaurants in the Organised Sector

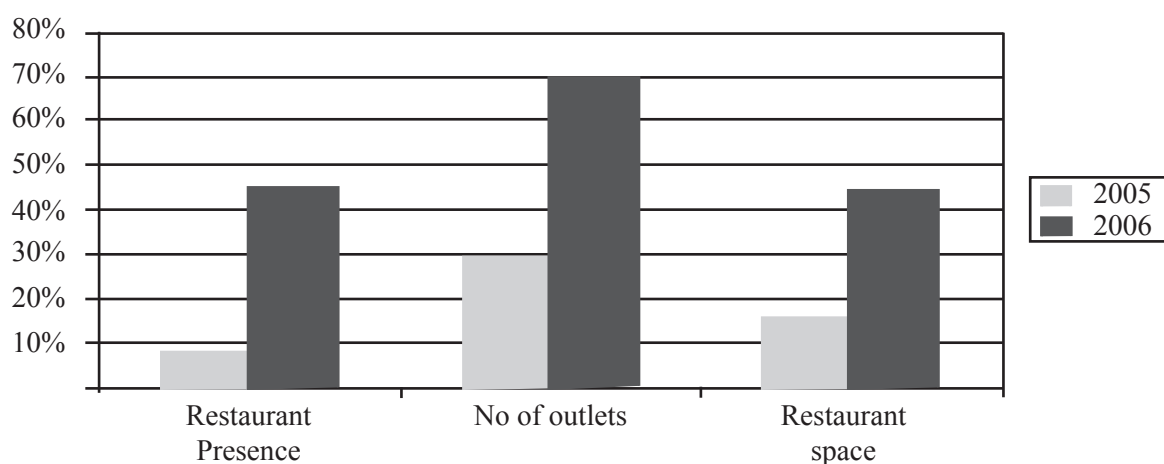


Fig. 1.1

(Source: India Retail Report – 2007, India Retail Forum 2007)

Major domestic and international players in the arena have on an average extended their retail reach by 45 percent in 2006 as compared to 2005. Tier II cities are currently the biggest growth drivers. Additionally investments in supply chain management are another important issue that must also be kept in mind.

The total number of outlets increased dramatically in 2006 registering a year on year growth of around 70% as compared to a y-o-y growth rate of 29% in 2005. The evolved Indian consumers are invariably seeking variety and are willing to experiment with new cuisines. KSA Technopak's studies have shown that while in the US seven basic meals cover 80 percent of all 'dinner at home' occasions, in India 15 meal types cover only 60 percent of 'dinner at home' occasions. The trend towards home delivery is also fast gaining popularity, with value sales shooting the roof over the last couple of year. India is one of the few countries where McDonald's has introduced its home delivery service.

In an environment that seems to be transforming itself with every new technology, marketing tactic or investment strategy, businesses rush to embrace change by trading in their competencies altogether – all in the name of innovation. But generating new ideas does not automatically result in innovations and success. It is only the beginning of the journey. The real challenge for an organisation is to convert these ideas into acceptable products or services for customers. This can happen only when organisations design and implement a structured approach to managing innovations.

Innovations are very important in the services sector, especially in the hospitality sector and albeit in the small and medium sized hotel business. The restaurant business requires entrepreneurs to continuously come up with new dishes; new ways to present or serve existing dishes, new services or schemes to satisfy customers, new ways of enhancing their ambience and new processes to economise operations. Without innovation, restaurants face the threat of becoming ‘obsolete’ - leading to sickness – and ultimately driving them out of business or forcing them to hand the business over to a more efficient and innovative entrepreneurs.

The study was conducted essentially in the restaurant and catering sector. The study was limited to the “small sector” typically what is called in Mumbai parlance as a “Udipi Hotel”. A “Udipi Hotel” can be defined as a typically South Indian dish serving type hotel. But others serving North Indian dishes like Parathas or Snacks or even those serving lunch and have a Bar is also being termed as “Udipi”.

Literature review

Not many studies have been conducted in the area of successful turning around of small and business units especially with respect to the hotels – Udipi Hotels. Most of the studies are general in nature and are aimed at the large corporate hotels.

Sonia Bharwani, “Successful Hospitality Innovations–Case study of Oberoi Resorts.” Institute for International Management and Technology, The 2nd International Conference on Services Management, 1st June 2007 1 evaluates the success of the Oberoi Group’s innovation of luxury resorts, by measuring across a number of dimensions like improved image, customer loyalty, revenues etc.

Michael Ottenbacher and Juergen Gnoth, “How to develop successful Hospitality innovations.” Cornell Hotel & Restaurant Administration Quarterly, May 2005 1 identifies nine factors that drive successful innovations in the hospitality service industry, such as,

- Market selection
- Strategic human resources management
- Training of employees
- Market responsiveness
- Empowerment
- Behavior-based evaluation
- Marketing synergy
- Employee commitment
- Tangible Quality

Cathy Enz, Judy Siguaw, “Innovations in hotel practice”, Cornell Hotel & Restaurant Administration Quarterly, October, 2003 talks about the importance of innovative ideas and practice in the hotel industry.

Dr. Ramamirtham Gopal, research paper on “Innovation – The key strategic weapon to Increase Competitiveness – A model to measure the impact of Innovation on the value of Business”, Allied Publishers Pvt. Ltd., 10th International Annual Convention on Strategic Management, 10 May, 2007 talks about the various types of innovations that takes place in the industry and the impact of the innovations on the value of the business. The paper brings out the difference between product innovation and process innovation. It also talks about Competitor centred and Customer centred innovation. The paper effectively brings out the importance of innovation for maintaining the Sustainable Competitive Advantage and how it ultimately results in an increase in margin or an increase in volume. The paper ends with some useful observations from a selected few sectors such as the hospitality and hotel sector offering insight as to the importance of innovations and how to measure the impact of these on the profitability of the firm.

Research objectives defined

The specific objectives of the study were:

- To determine the causes of sickness, especially in small businesses with special reference to the hospitality sector – small and medium hotels
- To understand the strategies adopted by entrepreneurs in bringing about successful turnaround
- To recommend action plan for a successful turnaround in the hospitality sector

Research methodology

The first step in the research processes was to determine the issues that need to be addressed for the purpose of the study. Initial talks and discussion were held with people from the service sector as well as the restaurants industry in consultation with the guide. Review of various data and literature available regarding all issues connected with the research was extensively undertaken. Books from various libraries were perused and the relevant ones were studied in detailed. Various journals magazines and research papers were referred too. Several web sites were browsed and relevant data was accumulated. The descriptive survey helped in preparing the ground work for the next step i.e. the field survey.

- **Historical survey:** The geographic area chosen for the survey was Mumbai city for the purpose of convenience. There is no official published data available giving the details of “Failed Restaurants”. Nor has there been any official or unofficial study known to have been conducted in this area of the small and medium sized hotels especially the UDIPI HOTELS.
- **Research instrument used in the study:** In order to achieve maximum information from these Industrialists (who are typically from Mangalore and are not generally known to be open to discussions about their business), exploratory research was predominantly used. Additionally certain quantitative information was also obtained by using the Likert scale of measurement. A 5 point scale was used where ever necessary.
- **The sampling design:** The Sampling design used for the study was a combination of convenience and judgment sampling. A detailed search was conducted to identify small / medium restaurant who had failed and have turnaround and also those who have not been successful in turning around. As mentioned earlier there are no official records available of the total number of such restaurants (small/medium) in the city of Mumbai. The “Word of Mouth” search reveled that in Mumbai there would not be more than 100 to 150 small/medium restaurants / hotels who have failed and than succeeded. A comprehensive list of these restaurants was not readily available. Of these estimated 150 small and medium restaurants / hotels who have failed, a judgmental and convenience sample of around 20 was selected. Data could be obtained only from around 10 hotels while the rest were not willing to speak about their successes or failures

Sr No.	Location	Number of Hotels in sample	Number of Hotel from whom data could be obtained
1	Borivali to Andheri	1	-
2	Andheri to Bandra	2	1
3	Bandra to Dadar-Wadala	8	5
4	Dadar to V.T.	7	3
5	V. T. to Colaba	2	1
	Total	20	10

Table 1 Sample design

- **Data collection:** Both primary and secondary data were collected for the research. The interview was conducted in a mix of all the three languages viz. English, Hindi and Tulu -- the language of the owners of these Udipi hotels.
- **Data analysis stage:** Data collected through primary and secondary sources was tabulated and summarised so as to draw logical conclusions.
- **Limitations of the study:** The study was confined to Maharashtra and therein Mumbai due to cost and time constraints. Only the Entrepreneurs view was used for the purpose of study. The views of the customers of these restaurants were not considered.

Findings of the survey

An attempt was made to link the innovative strategy used with the profitability of the business. However these attempts were not successful since almost all the restaurants used the CASH SYSTEM for collection and disbursal of revenues / expenditures. Reliably it was learnt that the balance sheet prepared may not necessarily reflect the true picture of the business.

Most of the organisations attributed their success to the impact of INNOVATION— innovation in the type and nature of cuisine offered to their customers. Additionally the ambience created especially exclusivity as well as openness was another cause for their success.

Table 2 gives the details of the innovative strategy – the new cuisines that were introduced, for turning around their business. It was observed that introduction of the Chinese type of food and blending the same with the Indian dish were the main drivers for the change.

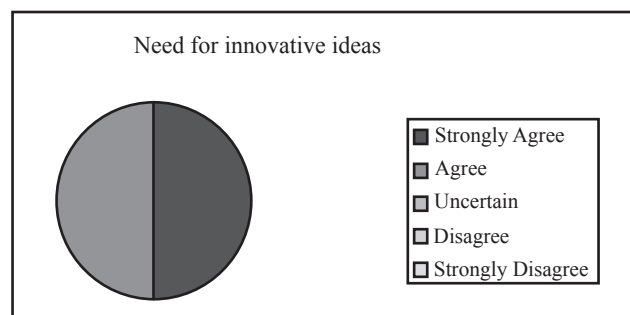
Name of the Restaurant	Main Innovative Strategy Adopted
DP's Fast Food	Innovative offerings – Fruit beer, Introducers of Schezwan Dosa & Idli Chilli, Innovative schemes for customers
Jai Hind Lunch Home	Exclusive seafood items – stuffed bombil, leaf wrapped fry fish, Process innovations.
Fric n Floc Fast Food	Innovative stand-out Décor and Ambience,
	Innovative Dishes
Canara Lunch Home	Category segregation, Plush ambience at affordable Rates, with different sections in hotel.

Harish Refreshment	Innovative Dishes – Chicken Idlis, Fish Dosa, Candle light dinners on certain days of the week.
Sizzling China	Innovative dishes' Chicken wrapped prawns, Momos, Exotic Sauces.
Mahesh Family Restaurant	Incentives to customers, Gifts, Discounts, On the house treats.
Laxmi Vilas Hotel	Speciality Konkani GSB Food & Speciality Amul Fry Misal, Milk pudding, Free trials of new dishes.
Ram Vijay Lunch Home	Day and Night Chinese Food, Innovative dishes
Swagat Refreshments	Speciality Variety Jain Food, Free gifts to children & customers

Table 2 Type of innovations

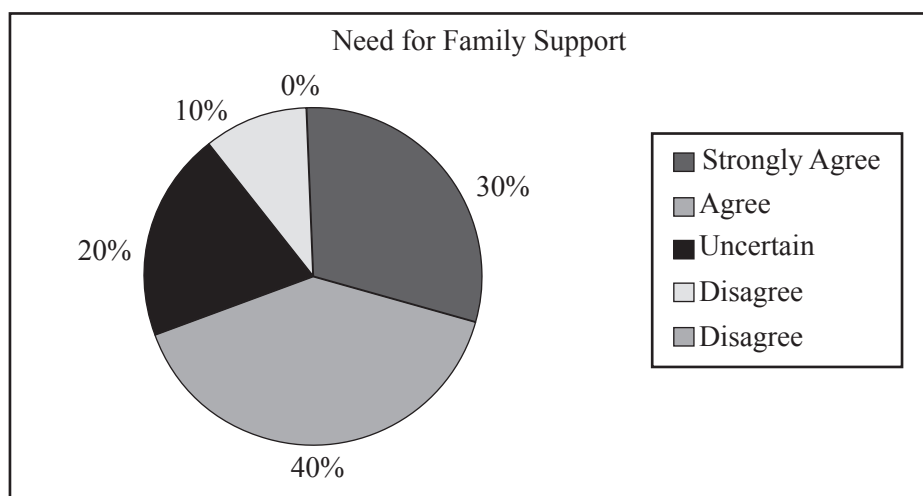
Need for innovations

Almost 100 % of the respondents indicated that innovative ideas were a must for an entrepreneurial venture like a hotel business. 50% of the respondents agreed while 50% of the respondents strongly agreed.



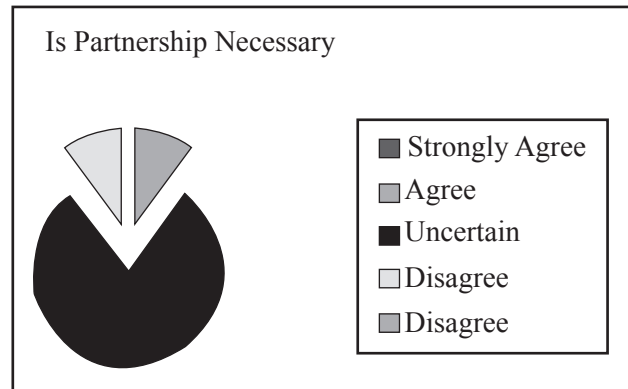
Need for family support

70% of the respondents indicated that there was a need for family support. The unofficial discussions indicated that family included also the EXTENDED FAMILY – friends were also included as family members. Further probe into the definition of support included not only monetary help but also help in getting some clearances from the various statutory authorities like the municipal offices or from the shops and establishment departments etc. A very small margin about 10% indicated that there was no family support at all in turning around the business.



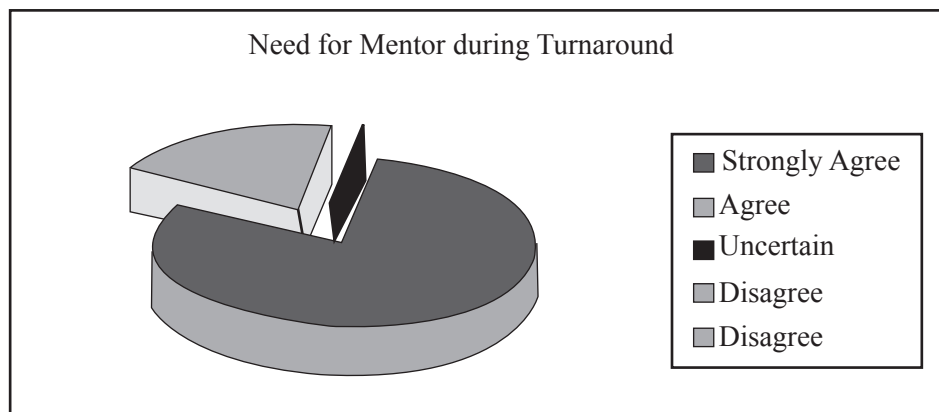
Need for partnership during the turnaround period

Almost all the respondents indicated that Partnership was not at all necessary and was not desirable during the turnaround period. While many felt that family including extended family and friend support was a MUST, however many felt that including them in the ownership and hence a share in the profits was a clear NO.



Need for a mentor during turnaround

All the respondents felt that a MENTOR or a FATHER figure was a MUST during the turnaround period.



Reasons for sickness in restaurant business

On querying as to on what were the causes for the businesses to go sick. It was found that Mismanagement and losing sight of business (i.e. not concentrating on the several business issues) were the main causes for the sickness. Surprisingly luck did not play any role. Table 3 gives the details of the causes.

Name of the owner	Mismanagement	Insensitivity to external Factors	Bad Luck	Unable to update Business	Losing Sight of basics
JK	++++	+++	+	++	++++
VS	++++	+++	+	++	++++
GS	+++	++++	+	++	++++
HK	+++	++++	+	++	++++
MJ	+++++	+++	+	++	+++
GIS	+++++	+++	+	++++	++
RS	+++	++	+	++++	+++
SS	+++++	+++	+	++++	++
MS	+++++	++++	+	++	+++
CK	++	++++	+	++++	+++

Table 3 Main cause for the business falling sick

Please note the name of the owner has been disguised.

+ = Not so important +++++ = Very Very Critical / Important

Impact of innovative solution (mainly innovative on cuisine and ambience) on the profit margin

All the respondents indicated a substantial increase in profit margins. It must be noted that these figures could not be corroborated with their accounts books. Table 4 gives the details.

Profit Margins Before and After Turnaround.		
Restaurants	Before	After
DP's	12%	28%
Jai Hind	15%	30%
Fric n Floc	15%	27%
Canara	20%	33%
Harish	18%	30%
Mahesh Restaurant	15%	32%
Shree Ram Vijay	12%	25%
Swagat Refreshments	15%	28%

Table 4 Impact of innovative solutions on the profit margins

Effect of innovative entrepreneurship on annual turnover before and after turnaround and also post expansion

The average annual sales also showed a phenomenal increase due to the impact of the turnaround cause by the innovative strategies employed by the entrepreneurs. However these figures could not be corroborated with the account books.

Average Annual Sales in Rupees			
Hotels	Before	After	% age growth in revenue
DPs	1000000	10220000	1022%
Fric n Floc	950000	6500000	684%
Jai Hind	1300000	10200000	785%
Canara	5400000	14500000	438%
Harish	5500000	9500000	433%
Mahesh Restaurant	400000	10300000	2575%
Shree Ram Vijay	1100000	4500000	500%
Swagat Refreshments	1080000	54000000	5050%

Table 5 Impact of the Innovative Solutions on the Revenue of the business

Miscellaneous issues

The discussions also revealed that the hotel business posed many issues and challenges. Some of these issues and challenges are given below:

- It is a complex business. The combination of purchasing, manufacturing, sales and service are only the beginning. The raw material is costly and perishable. The closing inventory of finished goods is always invariably equal to zero. Excess food is mostly given to the bovine animals.
- The nature of the customer varies from that in other businesses by their expectation; they do not only buy food, they expect to buy it appetisingly prepared and pleasantly served. They expect good value, comfort provided by compatible décor, good comfortable seating, lighting, heating, cooling, cleanliness, courtesy, and with the absence of noise, odors and long waits.
- The equipment is expensive, out of proportion to its fragility. Crockery, exhaust fans, ovens, refrigerators, slicers, toasters, food processors, fryers, and broilers are delicate and sometimes dangerous. The loss of linen and silverware, the breakage of china and glassware, and the pilferage of foodstuffs and beverages can be financially fatal.
- Well-trained help is hard to find because wages are often less than in other industries, the stress is high, and the work is hard. There is high attrition rate and by the time you have put in great effort and trained a person it is often found that he switches over to another job and one has to start all over again. The working hours are invariably long almost 12 to 15 hours. The employees are less educationally qualified and yet are expected to be good at mathematics and memory power.
- The restaurant owner is subject to licensing, inspections, and scrutiny by nearly 20 regulatory authorities and must insure against several risks.
- Business volume is limited by seating capacity. The responsibility for the safety and security of customers and workers is awesome. The profit margin is low and the hazards / risks are high. The restaurants survive mainly on account of VOLUME.
- Experience is the most important factor for success. Management skills, courtesy and good manners, entrepreneurial ambition, willingness to work hard and under pressure, attention to detail and effective controls are vital.

Conclusion

The restaurant business is one of the few industries which presents an opportunity where you can start as a dishwasher and dream of owning your own restaurant – and actually realise that dream. But it takes dedication and a willingness to work long and hard to accomplish your dream. One needs to keep thinking of new ideas and innovate if one needs to survive.

The reasons for sickness in the restaurant business can be attributed to (in order of importance):

- Mismanagement
- Insensitivity to external factors
- Inability to update the business
- Losing sight of the basics

The steps that can be adopted for successful turnaround can be listed as follows:

- Do a proper introspection and strategic analysis.
- Make a detailed survey of the prevailing business environment.
- Analyse the repercussions of the changes at the macro level on the business
- Write down the lacunae, business sales marketing and operations plans.
- Meet key personnel and employees
- Revise plans
- Have discussions with vendors and customers
- Contact the bank, tax authorities, and accountant
- Keep only essential employees
- Revamp
- Cut unnecessary cost
- Renovate and Innovate
- Implement plans
- Revise and reassess
- Ongoing Innovation

Innovative entrepreneurship is by far the most important tool in the hands of an entrepreneur to bring about successful turnaround in the hospitality business. Innovative ideas and ongoing innovation is what will facilitate entrepreneurs to bring about successful turnaround in ailing businesses. Hence, it is referred as the key DNA for successful turnaround in the hospitality sector.

(Source: Innovative entrepreneurship: The key DNA for a successful turnaround in the hospitality business [pdf] Available at: <<http://www.iitk.ac.in/infocell/announce/convention/papers/Industrial%20Economics%20%20Environment,%20CSR-02-Krishna%20shetty%20R%20Gopal.pdf>> [Accessed 9 December 2011].)

Questions

1. Enumerate the findings of the survey.
2. Which research methodology was adopted for the study?
3. What are the reasons for sickness in the restaurant business? What steps would you suggest to turn a sick restaurant into a profitable venture as per the case study?

Case Study III

Necessity

Recently graduated from university, Swati was selected for admission to The Times School of Marketing (TSM) New Delhi. She was just 20 years old and hailed from a conservative North Indian, Brahmin family. Her father was an engineer and was then serving as an officer in the Central Government. She also had a loving mother, a caring brother and a younger sister. Everybody in the house wanted her to appear for Union Public Services Commission (UPSC) examination and pursue her career in the civil services. There were only four options discussed for children in the family - civil service, engineering, medicine and teaching.

But, then being underage for the UPSC entrance, Swati applied for a media management course at the Times School of Management and was selected.

Just as she was to join TSM, she faced the first blow in her life. Her father was alleged in a series of court cases and the whole family was to face the wrath of the legal battle; they could never have imagined it then, but the whole issue was not resolved till the end of 1995. Swati therefore had to drop the idea of studying in TSM and started helping her father in his legal matters.

1992: The first step

Almost one year had passed since she had decided to forego the TSM opportunity. Her daily routine was visiting the solicitors and courts until 4 pm. She realised that she had nothing to do after 4 pm and was actually doing nothing productive. No part time job that started after 4 pm was available. Self-employment was the only option available. When she was still at school, Swati had completed a four-month course at Usha Sewing Machine Training School, Kolkata and had learnt about cutting, stitching, and sewing women's garments. She could not complete the remaining 8 months of the course because of the clash of timings of the course with her class XI timings at school.

Now that she had spare time in hand in the evenings, she borrowed Rs.5,000/- from the family and made some salwar suits and put them in 3 good boutiques in the city. (Boutique culture was very nascent at that time) Her design, fabric, stitching – all were good value for money, but the response was very discouraging. She would be paid only if the garment was sold, not otherwise. The waiting period for the garment to be sold was pretty long. Moreover, it was a free for all market in the sense that the boutique owner got Swati's design copied by personal tailors and her original piece would eventually remain unsold. There was no use fighting with the boutique owners, who belonged to the wealthy business class and could easily turn down someone like Swati – a new comer in the industry. Swati soon realised that this was not a workable idea. But she soon found a job for herself at one of the fabrication units which was manufacturing for BELLE.

She came across an advertisement released by BELLE. The company wanted fabricators for its garments in Eastern India. BELLE was an important national brand and undisputed leader in lingerie in Eastern India owned by the Malhotra family, who were based in Kolkata and operated from the prominent locality of Bhowanipore in South Calcutta. She responded to the advertisement. The terms of the company were very lopsided but clear. (Refer exhibit 1).

Swati proposed two changes in the terms and conditions:

She was not prepared to invest Rs.60,000/- in plant & machinery. She did not have so much money. Her contention was that she would produce the lingerie to the standard required by the parent company, but would not be liable to use the specific brands/models of machines recommended by Belle, nor would she be bound to source such machines through Belle's specified vendor. The representatives of the company could not visit her at any time. This was because she had decided to operate from her house, rather than creating a separate infrastructure for the project. Having a basic exposure to Belle's other fabricators' units, Swati – with her previous stint with basic sewing machinery – realised that the technical requirements for producing Belle lingerie could easily be worked on and simplified; this improvisation she did not wish to share with Belle unnecessarily.

It was a difficult negotiation because all other applicants were ready to work on the terms laid down by the company. But the company was convinced by her submission on the following grounds:

The company would have the right to reject the goods if they were not as per the specified quality and adjust the cost of raw materials with the security deposit.

Other applicants were generally from the tailoring background (but without any educational background whatsoever, as in the case of Swati). Additionally, the other applicants were all men and would be dealing in garments for women. In fact, the whole industry was then totally dominated by men – right from cutting masters, tailors to distributors and retailers whereas the product was entirely for the use of women. Swati was the only woman applicant.

Mr. Malhotra sympathised with her position and decided to give her a chance. She was given the fabrication work of lingerie, specifically to fabricate the then bestselling brand – RAJANI - for BELLE company.

Swati was happy. She felt as if the battle has been won. But it had actually just begun. She had to arrange for appropriate machines and related accessories at appropriate prices so as to be able to set up a unit ready for work. She sourced second hand/ used machinery for the project from Dasnagar (famous for the hosiery and garment industry and for related machinery), in Howrah. She went from shop to shop to search for machines which could do similar work as suggested by BELLE. At last she did get the machines which she reassembled after repair and service (with the help of her engineer father) and made them ready for use. The whole process demanded a lot of effort but saved her Rs.43,000/-. Yes unbelievable, but the machines cost her just Rs.17,000/-. This was an assembly line system comprising of 6 machines.

1993-1994: Learning the ropes

The basic training was completed. Six staff members were recruited. The machines started rolling. The total production was approximately 5000 units per month. After meeting all expenses Swati could not save more than Rs.600/- per month. But she was content because she was working with a national brand and learning about producing a complex garment that was otherwise impossible to learn elsewhere. She had a constant desire to reach out within the horizontal line of expansion of the industry but she had no idea. She had no idea of the source of raw materials, the distribution channels, inventory, checks and balances, advertising and publicity, the nuances of retailing, and the prevailing customs of the trade etc. She actually wanted to learn all this. She started visiting the office of BELLE frequently with the finished orders. The BELLE office was actually very cramped and was housed in an old dilapidated set of rooms with no norms of privacy whatsoever and one could listen to anyone talking there. She used to sit there for long hours waiting to get her own produce checked and passed by the quality in charge, and this was her first exposure to the commerce of the industry. Some of most critical questions or tricks of the trade were understood by her only during her visits, such as the following:

- How manufacturers finalise deals with distributors? What were the terms and conditions of manufacturer – dealer relationships in the hosiery industry?
- How do the manufacturers and distributors help in pushing different products/ brands vis-à-vis other brands of the same or competing companies?
- Who are the more powerful distributors and why are they so powerful? How are they treated differently from the rest?
- What are the various trade terminologies?
- How does one operate on money back policy instead of giving credit and what are the benefits of this policy to the manufacturer? In the backdrop was the fact that Belle had pioneered the concept of no-credit in the hosiery market; instead Belle was ready to refund cash for unsold goods. At that point of time, and even now, the norm in the industry was to offer anything between 30 – 90 days credit.
- What is the role of advertising and marketing in the sales volume of a product and why?
- What are the parameters based for the acceptance or rejection of the goods of fabricators?

In fact, to learn more in her core area of fabrication and related horizontal expansion, she used to sit on the floor near the main cutting master rather than the sofa in the small, non-demarcated sitting area. She gradually understood that the critical discontent (customer dissatisfaction) was in the cut of garments. It was the cutting of the garments that made them comfortable or uncomfortable. Very broadly speaking, the better the cut, the more the consumption of fabric. Therefore, the fabricators saved on the fabric compromising on the fit of the garment.

Once again, Swati felt that it was the gender biased industry to blame. Swati had one significant point about the role that gender has to play in such an industry: “Deducing from the above, it is only women who can empathise and deliver women’s garments appropriately; how can men cutters, sellers and retailers in a conservative society do a fulfilling job of the above?” Swati had strong views in this regard and she always felt she was right, even though many did not agree with her.

But Swati did not give up. Whenever she visited the BELLE office, she spent lots of time in watching how the garments were being cut and practiced what she had learnt when she got home. She had no intention of becoming a revolutionary representative of the Indian women. She was worried only by the lack of ethics about customers needs and satisfaction - the industry was constantly churning out bad quality products and trying to convince the women consumers that it was good for them; never mind the accompanying discomfort. It was Swati’s values along with the conviction that if things could be set right then there was an immense potential which lead her

1994-1995: A humble beginning

BELLE had some major problems (and it spread various rumours in the market) and decided to close their shop in Eastern India and shift to Delhi. Most of the fabricators lost their security deposit because the company shifted instantly. However Swati was fortunate. It could have been her hard work, dedication or commitment towards quality which she had promised to Mr.Malhotra, that unlike others, she was called to settle her accounts and take back her security deposit. So now she got back her Rs.10,000/- which was the security deposit.

The big question was WHAT NEXT? Actually, at the back of her mind Swati was not very content working with BELLE but she was not able to say no to them. Further, how could she start her own unit? Who would take care of the marketing, advertising and distribution? If she started she would have to provide credit, because only the bigger players could operate on money back policy since they had huge advertising budgets that created and sustained demand. All this was too huge a task to take up alone. Moreover, to do this entirely, one needed to have sufficient money. To conclude, she had begun to realise that she did not want to be only a fabricator for someone for a whole lifetime. BELLE’s exit had given her a chance to understand her way forward. So what could she do next?

The brand gap in the market was somehow being filled up by the emergence of other big entrants like Rupa, a leading brand, at least in Eastern India, of mass produced hosiery products. Swati was not confused. She was clear. She also had to keep the machines rolling so that the staff could be paid. She decided to launch her own brand which would be tiny in size and unheard of in the market as there was no publicity budget whatsoever. She had gathered enough experience to take up this venture boldly. She decided not to take the help of distributors, because her volume was quite small. Instead she appointed two direct sales persons who would do the needful under her supervision. She came out with her own range and started supplying them to small shops and mainly to makeshift stall owners on the road (vendors/ hawkers). Swati set up a very rudimentary supply schedule based on weekly trips to specific areas. This was an entirely new experience. The buyers wanted a huge credit period of 60-90 days. Payments would be available only after the market hours i.e. after the shops closed down - say 9 pm onwards. Collection of payment required one to visit the shops at odd hours. Not much work would be done even if you reached at 9 pm; socialising over tea and snacks was also critically essential. The two direct sales persons of Swati could not meet the above demands. Collections started slowing down. Swati purchased a second hand two-wheeler and started moving out of her house to make the collections. But her gender got her into trouble with the family. It was one thing to allow her to make lingerie at home – and that too had not been taken very kindly to, by her conservative north Indian family – and yet another to let her go from vendor to vendor collecting paltry sums of money at the late hours of the evening. She persevered because her margins were high and also because she could not visualise any other way of breaking into the trade.

Swati was operating at a margin of around 40% in the current mode with a high volume. Her sales were around 8-10 dozens per day. That was a big number i.e. 3000 – 3600 pieces per month. At that time the price range of the undergarment which was sold on the roadside was Rs.15/- to Rs.35/-, while the price range of the same quality undergarment (but packaged and formally branded) in the store was Rs.30/- to Rs.80/-. Swati also had dreams of having a packaged product which would sell in shops. But she had limited resources – money as well as manpower and decided not to deal with a sophisticated distribution channel. She was content with the way things were going.

Operation Sunshine was a drive by the Kolkata Municipal Corporation for eviction of roadside vendors/ hawkers, so that the city could become clean and people could commute easily on the pavements/ roadside. Sunshine actually brought sudden darkness in the life of Swati. Most of the roadside markets in the city were wiped out overnight. The stall operators could not be traced. Those that were traced had no money to give. In some cases, the products were seized by the authorities. Swati was in a state of shock because all the high margins which she had generated until now were actually put back into the business by way of credits. The operators who purchased from her were in touch with her, but wanted to extend the credits. Now the credits looked like becoming bad debts. Suddenly it was a cashless position. She had six staff by then. She was compelled to lay off three of them. She was by now in a vicious debt cycle. If she stopped supplying the products to the existing operators, then the business relationship would close down and the credits would definitely become bad debts. At the same time, it did not make sense to keep supplying large quantities. The operation was still on. There was no guarantee the new supplies would be paid for. So she had to continue but reduce her involvement. That is exactly what she did. She reduced the supplies from 10 dozens per day to 7 dozens per day and gradually to 5 dozens per day.

Swati was extremely worried. Two critical questions confronted her once again - How long could she continue like this? *What next?*

Exhibit 1

Summary of the terms & conditions

The applicant had to be able to invest Rs.60,000/- in plant and machinery as per the choice of the company. The applicant had to arrange required space & infrastructure for the workshop.

Rs.10,000/- had to be kept as refundable security deposit.

The company would provide all the raw materials to the fabricator like pre-cut material, thread, fabric, lining and accessories.

The company had a fixed rate per unit which would be paid to the fabricator. It would be deemed to cover all the expenses of the fabricator.

The company could visit the workshop at any time and check the standards being followed.

The company would provide only basic training to the fabricators.

Case Objectives

- To bring to table the issues before a first generation entrepreneur. How does an entrepreneur solve them?
- To observe the process of ‘identification of customer dissatisfaction/customer pain’. The case explains how Swati identified customer dissatisfaction/pain very objectively and chose to solve the customer’s problem.
- To understand challenges faced by a woman entrepreneur.
- To understand the aspects of a necessity based entrepreneurial venture.
- To understand that entrepreneurial pursuit is not necessarily an activity to find out Net Present Value. Entrepreneurial experiences and learnings are invaluable in the long run.

Answer to what next

Customisation and franchising

Swati's thought of customisation prevailed over all other factors and she went ahead with her plans. She chose to operate with the franchise model and grew to a stage of 6 franchises – 4 in Kolkata (India) and 2 in Nepal. All the franchises generated good business. The big question is as to how does an individual who is not a Bollywood or a Hollywood dress designer or talent from that league, have franchises to offer and there are six people ready to invest in the proposal – not only time but even real estate, money and all possible effort? The surprising answer is that all the franchises are run by her one time customers. Most importantly, these customers had come in not because she was a general manufacturer but because she had shifted to an extremely customised market as mentioned in the case. Thus, the second phase of her endeavor was as successful as the first one. The products were well received in the market. This confirms the power of brand loyalty and reward for an entrepreneur's conviction in customer satisfaction.

But, Swati wanted to wind up all franchises and work from her unit only. The major reason being the fact that while she focused on customisation and customer service, her franchisees focused on clearing stocks and generating revenue, even if this meant suggesting a wrong piece of garment to a customer. Swati could not be personally present at multiple locations at the same time. *What do you recommend?*

The discussion in class should deal with the decision issue – should Swati discontinue the model of franchises, which is apparently a great success? Participants will be asked to develop the positives and negatives of the franchise model.

Thereafter the present position of Swati can be revealed to them as an end to the case discussion.

Swati has discontinued the franchise model. Now, by end of 2007, Swati has three outlets in the prominent locations and malls in the city. She has been self employed for more than 15 years now. She is watched by leaders of the market. Her brand has an established clientele all over India and also abroad – in the form of Indians settled abroad - and this is reflected in the annual repeat orders that she gets. The business is growing at an average rate of 25%. The brand is sold in only through two self owned retail outlets – one in South Calcutta and the other in the North East of the City. Whilst keeping the enterprise going, Swati has also freelanced and written extensively for the 3 major English dailies of India for more than 10 years now on a variety of topics and reported both from within and outside the country. She has also completed her studies in the University of Sheffield in the subject of broadcasting journalism and today she is also the co-ordinator of a reputed advertising course (diploma) in the city of Kolkata. Yet another facet of a multitasking entrepreneur!

(Source: Khaitan. D, St.Xavier's College, *Necessity* [Online] Available at: <<http://www.nenonline.org/case-studies>> [Accessed 9 December 2011].)

Questions

1. Give a brief outline of Swati's business model.
2. Explain in detail the hurdles faced by Swati in starting her enterprise.
3. What have you learnt from Swati's experience?

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Self Assessment Answers

Chapter I

1. c
2. a
3. b
4. a
5. b
6. d
7. b
8. d
9. a
10. c

Chapter II

1. a
2. a
3. b
4. b
5. a
6. c
7. b
8. d
9. a
10. d

Chapter III

1. a
2. a
3. b
4. d
5. a
6. b
7. c
8. a
9. d
10. d

Chapter IV

1. a
2. d
3. a
4. a
5. a
6. c
7. a
8. d
9. a
10. b

Chapter V

1. d
2. d
3. a
4. a
5. d
6. c
7. a
8. d
9. b
10. c

Chapter VI

1. a
2. a
3. b
4. a
5. a
6. d
7. a
8. d
9. b
10. c

Chapter VII

1. a
2. b
3. d
4. a
5. a
6. c
7. a
8. a
9. d
10. b

Chapter VIII

1. b
2. a
3. c
4. b
5. a
6. b
7. d
8. b
9. b
10. a